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Moral Hazard Problem in Public Policy Makers

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Doi: 10.19044/esipreprint.12.2022.p296

Approved: 17 December 2022
Posted: 19 December 2022

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Cite As:
Alam N. (2022). *Moral Hazard Problem in Public Policy Makers.* ESI Preprints.
https://doi.org/10.19044/esipreprint.12.2022.p296

Abstract

The moral hazard problem in government organizations is very recurrent due to weak compensation system (i.e., take-home salary) and non-existence of any additional premium (e.g., ownership of stocks) for public policy makers as compared to their counterpart in private firms, hence it weakens their proprietorship of their organization. Since there is a principal-agent relationship between citizens and public policy makers, therefore, a loss in public goods and services to citizens signals meaningful level of moral hazard problem in public policy makers being the agents. The menace of moral hazard problem can be, lessened through a proper Reward Punishment Approach (RPA). Under existing setup, a weak compensation system with severe punishment mechanics indicates flaws in PRA which needs improvement through reforms in its existing structure. This paper recommends, to bring the compensation system (i.e., take home salary in terms of cash & a provision of additional premium) at par with market-based package along with various perquisites. The study expects a bare minimum financial implication which may be affordable for the government and decrease in moral hazard problem at least to some extent, leading to a better delivery of public goods and services for the citizens of the country.

Keywords: Moral Hazard Problem, Principal, Agent, Public Policy Makers, Premium

Introduction

Moral hazard problem appears more frequently in public policy makers because they are usually not the stakeholders and further, they do not enjoy any additional premium that is in vogue in terms of ownership of stocks in most of the private firms. The principle of Agency Theory categorizes these public policy makers as agents of the citizens of a country who are no doubt their principals. The moral hazard problem is a common feature in the fields of economics and finance wherein conflict of interests of principal and agent is, a reflection of this phenomenon. An agent is a person who exercises authorities on behalf of a single individual or a group of individuals, who is/are called principal(s). The agents may be managers of business firms, bureaucrats, or may be the political leaders of the country and others. The principals may be the owners or stockholders of the firm or may be the people or citizens of the country and so on. It is the prime objective of the agent that he/she should take decision to safeguard the interest of his principal at any cost. Nevertheless, in real life this is not the case, as the conflict of interests of agent and principal is a routine feature of many of the business firms and elsewhere. Since agents are ethically and legally bound to work to uphold the interest of their principals, therefore, any deviation in their behaviour against set norms raises the issue of moral hazard which is no doubt undesirable for the principals.

In existing literature, the term ‘moral hazard’ is being used in all fields. Moral is concerned with behaviour that could be good or bad and hazard stands for risk[1] which is a situation that involves an exposure to threat or danger. Hence, the moral hazard may be an outcome of bad behaviour leading to an exposure to threat. As per standard norms, good behaviour is the symbolic for desirability while bad one usually leads to undesirability because, generally the societies prefer to avoid taking risky decision in their day-to-day affairs. Moral hazard problem appears when desirability concludes to undesirability because of bad behaviour of an individual/a group of individuals that hurts the interest of another individual/a group of individuals because of an exposure of threat to his/their capital/capitals or life/lives. Hence, moral hazard problem is associated with risky decision that is taken by an individual or a group of individuals at the cost of interest of an individual or a group of individuals. These two sets of individuals must have some relationship showing certain interest e.g., financial, political, legal, social, cultural, traditional, environmental, technological etc. In literature, this relationship is named as the "Principal/Agent Relationship" and the proponent theory to it is called the "Agency Theory". The theory spells out

[1] Concise Oxford English Dictionary.

that principal/agent problem exists everywhere in private firms, universities, government organizations etc. (Jenson & Meckling, 1976). Gallagher and Andrew (2003) refer the principal/agent problem to as the 'agency problem' and suggest that this problem can be lessened by linking compensation of the manager with performance of the company and its stock price.

The problem of moral hazard is more prevalent in public policy makers as compared to executives in private firms. This is because they are usually not the primary stakeholder and do not enjoy any additional premium like their private sector counterparts. These public policy makers are categorized as agents of the citizens of a country by the Agency Theory which makes the citizens their principals. At times, these agents end up taking riskier decisions on behalf of their principals in order to generate an additional premium for themselves. Even though these decisions are usually self-centered, they are garbed under the umbrellas of “National Interest” and “Established Theory”. Consequently, the Public Exchequer suffers significant loss that is ultimately transferred to the citizens through a decline in deliveries of public goods and services. Since there is a principal-agent relationship between the citizens and public policy makers respectively, therefore, a loss in public goods and services to citizens signals meaningful level of moral hazard problem in public policy makers being the agents.

This paper examines moral hazard problem in public policy makers through descriptive approach and analyzes its impacts on deliveries of public goods and services to the citizens.

