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### GOVERNMENT AUDITS

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### ABSTRACT

Audits are a common mechanism used by governments to monitor public spending. In this paper, we discuss the effectiveness of auditing with theory and empirics. In our model, the value of audits depends on both the underlying presence of abuse and the government's ability to observe it and enforce punishments, making auditing most effective in middling state-capacity environments. Consistent with this theory, we survey all the existing credibly causal studies and show that government audits seem to have positive effects mostly in middle-state-capacity environments like Brazil. We present new empirical evidence from American city governments, a high-capacity and low-impropriety environment. Using a previously unexplored threshold in federal audit rules and a dynamic regression discontinuity framework, we estimate the effects of these audits on American city finance and find no marginal effect of audits.

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## 1 Introduction

Governments worldwide provide goods and services financed via public money and are thus concerned about improving efficiency and reducing waste in public spending. Most governments are highly decentralized, so a substantial share of public spending is managed directly by local governments. While decentralization is commonly thought to improve public service delivery (Bank 2003), it also poses agency problems (Bardhan and Mookherjee 2006). Local officials might have diverging preferences and conflicting incentives from national ones (Shleifer and Vishny 1993, Bardhan 2002, Besley, Pande, Rahman and Rao 2004), leading to the arousal of forms of active waste (i.e. corruption or fraud) and passive waste (i.e. inefficiencies) (Bandiera, Prat and Valletti 2009).<sup>1</sup>

Audits are a common mechanism to ensure accountability in the management of public funds, particularly in decentralized organizations.<sup>2</sup> While commonly used, audits are costly and do not always produce valuable results. In 2015, for example, the Canadian government spent \$23.6 million to audit its Senate and only uncovered less than \$1 Million of improper spending (Press 2015). When deciding whether or not to introduce audit requirements, or to expand audit efforts, governments face a trade-off between accountability and an efficient use of resources. The effectiveness of audits may vary between institutional environments in which they are conducted- both among poorer and wealthier nations, or between betterand worse-performing organizations within a single government. While the existing empirical literature has largely found audits to be beneficial, these benefits may be highly contextual to the circumstances in which they have been studied: moderate government capacity environments, which may be non-representative.

In this paper, we use theory and empirics to examine the effectiveness of internal government audits as a function of state capacity. We start by providing evidence from theory, developing a new model of when governments should audit their bureaucrats. Importantly, we focus on internal government audits, as opposed to tax or third-party audits, but our findings about the value of audits have natural extensions to those cases.<sup>3</sup> Next, we review past literature to discuss the effectiveness of audits as a function of state capacity. Finally,

<sup>&</sup>lt;sup>1</sup>According to Bandiera et al. (2009), active waste is such that it entails direct or indirect benefit for the public decision maker, while passive waste does not. Passive waste might arise as a result of officials' lack of skills or lack of incentives to achieve efficient spending.

<sup>&</sup>lt;sup>2</sup>Another common tool is the use of laws and regulations. For a review of the trade-offs involved in constraining public officials' discretion with regulation and their relationship with state capacity, see Bosio, Djankov, Glaeser and Shleifer (2022).

 $<sup>^{3}</sup>$ We also abstract from other types of monitoring undertaken directly by citizens (Olken 2007, Pande 2011) and/or the media, as they entail different types of trade-offs and do not pertain to the organizational design of government institutions.

we present novel empirical evidence using quasi-experimental US audits.

The trade-offs involved in agency relationships within governments and the role of monitoring have historically attracted large theoretical attention (Tirole 1986, Kofman and Lawarrée 1993, Mookherjee and Png 1995, Laffont and Martimort 1998, Mookherjee 2006). However, most of the literature has focused on monitoring issues within organizations but has abstracted from modeling the determinants of effectiveness in supervisory relationships across organizations.

Our new model of optimal government auditing discusses the conditions under which governments should conduct internal audits. The value of audits depends on two factors: the underlying level of waste the audit can detect, and the ability to respond to audit findings. The size of bad behavior is negatively correlated with state capacity (Shleifer and Vishny 1993, Banerjee 1997), while the ability to respond to audit findings is increasing in state capacity, which indicates that auditing will be most effective in middling-capacity environments or countries. When state capacity is low, and the highest levels of impropriety are present, governments tend to have little ability to respond to the findings of audits by imposing and enforcing punishment. In these contexts, rather than being beneficial, the presence of audits may create further opportunities for abuse, by giving incentives to the officials in charge of performing audits to take bribes or extort the targets of audits (Khalil, Lawarrée and Yun 2010, Angelucci and Russo 2022). When state capacity is high, and the lowest levels of bad behavior are present, audits are costly and without much benefit as there is little to detect, as in the Canadian example above. In this context, audits might be detrimental, leading to excessive regulatory burden and producing passive waste (Kelman 1990; 2005). Our model explores this trade-off and shows that audits are wasteful in circumstances of very high or very low state capacity.

Auditing of governments has garnered much attention in both the economics and accounting literature, with most studies exploring the effects of individual auditing programs. Section 3 compares these single-country studies, using estimates from the literature as data on the effectiveness of audits in different environments. We show that these patterns match our model, with audits being most effective in middle-capacity countries where there is both enough bad behavior to detect and also sufficient government capacity to respond to these findings. However, there is very little evidence on audit effectiveness in both high-capacity and low-capacity contexts.

To help fill this gap in the literature, and in support of our theoretical findings, we present evidence from the U.S. context using a previously-unexplored discontinuity. We exploit the federal mandate that requires cities receiving revenue from the federal government above a threshold to perform a Single Audit, wherein they hire a third-party firm to audit the city's spending.

We implement a dynamic regression discontinuity design in line with Cellini, Ferreira and Rothstein (2010). The first stage of our regression discontinuity shows that crossing the threshold increases audit likelihood by 20%, with no evidence of strategic sorting. However, our results show that these quasi-random audits have precise 0 effects on city finances, including revenues, taxes, and administrative expenditures. This suggests that the US is on the right side of the state capacity vs. audit value curve, where the value of auditing is low.

