

# **IMPROVING FISCAL GOVERNANCE AND CURBING CORRUPTION: HOW RELEVANT ARE AUTONOMOUS AUDIT AGENCIES?**

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## **ABSTRACT**

*This research therefore underscores the limits of institutional design and constitutional engineering for improving the performance of government auditing. External factors, such as the functioning of the national system of fiscal control, the cycle of legislative accountability and the balance of political powers, matter greatly. A critical and often dysfunctional link is that between the AAA and their main principal, the legislature, as mediated by the legislature's public accounts committee. This functional relationship is particularly important in the monocratic and collegiate models of external auditing where the autonomous audit agency acts as an advisory body to the legislature, such as in Argentina. It is a crucial relationship to enforce ex post government accountability in financial matters through the annual certification of public accounts and the discharge of government.*

## **GOVERNMENT AUDITING AND CORRUPTION CONTROL**

In the second stage of reform, strengthening external oversight of public finances is a defining challenge for emerging economies seeking to foster fiscal responsibility and curb corruption. Increasing budget transparency and financial accountability matters to safeguard the integrity and improve the efficacy of public spending, so that public resources can be more effectively deployed to promote development and reduce poverty. It also matters to boost the effectiveness of foreign aid and ensure that aid resources are used for the purpose intended, satisfying the fiduciary concerns of donor governments.<sup>1</sup>

There is thus renewed interest in the institutions of budget oversight and financial accountability as a means to enhance external scrutiny of public finances. Our understanding of what explains the effectiveness of government financial management has considerably expanded. Building on Aaron Wildavsky's seminal work on the politics of the budget process (Wildavsky and Caiden 2003), there is now a greater appreciation of the governance and institutional dimensions of public budgeting, in particular the role of parliaments (Schick, 2002; Lienert, 2005; Santiso, 2006b; 2005a, 2005b), autonomous audit agencies and civil society organizations (Ramkumar and Krafchik, 2005).

However, little remains known on what explains the effectiveness of autonomous audit agencies (AAA). How effective are they in enforcing financial accountability, improving fiscal governance and controlling corruption? How do they insert themselves

in the architecture of fiscal control and the political economy of public finance accountability? This research notes presents the findings of recent research to assess the effectiveness of AAAs and their impact on the quality of fiscal governance in emerging economies.

## **APPROACHES TO GOVERNMENT AUDITING**

Government auditing not only matters to detect and deter corruption; it also contributes to improve fiscal governance. Effective independent auditing of government finances is critical to enhance the credibility of public finances and ensure the probity of public administration. AAAs, traditionally referred to as supreme audit institutions, are those state agencies tasked with overseeing government finances, providing reasonable reassurances on the reliability of government financial statements, and verifying the truthfulness of government financial information through their audit reports and opinions. They are key institutions of intra-state horizontal accountability, contributing to combating corruption and improving public management (O'Donnell 1998). Importantly, they examine tax revenues, public expenditures and public debt.<sup>2</sup>

They verify the government's compliance with budget rules and financial regulations as well as the mandate enshrined in the budget law approved by the legislature through legal compliance and financial certification audits. They thus contribute to anchoring the rule of law in public finances, including through the imposition of administrative sanctions. In fact, in many countries, audit agencies are courts of auditors or tribunal of accounts with quasi-judicial powers in administrative matters and jurisdictional authority over public administrators, acting as an administrative tribunal.

Features and functions of AAAs vary across countries and have evolved over time. There have also been important changes in approaches to government auditing over the past two decades. AAAs have progressively assumed a wide variety of roles, broadening the traditional narrow scope of their mandate. In recent years, they have taken on new tasks and adopted new approaches to government auditing, which led to a fundamental alteration of the model of control in public finances. Modern AAAs increasingly emphasize the economy, efficiency and effectiveness of public spending through performance and value-for-money audits. What is sought is substantial compliance with the objectives of the budget and the achievement of results. Furthermore, in some countries, audit agencies also perform key anticorruption functions, for example through the oversight of asset declarations, ex-ante control of public procurement and the oversight of privatization processes. Lastly, in a few countries, they are also responsible for auditing the finances of the legislature and the judiciary.

