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Blessing corruption: institutional reforms

By

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Preliminary version

Abstract

Despite the claimed benefit argued by the implementation of institutional reforms in many economies, this benefit is not clear as there are some structural inefficiencies that hamper the benefit of such reforms. We develop a political-economic model in which a government in a country try to set the optimal institutional level taking into account the cost of this policy on FDI and on the benefit of two kind of people: honest and dishonest. We analyze the policy decision taking into account a political contribution made by a corrupted lobby group in order to benefit themselves from a lower institutional level. Our results suggest that the optimal institutional level will depend on the degree of efficiency of the legal structures against illegal structures.

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1 Introduction

In the last decade the growing of the institutional economics literature has been rather amazing.¹ It is an interdisciplinary enterprise covering a wide range of issues such that economics, sociology, law, political science, organization theory, etc. Coase (1937), Williamson (1975) and North (1990) are the best-known representatives of this branch in economics where its goal is to explain what institutions are, how they arise, what propose they serve, how they change and how -if at all- they should be reformed (Klein (1999)).

This impressive development has produced many refined opinions of many scholars and policy makers on the need to set and implement institutional reforms as a way to get a more substantial and solid economic growth and development. Numerous papers have been written on the topic.²

All of these studies make a deep analysis and lead to solid findings. However, the problem why these policies in developing countries just failed or simply are cancelled out, to our knowledge, has not been investigated well. Moreover, the theoretical studies of this issue is almost null.

The literature relating institutional reforms and economic performance has been huge. However, this literature as been focus on developed countries (Klein 1999). The evidence in Europe and some asian countries present a positive assessment for institutional reforms not only in economic growth but also in welfare. Supported in the last evidence, many scholars provide burning recommendations for institutional reforms in developing countries.

Despite all, many developing countries seem to delay (or even ignore) the necessary institutional reforms. Unclear legal framework to run the process, structural inefficiencies and poor results of the reforms are part of the reasons why developing countries neglect institutional reforms (Espinosa, 2001).

Based on this fact we develop a partial equilibrium model in which a good is produced by Foreign Direct Investment (FDI) and consumed in a country in which two kinds of people live in: honest and dishonest people. FDI is crucial in terms of considering the relevance of foreign investment on developing economies. Even when literature on FDI is huge, in this paper I do not intend to analyze FDI but to consider it to model a stylized fact³. On the other hand, honest and dishonest people offer a suitable parameter to consider corruption in our model.

The aim of this theoretical model is to offer an institutional explanation about

¹A good survey can be found in Klein (1999).

²Some examples are the impressive and accurate articles written by Rodrik (2000), Williamson (1996), Bardhan (1989) and others.

³A good surveys can be considered in Caves (1982) and Cantwell (1994).

how corruption and FDI coexist to determine a proper institutional policy. In this model, the foreign firms have two production costs: the traditional technical and market cost and the Fiscal Cost (FC) which is a cost levied by the government in the form of tax. However, when a firm tries to pay the tax, he faces a corrupted civil service that intends to bribe the firm in order to get an extra income. We assume that bribe is a common practice that the monopolist should consider in its production decision. This bribe comes together with the legal payment of taxes and moreover it is a compensatory option. That is, the firm has to pay its FC through two structures: an illegal and a legal one.⁴

It is assumed in his paper that honest people work for the private sector and dishonest work for the government as civil servants. It is a very strong but convenient assumption for developing countries where the social perception about the civil service is the one in which, independently of the existence of honest elements, the corruption is considered a generalized fact. The opposite perception about the private sector holds⁵. In other words, we are considering the "net" perceptions about the honesty of the workers in the private and public sector.

Honest people working for the private sector receive a transfer from the government equivalent to the amount of taxes paid by the firm through the legal structure. Dishonest people receive an income from the bribe paid by the firm⁶. The government can set an institutional policy in order to control this flows affecting the corruption of the civil service.