Our discussion then extends to the policy implications of audit effectiveness. The lack of effectiveness of US city audits indicates the federal government can raise the threshold above which cities can be audited, saving resources without compromising city integrity. We discuss the appropriateness of audits in low and high-state capacity countries, as well as the other governmental factors that function as complements or substitutes to auditing.

This paper relates to three existing strands of the literature. First, we relate to the body of work studying the role of audits as an anti-corruption tool (e.g., Ferraz and Finan (2008)). Next, our work is also related to a large literature studying the determinants of the effectiveness of audits and other audit programs (e.g., Shi (2022), Vannutelli (2022), Montenegro (2020)). While a vast literature has focused on specific programs and provided micro-evidence on conditions conducive to effective auditing, little work has considered the overall circumstances required for audits to succeed. Lastly, we speak to the more general literature thinking about the organization of the state and the regulation of public spending (e.g., Bandiera et al. (2009), Bosio et al. (2022)).

### 2 The Value of Audits

We present a simple model that discusses the value of government audits as a function of state capacity. The intuition of the model is simple: the effectiveness of audits depends on two components. First, the presence of abuse, and second, the ability to detect and enforce punishment against that behavior. The underlying level of abuse is negatively correlated with state capacity, and the ability to enforce is positively correlated with state capacity. Therefore, audits are most effective when the government has middling levels of state capacity.

This model is related to several other theoretical discussions of auditing and government capacity, although it is unique it in its focus on the relationship between these phenomena. Most closely, Ortner and Chassang (2018) discuss a model of auditing where a principal-agent relationship is moderated by a monitor, such as an auditor, and where the auditor can collude with the agent. Bosio et al. (2022) discuss public sector capacity in a way that is

similar to our metric of state capacity, and show the relationship between state capacity and optimal procurement rules, a different dimension along which governments seek to inhibit bad behavior.

### 2.1 When should governments audit?

Consider a central government of type  $s \in \mathbb{R}$ , reflecting state capacity. The government presides over a local agent that engages in abuse  $c \in \{0, 1\}$  with probability  $p_c(s)$  that c = 1. The abuse of the agent can be thought of as either waste, intentional mismanagement, or corruption. This probability follows  $p'_c(s) < 0$ : as state capacity s increases, the share of bad agents diminishes, and so does the probability that any agent is bad. Abuse is costly to the government: when c = 1, the government pays a cost  $\pi_c$ .

The government has a choice of whether to audit the agent, at a cost of a(s). Note that we allow the cost function to vary with state capacity. Audits allow the government to observe the otherwise-unknown value of c. If c = 1 is revealed by the audit, the government then undertakes enforcement action, and if c = 0, the government does nothing. Enforcement has a probability  $p_e(s) \in (0, 1)$  of success. The probability of successful enforcement is increasing in state capacity, with  $p'_e(s) > 0$ . When the enforcement is successful, the government recovers k from the agent, where  $k \geq \pi_C$ .

Should the government undertake the audit?

The government's expected payouts if it conducts the audit are:

$$-a(s) + p_c(s) \times \left[-\pi_C + p_e(s)k\right]$$

The government's expected payouts if it does not audit are:

$$p_c(s) \times (-\pi_C)$$

Therefore, to maximize expected value, the government should audit if:

$$-a(s) + p_c(s) \times [-\pi_C + p_e(s)k] > p_c(s) \times (-\pi_C)$$
$$-a(s) + p_c(s)p_e(s)k > 0$$
$$p_c(s)p_e(s)k > a(s)$$

Both  $p_c$  and  $p_e$  are functions of state capacity, with  $p_c$  decreasing in s and  $p_e$  increasing in s. When state capacity is very high,  $p_c(s)$  is low, shrinking the left term, meaning the central government has little to gain from audits because there is no abuse to detect. When state capacity is very low,  $p_e(s)$  is low, and thus the central government has little to gain from audits because the probability of successful enforcement is small. Audits are thus most effective for middle ranges of  $p_c(s)$  and  $p_e(s)$ .

Figure 1 displays the main intuition of our model, as it relates the value of audits with state capacity. Our theory produces an upside-down U-curve, reflecting the fact that audits are most valuable in middle-state-capacity contexts. On the left-hand side of the graph, the value is low due to the limited ability to enforce when audits find bad behavior. On the right-hand side of the graph, while enforcement capacity is high, there is limited abuse to detect, diminishing the value of audits.

### 2.2 Empirical Evidence in Support of the Model

Our model relies on two main ideas: that the underlying level of abuse to detect is decreasing in state capacity, and that the ability to respond to audits is increasing in state capacity.

Figure 2 presents empirical evidence in support of these ideas. On the X-axis, we measure state capacity using the World Bank government effectiveness measure, a measure also used by Bosio et al. (2022). In the left panel, we look at how a measure of audit responsiveness varies with state capacity. The measure comes from the Public Expenditure and Financial Accountability (PEFA) 2016 framework, an international program organized by the World Bank and other organizations to measure performance in public finance management(Kristensen, Bowen, Long, Mustapha and Zrinski 2019)<sup>4</sup>. The figure shows clearly that the ability to respond to audits is positively correlated with state capacity, which validates our assertion that  $p'_{(s)} > 0$  in the model. In the right panel, we look at the relationship between a proxy of underlying abuse and state capacity. Here, we exploit the Corruption Perception index rank from Transparency International, 2021.<sup>5</sup> We find that corruption is decreasing in state capacity, which supports our assertion that  $p'_{c}(s) < 0$ . The combination of these two patterns would produce an audit value that is inverse-U-shaped in state capacity, although in practice, empirical estimates of audit effectiveness only come from individual studies, which we discuss in Section 3.

