



# Supreme Auditing Institutions: A Politico-Economic Analysis

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## **Abstract**

While the beneficial aspects of a public accounting office's activity are not disputed here, it is argued in this article that four major distortions are produced: the concern with administrative rationality overlooks costs elsewhere (Section 2); budgetary aspects are overvalued compared to other issues (Section 3); incentives-oriented behavior is suppressed (Section 4); and the evaluation is biased by concentrating on minor, instead of major, aspects of inefficiency (Section 5). Section 6 considers alternatives to public accounting offices and makes some suggestions for new institutional arrangements particularly for constitutional rules.

## **1. A beneficial institution**

The information made available by the supreme auditing institution is a necessary precondition for the control of the public administration. Without the collecting, processing, and interpreting of information and the publication of the corresponding reports by the staff of the accounting office, members of parliament and the opposition parties would find it difficult or even impossible to supervise and criticize the workings of government, the media could scarcely play their role as extraparliamentary opposition, and the politicians in power would be at a loss how to improve the administration's performance. In short, the activity of the supreme auditing institution is of crucial importance for a well-functioning political and administrative system.

This view of the usefulness of the accounting office is rarely disputed; in fact, it is often taken as a matter of course. However, it should be pointed out that an alternative source of information about the public administration's workings exist. Monetary incentives may be set to make it profitable for private firms and individuals to overcome the free-riding problem involved (which consists in the information provided being available to all free of charge): Whoever is proving that the public administration acts in a wasteful or inefficient way receives part of the monetary gains reaped by the community. The activity of such "bounty hunters" will be directed to different issues and aspects than those of a public accounting office.<sup>1</sup> They will direct their attention to shortcomings in administrative behavior that are easy to prove; that is, they will concentrate on areas where public laws obviously have been violated and public money wasted in a major way. They will shun research involving a considerable amount of effort and where proof may not be easy. The private investigators' activities will be directly addressed against public bureaucrats, who will therefore

make an effort to withhold as much information as possible. While private firms acting on monetary incentives will certainly be able to uncover *some* waste and *some* inefficiency, their activity may create large negative externalities. Moreover, setting the appropriate monetary incentives may be more difficult than it looks at first, and the rewards may possibly have to be set at such a high level that the community as a whole does not have a large net gain when it relies solely on private production of accounting services.

What has been disregarded in the literature are the *systematic distortions* introduced in the public administration's behavior by an accounting office's activity. While its beneficial aspects are not disputed here, it will be argued in this article<sup>2</sup> that four major distortions are produced: the concern with administrative rationality overlooks costs elsewhere (Section 2); budgetary aspects are overvalued compared to other issues (Section 3); incentives-oriented behavior is suppressed (Section 4); and the evaluation is biased by concentrating on minor, instead of major, aspects of inefficiency (Section 5). Section 6 considers alternatives to public accounting offices and makes some suggestions for new institutional arrangements, particularly for constitutional rules.

## 2. Distortions due to "administrative rationality"

Supreme auditing institutions stress the observance of formal rules and regulations in the course of administrative actions. Whenever a failure or shortcoming is observed, it suggests that the rules and regulations should be enforced more strictly, that they should be applied more broadly, and that more of them should be introduced. In some cases this may be the appropriate response to an inefficiency observed. In many cases, however, the effort to tie the public administration more closely to legal prescriptions leads to a further reduction in efficiency and to new sources of waste. Indeed, the conflict between pursuing economic efficiency and obeying administrative rules has been widely observed (see Schwab, 1980, p. 586). It becomes particularly evident when public employees decide to *strictly* observe their legal obligation and to "work to rule." The effect invariably is that the performance drops drastically (examples are postal services and public transport) and that some areas of society are actively prevented from working (when the public administration withholds or retards the permission to run a business activity or to undertake a particular investment). Insofar as the accounting office's interference strengthens this kind of "work to rule,"<sup>3</sup> it has not only distortionary effects but *perversely reduces* efficiency.