## **INSTITUTIONAL ARRANGEMENTS FOR GOVERNMENT AUDITING**

Different institutional arrangements exist for organizing the external audit function in modern states, reflecting different historical trajectories and institutional traditions.

There are three ideal types of autonomous audit agencies (Stapenhurst and Titsworth, 2001):

- the *court model* of collegiate courts of auditors or tribunals of accounts with quasi-judicial powers in administrative matters often acting as an administrative tribunal, such as in France, Italy, Spain, Portugal, and, in Latin America, Brazil or El Salvador;
- the *board model* of a collegiate decision-making agency but without jurisdictional authority, such as in Germany, Netherlands, Sweden, and, in Latin America, Argentina or Nicaragua; and
- the *monocratic model* of an uninominal audit agency headed by a single auditor-general and often acting as an auxiliary institution to the legislature, a model prevalent in Anglo-Saxon countries such as the United States, the United Kingdom, Canada, and in Latin America, Chile, Colombia, Mexico or Peru.

In practice, however, AAAs are unique hybrids that do not fit easily in the traditional model of separation of powers. They combine several elements of the different ideal models. Key variations between agencies include the timing of control (whether ex-ante or ex-post control), its nature (whether emphasizing compliance or performance auditing), its effects (the follow-up of audit recommendations), as well as its status (the legal standing of audit rulings).

The most important issue, however, concerns the AAAs' approach to fiscal control and financial accountability. Fiscal control can be preventive, corrective or punitive. Compliance control is concerned with the formal adherence with the legal rules and financial regulations framing the budgetary process, while performance control is concerned with the substantive compliance with the objectives of the budget law and the manner in which public resources have been deployed.

As Speck (2000) aptly underscores, AAA are torn between two concerns: a liberal concern for limiting and restraining executive power, which is best achieved through ex-ante compliance control,<sup>3</sup> and a managerial concern with improving public sector management, which is best achieved through performance auditing. While both these functions are crucial for effective and accountable government financial management, the relative emphasis on one or another dimension will depend on the stage of development of the budgetary systems as a whole, including the quality of the bureaucracy and the prevalence of the rule of law. The trend, however, is towards a greater emphasis on the preventive and corrective functions through greater reliance on ex-post performance auditing.

## MEASURING EFFECTIVENESS OF AUTONOMOUS AUDIT AGENCIES

Government auditing in developing countries and emerging economies is in transition, seeking to redefine its contribution to government accountability and fiscal control. A key issue concerns the insertion of AAAs in the broader institutional framework of

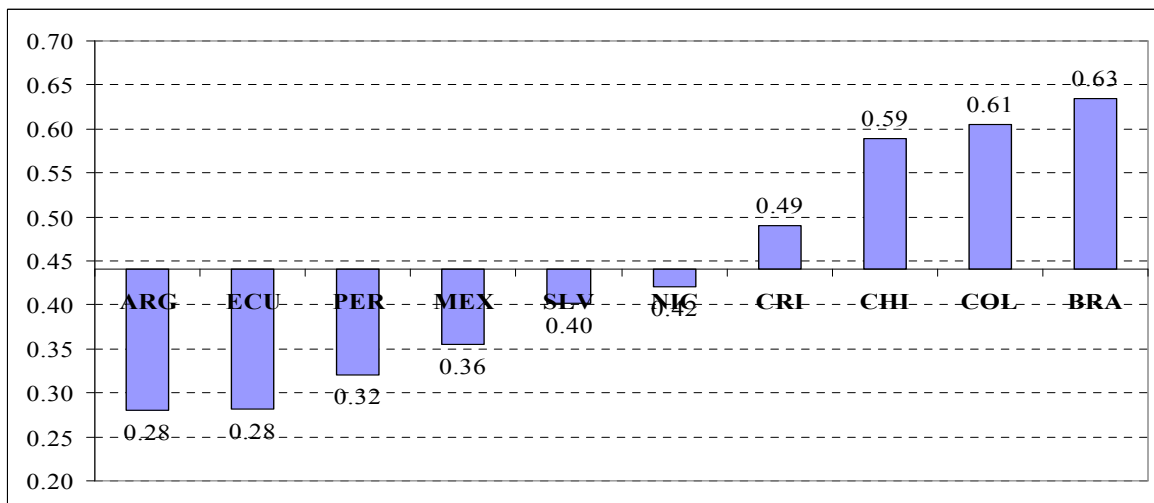
fiscal governance and the separation of powers, in particular their links to the cycle of political accountability legislative oversight and judicial control.