<sup>&</sup>lt;sup>4</sup>The Public Expenditure and Financial Accountability (PEFA) program was initiated in 2001 by seven international development partners: The European Commission, International Monetary Fund, World Bank, and the governments of France, Norway, Switzerland, and the United Kingdom. The PEFA framework is a standard methodology for public financial management diagnostic assessment using 31 indicators. For additional details, see https://www.pefa.org/about

 $<sup>^{5}</sup>$ We obtain very similar results when using a measure of bribe incidence from Bosio et al. (2022).

### 2.3 Model Discussion

Our stylized model, albeit simple, highlights two key ingredients that should be taken into account by governments when deciding whether or not to enact or expand audits. First, it shows how state capacity is necessary for audits to be effective because the government needs credible tools to punish those who misbehave. This is in line with empirical work on enforcement, such as Gonzalez Lira and Mobarak (2019), who show that preventing agents from engaging in illegal acts requires an institutional system that is not only able to enforce laws, but is also able to track agents' reactions to the enforcement, to prevent them from finding loopholes to skirt regulations. Second, it stresses the importance of having some significant underlying level of abuse to detect to justify the undertaking of audits. This is in line with the theory and evidence of Bosio et al. (2022), who show how laws, in general, are not correlated with procurement outcomes and suggest that regulation can be suboptimal in places characterized by a high public sector capacity, as it seems to be a far too great limitation to agents' discretion given the relatively low risk of abuse.

Similarly, our model can be interpreted through the lenses of the distinction between active and passive waste in (Bandiera et al. 2009). While the presence of active waste requires monitoring, if the underlying form of abuse is of the kind of passive waste, audit requirements might make things even worse by introducing additional regulatory burden. In this sense, audits might have a low (or potentially negative) value even if they were costless for the government, as they could introduce indirect costs, and sources of inefficiencies, leading to longer completion time for public works (Calvo, Cui and Serpa 2019a) and potentially inducing bureaucratic red tape.

Direct and indirect audit costs are likely to vary themselves with the level of state capacity. In an effort to keep the model as simple as possible, we abstract from costs here but we provide a detailed discussion of their role in Appendix A. We show how the value function relates to various specifications of the cost function, including costs increasing or decreasing in state capacity. Appendix Figure A1 shows that for many functional forms of the cost, the marginal benefit of audits will exceed costs in the middle of the curve, i.e. for middle state capacity environments, as long as the cost function is not a steeper parabola than the value function.

Our stylized model also abstracts away from some other features of audits, most notably their deterrence effects. Importantly, in our model, a bureaucrat's decision of whether to engage in bad behavior is not a function of the audit. This reflects the fact that our model considers a marginal audit, which is unlikely to change the underlying level of bad behavior. Put another way, we consider a government in a steady state of state capacity, deciding on the margin whether to conduct an audit, which motivates our static game. On the margin, these decisions are unlikely to have broader impacts on overall deterrence. However, our work does not indicate that audits should be abandoned altogether, as that could eliminate valuable deterrence in the dynamic, long-run repeated game. In Section 5, we discuss systems of internal controls that are complementary forms of monitoring that governments can do instead of additional marginal audits.

Similarly, this model simplifies various political aspects of the decision-making process. Auditing of governments is observed worldwide, even in circumstances where the returns are low either due to the low level of underlying corruption, or the low ability of the state to respond to the findings of the audit. It is reasonable that some countries conduct audits because they are politically popular, rather than efficient. For example, politicians in high state capacity environments might be risk-averse and afraid of facing electoral consequences for corruption scandals, and this could lead them to adopt overly-restrictive audit regimes even in the presence of a relatively little underlying amount of abuse.

## 3 Existing Studies

The model presented in Section 2 indicates that audits of governments are most valuable in middle-state-capacity contexts. In this section, we review the existing evidence on auditing, treating estimates from other studies like data. The literature has generally been very positive on audit effectiveness; however, most existing studies focus on middle-income countries where our theory predicts audits will be most effective in curbing the misuse of resources.

Table 1 presents a survey of economics articles that causally identify the effect of internal government audits. Point estimates are divided by dependent variable means so as to obtain comparable magnitudes expressed in percentage changes. Notably, looking at the country column, we see that auditing has largely been studied in middle-income countries such as Brazil, India, Indonesia, or Puerto Rico. There is very limited empirical literature that studies highly developed or very low-income countries.

Several studies on Brazil have found audits to be highly effective, which aligns with our theory, as Brazil has both a high level of underlying bad behavior and also a high administrative capacity for addressing its findings. Notably, these studies also highlight the key role of other aspects that would facilitate direct or indirect enforcement of punishments, such as the diffusion of information via radio and the presence of re-election motives (Ferraz and Finan 2008; 2011, Avis, Ferraz and Finan 2018).

Similar results were reported in the context of Puerto Rico by Bobonis, Cámara Fuertes and Schwabe (2016), who found a large percentage change of corruption due to the effects of audits. The authors show that municipalities that were audited before the elections were affected by systematically lower corruption in the short run, although with temporary results. Puerto Rico is unique in that its local institutions are relatively weak, allowing for local corruption, but its role as a US territory gives it access to high-quality enforcement tools like the US federal court system.

The timely diffusion of audits with information about misuse of resources has serious electoral consequences in Mexico, Brazil, and South Africa (Larreguy, Marshall and Snyder 2020, Ferraz and Finan 2008, Berliner and Wehner 2022), suggesting that voters both trust the information and that audits have the power to act as a tool promoting local accountability. Relatedly, expected audits are highly effective in reducing bureaucratic misappropriation of expenditures for NREGA in India (Wong 2021).

Audits can improve procurement in middle-capacity environments. Di Tella and Schargrodsky (2003) show that, during the first 9 months of a corruption crackdown conducted in Argentina, the price of medical supplies paid by hospitals decreased by 15%. Similarly, Olken (2007) describe a randomized control trial on over 600 Indonesian villages that were developing a road project, where increasing the probability of government audits to 100% significantly reduced missing expenditures. However, even in the presence of an audit probability of one, the amount of unaccounted funds didn't go down to zero but remained around 20%. A potential explanation, consistent with the channels highlighted in our models, is that even with an audit probability of 100%, the punishment probability was still much lower than 100% due to enforcement capacity constraints.

