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Moral Hazard Problem in Public Policymakers

Noor Alam, PhD
Retired Civil Servant, Government of Sindh, Karachi, Pakistan

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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 compared to their counterparts in private firms, which weakens the proprietorship of their organization. Since there is a principal-agent relationship between citizens and public policymakers, a loss in public goods and services to citizens signals a meaningful level of moral hazard problem in public policymakers as 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 focuses on bringing the compensation system (i.e., take-home salary in terms of cash and 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 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

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Introduction

Moral hazard problem appears more frequently in public policymakers because they are usually not the stakeholders. Furthermore, they do not enjoy any additional premium that is in vogue in terms of ownership of stocks in most private firms. The principle of agency theory categorizes these public policymakers as agents of the citizens of a country who are no doubt their principals. The moral hazard problem is a common feature in economics and finance, where the 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 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. It is the prime objective of the agent that he/she should take a decision to safeguard the interest of his principal at any cost. Nevertheless, this is not the case in real life, 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, any deviation in their behaviour against set norms raises the issue of moral hazard, which is 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. On the other hand, hazard stands for risk[1] and identifies 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 symbolic for desirability, while bad behaviour usually leads to undesirability. This is because societies generally prefer to avoid taking risky decisions 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 that principal/agent problem exists everywhere in private firms, universities, government organizations, etc.

[1]Concise Oxford English Dictionary.

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(Jenson & Meckling, 1976). Gallagher and Andrew (2003) refer to the principal/agent problem 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 policymakers 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 policymakers are categorized as agents of the citizens of a country by the agency theory which makes the citizens their principals. At times, these agents take 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, a loss in public goods and services to citizens signals meaningful level of moral hazard problem in public policy makers as 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, which linked 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 to 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 originate in the economic literature but in business insurance. He further discusses that before entering the economic literature, moral hazard was a business insurance concept where personal characteristics and morality had a role to play in the manifestation of

[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.

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the phenomenon. In contrast, the economics of moral hazard are solely focused on incentives, which is free of value judgments and character.

Literature traces back the dynamic modeling of the moral hazard envisioned by Becker and Stigler (1974), while 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 a motivational approach to offer better rewards for good performance of 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 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. This is 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 a milestone opening a floodgate of research on this subject in later stage, thereby leading to a marathon of debate on the roles of public policymakers. For instance, while discussing public debt management of a group of Asian Pacific Developing Countries (APDC) under debt trap, Alam (2007) documents that policymakers of these countries usually take decisions on short-term basis while focusing on 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 accordance with conventional wisdom, these measures can only reduce the visibility of the gravity of the prevailing crisis for the time being. Nevertheless, as an ultimate effect in the long run, it creates a unique trap of 'debt burden shifting' that does not follow the path of established norms. Conclusively, Alam (2007) raises a question of concern "Whether such debt burden shifting could be viewed as an administrative tool or simply as a reflection of moral hazard behavior? It is worth mentioning that literature on this subject reveals significant degree of

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[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.

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moral hazard problem in public policymakers as their policies are generally focused on their own interest or more specifically too much self-centeredness.

Similarly, the literature with reference to the failure of Lehman Brothers during the 2008 financial crisis highlights that it is 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. According to Allen et al. (2015), the introduction of government guarantees does not always stimulate banks to take excessive risk with the outcome that 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 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. Subsequently, the source of moral hazard in the model of Ghosal and Miller (2002) reveals 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. However, good effort implies that default only occurs with the bad exogenous shock while bad effort implies that default is inevitable. For example, good effort could relate to a situation where money is borrowed and used to build up R&D in the export sector to help the country internationally. Bad effort might relate to shifting borrowed money to rich people who put it in tax havens overseas, which exposes the country to currency risk and the budget to a loss of tax revenue.

In another study, Hernández-Catá (n.d.) contends that diversion of domestic or external funds originally appropriated for government investment into consumption by public policymakers is rampant which is done in connivance with their private sector accomplices and international donor agencies. In some cases, they do not reflect such changes in diversion of funds in official government consumption statistics as they succeed in hiding these changes. As a result, 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 where 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, which indicates

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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.