However, little is known on what explains the effectiveness of AAA and how to measure it. There is little comparative research on the effectiveness of alternative institutional arrangements for fiscal control and government auditing. Furthermore, the impact of government auditing on the quality of fiscal governance remains largely understudied. Emerging lessons, however, suggest that the performance of AAAs requires understanding the political economy of government auditing, in particular the role of institutional arrangements and political incentives. The degree of political competition and contestation is key, as it is the opposition who has the greatest interest and incentive to oversee government (Messick, 2002).

To better measure the effectiveness of AAAs, we construct an indicator of institutional effectiveness in ten Latin American countries along the four key attributes, (i) their independence from the executive, (ii) the credibility of audit findings, (iii) the timeliness of audit reports, and (iv) the enforcement of audit recommendations. Figure 1 reproduces the indicator of effectiveness of autonomous audit agencies in ten Latin American countries and Table 1 shows how the indicator is constructed.

This data underlines three issues. First, specific institutional arrangements vary greatly within ideal types. Second, governance contexts appear to have greater influence on organizational performance. Third, the model of external auditing chosen by a given country does not predetermine the overall performance of an AAA. While Ecuador, Peru, Costa Rica, Mexico, Chile and Colombia follow the monocratic model, they show great variation in organizational performance. Similarly, while Brazil and El Salvador follow the court model with quasi-judicial powers, their relative performance differs substantially.

*Figure 1: Indicator of Effectiveness of Autonomous Audit Agencies in Latin America (2005)*



Source: Author, 2006c

*Table 1: Indicator of Effectiveness of Autonomous Audit Agencies in Latin America (2005)*

Country	AGGREGATE			Enforce- ment	
	INDICATOR	Independence	Credibility Timeliness		
ARG	<b>0.28</b>	0.44	0.22	0.13	0.33
BRA	<b>0.63</b>	0.88	0.42	0.24	1.00
CHI	<b>0.59</b>	0.78	0.40	0.18	1.00
COL	<b>0.61</b>	0.75	0.46	0.21	1.00
CRI	<b>0.49</b>	0.66	0.48	0.16	0.67
ECU	<b>0.28</b>	0.66	0.14	0.00	0.33
SLV	<b>0.40</b>	0.53	0.08	0.00	1.00
MEX	<b>0.36</b>	0.59	0.38	0.12	0.33
NIC	<b>0.42</b>	0.78	0.20	0.03	0.67
PER	<b>0.32</b>	0.78	0.12	0.04	0.33
LAC10	<b>0.44</b>	0.68	0.29	0.11	0.67

Note: Indicator scale from 0 to 1, with lower scores meaning lower performance.

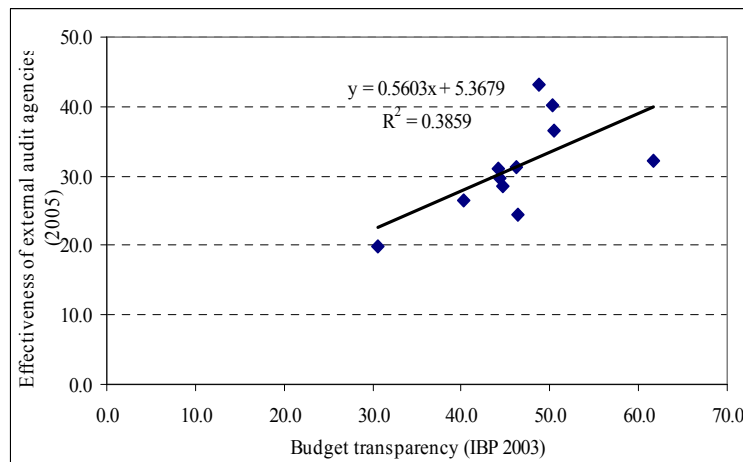
Source: Author, 2006c

## GOVERNMENT AUDITING AND FISCAL GOVERNANCE

We proceed with ascertaining the impact of AAAs on both (i) fiscal performance and (ii) fiscal governance, resorting to simple correlations with different measures of fiscal policy and institutional quality. We used as proxy indicators of the performance of fiscal policy quantitative and qualitative measures of budget credibility, such as the level of deficit, volatility, centralization and transparency of the budget. Proxy indicators for institutional quality include the rule of law, bureaucratic efficiency, corruption control and constraints on executive power.