Zamboni and Litschig (2018) show that, in Brazil, a temporary increase in audit risk can efficiently discourage an individual from committing fraud in public procurement, as long as authorities have the capacity to both identify and punish those committing the act. On the other hand, audits are not useful to improve the quality of health-related services for primary and preventative care, since the government was not able to correctly pin down the party responsible in that specific sector.

In Italy, a country with relatively good state capacity but a high risk of corruption, Vannutelli (2021) illustrates that increasing auditors' independence by severing their possible ties with local mayors significantly improves municipal fiscal performance.

In China, Chu, Fisman, Tan and Wang (2021) show that local auditors, as opposed to external ones, find a significantly lower number of questionable expenditures in the municipalities' budget. According to the authors, this phenomenon is a result of greater leniency of the auditor, rather than the municipality decreasing corruption because of greater enforcement. China is another interesting example fitting the story of our model, a middle-income country with a large potential for corruption but also a government with a strong enforcement capacity.

Finally, audits have proven to have positive indirect effects, that could improve governance and spending quality more broadly. Again in the context of Brazil, Lauletta, Rossi and Ruzzier (2022) show that audited municipalities reduce the size of public employment for a given level of services and reduce the share of discretionary (as opposed to exam-based) hirings.

While it seems clear that audits are an efficient policy tool in improving the management of public resources in middle-capacity countries such as Brazil, Indonesia, and even Italy, the same is not necessarily true for both high and low-capacity countries. In the US, Calvo, Cui and Serpa (2019b) presents striking evidence of how audits and project oversight can meaningfully increase the bureaucratic burden and, consequently, create additional project delays. In terms of financial performance, there also appears to be no significant difference between the financial conditions of local governments that were closely monitored and municipalities that were not. Spreen and Cheek (2016) and Nakhmurina (2020) investigate the effectiveness of state-level fiscal monitoring, as opposed to audits, finding conflicting results.

In Chile, a relatively low-corruption, high-capacity setting, Gerardino, Litschig and Pomeranz (2017) show that procurement audits are not only ineffective, but they introduce distortions in the process, inducing a shift away from open auctions towards less competitive and less transparent procedures that are less likely to be subject to audit checks.

Finally, Ensminger and Leder-Luis (2022) study audits in a low capacity and high corruption context: development projects joint between the World Bank and the Kenyan government. The authors find high levels of impropriety in expenditure reports and discuss how a similar World Bank forensic audit failed due to the inability to respond to audit findings. This aligns well with our theory of the effectiveness of audits, where audits are ineffective if the organization lacks the capacity to enforce bureaucratic behavior based on its findings. Notably, this paper does not causally estimate treatment effects, but rather uses statistical patterns to detect misreporting, and is therefore excluded from Table 1.

### 4 Auditing Local Governments in the U.S.

The United States is highly decentralized, and the US federal government transfers a significant and ever-growing amount of money to state and local governments to finance public goods and services. In 2018, federal grants accounted for over 22% of the total revenues of state and local governments, for an amount of \$570 billion (Office 2020). According to the federal government, this motivates the use of audits to ensure accountability in the use and management of federal funds.

On the other hand, the United States also has high levels of state capacity. Our model predicts audits in the US to be of low marginal value given the high-enforcement, low-abuse environment. However, the effectiveness of these audits has never been evaluated empirically.

We use a new, unexplored regression discontinuity to causally estimate the effects of city audits on local finance. Local governments that expend a total amount of federal funds above a threshold are required to perform an annual Single Audit. Single Audits were introduced in 1984 by the Office of Management and Budget to standardize and simplify audit requirements for local governments. Audits are performed by third-party auditors. This threshold has changed over time: originally, it was set at \$100,000 of expended federal funds; the threshold was increased to \$300,000 in 1996, to \$500,000 in 2004, and the current threshold of \$750,000 has been in effect since 2015 (Tassin, Waymire and Hines 2019).

The objective of these audit is to review financial statements and evaluate the quality of internal controls and the compliance with laws, regulations, and grant provisions of each major program for which the entity receives federal support. Auditors are also charged to check specific performance goals assigned from federal grantor agencies to grantees.<sup>6</sup> Audit outcomes are used by the federal government to evaluate future grant awards, so that poorperforming entities risk losing future grant access. We provide further details on the specifics of the audit process in Appendix B.

The threshold limit for auditing provides a source of quasi-experimental variation that allows us to estimate the causal effects of the audit. Cities that lie just above or just below the threshold are similar in many regards, except that those just above must be audited. We employ a dynamic regression discontinuity design to examine the effects of audits on city finance outcomes over a panel of years.

### 4.1 Data

In order to assess the causal effect of audits, we need data on both audited and unaudited local governments, which are not easily available.<sup>7</sup> We rely on data from the state of New York, which publishes detailed financial statements for all of its local governments, regardless of their federal audit status.

We begin with the entirety of cities in the State of New York. Our data include a total of 1,593 local governments. We collect data on the universe of financial statements from these local governments from 2001 to 2019. The data allow us to calculate the total amount of

<sup>&</sup>lt;sup>6</sup>The latter was introduced by the Uniform Guidance, issued in 2013 and effective in 2015. The Guidance raised the threshold and significantly streamlined and clarified previously existing guidance for single audits, intending to focus auditors' efforts towards programs and aspects at higher risk of waste and fraud, but also shifted the focus from simple compliance checks to a more performance-oriented review.

<sup>&</sup>lt;sup>7</sup>The Census annually surveys city finances, but the survey is only voluntary so coverage is incomplete.

federal revenues *received* by each local entity in a given year, a proxy for federal revenue *expended* in a given year, which triggers a single audit. Moreover, these data give us detailed information about spending and revenues for several budgetary categories, including taxes, fees, administrative expenditures, and debt service expenditures, which we use as outcome variables to measure the effects of audits on local fiscal outcomes.