Literature Review

The term moral hazard was first used in 1865, in the fire insurance literature linking the ‘character component’ of moral hazard with the risk associated with the insurance contract itself. It was noted that the heavy insurance also increased the moral hazard associated with the motive for crime manifestation from both bad character (i.e., immoral people who will deliberately fraud) and wrong incentives (i.e., insurance contract design which could tempt good people to act carelessly)[2]. The insurance writers referred it as a moral or ethical problem or moral hazard was every deviation from correct human behavior that could pose a problem for an insurer (Pauly, 1968). Since the work of Kenneth Arrow (1963), the idiom became widely used in economics and, at the same time, moved into the policy debate[3]. More recently, Pierret (2019) quotes that moral hazard do not

[2] Pierret, L. (2019). The political use of the term “moral hazard”: evidence from policymakers of the Eurozone by European Political and Governance Studies. College of Europe.

[3] Arrow, K. J. (1963). “Uncertainty and the welfare economics of medical care”, American Economic Review, vol. 53, no. 5, pp. 941-973.

originate in the economic literature, but in the business insurance one. He further discusses that before entering the economic literature, moral hazard was a business insurance concept, where personal characteristics and morality had an important role to play in the manifestation of the phenomenon. In contrast, the economics of moral hazard are solely focused on incentives, free of value judgments and character.

Literature traces back the dynamic modeling of the moral hazard envisioned by Becker and Stigler (1974) describing economic insights into the problems of maintaining long-term trust of agents who practices entrusted power in a relationship or organization. The work of Myerson (2008 & 2015) in this context is also commendable. The model analyzes how government officials could be efficiently motivated to enforce laws as problems of trust are essential to every organization. The agency theory focuses on motivational approach offering better rewards for good performance of the agents in order to mitigate the opportunities for profitable abuse of power. It is imperative that the required rewards for good performance may be more than what agents would demand simply to accept the position. Thus, agents who hold such responsible positions must be promised surplus rewards, called moral-hazard rents. However, in dynamic modeling, the costs of moral hazard rents can be lessened by deferring substantial rewards until late in agents' careers, because the expectation of a late-career reward for good long-term accomplishment can motivate good behavior throughout an agent's career[4].

The seminal work of Jenson and Meckling (1976) on agency theory is no doubt a milestone opening a floodgate of research on this subject in later stage leading to marathon of debate on the roles of public policy makers. For instance, Alam (2007) while discussing public debt management of a group of Asian Pacific Developing Countries (APDC) under debt trap, documents that policy makers of these countries usually take decisions on short-term basis focusing their own self-interest. Their prime concern is to maintain their efficiency through an inefficient means, so that the crisis could be delayed for the time being. In this context, the tax-tilting approach under higher debt servicing obligation, debt burden shifting through diversion of resources from development to debt servicing sectors, grabbing of states' legitimate share, or inclination towards the extension of loans instead of issuing grants to the states, are few examples. In accord to conventional wisdom, these measures can only reduce the visibility of gravity of the prevailing crisis for the time being, nevertheless, as an ultimate effect in long-run it creates a unique trap of 'debt burden shifting' that does not

[4] Myerson, R. B. (2008-2015). Moral hazard in high office and the dynamics of aristocracy. Economics Department, University of Chicago, 1126 East 59th Street, Chicago, IL 60637, USA.

follow the path of established norms. Conclusively, Alam (2007) raises a question that "Whether, such debt burden shifting could be viewed as an administrative tool, or it may be simply a reflection of moral hazard behavior? It is worth mentioning to note that literature on this subject reveals significant degree of moral hazard problem in public policy makers as their policies are generally focused on their own interest or more specifically too much self-centered.

Similarly, the literature with reference to the failure of Lehman Brothers during 2008 financial crisis highlights that it's troublesome because the moral hazard imposed on the system is actually astounding in scale and scope. Across the world the banks and insurers whose errors of judgment generated the bubbles have been bailed out without reluctance, at marginal cost to them but at substantial costs to taxpayers. Allen et al. (2015) in their study underline that the introduction of government guarantees does not always stimulate banks to take excessive risk, with the outcome that the public intervention increases instead of reducing the instability in the financial sector. This has important consequences for policymakers since it recommends that restricting the size and the scope of the intervention, in the effort to regulate the moral hazard problem on the side of banks, could be damaging.

Barro (1998) when debating the subject of bailouts opines that bailout may raise the probability of sovereign default and it may increase 'moral hazard' by rewarding and encouraging bad policies by governments and excessive risk-taking by banks. According to him there may be a meaningful possibility that as a sovereign debtor, the government would use the money borrowed from creditors imprudently. While the source of moral hazard in model of Ghosal and Miller (2002) is that the sovereign debtor has non-contractible payoffs, and the incentives of the sovereign debtor are not aligned with those of the creditors. They further assume that the value of these debtor payoffs depends on whether 'effort' is good or bad, where good effort implies that default only occurs with the bad exogenous shock, but bad effort implies that default is inevitable. Good effort could relate to a situation where, for example, money is borrowed and used to build up R&D in the export sector to help the country keep on internationally competitive. Bad effort might relate to shifting borrowed money to rich people who are free to put it in tax havens overseas, exposing the country to currency risk and the budget to a loss of tax revenue.