We find that the quality of external auditing has limited explanatory power and only indirect influence on fiscal outcomes. It does nevertheless have greater significance for the credibility of budget processes measured in terms of fiscal transparency, as shown in Figure 2. Surprisingly, external auditing does not appear to be correlated with the strength of legislative budgetary powers, which would seem to indicate an important disjuncture between external auditing and legislative oversight. In fact, there is greater correlation between external auditing and the centralization of budgetary powers in the executive (prevalent in Latin American presidential systems of government), which would seem to suggest that external auditing is obliged to counterbalance weaknesses in legislative oversight and check executive discretion.

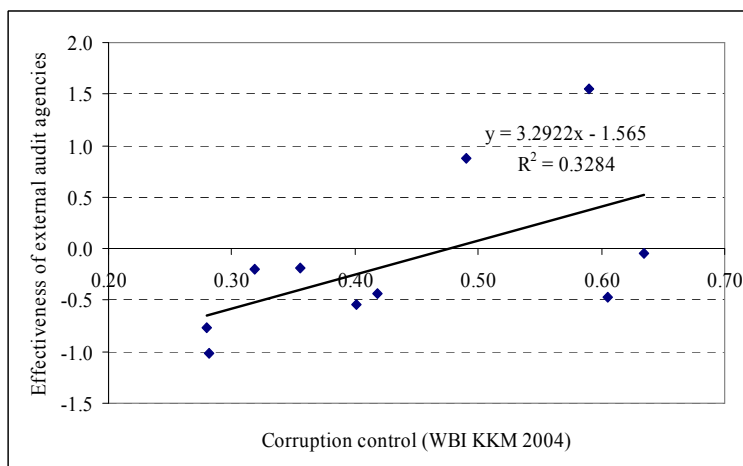
Figure 2: External Auditing and Budget Transparency



Source: Author, 2006c

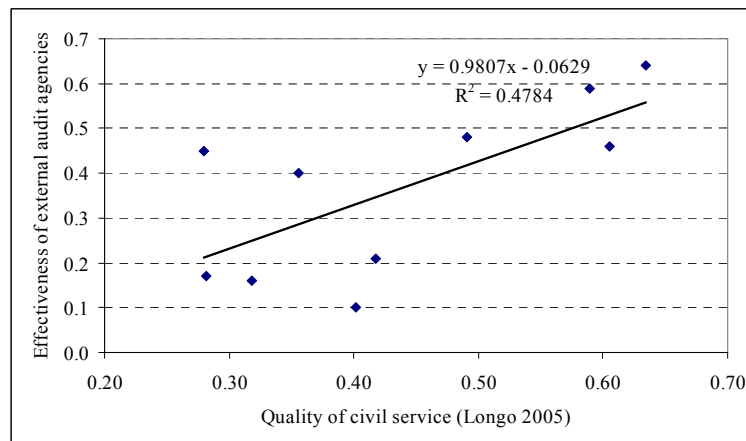
However, we find an important link between the external auditing and the quality of fiscal governance. Considering the wealth of empirical and statistical research underscoring the contribution of governance institutions to economic development, we can infer that AAAs have an indirect influence on fiscal performance. The research reveals a strong correlation between the credibility of external auditing and the quality of fiscal governance, in particular corruption control (Figure 3) and bureaucratic efficiency (Figure 4). While correlation is not causation, this data strongly suggests that AAA are a core component of the system of fiscal control and government accountability in financial matters.

