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Economic integration and corruption

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Abstract

We study the link between corruption and economic integration. Integration is modeled by a common regulation for public procurement. We show that integration resolves a term of trade driven prisoner's dilemma and will always take place in the absence of corruption. Corruption may destroy the incentives for integration. If the propensities to corruption are too different, the more honest country, which benefits less from integration, will not be willing to join the union. This difference in corruption propensities can be offset by a difference in efficiency. We also show that integration has the positive effect of reducing corruption.

JEL classification: D72; F15; H57

Keywords: Corruption; Procurement; Economic integration

1. Introduction

This paper formalizes the institutional hypothesis that economic integration is more attractive for countries with internal problems and little trust in their national government than for well-functioning countries. These countries are less reluctant to transfer sovereignty to a supernational organization since their national institutions are not very

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reliable.[2] A casual look at the data suggests that this might indeed be the case in the European Union (EU). Fig. 1 plots the corruption perception index (CPI) as a proxy for a nation's trust in their institutions against the national means of desired speed of integration for the EU countries averaged over the period 1995–1997.[3] The figure suggests a strong negative linear relationship between the desired rhythm of integration and the index of corruption.[4] Since a higher CPI implies less corruption, this relationship is consistent with the institutional hypothesis.

In our model, we will use corruption to represent internal problems of a country. Corruption is highly correlated with other "bad country" variables, such as minimal accountability of political parties, a badly functioning juridical system, etc. Moreover, recent empirical studies confirm the negative effects of corruption on the amount of private investment (Mauro, 1995), the quality of public investment (Tanzi and Davoodi, 1997), and the investment in human capital (Mauro, 1998).

For the sake of tractability, we will study a two-country model and only allow for corruption in public procurement.[5] Public procurement is an important part of a country's economic activities (between 10% and 20% of GDP in most industrial countries)[6] and is a sector very prone to corruption: usually the sums of money involved are very big and the government is often the only buyer; asymmetric information makes favoritism difficult to detect.

In our model, the citizens delegate to an official (bureaucrat) the responsibility to implement public procurement contracts. The commodity or public project can either be bought from a local firm at a fixed price (sole-source procurement) or it can be purchased through international competitive bidding. On the one hand, the competitive bidding decreases the expected purchase cost. On the other hand, it involves a fixed organizational cost that is private information of the bureaucrat. Competitive bidding is optimal if its organizational cost is low compared to the size of the project. Otherwise, fixed price purchase is optimal.[7] However, our bureaucrat is self-interested and therefore corruptible. She might misrepresent these organizational costs and favor a local producer in exchange for a bribe if this maximizes her revenue. The citizens, i.e., the voters, decide the discretion

[2] The institutional hypothesis has been defined, e.g., in Sanchez-Cuenca (2000).

[3] For more details and the underlying data, see Appendix B1 and B2.

[4] This linear relationship has been confirmed in various regressions. In the working paper version of the present article (Ganuza and Hauk, 2001), we ran OLS regressions using panel data for 1995–1997 controlling for log GDP per capita and transfers to/from the European Union. Sanchez-Cuenca (2000) runs an OLS regression for the year 1995 controlling for the level of social expenditure and GDP per capita. In all those regressions, the corruption perception index is a highly significant explanatory variable for the level of ProEuropeanness.

[5] Rose-Ackerman's (1975) seminal paper on corruption also concentrated on public procurement.

[6] The cost of public projects administrated by the European Union is around 720,000 millions of euros every year, which corresponds to 11.5% of the GDP of the member states in 1994 and is equivalent to the economy of Spain, Denmark, and Belgium together.

[7] Various factors may justify choosing sole source procurement instead of competitive procurement. The administrative cost may be lower, sole source procurement is faster and there might be positive strategic effects, e.g., repeated sole source procurement might reduce moral hazard problems due to the threat of awarding future projects to foreign firms. For a discussion of this issue in the public procurement setting, see McMillan (1998). See also Marshall et al. (1994) and Auriol (1998) who assume (like the present paper) that sole source procurement has lower transaction costs than competitive procurement.