Supreme auditing institutions, being members of the administrative structure themselves, tend to concentrate on only *one* recourse to fight waste and inefficiency: to strengthen and increase regulations. They easily overlook that, in a broader sense, the shortcomings may, in the first place, be the result of overregulations and that the appropriate action would consist in reducing the legal constraints and to substitute them by incentive oriented measures (see Section 3).

In German-speaking countries, but not only there, the established budget principles are a case in point. One such rule states that budgets may be spent only within the period (year) for which they are appropriated. A well-known consequence is that the administrative units spend all the money allocated toward the end of the year even if there is no need. A failure to do so results in the funds appropriated being lost and future budgets being

reduced. To avoid this, administrative units have devised a set of measures to achieve a minimum amount of flexibility (one is to order and pay for an object in the current year even if it will be supplied only in the coming year). If the accounting office insists on the cameralistic principle contained in the law, and prevents the use of measures to increase flexibility, the response will not be higher efficiency but rather an even more wasteful spending of public money within the year of appropriation.

### 3. Distortions due to overemphasizing budgetary aspects

For *any* accounting office, whether public or private, budget flows are a crucial element to concentrate on. The main reason is that they are more easily observable than nonmonetary flows. As a result, nonbudgetary costs tend to be given too little weight. In particular, supreme auditing institutions press for reductions in budget outlays even when the cost has to be borne by the citizens or firms. Examples are road congestions arising because, on the insistence of the accounting office, the repairs are carried out as cheaply as possible, or the statistical tasks a firm has to undertake in order to reduce the public administration's budgetary cost. The public bureaucrats may be *more* sensitive to these nonmonetary, or external, costs because they are the addresses of the complaints and the abuses of the people and firms burdened, while the supreme auditing institutions being removed from the scene, are not.

As far as the accounting office relies on standard bookkeeping it also systematically disregards cost.<sup>4</sup> The entries record only the actual incomes and expenditures, but they do not reveal the benefits *alternative* uses of the money outlays would have reaped. This introduces a conservative distortion in an administrative unit's evaluation by the accounting office; there is no direct link to the opportunities missed. A unit only tends to be blamed in the record if it does not use the budgetary funds in the "appropriate" way. The office's record, on the other hand, rarely states what the available alternatives were and how they would have affected the bookkeeping entries.

### 4. Distortions due to a disregard for incentives

The basic principle of the administrative sector is that bureaucrats act *solely* on the basis of a particular moral standard: public officials always and under all conditions pursue the public good. They do not have any goals or interests of their own. Accordingly, they are *not* to be given any (further) incentive to act in the public's interest. The supreme auditing institution has no other possibility than to accept this creed though it is often painfully aware that this view of bureaucrats is far from reality (see the economic theory of bureaucracy: Tullock, 1965, 1971; Downs, 1967; Niskanen, 1971; Breton and Wintrobe, 1975). As a consequence, when it observes a gap between what *should* be done by, and what is actually done within an administrative unit, it cannot propose (monetary or other) incentives to remedy the situation (rather, as discussed in Section 2, it suggests that even more rigorous regulations are needed). It cannot favor introducing incentive wages for public officials in order to bring the bureaucrats' private and the public's interests more closely together.

A good example is provided by the German (-speaking) university system. Up to the 1960s, professors used to get a considerable part of their salary based on the number of students who enrolled in their lectures (*Kolleggeld*). With the "reform" of the university system, this incentive was abolished, and the average size of the *Kolleggeld* was added as a fixed sum to the salary. As a result, professors tended to reduce their teaching-load to the legal minimum, to the disadvantage of the students. The dramatically rising students-teacher ratio could be dealt with in an efficient way by linking salaries of *all* university teachers again to the number of students taught, while retaining the quality of teaching—but this solution is exactly one that a supreme auditing institution sticking to the "ideal" public official view is not willing to make.<sup>5</sup>