Additionally, the role of international lending agencies facilitate and encourage moral hazard problem in public policymakers (Corsetti, Guimaraes & Roubini, 2003). While critically analyzing the official lending, the researchers point out that official lending also causes moral hazard distortions through bailout package extended by the International Monetary Fund(IMF). Generally, the debtor countries have weak incentives to implement good but costly policies, which amplifies 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: 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 established offense 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 tax crime was. 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]

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

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

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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 from residents and foreign-owned capital. In developing 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 depend. The offshore system has also added to the rising occurrence of financial crises that obliterate businesses in developing countries. The recent financial crises in East Asia, Russia, Turkey, and Argentina illustrate 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 many cases, these transferred moneys are 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 the case of "Tax Culture and Deficit Financing" for a group of developed, newly industrialized, and developing countries from 2014 to 2018 and 2015 to 2019. The data have been taken from the website of the Asian Development Bank on Key Indicators for Asia and the Pacific 2021. The number of countries vary in each set of analysis depending on availability of data. Also, the 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 policymakers. The public policymakers 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 policymakers exists due to low provision of monthly

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

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compensation (i.e., monthly take-home cash salary) compared to the salary package available in the market. Furthermore, there is no additional premium in terms of ownership of stocks in the government system which exists in most private firms. Under such circumstances, there may be a likelihood of manifestation of moral hazard problem in public policymakers (being agents) through generation of additional premium for themselves by making self-centered policy. This would result to 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 policymakers 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, while discussing the roles of International Monetary Fund (IMF), Lane and Phillips (2001) ascertain that IMF financing may create moral hazard. However, it is difficult to find clear evidence of such an effect. Some smart moves of public policymakers may be observed in foregoing discussions. Tanzi and Blejer (1988) document that, in the 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 debt repayment is in the future, which creates problems for the next government. This public choice reason has certainly played a significant role in the growth of public debt. In this context, Lucas and Stokey (1983) and Person and Svennson (1989) put forward their arguments on the same line that a government relies more on debt financing since it is used as a tool to influence or constrain the decisions of future governments. Accordingly, the ultimate impact of such policy implications creates distortion as the burden of current debt under this setup is transferred to future taxpayers who 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 the burden of debt is a tax incidence problem in an intergenerational setting. 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 that create distortions are actually the reflection of bad behaviour on the part of public policymakers. Hence, treating it as an emblematic moral hazard problem may seem quite plausible. In forthcoming sub-sections, the roles of public

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policymakers in signaling moral hazard problem in their self-centered policies and its impacts are discussed with the support of existing literature and available data on macroeconomic indicators wherever it is required.

Tax Culture

As mentioned earlier, supply-side economy refers to higher tax as a strain to the society because it reduces willingness to work and affects productivity negatively. Notwithstanding, the tax culture is stronger in developed nations than in developing nations. Therefore, the supply-side approach in such a situation does not seem more plausible. In real world, the level of productivity always remains at a higher level in developed countries compared to developing countries where potential taxable capacity is likely to be higher (Congdon, 1987). The reasons 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, and less transparent tax laws/policies and irrational motivational approach mechanics are common features. Hence, encroachment of tax domain among various tiers of the government, tax evasion, tax avoidance, and overlapping/duplication of taxes are common. Their decisions reflect their bad behaviour where demand and supply-side approaches are used as a tool to achieve their own objectives. This is done without realizing the losses to be suffered by the citizens, thus gesticulating moral hazard problem in public policymakers.

It is conventional wisdom that a low tax to GDP ratio is symbolic for tax-avoidance, tax-evasion, inefficiency, and corruption in tax machineries. Policymakers 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 states that taxation should depend on the capacity of the taxpayer to pay it. In addition, the tax machineries are more inclined towards encroachment of tax jurisdiction in other tiers of the government instead of increasing their own tax collection capacity through reforms. For instance, there is ample evidence that in several developing countries, the public policymakers at federal government attempt to grab sub-national and local governments' tax jurisdiction, while 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 usually create additional burden of tax. Therefore, the taxpayers connive with agencies to evade tax payment. As a result, it creates an avenue to generate some tax relief for the taxpayers as well as some premium for the

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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 the advantage of an additional premium for agents (Public Policy Makers/Tax Collecting Machineries/Tax Collectors) and loss of deliveries of public goods and services for their principals who are the citizens of the country. The agency theory specifies it as 'moral hazard problem' in public policymakers as agents of their citizens.

Figure 1 (see data at Annexure-I) reveals statistics of a group of 32 Asian Pacific Countries (APC), which shows a comparative trend in tax collection as a percentage of GDP within five years from 2015 to 2019. The tax to GDP ratio in the case of Armenia, Australia, Georgia, Japan, Kirgiz, Kiribati, Korea, Nepal, New Zealand, China, Tajikistan, Thailand, and Uzbekistan is above 15%. On the other hand, it is less than 15% or in some cases less than 9% in other countries. 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 countries having tax to GDP ratio less than 15% may need to compromise its economic goals which could lead to financial crisis. Furthermore, the trend in macroeconomic data of any country is self-explanatory as it reflects the performance of the country in accordance with 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 policymakers. 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 policymakers is inevitable.