### 4.2 First Stage

Our empirical strategy exploits the threshold requirement for Single Audit using a regression discontinuity (RD) design, comparing cities just above the threshold prescribed by the law to cities just below, across a panel of years. We first consider the cross-sectional first stage across all years to validate that the threshold causes a shift in auditing behavior.

Figure 3 shows the first stage of the discontinuity, plotting the binned probability of audits against the federal revenue a city receives in a given year. The running variable has been normalized, where 0 is the auditing threshold in a given year. Crossing the threshold is associated with a 0.21 to 0.28 increase in audit probability, depending on whether a linear or polynomial fitting is specified. Under both specifications, this estimate is statistically significant at the 5% level. Crossing the single audit threshold for federal revenue causes cities to be audited. The linear specification of the first stage selects an optimal bandwidth of about \$200,000, which we use for all further analysis.

Appendix Figure A2 shows the results of the McCrary test for running variable manipulation McCrary (2008). There is no evidence of sorting across the discontinuity. This may be because cities are unable to control the sum of their federal transfers that trigger auditing, as the total includes money transferred indirectly to cities in the form of pass-through grants given first to states. The lack of sorting supports the identifying assumptions of the RD design.

### 4.3 Dynamic Regression Discontinuity

Because auditing can affect fiscal outcomes beyond a single fiscal year, we use a dynamic regression discontinuity (DRD) design, following Cellini et al. (2010).

#### 4.3.1 Sample Construction

We construct a sample of cities that are quasi-randomly audited. We consider city-years as having a quasi-experiment if the total amount of federal revenues they received in a given year falls within \$200,000 of the relevant audit threshold. Cities that always receive a high amount of federal revenue are always audited and therefore are not identified by our RD design; the same applies to cities that are always below the threshold. We use the full panel of data for cities that ever have an experiment in order to compute the full dynamic effects of the quasi-random audit. Our final sample contains 271 unique cities and over 5,000 city-years.

Appendix Figure A3 shows the geographic variation in the number of audits per city in our estimation sample. There is wide variation and good geographic coverage, providing identifying variation which we exploit.

For our outcome variables, we use budget data from local governments, including revenues and expenditures by category, like taxes, debt services, and utilities. Dollar values are inflation-adjusted into real 2018 dollars. We winsorize the data at the 99th and 1st percentile, compute per-capita values using the local population, and take the logarithm. Appendix C describes the data cleaning process, and how the detailed city budget categories were collapsed into outcome variables.

We complement the state-generated financial statements data with federal Single Audit FAC Data. This dataset contains detailed information about all entities that have been audited, from 1997 to 2020, with all the relevant data on the audit process and its outcome. Appendix C discusses the relationship between single audit exact expenditure data and state-provided federal transfer data.

#### 4.3.2 Dynamic RD Specification

Consider fiscal year t. Define  $b_{it} = 1$  if federal awards in fiscal year t exceeded the single audit threshold, and 0 otherwise. Cellini et al. (2010) define a one-step treatment-on-the-treated (TOT) dynamic RD estimator using the following specification:

$$y_{jt} = \sum_{\tau=0}^{\overline{\tau}} (b_{j,t-\tau}\theta_{\tau}^{TOT} + m_{j,t-\tau}\alpha_{\tau} + f(z_{j,t})) + \lambda_j + \kappa_t + u_{jt}$$
(1)

where the variable  $b_{jt}$  indicates whether the federal revenues is above the threshold;  $m_{jt}$  is an indicator for whether or not municipality j had a quasi-experiment in year t, which in our sample means being within \$200,000 from the threshold in year t. We consider the full panel of years for all cities with any quasi-experiment.  $z_{jt}$  represents the distance in federal revenues from the threshold and  $f(z_{jt})$  controls for up to the third degree polynomial. Lastly, the specification also includes controls for municipality  $(\lambda_i)$  and calendar year  $(\kappa_t)$  fixed effects.

#### 4.3.3 Results

Table 2 presents the effects of single audits on city finance outcomes using our dynamic regression discontinuity empirical design. Each column presents a different outcome variable, a category of the city's budget, including taxes, revenues, charges for services, debt expenditure, administrative expenditure, and more. If audits were to impact city finances, we would expect the budget to reflect these changes. Variables are reported in logs, and the causal effects of auditing with standard errors are reported in each cell.

Overall, Table 2 shows reasonably precise 0 effects of auditing on city financial outcomes. Estimates are close to 0 and nearly none are statistically significant. The precise 0s indicate no effect of quasi-random auditing on city financial outcomes.

The 0 effects of auditing indicate that US cities are not an environment where bad behavior can be both detected with audits and punishment can be successfully enforced. This leaves open the question of whether audits are not valuable due to lack of detection or lack of enforcement; we believe that these audits fail to detect meaningful bad mishandling of funds. Section B describes the single audit process and findings. First, through reading the results of many of the audit reports, many audits produce no findings and those that do tend to focus on very minor findings like basic paperwork errors. Second, impropriety with federal funds at a city level can be prosecuted by the US federal government, and therefore we do not anticipate that inability to respond to audit findings is the limiting factor.

Another natural question to ask is, if audits were highly effective, whether we would expect to observe any change in local fiscal outcomes. An ideal study would observe direct measures of abuse; however, this is impossible to observe in our setting, given that audit findings are available only for audited cities and our identification rests on the comparison of audited and non-audited cities. On the other hand, given the specific objectives of Single Audits in the US, we argue that, if audits detected and eliminated abuse, we would expect to observe changes in fiscal outcomes. One of the main scopes of audits is to check on whether local governments are using federal money to finance expenditures towards which those funds were earmarked. Thus, for example, audits are supposed to check whether Title I funds are used to finance school spending. Thus, should a local government be found liable for abuse of Title I funds, for example, because it used them to finance other types of spending (e.g. administrative expenditures), we would expect to observe changes in both its education expenditures as well as its administrative expenditures.

