The Lure of State Capitalism: A CRCE Colloquium

Unbundling Corruption
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Corruption: the benchmark

A price for some scarce good is set and known to all interested parties.

A buyer approaches the seller and offers a lower price.

This lower price is accepted.

A problem: efficiency of corruption?

This is a voluntary transaction by two parties and therefore seems to be efficient.

Yet (with little more context specified), it also describes corruption.

Hence, corruption seems to be efficient?

Is this conclusion correct?

Does context matter, and if so in which way?

If context matters what attributes of the transaction we need take into account?

Transaction attributes

Is the seller the agent or the principal?

Do other parties know about this transaction?

CASE 1 (Seller as Principal; Transparency)

Consider first that the seller is the principal and the transaction takes place in public.

An example: a seller on the farmers' market sells cheap when the market is about to close.

Interested parties are aware of the situation.

Hence, what we have here is price discrimination.

The buyers self-select into two categories: those who come early (and have a wider choice) and those who come late and have lower price, but with some risk that the commodity may not be available.

This case of price discrimination seems efficient.

CASE 2 (Seller as Principal; Lack of Transparency)

- there is a price for the product known to everybody,
- yet the seller, who is the principal, offers a discount to somebody,
- and parties outside this specific transaction, are not aware of it.

Now a potential inefficiency arises, as we may have participants whose marginal utility was higher than that of the buyer who was offered a discount, yet they did not buy as they faced a higher price.

However, assuming rational behaviour of the seller there was a reason why lower price was offered. Possibly, the price, as known to everybody, no longer represented equilibrium. If so, what we face here is price adjustment. Thus, from a dynamic perspective the situation is not necessary inefficient.

Sooner or later, a new (lower) equilibrium price may emerge.

If the seller continues to offer lower price to selected buyers, without an economic justification (when market price represents equilibrium), he will be driven out of the market by competition. Thus the problem is either apparent not real, or is of transitory nature. [*note we are not far from Gary Becker on cost of discrimination*]

CASE 3 (Opportunistic Agent)

Seller is now agent not principal, and offers a discount against principal's intentions.

With the principal – agent structure (i.e. hierarchy as a governance mode), the scope for opportunistic behaviour by the agent emerges.

For example, at the farmer's market, a discount is offered by the seller not because of the risk that some vegetables will remain unsold, but because the agent wishes to close the sale earlier and go home, against an implicit or explicit contract with the principal.

Some redistribution of income from the principal to the agent follows. As it is in breach of contract (which may be incomplete, i.e. not articulated in full), this can be judged as unethical, but here redistribution as such is not a source of inefficiency. It never is in economics.

So what is (if)?

CASE 3 (Opportunistic Agent): Sources of Inefficiency

(Microeconomic) inefficiency arises because as in most other cases, redistribution of income cannot be separated from changes in value added. Like in Case 2, inefficiency emerges because the price in no longer aligned with the structure of preferences of the buyers. Vegetables may not find their way to those who value them most and that destroys value.

In addition, offering a discount by the agent against principal interest, would come at cost of destroying value, if income is redistributed away from principal who could presumably use it for value-generating investment, and towards the agent that would not [*the argument is in the spirit of Adam Smith: income gained from unproductive activities is typically also used in a less productive way*].

More on CASE 3: Inefficient Transaction versus Inefficient Governance Structure

However, despite agent's revealed opportunism, there may be no better feasible governance structure that could be applied to this transaction. For example, the opportunity cost for the principal to sell himself/herself is too high. Or, if principal would restrict the discretion of the agent by demanding all is sold with no discount, the disadvantage of lower flexibility would out weight the cost of opportunism (as some vegetables will remain unsold). (Note that here, the limits to opportunism are determined by what the principal knows about the market and the extent of his/her ability to distinguish between the results of random variation in demand and shirking by his/her employee).

In general, assuming rationality on behalf of the principal, a particular governance structure can only be inefficient in a sense of some other alternatives that the principal is unaware of (say, due to his/her incompetence).

Thus, while corruption itself is inefficient (as it destroys some value), a particular governance structure where incidences of corruption occur should not necessarily be labelled as inefficient unless additional conditions are met (feasible superior alternatives exist).

CASE 3: The role of Competition between Governance Structures

Last but not least, the market competition imposes a clear constraint on the extent of the opportunistic behaviour by the agent.

If other firms are able to adopt better governance structures they will either drive inefficient firms out of the market or force them to learn and adopt.

Again, with competition, inefficiency is of transitory nature.

CASE 4. Opportunistic Agent under Limited Competition

What if the structure of transaction is such that the competition cannot arise?

Assume for example that for the farmers' market to operate, an adjacent parking lot is required, enabling customers to come. Yet the space is scarce so a positive price is needed to adjust demand.

Again, an agent (parking attendant) is approached by a driver, and offered a lower price for parking that the official one. The agent accepts the lower price and pockets the money without issuing the receipt.

Thus, similar to the previous example we have an opportunistic agent who steals from the principal. Again, redistribution is involved, but this itself is not a source of inefficiency. Inefficiency results because due to lowering average price, the parking becomes overcrowded so some participants with willingness to pay cannot use it.