Figure 3: External auditing and corruption control



Source: Author, 2006c

Figure 4: External auditing and bureaucratic efficiency



Source: Author, 2006c

The data nevertheless reveals a weaker connection between external auditing and adherence to the rule of law and constraints on the executive, suggesting that AAAs only marginally contribute to the systems of checks and balances. This latter finding tends to confirm that, whilst AAAs could potentially play a critical role in strengthening government accountability, they often fail to do so because of structural dysfunctions in the system of fiscal control in which they are embedded.

These results thus point out to systemic failures in government auditing systems. They suggest that other factors linked to the broader governance context bear greater explanatory power on the relative performance of AAAs across countries and over time. Comparative longitudinal case study research carried out in Argentina, Brazil and Chile (which represent the three main models for organizing government auditing) carried out between 2003 and 2005 suggests that the ultimate effectiveness of AAAs do not necessarily nor primarily dependent on the choice of organizational model or the strength of the agency taken in isolation (Santiso, 2006c and 2006d). More fundamentally, it shows that accountability gaps in budget oversight are caused by wider dysfunctions in the systems of fiscal control.

Skewed political incentives, rather than weak technical capacities, largely explain the limited effectiveness of AAAs. For example, in Argentina, the reform of the AAA led to its neutralization during most of the 1990s. In 1993, then-president Carlos Menem replaced the *Tribunal de Cuentas de la Nación* (TCN) with the *Auditoría General de la Nación* (AGN), a collegiate body of seven auditors-general focusing on ex-post control and reporting to the legislature. Under the previous arrangement, the TCN was a collegiate tribunal of accounts headed by five judges. It was endowed with quasi-judicial powers of sanction and ex-ante control prerogatives, which could effectively block questionable executive decrees. It indeed contested several privatization procedures initiated by the government in the early 1990s. Under the new institutional arrangements, audit findings go through political filtering, both within the audit agency itself, as well as in the legislature.

This research therefore underscores the limits of institutional design and constitutional engineering for improving the performance of government auditing. External factors, such as the functioning of the national system of fiscal control, the cycle of legislative accountability and the balance of political powers, matter greatly. A critical and often dysfunctional link is that between the AAA and their main principal, the legislature, as mediated by the legislature's public accounts committee. This functional relationship is particularly important in the monocratic and collegiate models of external auditing where the autonomous audit agency acts as an advisory body to the legislature, such as in Argentina. It is a crucial relationship to enforce *ex post* government accountability in financial matters through the annual certification of public accounts and the discharge of government.

## CONCLUSIONS AND POLICY IMPLICATIONS

This research confirms that the contribution of AAAs to the fiscal control and financial accountability is hampered by structural factors linked to the political economy of government auditing, in particular the dysfunctional linkages between government auditing, legislative oversight and judicial control (Santiso, 2005a, 2005b, 2006c). There are five main conclusions and policy implications for this incipient research.

***First, budget institutions cannot be strengthened in isolation.*** Dysfunctions in systems of fiscal control are systemic, not agency specific. Ultimately, the effectiveness of AAAs depends on the broader political economy of executive-legislative budget relations in which they are embedded. It also hinges upon the quality of their insertion in the national system of fiscal control and budget oversight, what Transparency International refers to the 'national integrity system,' which include internal control systems, government accounting and legislative budget oversight. Therefore, improving government auditing required tackling the incentives for inter-institutional cooperation.

***Second, reform strategies based on radical reform or institutional transplant of exogenous models are likely to fail.*** Stages of institutional development cannot be bypassed. The radical change of external audit model in Argentina in 1993, which changed from the court model to the collegiate model overnight, constitutes an example of reform failure. AAAs are path-dependent and are embedded in a particular culture of public administration. Gradual approaches based on incremental adjustments and piecemeal changes, such as those privileged by the Brazilian Tribunal de Contas da União (TCU) since its creation in 1891 (in particular in 1964 and 1988), are likely to bear greater, more sustainable results. These findings underscore the limits of institutional design and institutional import as effective reform strategies. While radical reform is sometimes warranted, it requires carefully crafted and politically astute reform tactics, both in the design and implementation of the reforms considered. More importantly, it requires moving away from erstwhile technical approaches to institutional reforms.