# 5 Discussion and Conclusion

Our stylized model shows how state capacity is crucial for audits to be effective, because the government needs to have credible tools to punish those who misbehave. At the same time, high-capacity environments might be also associated with a low level of underlying abuse to detect, and thus audits might not be always an efficient choice for governments in these contexts. This provides some guidance toward how we could improve policy-making decisions in both high and low-capacity states.

For low-capacity organizations, the key priority should be to establish and strengthen institutions that are a precondition for audit effectiveness. Two important features here are judicial and media independence, without which the bad behavior of bureaucrats cannot be disciplined nor their bad conduct publicized. Moreover, low-capacity states can begin by ensuring transparency in their monitoring, auditing, and governmental budgetary process, as well as adopting changes to the regulatory structure that would help avoid auditors' capture and conflicts of interest. Before these features are in place, audits are a potentially wasteful way of combating impropriety, because while they may reveal bad behavior, the state lacks the ability to do anything about it.

In contrast, our model shows that marginal audits may not be valuable in high state capacity environments, as it is an investment in detecting bad behavior that does not necessarily exist. This understanding is key for guiding policy. Increasing audits can potentially increase passive waste, adding bureaucratic red tape but without improving actual governance.

One potential reason audits remain politically popular, despite their potential inefficiency, is that they are relatively simple tools to deal with situations in which the government interacts with private parties, and conflicts of interests may arise, as in the case of legal but distortive lobbying or regulatory capture. Empirical work from high-state-capacity governments shows that audits and enforcement can be particularly valuable when targeted toward *external* firms spending government money (Shi 2022, Leder-Luis 2019). This reinforces our finding that optimal auditing is a function of organizational capacity, even within governments. As a practical consequence, governments should exert the greatest auditing effort on the parts of their organizations where bad behavior proliferates and the tools to enforce detected bad behavior are also present.

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# **Tables and Figures**

Article	Journal	Country	Treatment	Outcome	Point	Dependent	%
				Variable	Estimate	Variable Mean	Change
Di Tella and	Journal of Law	Argentina	Audits	Hospital			
Schargrodsky (2003)	& Economics			prices (log)	-0.146	Not reported	15%
Avis et al.	Journal of Political	Brazil	Random audits	Number of			
(2018)	Economy			irregularities (logs)	-0.06	Not reported	-1.33%
Ferraz and	The Quarterly Journal	Brazil	Timing	Incumbent likelihood's			
Finan (2008)	of Economics		of audits	of reelection	-0.03	Not reported	-9%
Ferraz and	The American Economic	Brazil	Term Limit	Corruption's			
Finan (2011)	Review		of Mayors	detected by Audits	-0.019	0.06	-30.2%
Lauletta et	Economica	Brazil	Random	Discretionary			
al. (2022)			audits	employment	-1.445	12.24	-11.8%
Zamboni and	Journal of Development	Brazil	Increase in	Audited funds			
Litschig (2018)	Economics		audit risk	in procurement	-0.118	Not reported	Not reported
Gerardino et al.	Working paper	Chile	Public sector	Usage of auctions			
(2017)			audits	in procurement	-0.079	0.67	-11.9%
Chu et al.	American Economic	China	Auditor's	Suspicious			
(2021)	Journal: Applied Economics		local ties	expenditures	0.471	11.7	4%
Wong (2021)	Working Paper	India	Timing of	Misappropriated			
			random audits	expenditure	28.06	187.1	-15%
Olken (2007)	Journal of Political	Indonesia	Random	Missing			
	Economy		audits	expenditure	-0.085	0.25	-36.8%
Vannutelli (2021)	Working paper	Italy	Change in	Budget			
			auditing policy	management	15.88	-306.97	-5.2%
Larreguy et al.	The Economic	Mexico	Timely diffusion	Incumbent mayors			
(2020)	Journal		of audits	vote share	0.02	-0.035	-62.47%
Bobonis et al.	American Economic	Puerto Rico	Timing of	Number of corruption			
(2016)	Review		audits	violation	-1.43	1.38	103.5%
Berliner and	Journal of	South Africa	Timing of	Incumbent mayor's			
Wehner (2021)	Politics		audits	vote share	0.071	0.655	10.8%
Calvo,Cui and	Management Science	United States	Federal law	Projects			
Serpa (2016)			requiring audits	delays	0.59	Not reported	6.1%

# Table 1Survey of Studies on Government Audits

*Notes*: This table presents a survey of economics papers that causally identify the effects of government audits on a variety of outcomes. The main outcome of each paper is presented. Point estimates are scaled by the dependent variable mean to produce a percent change and allow an easier comparison across outcomes.

Table 2 The Impact of US Single Audits on City Fiscal Outcomes: Dynamic Regression Discontinuity Estimates