CASE 4. Competition and Knowledge

What changed now is that we cannot rely on market competition to restore efficiency. Competition is an inexpensive mechanism for acquiring information. If there were a number of parallel parking lots with no potential to collusion amongst agents across those, a principal could learn a lot about his agent's behaviour by simply observing the prices the other competitors are able to charge.

Note that we stress the role of competition in generating useful knowledge [*in Hayek's spirit*]. Accordingly, for our purpose, what is critical here is not the direct competition, but decentralisation of economic activity, where learning opportunities exist. For example, if a particular governance structure of exchange is common (there are many parking spaces where parking attendants are hired, characterised by varying degree of opportunism), the principal may still learn from other firms and assess performance of his/her agents.

Governance and Government

While not discussed yet, all previous cases implied some underlying structure of enforcement, where expropriation is being punished, so that control over commodities or services (vegetables, rented parking space) is shifted only as a result of voluntary transactions.

In many cases prevailing norms may be sufficient to guarantee such an outcome reasonably well. That happens either because such norms are internally accepted by the participants or are socially enforced: neighbours in local community may ostracise those who steal vegetables, and, for example, refuse to enter into transactions with them. Reputation matters.

In other contexts, norms alone may not be able to sustain the structure of voluntary exchange. Coercion and punishment of those trespassing, based on stable rules may lead to a more efficient outcome. It is here we introduce the government, and therefore also an additional governance mechanism that can be applied to particular structures of exchange: the role of government may go beyond securing property…

Back to the Parking Lot

The parking lot adjacent to the farmers' market may be controlled jointly by the sellers (acting as a principal), by a private owner, or control may be transferred to the local government. If governance mechanism relies on the latter, it is typically implemented by regulation supported by coercion mechanism that the local authorities have at its disposal.

For example, to adjust demand to limited space, a restriction is imposed of no more that one hour of parking time and this is enforced by parking inspectors.

How that compares with the private governance structure considered above?

Which one is more efficient will depend on circumstances.

Government versus private principals

The advantage of using the government may result from economies of scale. It may be costly to find and train parking attendants, to work at a particular time on Sunday only, where the farmers market is open. It may also be more efficient to use government employees who instead of being stuck at one place, may remain mobile and by applying a mixed strategy of monitoring several places in variable pattern, may achieve compliance at lower cost [*note: this is a standard argument underlying law and order enforcement seen as a public good*].

In that case, bribing ticket inspectors will increase inefficiency by undermining the whole governance mechanism, in the same way as offering lower price to parking attendants was in the previous example.

Bribery leads to both microeconomic inefficiency (by driving the wedge between preferences and prices) and to higher transaction cost, as additional governance structures may be required to alleviate its effects. This conclusion does not rely on a given governance structure of exchange being operated by private actor or by the government.

If a given governance solution is inefficient (in a sense of availability of a superior feasible alternative), the remedy implies seeking to replace the former with the latter.

Within any political context where democratic decision making is present, such remedy, while could be difficult to achieve, is always feasible.

A Complication: Power against Prosperity

Power however comes with a possibility of misuse: structure or costs and benefits may be altered, and scarcity may be created artificially, so that higher price may be charged and redistribution towards those holding power achieved.

Such inefficiency may easily emerge under a democratic political process. However where the latter is available, a strategy of aiming at change in the structure of governance is always superior to the one of correcting the outcome locally based on bribery. Given that there is a superior governance structure, it comes with higher gains, so it is always possible to build a political coalition based on additional benefits to achieve it.

But what if there is no democratic process available to achieve the change in governance?

A Criminal Government

What if:

- the power structure is not democratic, and there is no political process in place to achieve a change in governance structure?

Let assume additionally that:

- the government uses revenue for objectives that diminishes welfare.

If those conditions are met, bribery increases efficiency as a second best strategy.

To use some extreme examples, think about Polish peasants hiding some food production during the Nazi occupation, or somebody bribing a Nazi official to save a life of a Jewish person. In both examples, some resources are diverted from a criminal government to private agents. Assuming that these private agents will use the resources in a less damaging way than the government, the outcome is beneficial.

Conclusions: 1. Bribery represents a class of post-contractual opportunism problems. Hence, we need to assume the existence of hierarchy, as a type of governance structure. In contrast, if we face a principal operating on a competitive market, there is no bribery.

2. Within a hierarchy, the nature of the problem does not critically depend on who is the principal; the principal may be either private, public, or as often the case now-a-days, a given hierarchy may represent a chain, where customers face a private agent (a contractor), who himself/herself represents the public as the principal.

3. While bribery may arguably improve welfare of the two party involved (as any other voluntary transaction), it comes at cost. It is inefficient. The particular governance structure concerned may or may not be inefficient, but the judgment depends on what is a feasible set of alternative governance structures.

4. The nature of the problem changes critically, when principal's objectives become criminal. In that case, corruption, by having an effect of diminishing revenue that the principal collects, has beneficial effects.