However, the dishonest lobby the government to influence negatively in the setting of a strict institutional policy. This lobby would depend on the corruption of the political process (the government's willingness to accept contributions). Lobbying in this paper takes place in a country which determines the institutional level. We model lobbying by following the political contribution approach. That is, the lobbyists make political contributions to the political party in power, and the amount they contribute is contingent upon the policy that the government adopts. The political contributions approach, derived from the common agency problem analysed by Bernheim and Whinston (1986), was first introduced by Grossman and Helpman (1994) in modeling the

⁴It is well known that bribe is widely used in developing countries in order to simplify or avoid any legal and administrative procedure that can be significantly costly by the legal way.

⁵For more details see Global Corruption Report 2003 in <http://www.globalcorruptionreport.org> (october 2003).

⁶In the case of the honest income received for working in the private sector we consider that in the background there is a second commodity in a competitive market produced under constant returns. This is taken as numeraire. Both goods require only a single factor of production, let say labour, which is fixed supply under a perfect competitive market and full employment. On the other hand the income of dishonest people working for the government it can be considered as a lump-sum transfer from the government which for simplicity can be ignored

political economy of trade protection with quasi-linear preferences.⁷ Dixit, Grossman and Helpman (1997) have recently generalised the Bernheim-Whinston framework to allow for general preferences and therefore variability in marginal utilities of income. Given that our framework is a partial equilibrium one, we shall follow the original Grossman-Helpman (1994) approach.

Our aim is to construct a model in which the reasons for a particular institutional level is found not only in the moral considerations, but also in the way the domestic political equilibrium is determined taking into account we have two corrupted scenarios highly related: Corruption of the political process of the government which is exogenous, and corruption in the civil service which can be affected by the policy decision. Both scenarios can coexist perfectly⁸. We shall focus on the determination of the optimal institutional level.

The optimal institutional level depend mainly on the cost between the legal and illegal structures to pay the FC. In this sense, we have two cases of analysis: in the first case we consider that the fiscal cost for using the illegal structure is larger than the fiscal cost for using the legal structure. The second case is the opposite.

The model is spelled out in detail in the next section. In section 3 we will set the optimal institutional level taking into account the level of government political corruption, efficiency of the structures and the market size. In section 4 we conclude.

2 The Model

Our focus is on a country which hosts n identical foreign firms competing in a oligopolistic industry. These firms produce a homogeneous good X which is consumed entirely in the host country where there are not a domestic producers.⁹ The marginal cost of each firm is C which is taken to be constant, and therefore equal the average variable

⁷The importance of political process in economic decision making in general and international policy issues in particular is well recognised (see Dixit (1996)). The particular aspect of lobbying by interest group has derived a lot of attention from international economists. The alternative approaches in modeling political equilibrium include the tariff-formation approach (Findlay and Wellisz (1982)), the political support function approach (Hilman (1989)), median voter approach (Mayer (1984)), the campaign contribution approach (Magee *et al* (1989)), and the political contribution approach (Grossman and Helpman, (1994)).

⁸If we consider a link between both scenarios or if we assume the corruption of political process as endogenous, we will obtain similar results as obtained in this paper.

⁹The assumption that there are only foreign firms is made for two reasons: first, it models better a developing feature, and second it is made for simplification. In the case of domestic production the results are similar to those found in this paper.

cost.¹⁰

In order to make the analysis at a tractable level, we assume a linear demand function of the form

$$P = a - bQ$$

where a and b are positive parameters, $Q = nX$ is the total demand and P is the price of the good X .¹¹ The profit function of each n firm is

$$\pi = (P - C)X, \quad (1)$$

Each firm has a Cournot perception: it takes the output of other firms as given while maximising its profits. Under Cournot-Nash assumptions from (1) profit maximisation yields the following result

$$X = \frac{a - C}{2b}, \quad (2)$$

where the benefit of each oligopolistic firms is given by (2) in (1) as

$$\pi = (P - C)X = bX^2. \quad (3)$$

To produce, firms incurs two kinds of costs: the usual technological and market conditions cost and the legal fiscal cost. That is,

$$C = c + \Delta \quad (4)$$

where c is the technological and market conditions cost (which is constant), and Δ is the Fiscal Cost (FC) which is a levied tax firm should pay to the government for fiscal reasons. It will be characterized as being a per-output tax that allows the firm continuing operations regularly.

The FC tax have two components: a legal and an illegal one. The legal component of this tax will be paid through the government's legal structure (legal option) and the illegal component will be paid through an alternative illegal structure (illegal option).

