

Corruption

EE461 - Lecture 8

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Corruption: Basic Model

- ▶ One government produces homogenous good, such as a license, or a right to use government resources
- ▶ Demand curve from private agents: $D(p)$
- ▶ An official (seller) has the opportunity to restrict the quantity of the good that is sold.
- ▶ The government official is a monopolist. His objective is to maximize the value of the bribes collecting from selling this government good.
- ▶ Let p be the official government price of this good.
- ▶ What is the marginal cost to the official of providing this good?

Corruption without theft vs. with theft

- ▶ Without theft:
 - ▶ The official turns over the official price of the good to the government
 - ▶ $MC = p$
 - ▶ Corruption raises the total price of the good.
- ▶ With theft:
 - ▶ The official does not turn over anything to the government
 - ▶ The price that the buyer pays = bribe, could be lower than the official price
 - ▶ $MC = 0$
- ▶ Equilibrium: set $MR = MC$ (see figure 1a and 1b)

Corruption without theft vs. with theft

- ▶ Think about bribes as commodity taxes
- ▶ Without theft, the bribe is equal to the revenue-maximizing commodity tax when marginal cost is equal to the state price p . The difference is that taxes are kept by the government rather than the officials.
- ▶ Penalizing the official for corruption changes the level of the bribe, but does not change the essence of the problem.
 - ▶ If the probability of detection and the penalty are independent of the bribe and of the number of people who pay it, the official will charge the same bribe provided that the penalties are not so high that corruption is no longer profitable.
 - ▶ If the expected penalty increases with the level of bribe, the official might reduce the bribe and raise output.
 - ▶ If the expected penalty rises in the number of people, the official will reduce the supply and raise the bribe.

Impacts of Corruption

- ▶ We can define corruption as the use of public office for private gain.
- ▶ Hence, we can see that corruption acts like a tax, adding to the cost of providing public services and conducting business.
- ▶ Corruption is costly due to secrecy. The demands of secrecy can shift a country's investments away from the highest value projects (health and education) into potentially useless projects (defense), if the latter offer better opportunities for secret corruption.
- ▶ It also causes leaders to maintain monopolies, to prevent entry, and to discourage innovation by outsiders.
- ▶ Corruption may be a major contributor to the low growth rates of many developing countries (Mauro 1995).

Approaches to reducing corruption

- ▶ Becker and Stigler (1974): use the combination of monitoring and punishments
 - ▶ Argument: individuals who do the monitoring and enforcing punishments may themselves be corruptible.
- ▶ Alternative: increase grassroots participation by community members in local-level monitoring
 - ▶ Supportive argument: community members benefit from a program, so they may have better incentives to monitor than disinterested central government bureaucrats
 - ▶ Drawbacks: free-rider problem as monitoring is a public good; local elites dominance