In another study for instance, Hernández-Catá (n.d.) contends that diversion of domestic or external funds originally appropriated for government investment into consumption by public policy makers is rampant which is done in connivance with their private sector accomplices and international donor agencies. In some cases, even they do not reflect such

changes in diversion of funds in official government consumption statistics as they succeed in hiding these changes therefore official estimates of investment are biased upward. Tsyrennikov (2007) documents that banking and the financial sectors in emerging economies are largely unfree. He quotes Argentina as a special case wherein the government retains full ownership in four large banks, including the country's largest bank, Banco de la Naci´on. This implies that a significant part of funds is directed into politically motivated projects indicating lender's inability to monitor the use of funds by Argentina transmitting signals for the moral hazard problem.

The empirical study of Pierret (2019) using discourse analysis techniques provides information on how and why policymakers of the Eurozone use the term "moral hazard". The study argues that contrary to appearances, moral hazard is a politicised concept designed by planned interests and/or prevailing set of ideas that describe different preferences towards risk sharing. He finally concludes that rather than the genuine reason behind different risk sharing preferences, moral hazard seems to be the justification.

It is also no need to mention that the roles of international lending agencies remain as a facilitator in encouraging moral hazard problem in public policy makers (Corsetti, Guimaraes, & Roubini, 2003). The researchers while critically analyzing the official lending, point out that official lending also causes moral hazard distortions usually through bailout package extended by the International Monetary Fund (IMF). Generally, the debtor countries have weak incentives to implement good but costly policies, thus raising the possibility of a crisis. They further point out that international financial crises are caused by the collaboration of bad fundamentals, self-fulfilling runs, and policies by three classes of augmenting agents namely as international investors, the local government and IMF. For instance, Rossel, Unger and Ferwerda (2021) document that in 2012 the Financial Action Task Force (FATF), an intergovernmental organization that sets international standards to fight money laundering, recommended tax crimes as an establish offense1 for money laundering. Astonishingly, in the legislation of EU Member States, the tax crimes were included without a solid definition, leaving each jurisdiction to define or redefine what they thought a tax crime. The dearth of an integrated definition of tax crimes resulted from a lack of consensus among Member States (Thirion & Scherrer 2017; Turksen & Abukari 2020). However, the parliament observed that "Agreeing on a definition of tax crimes is an important step in detecting those crimes"[5]

[5] Council of the European Union 2014, p. 11.

In recent days, lawmakers in one of the most liberal tax havens in the United States are urging to close a key doctrine of financial secrecy by requiring the owners of highly confidential trusts to ascertain themselves. The proposal in Alaska is part of a growing push to stop the flow of undisclosed money into the United States, which has for years taken international wealth through state laws that provide secrecy for the owners of trusts, limited liability companies and other financial arrangements. New York and Wyoming are also pondering reforms, and, at the federal level, the bipartisan 'Enablers Act' would for the first time require trust companies, registered agents, and others to analyze clients and inform questionable transactions. The stories in Pandora Papers revealed how oligarchs, political elites and others conceal wealth in the United States and around the world. Grippingly, the lawmakers in New York quite recently presented legislation necessitating limited liability companies to unveil their owners (Cenziper, 2022).

The unlawful transfers of millions of dollars into Swiss bank accounts by corrupt regimes in developing countries, or investment funds run by drug moguls or terrorists in the Caribbean, remains the major topic of debate in current literature. The part of these endeavors in financial markets is a crucial factor that restricts the capability of individual countries to raise revenue through taxation, both of their own residents and foreign-owned capital. Especially, in poor countries, the diversion of scarce resources weakens the capability of governments to make crucial investments in social services and economic infrastructure upon which human welfare and sustainable economic development depends. The offshore system has also added to the rising occurrence of financial crises that obliterate businesses in poor countries. The recent financial crises in East Asia, Russia, Turkey, and Argentina are illustrative of what happens when middle-class businesses evaporate, and massive numbers of people are added to the already substantial portion of the population living in poverty[6]. In a number of cases, these transferred moneys are no doubt the premium earned by the public policy makers of the government of the country.

Methodology and Conceptual Framework

The paper follows descriptive approach by using secondary data of macroeconomic indicators in case of "Tax Culture and Deficit Financing" for a group of developed, newly industrialized, and developing countries for the period from 2014 to 2018 and 2015 to 2019. The data have been taken from website of the Asian Development Bank on Key Indicators for Asia

[6] Mark Schapiro (Center for Investigative Reporting, New York) and Frank Schröder (Friedrich-Ebert-Stiftung, New York Office (2003).

and the Pacific. The number of countries vary in each set of analysis depending on availability of data. While remaining two topics "Resource Sharing and Subsidies" are, solely covered through discussion (in narrative format) with support of literature due to data constraint. The study assumes that macroeconomic indicators are the appropriate yardsticks to gauge the performance of any country therefore a negative trend in macroeconomic indicators signals moral hazard problem in public policy makers. The public policy makers are the politicians and bureaucrats who are engaged in public policy making process of the country.