The amount of tax paid through the legal and illegal options would depend on the efficiency of the government institutional framework. The institutional framework

¹⁰As we mention before there is a numeraire good in the background which is produced under competitive conditions and a factor of production whose price is determined in the competitive sector.

¹¹The utility can be approximated from $U = u(X) + m$ where X is the good under consideration and m is the expenditure on the numeraire good. The use of this approximation removes a number of theoretical difficulties, including income effects.

is understood as the legal environment set by the government in order to regulate the political and economical activities properly. In this sense, an efficient institutional framework strengthens the control against illegal activities. An inefficient institutional frameworks means a weak control over illegal activities¹².

The institutional framework is set by the government through a credible political reform of the legal system. For simplicity we consider that this reform is the result of a political-legal process where no direct ex-ante economic cost is attached to this reform. This process will produce a parameter α which measure the efficiency of the institutional framework and it will be determined by the government. This parameter will be set between 0 and 1 and will be called institutional level.

Therefore the two parts of the FC can be written as

$$\Delta = \gamma(1 - \alpha) + \beta\alpha \quad (5)$$

where $\gamma(1 - \alpha)$ is the illegal component and $\beta\alpha$ is the legal one. γ and β are the per-unit structural illegal and legal costs respectively. These two per-unit costs can be defined as the degree of efficiency in both structures. Therefore, $\gamma(1 - \alpha)$ gets smaller as the institutional level increases while $\beta\alpha$ becomes larger. When the institutional level α , the policy instrument of the government, is close to one the institutional framework is more efficient, when α is closer to zero the institutional framework is more inefficient¹³.

In order to pay this tax, the firms should face a civil service body in charge of collecting taxes. This civil service is formed by dishonest individuals (labeled ς) who benefit from and support the illegal structure through which the firm pay taxes. On the other hand, there are honest people (labeled σ) working for the private sector. They are homogeneous within their own type.

Dishonest people work and obtain an income from illegal activities, specifically through the bribe they charge from the producer once the latter faces tax obligation. On the other hand, the honest people receive an income through the (legal) tax levied on the producer. It can be seen as a transfer from the government to the honest people.

Taking into account the considerations mentioned above, we shall specify the utility function of the honest people, dishonest people and the government: we will use these functions to determine the optimal institutional level. Assuming quasi-linear preferences the utility of the honest people can be defined as

$$I^\sigma = \alpha\beta nX + \mathcal{CS}, \quad (6)$$

¹²Institutions is understood as the rules of the game which all the economic agents agree to play.

¹³Although the FC depend on β , γ and α , when α get the extreme values 0 and 1 the institutional framework will be clearly inefficient and efficient independently of the values of β and γ .

In expression (6), the first term is the legal payment of tax obligations made by the firm. This payment, which will be the income of the honest people, is transferred in a lump-sum fashion from the government. The second term is the consumers surplus which satisfies:

$$d\mathcal{S} = -QdP,$$

where Q is the total consumption of X , and P is its price.

The income of the dishonest people is given by

$$I^s = \gamma(1 - \alpha)nX, \tag{7}$$

Clearly, the source of the income is the bribes taken from the firm¹⁴.

The institutional parameter α is a policy instrument for the government and is determined by a political equilibrium. We shall follow closely Dixit *et al* (1997) in specifying this equilibrium. The honest people do not lobby the government, but the dishonest make political contributions to influence the government's decisions. The political contribution schedule for the dishonest is denoted by $c(\alpha)$. The host government's objective function is given by

$$G = \rho c + (I^\sigma + I^s), \tag{8}$$

where $\rho > 1$ is a constant parameter. Equation (8) states that the government considers the total welfare of its nationals (the terms in parenthesis), as well as the total amount of political contribution that it receives (the first term on the right hand side of (8)).

The political equilibrium is the outcome of a two-stage game. In stage one of the game, the dishonest people choose their contribution schedule. The government then sets its institutional policy in the second stage. A political equilibrium is given by (i) a political contribution function $c^*(\alpha)$, such that it maximizes the welfare of all the dishonest people given the anticipated political optimisation by the government, and (ii) a policy variable, α^* , that maximises the government's objective function given by (8), taking the contribution schedule as given.