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)
VARIABLES	$state\_rev\_pc$	taxes_pc	$ch\_serv\_pc$	$tot\_rev\_pc$	admin_pc	$cult\_educ\_pc$	$debt\_serv\_pc$	empl_pc	gen_serv_pc	$utilities\_pc$
audits_prev0	0.176	-0.0183	0.0232	-0.00203	-0.0470	0.113	0.0397	-0.0200	0.00741	0.122
	(0.101)	(0.0179)	(0.0525)	(0.0235)	(0.0379)	(0.0919)	(0.114)	(0.0790)	(0.0472)	(0.138)
$audits\_prev1$	0.133	-0.0152	0.0140	0.0207	-0.00228	-0.0894	-0.0435	-0.0489	0.0619	-0.0943
	(0.0923)	(0.0188)	(0.0562)	(0.0201)	(0.0326)	(0.0719)	(0.120)	(0.0728)	(0.0458)	(0.126)
audits_prev2	0.214	-0.0124	0.0441	0.0380	-0.0260	-0.0327	-0.0698	0.0134	-5.54e-05	-0.106
	(0.103)	(0.0200)	(0.0570)	(0.0260)	(0.0394)	(0.0671)	(0.116)	(0.0688)	(0.0513)	(0.147)
audits_prev3	-0.0517	-0.0138	0.0487	-0.0134	-0.0141	0.0462	-0.0201	-0.00555	-0.000697	-0.220
	(0.0883)	(0.0212)	(0.0634)	(0.0238)	(0.0424)	(0.0746)	(0.110)	(0.0734)	(0.0547)	(0.142)
audits_prev4	0.0246	-0.0134	-0.0236	-0.0232	-0.00453	0.0393	-0.0995	-0.00843	-0.123	-0.324
	(0.0991)	(0.0238)	(0.0624)	(0.0252)	(0.0438)	(0.0751)	(0.112)	(0.0689)	(0.0537)	(0.169)
audits_prev5	0.0232	-0.0234	-0.0263	-0.0214	0.0415	0.0808	-0.165	-0.0846	-0.110	-0.330
	(0.111)	(0.0255)	(0.0648)	(0.0281)	(0.0529)	(0.0945)	(0.134)	(0.0772)	(0.0533)	(0.165)
audits_prev6	-0.0740	-0.0163	-0.0498	-0.0202	-0.000979	0.0892	-0.208	-0.0165	$-0.179^{+}$	-0.184
	(0.111)	(0.0259)	(0.0672)	(0.0284)	(0.0476)	(0.0938)	(0.168)	(0.0782)	(0.0645)	(0.167)
Observations	5,149	5,149	5,149	5,149	$5,\!149$	5,149	5,149	$5,\!149$	5,149	5,149
$R^2$	0.666	0.981	0.947	0.966	0.928	0.903	0.794	0.919	0.857	0.811
Y mean	4.997	6.920	5.533	7.480	6.097	3.984	4.674	4.434	6.877	4.804

Notes: This table presents dynamic regression discontinuity estimates of the effects of single audits on city fiscal outcomes. The sample includes a balanced panel of all cities that, at any point in time in our sample period, have received a total amount of federal revenues within \$200,000 from the Single Audit threshold. The specification corresponds to equation (1). The coefficients reported correspond to the  $\theta_{\tau}^{TOT}$ , where  $\tau$  represents the relative time elapsed since a given audit event. We include all possible values of  $\tau$  in our estimation, but for simplicity, we only report coefficients for values of  $\tau$  from 1 to 6, though we verify that none of the others are significant. Given the high number of coefficients and outcomes, we use a Bonferroni correction and set the significance thresholds at 0.01 (marked +) and 0.005 (marked \*).





*Notes*: The figure shows the predictions of our model of section 2 in terms of the evolution of the marginal value of an audit with state capacity. According to our model, the value of an audit depends on both the level of abuse, which is decreasing in state capacity, and the ability to enforce against bad behavior, which is increasing in state capacity. Therefore, audits are most valuable in middle-state-capacity contexts. Appendix A discusses how this value compares to costs.





*Notes*: The figure presents evidence in line with our theory, which indicates that corruption is decreasing in state capacity and that the ability to respond to audits is increasing in state capacity. We combine data from three sources: state capacity measures from Bosio et al. (2022) on the X axis, the ability to respond to an internal audit, as measured by Kristensen et al. (2019) on the Y axis of the left panel, and the corruption ranking from the 2021 Transparency International Corruption Perceptions Index on the Y axis of the right panel. In line with our theory, the ability to respond to audit findings is increasing in state capacity, while corruption is decreasing in state capacity.





*Notes*: This figure presents the first stage estimate of the discontinuous effect of federal revenue on auditing, using the full sample of city-years from New York State. The x-axis value of 0 corresponds to the threshold above which cities are required to undertake a Single Audit. There are 29,048 observations. The coefficient for Panel A is 0.28 with a *p*-value less than 0.001. The coefficient for Panel B is 0.21 with a *p*-value of 0.029.

# Appendix

### A Model with Varying Costs

The model presented in Section 2 shows that the marginal benefit of audits is a downward parabola in state capacity, without discussing costs. This combination indicates that audits have the highest value for middling state capacity countries. In this appendix, we discuss the relationship to costs.

The model's condition for audit benefits to exceed costs is given by:

$$p_c(s)p_e(s)k > a(s)$$

Where a(s) indicates that costs can vary in state capacity.

It is unclear *a priori* whether audit costs are constant, increasing or decreasing in state capacity, or of some other functional form. Largely, it does not matter.

Appendix Figure A1 shows the relationship between various cost functions and the value function presented by our theoretical model. If costs are constant in state capacity, then middle-income countries are the ones for which audit value exceeds costs, for any constant cost as long as it does not exceed the maximum of the parabola. Next, consider costs that are increasing in state capacity, of the form  $a(s) = \alpha + \beta * s$  with  $\beta > 0$ . Then, as long as the line intersects the parabola in two places – that is, it is not steeper than the parabola, nor tangent to it – it still holds that audits are optimal in some middle range of state capacity. Similarly, consider costs that are decreasing in state capacity, of the form  $a(s) = \alpha + \beta * s$  with  $\beta < 0$ . Then, once again, as long as the line intersects the parabola in two places – that is, it is not steeper than the parabola, nor tangent to it – it still holds that audits are optimal in some middle range of state capacity is not steeper than the parabola, nor tangent to it – it still holds that audits are optimal in some middle range of state capacity. Finally, the monotonicity of costs in state capacity is not necessary for the condition to hold that audits are optimal for middle-state-capacity countries. Consider, instead, if costs are parabolic in state capacity; then, for any parabola less steep than the marginal value parabola, there is still a central region of state capacity where audit values exceed costs.

There is a condition where middle-state-capacity countries are not the ones that should audit under this model. It is only where audit costs are somehow of a steeper parabola than audit value – or some non-monotonic functional form, such as a sinusoid – that audit values do not exceed costs in some central regions. There is no evidence or motivation for this cost structure.