The conceptual framework is, based on the assumption that moral hazard problem in public policy makers exists due to low provision of monthly compensation (i.e., monthly take-home cash salary) as compared to the salary package available in the market. Moreover, there is no additional premium in terms of ownership of stocks in government system which exists in most, of the private firms. Under such circumstances, there may be a likelihood of manifestation of moral hazard problem in public policy makers (being agents) through temptation for generation of additional premium for themselves by making self-centered policy which would make colossal losses to the Public Exchequer leading to decrease in deliveries of public goods and services for the citizens (being principals) of the country.

The analysis in upcoming sections is based on the above assumption with the support of existing literature on the subject as follows.

Analysis

The literature discusses moral hazard problem in public policy makers in a very, interesting manner. For a layperson it may be not an easy task to comprehend it easily as agents involved under this setting are smart enough. In this perspective, Lane and Phillips (2001) while discussing the roles of International Monetary Fund (IMF) ascertain that IMF financing may create moral hazard however it is not easy to find clear evidence of such an effect. Some smart moves of public policy makers may be observed in foregoing discussions as: Tanzi and Blejer (1988) document that in a many instances governments borrow for consumption purposes as they could score political gains in short run by increasing subsidies or public employment without raising domestic revenues. The government obtains immediate political benefits by spending the proceeds of borrowing while the repayment of the debt is in the future and thus a successor government's problem. This public choice reason has certainly played a significant role in the growth of public debt. Lucas and Stokey (1983); Person and Svennson (1989) put forwarded their arguments on the same line that a government relies more on debt financing as she uses it as a tool to influence or constrain the decisions of future governments. It is no need to mention that the ultimate impact of

such policy implications creates distortion as the burden of current debt under this setup is, transferred to the future taxpayers who actually do not enjoy its benefit. For instance, Ihori (1988) highlights that debt finance benefits the existing older generation and hurts the future generation. Similarly, Rosen (1995) documents that burden of debt is, a tax incidence problem in an intergenerational setting. While Dornbusch et al. (2002), state that there is no fixed economic principle that describes what is fair and not fair in allocating burdens among generations. All stakeholders are unanimous and have strong views on how burdens should be shared across generations however they conclude at one point that policies of government creating distortions are actually the reflection of bad behaviour on part of public policy makers hence treating it as an emblematic of moral hazard problem in them may seem quite plausible. In forthcoming sub-sections, the roles of public policy makers signaling moral hazard problem in their self-centered policies and its impacts are discussed with the support of existing literature and available data of macroeconomic indicators wherever it is required.

Tax Culture

As mentioned earlier that supply side economy refers higher tax as a drag to the society because it reduces willingness to work and affects productivity negatively. Notwithstanding, it is also no need to mention that tax-culture is stronger in developed than the developing nations therefore the supply side approach under such situation does not seem more plausible. Actually, in real world the level of productivity does always remain at higher in developed as compared to developing countries wherein potential taxable capacity is likely to be higher than in the later (Congdon, 1987). The reasons behind it may be the better tax culture, efficient tax machineries, improved infrastructures, more transparency in tax laws/policies and a meaningful motivational approach mechanics. In developing countries, poor tax culture, inefficient tax machineries, weak infrastructures, less transparent tax laws/policies are common features, and irrational motivational approach mechanics. Hence, encroachment of tax domain among various tiers of the government, tax evasion, tax avoidance, overlapping/duplication of taxes are common. Their decisions are actually the reflection of their bad behaviour wherein demand and supply side approaches are used as a tool for the achievement of their own objectives without realizing losses to be suffered to the citizens being their principals gesticulating moral hazard problem in public policy makers.

It is conventional wisdom that a low tax to GDP ratio is symbolic for tax-avoidance, tax-evasion, inefficiency, and corruption in tax machineries. Policy makers under this setup are more inclined towards dependency on tax-rate increase instead of broadening the tax-base. The literature does not

support too much reliance on tax rate increase as the canon of taxation holds that taxation should depend on the capacity of the taxpayer to pay it. Moreover, the tax machineries are more inclined towards encroachment of tax jurisdiction other tiers of the government instead of increasing their own tax collection capacity through reforms. For instance, there are ample evidence that in a number of developing countries, the public policy makers at federal government attempt to grab sub-national, and local governments' tax jurisdiction and sub-national/state government try to capture local governments' tax mandate. The encroachment of tax jurisdiction creates dispute among national, sub-national, and local governments specifying duplication/overlapping in taxation system. Any duplication or overlapping in taxation may usually create additional burden of tax therefore the taxpayers entice to attempt for tax avoidance and tax evasion in connivance of tax collecting agencies. As a result, it creates a venue for the generation of some tax relief for the taxpayers as well as some premium for the tax collectors. As a result, the Public Exchequer suffers a colossal loss of revenues which reduces the quantity and quality of deliveries of public goods and services for the citizens of the country. This scenario shows a gain of an additional premium for agents (Public Policy makers/Tax Collecting Machineries/Tax Collectors) and a loss of deliveries of public goods and services for their principals who are no doubt the citizens of the country. The Agency Theory specifies it as 'moral hazard problem' in public policy makers being the agents of their citizens.