Dixit *et al* (1997) develop a refinement known as truthful equilibria that implement Pareto efficient outcomes. Stated formally, let $(c^\circ(\alpha^\circ, I^{s^\circ}), \alpha^\circ)$ be a truthful equilibrium in which I^{s° is the equilibrium per-capita utility level of the dishonest

¹⁴This is not the only income the dishonest could have received. We can consider that the dishonest people receive a fix wage w as a lump-sum transfer from a lump-sum tax levied on the monopolist. In this case, given the lump-sum characteristic of this income, it does not affect the result of the model and, for simplicity, we can ignore it.

people. Then $(c^\circ(\alpha^\circ, I^{\circ}), \alpha^\circ, I^{\circ})$ is characterised by

$$c(\alpha, I^{\circ}) = \text{Max}(0, \varrho), \quad (9)$$

$$\alpha^\circ = \text{Argmax}_\alpha \{ \rho c(\alpha, I^{\circ}) + (I^\sigma(\alpha) + I^{\circ}) \}, \quad (10)$$

$$I^\sigma(\alpha_1) + I^{\circ} = \rho c(\alpha^\circ, I^{\circ}) + (I^\sigma(\alpha^\circ) + I^{\circ}), \quad (11)$$

where ϱ is defined in

$$I^{\circ} = I^s - \varrho, \quad (12)$$

and

$$\alpha_1 = \text{Argmax}_\alpha (I^\sigma(\alpha) + I^{\circ}). \quad (13)$$

Equation (9) (together with (12)) state that the truthful contribution schedule is set to the level of compensating variation relative to the equilibrium utility level of the dishonest. The definition of ϱ is the basic concept of the compensating variations. Under a truthful equilibrium payment function, for any change in α , the change in the contribution received by the government will exactly equal the change in the dishonest welfare, provided that the payment both before and after the change is strictly positive. Equation (10) is self explanatory: the government takes the utility level of the dishonest as given and chooses the institutional level so as to maximize its objective function. Equation (11) (together with (13)) complete the characterization of the truthful equilibrium and tie down the equilibrium utility level of the dishonest people, which is derived from the premise that the dishonest would pay the lowest possible contribution to induce the government to pursue the equilibrium policy given in (10). For this to be the case, the government must be indifferent between (i) implementing the equilibrium policy and receiving contributions from the dishonest, and (ii) implementing a policy by accepting no contribution. Equation (11) states precisely that.¹⁵

According to Grossman and Helpman (1994, pp. 845-846), in the case of one lobby group there is no opposition from competing interests, and the lobby group captures all of the surplus from its political relationship with the government. In this political equilibrium, the government derive exactly the same utility as they would have achieved by allowing no contribution. An interesting example with one lobby group can be found in Rama and Tabellini (1998, p. 1311).

Finally, the number of domestic firms is fixed whereas the number of foreign firms is endogenous.¹⁶ The government can affect the number of foreign firms by

¹⁵See Dixit, Grossman and Helpman (1997), pp. 756-759.

¹⁶It is not possible to endogenise the numbers of firms in both countries as then one group of firms

changing the fiscal policy. It is assumed that the host country is small in the market for FDI. Foreign firm moves into (out of) the host country if the profit it makes in the host country, π^f , is larger (smaller) than the reservation profit, $\bar{\pi}$, it can make in the rest of the world. Therefore, the FDI equilibrium provides

$$\pi^f = \bar{\pi}. \quad (14)$$

From (3), (4), (5) y (14), we have the defined solutions

$$X = \sqrt{\bar{\pi}/b} \quad (15)$$

$$n = \frac{a - c - \gamma(1 - \alpha) - \beta\alpha}{b\sqrt{\bar{\pi}/b}} - 1 \geq 1. \quad (16)$$

Now we have established the backbone of our analysis.