The model presented in the paper is useful in conveying intuition about the value of

audits, more so than the costs; because the value of audits depends both on detecting bad behavior *and* being able to enforce against it, the value of audits are highest for middle ranges of state capacity. The examples in this appendix further demonstrate that the particular functional form of costs may determine which exact countries should audit, but does not eliminate the aforementioned intuition.

# **B** Description of the Single Audits Process

Non-federal entities are required by the Single Audit Act Amendments of 1996 and OMB Circular A-133 to have an annual audit of their federal awards.

A single audit consists of (1) an audit and opinions on the fair presentation of the financial statements and the schedule of expenditures of Federal Awards; (2) gaining an understanding of and testing internal control over financial reporting and the entity's compliance with laws, regulations, and contract or grant provisions that have a direct and material effect on certain federal programs (i.e., the program requirements); and (3) an audit and an opinion on compliance with applicable program requirements for certain federal programs.

Before the introduction of the Single Audit legislation, financial audits of recipients of government grants were carried out grant-by-grant, an ineffective procedure that allowed gaps in audit coverage. The single audit concept was created in 1984 as a response, calling for an entity-wide, thorough audit that included a review of the grant recipient's internal controls, as opposed to a detailed audit of each award.

The single audit adheres to Generally Accepted Government Auditing Standards for evaluating internal controls (GAGAS, also commonly referred to as the Yellow Book, GAO [2011]). The auditor also needs to determine so-called "major programs", that is federal programs from which a given entity receives money above a certain threshold. Compliance with grant provisions needs to be verified for each major program. An auditee that performs poorly could lose access to grant money in the future (Tassin et al. 2019).

From 1997 onwards, the federal government instituted the Federal Audit Clearinghouse, where all single audit reports for all entities can be freely downloaded. The FAC was introduced with the objective of enhancing transparency and providing stakeholders with access to potentially useful information to hold auditees accountable.

Entities are allowed to choose any Certified Public Accountant to perform the Audit, who needs to complete and submit the audit within nine months of the end of the audit period. Auditors can provide four different types of opinions:

• Unqualified opinion – auditee complied, in all material respects, with the requirements of the major program.

- Qualified opinion auditee complied, except for certain instances of material noncompliance, in all material respects with the requirements of the major program.
- Adverse opinion auditee did not comply, in all material respects, with the requirements of the major program.
- Disclaimer of opinion the scope of the auditor's work is insufficient to express an opinion on the auditee's compliance with the requirements applicable to the major program.

The opinions are based on the findings of the audit. Findings can be broadly organized into the following categories: a) financial statement findings, b) Federal award findings, c)deficiencies in internal control and d) instances of material noncompliance.

# C Single Audit and State Data

We use data from New York State on city finances, as well as from the Federal Audit Clearinghouse on city audits. This appendix describes the data used.

The dynamic regression discontinuity analysis starts with the city finance data. We produce broad expenditure and revenue categories to limit the number of left-hand side variables. Table A1 shows the list of variables and how they are aggregated. For example, the Culture and Education category includes expenditures listed by the state under the categories: "cultural services, library, recreation services, instruction, community college, and miscellaneous education." The aggregation is based on the account code and narrative, which can be found in the Account and Reporting Manual published by the Office of the New York State Comptroller.

The Federal Audit Clearinghouse provides a source of data to validate the city finance outcomes among audited cities. Technically, the city data provides us with dollars received, while the audit threshold is based on dollars expended. For the sample of audited entities, we can inspect whether the total amount of federal revenues received in a given year from the state data represents a good proxy for the total amount of federal revenues expended in a given year for the audit. Figure A4 displays a binned scatterplot of the relationship between these two variables, using our main estimation sample for the dynamic regression discontinuity. There is a very strong correlation between the two across all ranges of federal revenue.

# Appendix Tables and Figures

# Table A1 Budget Categories

Variables	Category	Description
Administrative	Expenditure	General government costs, employee insurance, related
Expenditure		expenditures and employee administration expenditures.
Charges for service	Revenue	Community services, culture and recreation, public safety sanitation, social services and transportation fees
Culture and education	Expenditure	Cultural services, library, recreation services, instruction, community college and miscellaneous education
Debt services	Expenditure	Debt principal and interests on debt
Employment	Expenditure	Exmployee benefits (retirement, life insurance, unclassified benefits), social services
General services	Expenditure	Community services, health, public safety, sanitation, social services, transportation
State revenue	Revenue	State aid in community services, economic development health, utilities
Taxes	Revenue	City income tax, property tax, special assessments, sales and use tax
Utilities	Expenditures	Economic development, general government zoning and planning, water utilities
Total revenue	Revenue	All revenue excluding federal aid

Figure A1 Audit Costs and State Capacity



*Notes*: This figure shows the value of audits compared to their costs, with different cost functions that are either constant (top-left), increasing (top-right), decreasing (bottom-left), or parabolic (bottom-right) in state capacity. Our main theoretical results are robust to allowing for various functional forms of audit costs.

Figure A2 McCrary Test for the First Stage



*Notes*: This figure presents the McCrary test of the first stage, using all city-years within \$200,000 of the audit threshold. The x-axis value of 0 corresponds to the threshold above which cities are required to undertake a Single Audit. We fail to reject that the densities are the same on the two sides of the cut-off. The estimated discontinuity is equal to -.125, with a standard error of .173.

Figure A3 Geographic Variation in Audits



*Notes*: This figure shows a map of the cities included in our estimation sample for Table 2. We report the total number of audits per city in our full sample period. Darker colors correspond to higher numbers.

### Figure A4 Correlation of Total Amount of Federal Revenues Received and Expended - Audited Cities



*Notes*: This figure shows the correlation between the total amount of federal revenues received and expended in a given year and the fitted values using the coefficients from the regression of Federal Expenditure on Federal Revenue. The two numbers are available only for audited cities, as the total amount of federal revenues expended is the key variable determining single audit assignment and it is reported by audited cities as part of the single audit reports.