Another example showing that accounting offices do not think in terms of incentives is provided by the Salzburg *Festspiele*. The Austrian *Bundesrechnungshof* (RH 1984) has published a comprehensive report of the inefficiencies and waste of this popular and highly esteemed festival. It has pointed out in detail that the artistic, technical, and administrative staff is highly overpaid compared to what is earned elsewhere, that the admission fee is much too low (there is a huge queue for tickets and a lively black market), and that the performances are staged with unnecessarily high outlays. The Austrian *Bundesrechnungshof* had criticized basically the same inefficiencies in an earlier report but without effect. Yet the reason for these clear instances of waste are easy to locate (see Frey, 1986): the managers of the festival have little incentive, or none at all, to behave in an economic way because they benefit from a federal law stating that *all* the deficits will be covered by the public purse. Instead of writing a lengthy and costly report on the basis of much painstaking investigation, which will have little effect, if any, it would have been much more effective to suggest a change of this seriously distorting subsidy law.

In the same vein, another source of creating incentives for performing well, *competition*, is systematically neglected in the reports of accounting offices. When it observes that two administrative units are active in the same area and are producing similar services, it is quick to criticize this overlapping as repetitiveness. Despite the evidence that competition fosters the efficiency of bureaucracies (e.g., Niskanen, 1975; Borcharding, Pommerehne, and Schneider, 1982; Caves and Christen, 1980) the government is as a rule asked to intervene in order "to save resources." This tendency is applied to all areas of public activity, but it is particularly damaging in those where output is difficult or impossible to measure and where even a benefit-cost analysis is inapplicable. One such area is scientific research where supreme auditing institutions strengthen the tendency to suppress competition.<sup>6</sup>

## 5. Distortions due to "mini-maximizing"

The reports of supreme auditing institutions invariably contain a wealth of data and facts; one cannot help but be impressed by how seriously the investigations are carried out and how carefully they are prepared. Yet the reports often lack perspective; they attribute equal importance to small and large inefficiencies. They report with great precision on rather minor deviations from administrative rationality, while they often disregard the really major inefficiencies.

An example is agriculture. Accounting offices' reports are full of detailed analyses of how regulations are violated, and public money is wasted by the bureaucratic units engaged in administering agricultural support. It is easily forgotten that such violations—even if quite large in absolute amount—are small in size compared to the *overall* efficiency loss brought about by the way agriculture is supported.

The *reason* that supreme auditing institutions are prone to “mini-maximizing” is obvious: the agricultural policy (and other major policies) are of a deeply political nature, a field the institution may not comment on. While there are certainly good reasons why an accounting office may not engage in political issues, it is nevertheless true that this means that it may not attack the really large problems but must deal only with the minor ones. This restriction seriously limits the usefulness of the supreme auditing institution for improving efficiency. Under some conditions, it may even reduce efficiency—namely, when attention is directed away from major problems and when a policy otherwise doomed to failure is saved by making it run more smoothly.

## 6. Concluding remarks

The discussion of the approach and the activity of the supreme auditing institution has revealed both important advantages in terms of supplying crucial information to political decision makers but also systematic distortions brought into the administrative process. In line with the comparative analysis of institutions it is not sufficient to state that an institution is not perfect; what matters is whether a superior alternative exists in reality.

An alternative way of increasing efficiency in the public sector is indeed available. *Constitutional rules* (Buchanan and Tullock 1962, Frey 1983, Brennan and Buchanan 1980, 1985) can be devised that provide incentives to the various decision makers in the current politicoeconomic process to act in ways that reduce waste and enhance efficiency. Such rules include the following:

1. Strengthen political competition between the parties. Staying in power, or coming into power, through regular elections requires then that political parties respond more closely to the voters' wishes and make an effort to supply efficient public services.
2. Increase the direct democratic participation rights of citizens via initiatives and referenda. As has been shown empirically (Pommerehne, 1978), the more extensive democratic participation, the more efficient is the production of public services. An important way to increase democratic participation also consists in shifting public decisions to a lower level—to strengthen federalism.
3. Expose administrative units to competitive pressure by allowing private firms to compete or by creating public bureaus competing for a given budget.
4. Devise incentive schemes for public employees to work more efficiently. Such incentives need not be merely monetary; it may well be that nonmonetary incentives (such as orders and titles as practiced in the United Kingdom) are in some respects even equally effective, cheaper, and are less prone to the hidden cost of rewards. This may necessitate splitting public administration up into smaller and more independent units.