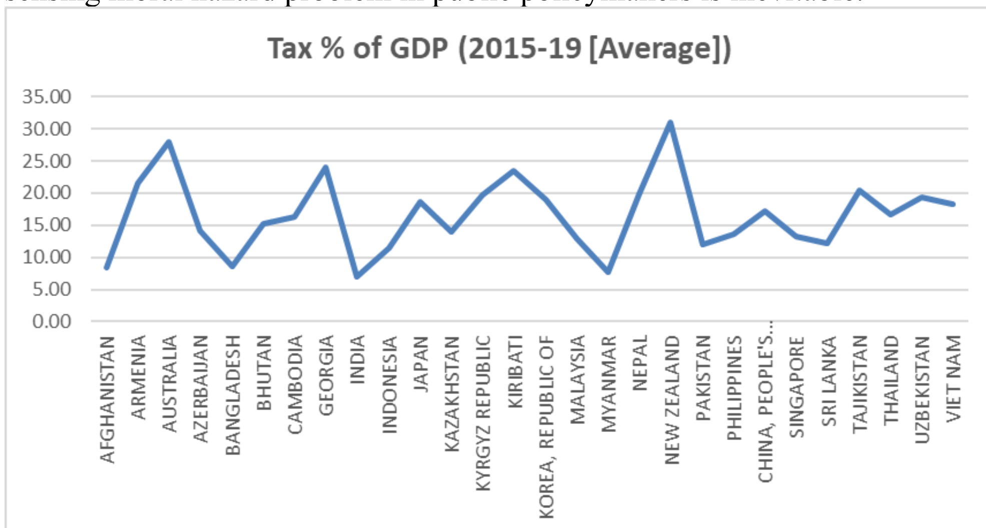

Figure 1. Tax as % of GDP

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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 any 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, thus increasing the government debt with an ultimate default as a serious preoccupation (Hernández-Catá, n.d.). In most developing countries, the politically motivated government follows debt financing by taking advantage of demand or supply-side approaches where a deficit financing increases aggregate demand or taxation induces a distortionary effect in the economy respectively. The demand side economists state that an increase in government expenditure increases aggregate demand, which reduces unemployment rates and boosts the economy. The economists of supply side approach believe that higher tax is a strain to the society. This reduces the willingness to work and affects 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 popular to a great extent. However, this approach could not conclude in successful expedition in several developing countries that underwent financial crisis. The reasons could be linked with ethics/morals of the public policymakers 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 policymaker of public or private organization.

In most cases, the literature on public finance highlights that the political government extends subsidies to their political workers without following the basic norms of public financial management. In many cases, loans are granted without any proper collateral. These loans turn out as bad debt or non-performing loans. Furthermore, no proper attention is given on

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project selection at the time the borrowing is made. Many government interventions that focus on offsetting 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). Furthermore, Alam (2012) documents that policymakers 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 with a slight increase in tax revenue over expenditure. Hence, there is no need for deficit financing under this state of affairs. Nonetheless, other countries depict an increasing trend in expenditure exceeding tax, implying a need for deficit financing. Azerbaijan, Mongolia, and Japan reveal a tax-expenditure gap close to 20% of GDP.

The public policy makers when tackling fiscal policy generally use Keynesians' expansionary fiscal policy. For instance, Sobel et al. (2006) documents that in expansionary fiscal policy, an increase in government expenditure and/or a reduction in tax rates is done in such a way that the expected size of the budget deficit still expands. This means that expansionary fiscal policy focuses more on increasing expenditure than increasing/innovating 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 overestimate the benefits. Hence, it provides an opportunity for the public policymakers to achieve their objectives as one can even deduce an assumption that an increase in expenditure increases the share of public policymakers 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 generate some premium for public policy makers in connivance with taxpayers and further attract 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 supportive under the norms of sound public financial management. A persistent deficit financing for a long time may lead the country to the path of a debt trap (Alam, 2007). Hence, such policy may be tantamount to bad behaviour or moral hazard on the part of public policymakers under agency theory.

Resource Sharing

Usually, there remains a big dispute among federal, states, and local governments in most developing countries on distribution of resources out of the national divisible pool. In a crisis-ridden country, this issue becomes a

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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 are usually 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). In most 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. While analyzing the resource distribution problem. In case of India, Rao (2000) concludes that the transfer system from the center to states has an inherent moral hazard problem.