Figure 1 (see data at Annexure-I) reveals statistics of a group of 32 Asian Pacific Countries (APC) showing a comparative trend in tax collection as percentage of GDP in average of five years for a period from 2015 to 2019. The tax to GDP ratio in case of Armenia, Australia, Georgia, Japan, Kirgiz, Kiribati, Korea, Nepal, New Zealand, China, Tajikistan, Thailand, and Uzbekistan is at above 15% whereas in rest of the countries, it is less than 15% or even in some cases less than 9%. In this context conventional wisdom is that countries having a threshold of 15% or above of tax to GDP ratio may run its affairs more smoothly under ceteris paribus while, the countries having tax to GDP ratio less than 15% may usually need to compromise its economic goals and sometimes it may entrap with financial crisis. It is also no need to mention that trend in macroeconomic data of any country is self-explanatory as it reflects the performance of the country in accord to globally accepted proposition. The performance of the country may be tilted towards positive or negative direction subject to direction of the relevant policies which are made by the public policy makers. A persistent weak or negative trend in tax to GDP ratio usually signals problems in policy making, its implication and implementation, hence sensing moral hazard problem in public policy makers is inevitable.

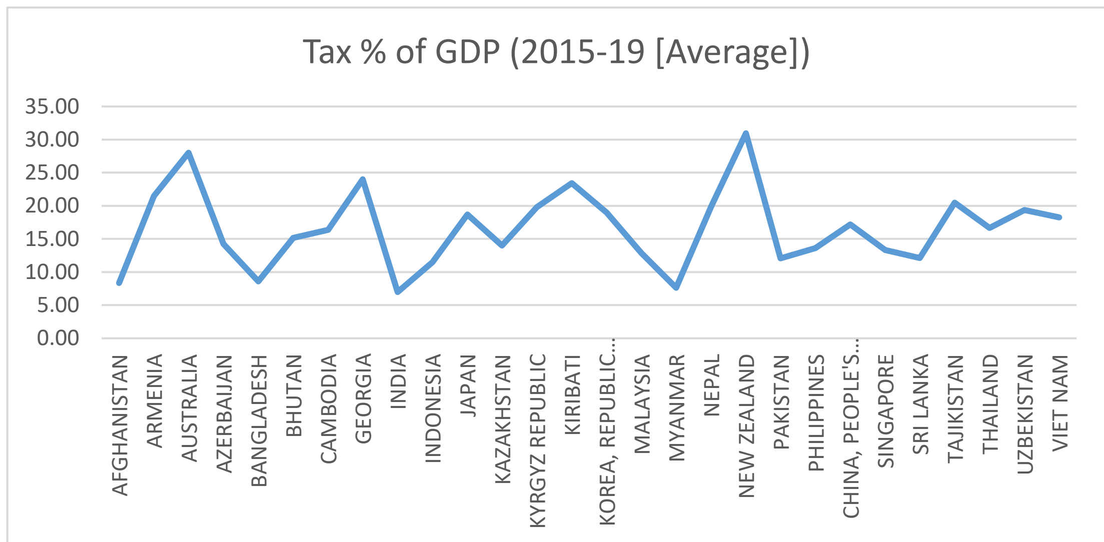

Figure 1. Tax as % of GDP

Deficit Financing

The need for deficit financing (i.e., debt finance) arises when government expenditure exceeds the revenue (i.e., budget deficit). An increase in budget deficit takes place either through an increase in expenditures under no change in tax rate or a reduction in tax rates when expenditures remain unchanged. It is a well-set rule in public finance that in conditions of full employment a budget deficit brought about by a reduction in the tax rate in the absence of any change in government spending can be financed either by issuing bonds or by printing money (Alam, 2007). The ambition of higher economic growth persuades government to embark on either any one of the aforementioned two options or both as an instrument for deficit financing. The literature on public finance highlights that decision between tax and debt finance is also a moral issue (Will, 1985a). Conventionally, the deficits would crowd out private investment and net exports increasing the government debt with an ultimate default as a serious preoccupation (Hernández-Catá, n.d.). In most of the developing countries the politically motivated government follows debt financing by taking advantage of demand or supply side approaches wherein a deficit financing increases aggregate demand or taxation induces a distortionary effect in the economy, respectively. The demand side economists hold that an increase in government expenditure increases aggregate demand that reduces unemployment rates and boosts the economy. The economists of supply side believe that higher tax is a drag to the society, and it reduces the willingness to work thus affects the productivity negatively.

In real world the demand or supply side approach may not be workable in all setups as the impact of fiscal policy varies between developed and developing nations and from country to country and it is also intertemporal. For instance, the Keynesian expansionary fiscal policy or demand-side approach was introduced during the Great Depression of 1932, and it was proved as popular to the greater extent. However, this approach could not conclude in successful expedition in several developing countries that underwent in financial crisis. The reasons could be linked with ethics/morals of the public policy makers who are more inclined towards their own interest while making a policy or taking a decision in public offices. Their policy is more leaning towards their own personal interest which may be the center point for the existence of moral hazard problem in a policy maker of public or private organization.