***Third, it is necessary to enhance the institutional and functional linkages between autonomous audit agencies and the other components of the systems of fiscal control.*** The effectiveness of AAAs, as 'pillars of integrity' (Dye and Stapenhurst, 1999), largely depends on the quality of their insertion in the national systems of integrity. This, in



turn, requires a adopting a systematic view of fiscal control and financial accountability in which the linkages between organizations matter inasmuch as the performance of agencies in isolation. Three linkages are of critical importance: (i) with the legislature to enforce political accountability, (ii) with the judiciary to enforce judicial accountability and (iii) with civil society to enforce societal accountability. Improving these inter-institutional linkages is likely to enhance external scrutiny of government finances.

More effective linkages between AAAs and parliamentary oversight committees, in particular public accounts committees, are of utmost importance (Santiso, 2006b, 2005a, 2005b, 2004b; Stapenhurst et al., 2005).<sup>4</sup> There is indeed a symbiotic relation between external auditing and legislative oversight of public finances, a relation that is severely dysfunctional in many developing countries. Similarly, more efficacious links between civil society and oversight agencies are likely to bear significant results (Ramkumar and Krafchik, 2005).

***Fourth, institutional independence is not an end in itself but a guarantee of impartiality and credibility.*** Therefore, independence ought to be approached as a continuous rather than a dichotomous variable. Indeed, this research note reveals a paradox of independence: while AAA ought to be sufficiently autonomous to act independently, they need to develop effective functional relations with those institutions tasked with enforcing government accountability. The Chilean *Contraloría General de la República* (CGR) is a highly independent and respected institutions, often compared the ‘fourth power of the state.’ However, by insulating and isolating itself in the Chilean architecture of fiscal governance, it fails to fully exploit opportunities to enhance its impact through a more efficacious relationship with the legislature and the judiciary.

***Fifth, conceptually, it is important to distinguish more sharply oversight agencies from accountability institutions.*** There is considerable debate in the accountability literature on the importance of enforcement and sanctions and the role of oversight agencies. There is considerable debate in the accountability literature on the role of oversight agencies and the importance of enforcement and sanctions. They are legally empowered to *directly* enforce accountability on the executive. In contrast, oversight agencies, such as AAAs, cannot *directly* enforce accountability on the government, as ‘agents cannot hold other agents accountable, only their principals can’ (Moreno et al., 2003:117). They are generally auxiliary bodies to accountability institutions, either the judiciary (in the court model) or the legislature (in the two other models). Oversight agencies, it is suggested, can only enforce accountability *indirectly* by referring the cases to accountability institutions. Their main contribution is, therefore, to support the accountability functions of the legislature and the judiciary.

This research thus underscores the critical links between external auditing, legislative oversight and judicial control. It invites further inquiry into the political determinants of the effectiveness of those formal and informal institutions tasked with overseeing government and controlling corruption. More fundamentally, it underscores the critical need to increase *demand for accountability*, from both formal and informal institutions, as well as civil society and the media, to effectively dent corruption. Further research is in particular needed into the political and institutional determinants of the role of parliaments in the oversight of the budget. Strengthening the institutions of legislative budget oversight and the agencies of public finance integrity is undoubtedly a structural challenge for Latin American emerging economies. It is nevertheless a critical one.

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The views and interpretation of this paper are those of the author and should not be attributed to the aforementioned institutions.

## NOTES

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<sup>1</sup> This latter dimension is particularly important, as donor governments have committed, in 2005, to increase aid flows and enhance donor harmonization, in particular through direct budget support and policy-based lending which entail placing greater reliance on developing countries' financial management systems (Santiso, 2006a, 2006b, and 2004a).

<sup>2</sup> It is important to underscore that AAAs scrutinize public finances in their entirety, including revenue. Thus, in theory, they contribute to deter fiscal corruption in revenue agencies and taxation systems, such as tax evasion, elusion and exemptions (Fjeldstad and Tungodden, 2003).

<sup>3</sup> Furthermore, with ex-ante control and the capacity to question or annul illegal administrative acts, the autonomous audit agency becomes a 'veto player' in the budget policymaking process (Tsebelis, 2002).

<sup>4</sup> AAAs in the monocratic and collegiate are institutionally and functioning linked to parliaments in the exercise of their oversight functions, in particular through the annual review of government accounts and the decision whether or not to discharge government.

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