3 Optimal Institutional Level

Having described the properties of the political equilibrium, in this section we shall analyse the optimal institutional level and its effect on welfare. From (2) we have

$$\frac{dn}{d\alpha} = \frac{\gamma - \beta}{bX}. \quad (17)$$

An increase in the institutional level α will increase the number of foreign firms if the per-unit structural illegal cost is larger than the per-unit structural legal cost. In other words, when the illegal option is more inefficient than the legal one, an increase in the institutional level, α , will reduce the cost of the firms because the tax payment is made in a cheaper way inside the legal structure. In the opposite way when β is larger than γ , the illegal option is cheaper and an increase in α will reduce the number of incoming foreign firms. The increase in the institutional control will increase the firm's costs.

On the other hand, the effect of a change in the institutional level on the optimal output is null because the FDI adjusts to any output modification. From (15) we have

$$\frac{dX}{d\alpha} = 0 \quad (18)$$

The first step to determine the optimal α is to obtain the first order condition for the optimisation problem given in (10). From (6), (7), (8), (17) and (18) we obtain

-the ones with higher marginal costs- will be forced out of the market. One way out could be to relax the assumption that the goods produced by the two group of firms are homogeneous as was done in Lahiri and Ono (1998c).

implicitly the following result

$$G_\alpha = nX(\beta - \rho) + \frac{\gamma - \beta}{b}(\rho + \alpha(\beta - \rho)) + X(n + 1)(\gamma - \beta) = 0, \quad (19)$$

where from this equation we get

$$\alpha^* = \frac{\rho(\gamma - \beta)}{\Delta} + \frac{bX}{\Delta}[(n + 1)(\gamma - \rho) - \beta], \quad (20)$$

where $\Delta = (\gamma - \beta)(\rho - \beta)$. On the other hand the second order condition is given by

$$G_{\alpha\alpha} = \frac{(\gamma - \beta)}{b}[(\beta + \gamma) - 2\rho],$$

where concavity holds under the following conditions to consider in the analysis

$$\begin{aligned} \text{if } (\gamma - \beta) > 0 \text{ then } \rho &> \frac{\beta + \gamma}{2}, \\ \text{if } (\gamma - \beta) < 0 \text{ then } \rho &< \frac{\beta + \gamma}{2}. \end{aligned} \quad (21)$$

Under this conditions we can conclude that $\Delta > 0$.

From (20) we can see that the value of α^* is pretty ambiguous. This value will depend on the corruption parameter, the efficiency of the legal and illegal options and the market size. In order to cut clear results we consider two possible scenarios: first, we assume that the illegal option is more expensive than the legal option. Second, the illegal option is cheaper than the legal option.

In the first case, the firms face a efficient legal structure to pay taxes. It probably means legal and technical facilities implemented by the government to all tax payers. Simplicity in the fiscal structure is argued by most economist in emerging economies in order to solve the fiscal evasion and corruption. In this case we consider that the illegal structure is economically and legally more expensive.

In the second case, the firms face a inefficient government structure to pay taxes and the illegal option becomes a better option to pay taxes. Probably a complicated fiscal system and/or technical barriers are some of the main reasons why firms may prefer the illegal way.

3.1 Case 1: illegal cost option larger than the legal cost option ($\gamma > \beta$)

When the illegal option is more expensive than the legal one, by (21) can see that ($\rho > \beta$). The optimal α is ambiguous and would depend on the corruption level and market size which is defined as $S_X = (a - C)/b$ and, without loss of generality, it could be measured by a according to (15) and (16).¹⁷

¹⁷See Stephen Martin (1983, p. 15)

In the case in which the cost of bribe is larger than the cost of using the legal structure, an increase in the institutional level will increase the cost of the illegal option since the firms will be averse to use a costly and risky option. Under these conditions, there are two specific effects on government objective function: an indirect effect on FDI given by an increase in the number of entry firms, and a direct effect given by the change in the institutional level itself.

In the first one, an increase in the institutional level will increase the income of honest and dishonest people, the consumer surplus, the producer surplus and the contribution offered by the dishonest people due to the increase in the number of incoming firms. This is an indirect effect produced by the positive externality of new firms in the market. However, there is a direct effect produced by the increase in the institutional level which reduces the income of dishonest people and consequently the bribe paid by them to the civil service. This reduction in the bribe is produced by the reduction in the income of the dishonest people.