The literature on public finance highlights that in most of the cases, the political government extends subsidies to their own political workers without following the basic norms of public financial management. In many cases, loans are granted without any proper collateral that turns these loans in later stage as bad debt or non-performing loans. Further, no proper attention is given on project selection at the time the borrowing is made. Many government interventions focusing on to offset the losses of some members of society at the expense of the general taxpayer generate moral hazard as it results in distortionary costs for society, as a whole (Mussa, 2002). Moreover, Alam (2012) documents that policy makers at federal level usually take decisions on public debt management on short-term basis that usually focus on their own self-interest.

Figure-2 (see data at Annexure-II) reveals tax-expenditure gap (i.e., expenditure exceeding tax leading to deficit financing) for an average period of five years i.e., 2014 to 2018. Singapore is the only country which shows a slight increase in tax revenue over expenditure hence there is no need for deficit financing under this state of affairs. While rest of the countries depict an increase trend in expenditure exceeding tax implying a need for deficit financing. Especially Azerbaijan, Mongolia, and Japan reveal a tax-expenditure gap close to 20% of GDP.

The public policy makers when tackling fiscal policy generally uses Keynesians' expansionary fiscal policy. For instances, Sobel et al. (2006), document that in expansionary fiscal policy, an increase in government expenditure and/or a reduction in tax rates such that the expected size of the budget deficit expands. It means that expansionary fiscal policy focuses more on to increase in expenditure than to increase/innovation in tax thus it opens an avenue for borrowing as an ultimate source for filling the tax-expenditure gap. Rosen (1995) argues that political process tends to underestimate the costs of government spending and to overestimate the

benefits. It provides an opportunity for the public policy makers to achieve their own personal objectives as one can even deduce an assumption that an increase in expenditure increases the share of public policy makers in terms of bribe/kickbacks proportionately. Similarly, a decrease or no innovation in tax rate or a relief in terms of tax exemption may also generates some premium for public policy makers in connivance with taxpayers and it further attracts voters in nearby election. It is also expected that an increase in tax-expenditure gap may lead to reliance on deficit financing which is not much supportive under the norms of sound public financial management. As, a persistent deficit financing for a long period of time may usually lead the country to the path of debt trap (Alam, 2007), hence such policy may be tantamount to bad behaviour or moral hazard on part of public policy makers under Agency Theory.

Resource Sharing

Usually, there remains always a big dispute among federal, states, and local governments in most of the developing countries on distribution of resources out of the national divisible pool. Especially, in a crisis-ridden country, this issue becomes the matter of great concern, as the federal government, under such circumstances, tries to grab a bigger share out of the pool with the justification of national interest. The states and local governments, on the other hand, try to project their own constraints and usually they are reluctant to share any burden at national level. The evidence is quite visible in a group of countries which have been caught in public debt crisis (Alam, 2007). Since, in most of the developing countries, the Federal Government acts as the ultimate custodian of the domestic and foreign debt therefore it has more leverage to claim undue share out of the national divisible pool with a justification of heavy burden of servicing/retirement of national debt. Gurtner (2002) discusses this issue briefly in the context of national debt problem in Argentina. Rao (2000), while analyzing the resource distribution problem in case of India, concludes that the transfer system from the center to states has an inherent moral hazard problem.

Williams (2020), discusses moral hazard problem in US federal system especially with reference to federal aid to state governments and municipalities. He points out that despite federal government is the only agent that can backstop state revenues during a crisis, federal lawmakers have an incentive to abstain from doing so. Federal legislators may polish their reputations for budget discipline while state and local officials face the political price for layoffs and cuts. With this in mind, it is not possible for states to be exemplified as the agents in a moral hazard problem. When the economy collapses, their bankruptcy is not their fault. Given the highly procyclical nature of both their income and expenditure streams, they face an

acute capital structure trap in an economic downturn (Pettis 2001). He further argues that the only agent capable of providing them insurance against this capital structure trap—capable of delivering them with an associated capital structure—is the federal government. With this shift in mind, there is clearly still a moral hazard problem, although a quite different one from that presented by the fiscal federalism literature.

The procyclical rejoinder by state governments exacerbates the recession locally, as the government lays off workers and inhibits spending at the same time as the private sector. This redounds on the tax base available to the state government, which pushes a further round of cost-cutting. This process mimics Pettis's account of the capital structure trap, where traders are compelled into counterproductive, procyclical positions by virtue of their expenses rising at the same time as their incomes fall (Pettis, 2001). The only entity capable of providing a counterbalance that would halt this process is the federal government. At this point, moral hazard resurfaces. Politicians at the federal level conceit themselves on spending as little money as possible, in the name of "sound finance" and "deficit reduction" (Henwood, 2019). They consider themselves liable for—and their voters hold them accountable for—national outcomes. Federal-level politicians are able to avoid guilt for the fiscal crises of state governments by arguing that the state governments are living above their means and undeserving of a bailout by the federal government. They can influence state governments to engage in counterproductive austerity, safe in the knowledge that its catastrophe as economic policy will not impact them politically.