The activity of the supreme auditing institution can, however, not be fully substituted by such constitutional rules. Rather, its beneficial aspects must be strengthened, and the distortionary effects reduced. Competition between various accounting offices should be actively furthered—in particular, by allowing private firms to supply the same services. The public accounting offices should be forced to become active in those areas where the external effects are large and where therefore private firms find it unprofitable to enter. The compensation of private suppliers should be related as far as possible to the efficiency gains achieved, or the waste prevented, which means that “bounty hunting” should be used in appropriate areas.

Supreme auditing institutions necessarily being part of the public administration as a whole, they should be complemented by an institution that concentrates on constitutional changes promising to raise efficiency. In a democracy, such an institution cannot, of course, have the power to establish such new rules; it must be restricted to suggesting them to the citizens. Thinking about constitutional rules requires detachment from the current political process (which could be served by a committee of elders, as suggested by Hayek), but it also requires a long-term horizon. It may well be that this second prerequisite is better served by a committee composed of young people who can expect to remain for a long period.

## Summary

Information provided by the supreme auditing institution is a necessary precondition for controlling the public administration. Nevertheless, four major distortions are produced: the concern with administrative rationality overlooks costs arising elsewhere; budgetary aspects are overvalued compared to other issues; incentive-oriented behavior is suppressed; and the evaluation is biased by concentrating on minor, instead of major, aspects of inefficiency. An alternative way of increasing efficiency in the public sector is offered. Constitutional rules can be devised that provide incentives to decision makers in the current politicoeconomic process to act in ways that reduce waste and enhance efficiency.

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## Notes

1. An analysis of bounty-hunting agents in the area of taxation is given by Toma (1989).
2. The theoretical analysis draws on the economic theory of regulation (for a survey see, e.g., Joskow and Noll, 1981), information, and auditing (see, e.g., Baron and Besanko, 1984; Laffont and Tirole, 1986). The empirical evidence underlying the analysis is mostly drawn from the reports of the German *Bundesrechnungshof* (various years), but in order not to overload the exposition, no specific references are given.

3. The legalistic, formalistic approach applies more strongly to public auditing institutions in German- and Latin-speaking countries than to Dutch, Scandinavian, and Anglo-Saxon ones. The latter tend to refuse action that they know would lead to a reduction of efficiency because they have more discretion and are not forced to strictly follow formal administrative rules.
4. This holds also for bookkeeping in the private sector. "Accountants are doing a disservice by training decision makers to ignore opportunity costs" (Neumann and Friedman, 1978, p. 400; see also Becker, Ronen, and Sorter, 1974, and Hoskin, 1983). Johnson and Kaplan (1987) claim that accounting information systems typically used by large firms are incapable of providing decision-relevant information, (see also Jordan, 1989). More general aspects of the elusive link between information provided by accounting and decision making are discussed in March (1987).
5. It is not argued here that this would solve all university problems. Steering behavior by setting the appropriate relative prices is *not* always the only and best solution. In particular, one should be aware of the danger that monetary payment may drive out the willingness to perform based on one's moral standards. These *hidden costs of reward* have been analyzed by experimental psychologists (see McGraw, 1978) and are discussed in the social science context by Frey (1990, ch. 10).
6. Those not convinced that competition is a very strong incentive in research are advised to read Watson's (1981) account of the detection of the DNA double helix structure.

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