Corruption
Andrei Shleifer and Robert W. Vishny (1993)

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Motivation

- Corruption is pervasive around the world and can take various forms

- Principal-agent model of corruption
  - Public officials have effective property rights over government goods
  - Top level of government wants to motivate officials to be honest

- Consequences of corruption for resource allocation
  - What are implications of how the corruption network is organized on economic activity?
  - Why does even well-organized corruption appear to be more distortionary than taxation?

Basic Model

- Assumptions
  - Homogeneous government-produced good with demand curve $D(p)$
  - Good sold by official who can restrict supply with impunity
  - Objective for monopolist to maximize the value of bribes collected

- Marginal cost to the official of providing good
  - *Without theft*: keep bribe but turn over amount $p \implies MC = p$
    - Raises buyer's cost and gives her incentive to expose official
  - *With theft*: turn over nothing and hide sale $\implies MC = 0$
    - Aligns interests of buyers and sellers, making it more persistent
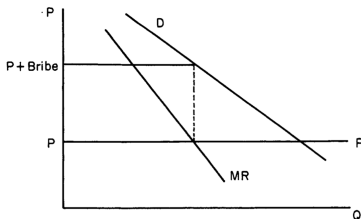

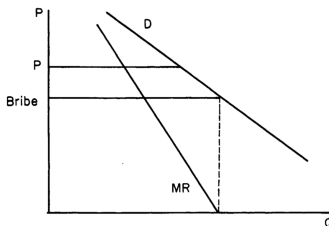FIGURE Ia
Corruption without Theft

FIGURE Ib
Corruption with Theft

Industrial Organization of Corruption (I/II)

- **Case 1:** joint monopolist agency sets price p_i, quantities sold are x_i
  - Per unit bribes are $p_i - MC_i$, and in the 2 good case, p_1 is set s.t.

$$MR_1 + MR_2 \frac{dx_2}{dx_1} = MC_1$$

  - Goods are complements $\implies \frac{dx_2}{dx_1} > 0 \implies MR_1 < MC_1$ at optimum

- **Case 2:** goods allocated by independent monopolist agencies
  - Per unit bribe higher, output and aggregate bribes lower than above

- **Case 3:** each good can be supplied by at least two agencies
  - Bertrand competition in bribes foces bribe down to zero
  - Two competitors not necessary if market subject to potential competition or entry

Industrial Organization of Corruption (II/II)

- What determines the industrial organization of corruption markets?
  - Joint bribe maximization likelier when bribe increases easily observed
    1. Government has effective policing machine to monitor bureaucrats
    2. Ruling elite is small
    3. Society is homogeneous and closely knit
  - Ability of leadership to exclude deviators from rents promotes collusion
  - Political modernization usually accompanied by increases in corruption
    - However, political competition also reduces corruption

- Implications of industrial organization perspective
  - *Without theft*: reduce corruption through competition b/w bureaucrats
  - *With theft*: competitive pressure may increase theft from government
    - Intense monitoring essential

Corruption and Secrecy

- **Claim**: taxes are the markup on price that goes into the treasury and bribes are markup that goes into pocket of monopolist
    - If treasury and pocket are the same, taxes and bribes are the same
    - With multiple monopolists, bribes also similar to taxes, with independent agencies setting rates to maximize revenue
    - Competing monopolists correspond to competing jurisdictions

- If bribes and taxes are similar, why are the former more distortionary?
    - Corruption is illegal and must be kept secret $\implies$ efforts to avoid detection and punishment
        - E.g. corruption opportunities on buying unique, expensive machine greater than on buying cheaper, generic products
    - Imperative of secrecy produces hostility to change and innovation
        - Secrecy requires keeping down number of people involved

Conclusion

- Two broad reasons corruption may be costly to development
  1. Weakness of central government allows officials to impose independent bribes on private agents seeking complementary permits
  2. Costly distortions entailed by necessary secrecy of corruption

- Framework can be used to explain and evaluate important phenomena
  - Different organization of corruption networks
    - Government goods can be obtained without bribe (United States)
    - Person paying bribe is assured of property rights over good (Korea, Communist Russia)
    - Numerous bureaucrats need to be bribed and no guarantee of property rights (African countries, post-Communist Russia)
  - Diversion of investments from health and education into defense and infrastructure