This is a classic principal–agent problem. The federal government is the only body that can diminish the capital structure trap of state governments, but its enticements are such that its decisionmakers gain from aggravating the capital structure trap. The moral hazard problem in a modern federation is one in which the federal government is the only entity that can deliver state governments the tools they can use to defend themselves from economic conditions outside of their control, but that same federal government has an enticement structure that keeps them from delivering these tools to state governments. This is fundamentally different from the perception of moral hazard as concentrated benefit and dispersed cost within the fiscal federalism literature. From a theoretical point of view, the only way to solve this truly operative moral hazard problem is to buckle the hands of legislators (Williams 2020a, 2020b).

Willaim (2020) discusses that to the extent there are principled objections to the federal government delivering financial assistance to states, they manage to put on faulty theoretical grounds. Although sometimes framed in its biased form as "bailing out high-spending blue states." If state governments form beliefs that they can trust upon federal support, so the

conventional argument goes, they will have an enticement to spend beyond their means. The federal fiscal aid generates moral hazard. The fundamental flaw of this moral hazard objection, in formal terms, rests on a premise that state governments are “agents” in a principal–agent problem. This study in this perspective believes that none of the government at any tier can be claimed as “principal” for itself in accord to any set of doctrine as only citizen of a country is the true “principal” in all situations as he (citizen) sponsors all expenses to run the affairs of the government through taxes and fees (see, the “Principal-Agent Doctrine” in methodology discussed earlier).

Subsidies

A subsidy is an enticement provided by the government to individuals or businesses in the form of cash, grants, or tax breaks that enhance the supply of certain goods and services. It is an instrument through which consumers can get access to cheaper products and commodities. Schwartz and Clements (1999) document that governments deliver subsidies to accomplish different policy objectives, including compensating market imperfections, manipulating economies of scale, and meeting various social policy objectives. The literature in this background emphasises that government employs subsidies as a tool to accomplish its political objectives. In most cases, it offers subsidies to a target group in order to achieve its political objectives without recognizing its long-term influence on the economy of the country. Their only intention is to obtain political support from the beneficiaries of such subsidies. It is no need to mention that such helps from the government to a particular group of citizens usually promote a distortionary impact on taxpayers who do not receive these relieves in return.

Schwartz and Clements (1999) state that subsidies enforce a substantial burden on the economy, both in terms of fiscal costs and adverse effects on efficiency. They also speak out that in the appraisal of fiscal burden of subsidies and preferences for reform, it is essential to concentrate on improving transparency, boosting cost effectiveness, restricting duration, bolstering cost control, and choosing a rational approach to subsidy policies. While economic considerations suggest that subsidies can only be justified under extremely specific situations; in most cases where subsidies have been used, they would be challenging to justify on merely economic grounds. In practice, subsidy programs are often expensive in terms of their fiscal and quasi-fiscal burdens and the distortions they cause in resource allocation and are not very effective in reaching their expected target group of recipients.

The literature also underlines that subsidy may sometimes have undesirable enticement effects. For instance, Grosh (1994) evaluated six (06) studies on general food price subsidies and observed that the benefit incidence was regressive in each case, in the sense that the subsidy benefitted

the rich more than the poor in absolute terms. Similarly, Pinstrup-Andersen (1988) analyzed food subsidy programs in a number of countries, and discovered that, in absolute terms, higher-income households usually received more benefits than lower-income groups. In another study, Petrei (1987) found that, in Latin America, water and sewage subsidies were heavily skewed toward upper income groups. Also, in Bangladesh, a lopsided share of infrastructure subsidies was garnered by the nonpoor (World Bank, 1994a). Previous research on government subsidies has often created in national administrations, and mostly been forced by concerns that subsidies and other special benefit programs were turning out of control. Putting it more candidly, and possibly resonating public sentiment, a recent article concluded that `where there are subsidies, there will be fraud' (The Economist, 1994; as cited in Schwartz & Clements, 1999).

In a number of instances, governments do not seem benevolent or welfare oriented while initiating a subsidy programme however its main objective is to compensate the failures. It is likely that by such interference, the allocative mechanism may withstand some distortion concluding to either market failure, or policy failure, or both. For instance, Mussa (2002) mentions that many government interventions focusing on to offset the losses of some members of society at the expense of the general taxpayer generate moral hazard as it results in distortionary costs for society. There is a plenty of literatures on this subject highlighting moral hazard problem in policy makers in the government who, design such kind of relief package just to achieve their own political objectives.