Williams (2020) discusses the moral hazard problem in US federal system with reference to federal aid to state governments and municipalities. He points out that although the federal government is the only agent that can backstop state revenues during a crisis, federal lawmakers have the 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 federal government is the only agent capable of providing them insurance against this capital structure trap and delivering them with an associated capital structure. With this shift in mind, there is still a moral hazard problem, quite different from that presented by the fiscal federalism literature.

The procyclical rejoinder by state governments exacerbates the recession locally since the government lays off workers and inhibits spending at the same time as the private sector. This redounds on the tax 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

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above their means and undeserving of a bailout by the federal government. They can influence state governments to engage in counterproductive austerity since 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. Nevertheless, its enticements are such that its decision makers 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 to state governments the tools they can use to defend themselves from economic conditions outside of their control. However, the 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 a 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 there are principled objections to the federal government delivering financial assistance to states as they manage to put on faulty theoretical grounds. Although it is framed sometimes in its biased form as "bailing out high-spending blue states." If state governments form beliefs that they can trust federal support based on conventional argument, 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 the 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 claim "principal" for itself in accordance to any set of doctrine. This is because only the citizen of a country is the true "principal" in all situations as they (citizen) sponsor all expenses to run the affairs of the government through taxes and fees.

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

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country. Their only intention is to obtain political support from the beneficiaries of such subsidies. Receiving such helps from the government to a particular group of citizens usually promotes a distortionary impact on taxpayers who do not receive these reliefs 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. Furthermore, they are ineffective 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, such 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 been created in national administrations and has mostly been forced by concerns that subsidies and other special benefit programs were turning out of control. Putting it more candidly and possibly resonating with 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 several instances, governments do not seem benevolent or welfare oriented while initiating a subsidy programme. However, its main objective is to compensate for the failures. By such interference, the allocative mechanism may withstand some distortion such as market failure, policy failure or both. For instance, Mussa (2002) mentions that many government interventions focus on offsetting the losses of some members of society at the expense of the general taxpayer may generate moral hazard as it results in distortionary costs for society. There are many literatures on this subject highlighting moral

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hazard problem in policymakers in the government who design such kind of relief package to achieve their own political objectives.

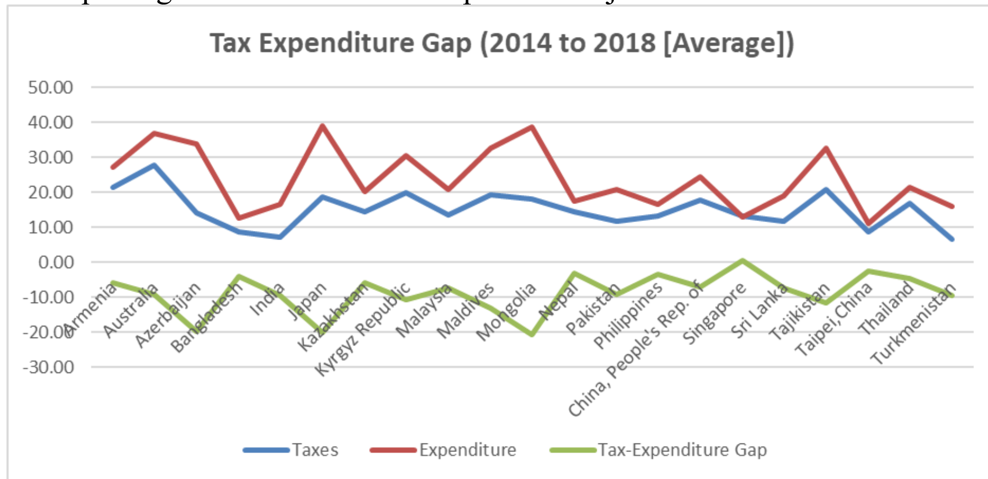

Figure 2. Tax Expenditure Gap

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 bringing the compensation system (i.e., take-home salary in terms of cash and 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 in order to decrease moral hazard problem to some extent, thus leading to a better delivery of public goods and services for the citizens of the country.

This study could not cover the subject more thoroughly due to data constraint. Thus, it could only portray a limited and macro level approach on tax culture, deficit financing, resource sharing, and subsidies. Descriptive approach was used through secondary data of macroeconomic indicators in the case of tax culture and deficit financing, Also, the 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. Furthermore, a case study of public and private sectors may reveal some interesting and unique aspects of moral hazard problem in both 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
Republic of Korea	19.01
Malaysia	12.91
Myanmar	7.64
Nepal	19.85
New Zealand	30.96
Pakistan	12.09
Philippines	13.64
People's Republic of China	17.20
Singapore	13.35
Sri lanka	12.13
Tajikistan	20.48
Thailand	16.66
Uzbekistan	19.36
Viet nam	18.25

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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
People's Republic of China	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