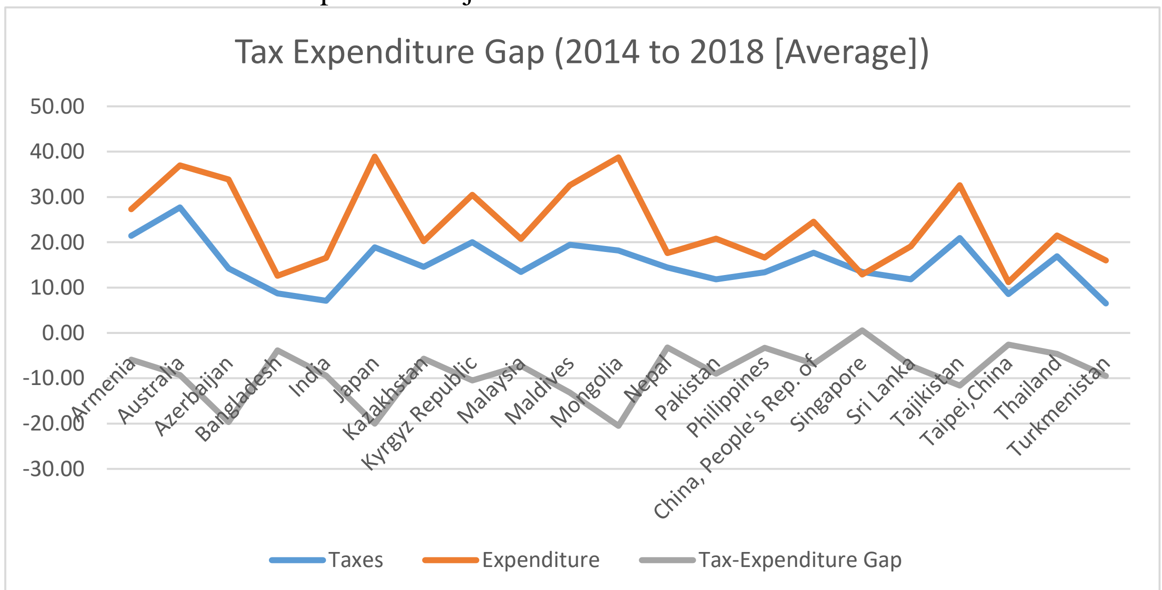

Figure 2. Tax Expenditure Gap

Conclusion

The menace of moral hazard problem can be lessened through a proper Reward Punishment Approach (RPA). Under existing setup, a weak compensation system with severe punishment mechanics indicates flaws in PRA which needs improvement through reforms in existing RPA. This paper recommends, to bring the compensation system (i.e., take home salary in terms of cash & a provision of additional premium) at par with market-based package along with various perquisites. The study expects a bare minimum financial implication which may be affordable for the government and decrease in moral hazard problem at least to some extent, leading to a better delivery of public goods and services for the citizens of the country.

It could not be possible for this study to cover the subject more thoroughly due to data constraint therefore it could only portray a limited and macro level approach on tax culture, deficit financing, resource sharing and subsidies. In this perspective, for instance, it followed descriptive approach by using secondary data of macroeconomic indicators in case of tax culture and deficit financing, while remaining two topics resource sharing and subsidies were solely covered through discussion in narrative format. Accordingly, an empirical attempt on the aforementioned topics for future research is recommended. Moreover, a case study of public and private sectors may reveal some interesting and unique aspects of moral hazard problem in both of these sectors.

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Annexure-I % of GDP (2015-19-Average)	
Countries	Taxes
Afghanistan	8.37
Armenia	21.48
Australia	28.03
Azerbaijan	14.23
Bangladesh	8.59
Bhutan	15.15
Cambodia	16.40
Georgia	23.99
India	6.98
Indonesia	11.49
Japan	18.68
Kazakhstan	14.01
Kyrgyz Republic	19.79
Kiribati	23.45
Korea, Republic of	19.01
Malaysia	12.91
Myanmar	7.64
Nepal	19.85
New Zealand	30.96
Pakistan	12.09
Philippines	13.64
China, People's Republic of	17.20
Singapore	13.35
Sri lanka	12.13
Tajikistan	20.48
Thailand	16.66
Uzbekistan	19.36
Viet nam	18.25

Annexure-II % of GDP (2014-18-Average)			
Countries	Taxes	Expenditure	Tax-Expenditure Gap
Armenia	21.41	27.32	-5.90
Australia	27.70	36.95	-9.26
Azerbaijan	14.24	33.87	-19.63
Bangladesh	8.74	12.60	-3.86
India	7.093	16.54	-9.45
Japan	18.88	38.90	-20.01
Kazakhstan	14.56	20.22	-5.66
Kyrgyz Republic	19.99	30.47	-10.48
Malaysia	13.49	20.73	-7.25
Maldives	19.44	32.60	-13.16
Mongolia	18.21	38.72	-20.51
Nepal	14.45	17.65	-3.20
Pakistan	11.80	20.83	-9.03
Philippines	13.35	16.64	-3.29
China, People's Rep. of	17.70	24.54	-6.85
Singapore	13.44	12.88	0.57
Sri Lanka	11.83	19.09	-7.26
Tajikistan	20.95	32.56	-11.61
Taipei, China	8.61	11.20	-2.59
Thailand	16.88	21.47	-4.59
Turkmenistan	6.51	15.98	-9.47