The net effect is going to depend on the weight attached to the dishonest payment on the government objective function. From (20) we can see that the level of corruption and the market size are the determinant variables. Despite the illegal option is more expensive than the legal one, a large corruption and market size parameters may produce the lowest institutional level. When the corruption parameter is small, the government may choose the highest institutional level. Formally we can say

Proposition 1 *When the illegal fiscal option is more expensive than the legal one, the optimal institutional level set by the government will be*

$$\begin{aligned} \alpha^* &= 0 && \text{if } \rho > \gamma \text{ and } a \gg 0 \\ \alpha^* &> 0 && \text{if } \rho \leq \gamma \end{aligned}$$

Intuitively the weight attached to the political contribution made by the dishonest people is determined by two parameters: the corruption parameter, ρ , which measures the governments sensibility of the contribution in the political process¹⁸; and the market size which determines the magnitude of the contribution taking into account the amount of production.

With a large corruption level, the contribution is a valuable objective for the government. There are incentives to set a lower institutional level in order to receive a increasing flows of contributions from the dishonest people. However it may not be enough because the amount of the contribution is going to depend on the amount of income received by the dishonest people. When the market size is large enough, the income from bribes is large too. Therefore, with a large corruption parameter and

¹⁸This sensibility may change according to many factors like election times and political scandals.

market size, the government will be willing to set the lowest institutional level despite the efficient legal structure¹⁹.

On the other hand, when the level of corruption is small (or the market is reduced), the weight of the political contribution is limited and the government is willing to maximize the benefit of the society in terms of consumer and producer surplus promoting the entry of firms and the benefit of the honest people. The government consider significantly the benefit of setting a high institutional level in order to increase the number of incoming firms. The efficiency of the legal structure will promote the foreign investment and the government is willing to eradicate any corruption in the civil service. The government will be more efficient as less corrupted civil service he has, and the way in which he eliminates the corrupted civil service is setting the highest institutional level.

3.2 Case 2: illegal cost option shorter than the legal cost option ($\gamma < \beta$)

When the illegal option is cheaper than the legal one, from (21) we can see that $\rho < \beta$. The optimum α will be again ambiguous. The value of the institutional level would depend again not on corruption level and market size.

The fact that the illegal structure is more efficient (or cheaper) than the legal structure is the more common case in developing economies. Actually the existence of these illegal structures depend on their ability of being a better option to overcome efficiently administrative and legal process rather than the legal option which is sometimes a pain in the way.

The firms take the illegal way in order to avoid all the administrative stuff. They prefer an efficient bribe rather than an inefficient administrative procedure. According to Klein (1999), with a social acceptance the illegal structure becomes an institution. The bribe is then a valuable institution which reduces the social uncertainty produced by an inefficient legal administrative structure.

Implicitly we are here considering that the origin of the illegal structure comes from the inefficiency of the legal one. In the previous case, in which the illegal structure was more inefficient than the legal one, it is implicitly assumed that the origin of the illegal structure is independent of the legal one. The former is seen as externally imposed²⁰.

¹⁹In this case the government magnifies the benefit of the political contribution. According to Magee et. al. (1989) this fact can be presented at the en of the political cycles, at election or re-election times, or under any political event which requires economic contributions.

²⁰Some cases like terrorism and drug trafficking can be considered here.

From (20) when the level of corruption ρ is relatively large, the institutional level set by the government will be the lowest possible. However, when the level of corruption is relatively small, and the market size is sufficiently large, the government will adopt the strictest institutional level. Formally we can say

Proposition 2 *When the legal fiscal option is more expensive than the illegal one, the optimal institutional level set by the government will be*

$$\begin{aligned} \alpha^* &= 0 && \text{if } \rho \geq \gamma \\ \alpha^* &> 0 && \text{if } \rho < \gamma \quad \text{and } a \gg 0 \end{aligned}$$

Intuitively we suspect that a cheaper illegal option may incentive to the firms to play against the legal way. In this sense a reduction in the institutional level will reduce the cost of the firms promoting the increase in the incoming number of firms. A reduction in the institutional level will produce again two effects on welfare: a direct effect given by the reduction in the income of the honest people (and the increase in the income of dishonest people); and an indirect effect given by the increase in FDI and its effect on the income of honest, dishonest, consumer and producer surplus.

When the corruption parameter, ρ , is sufficiently large, the incentives of the firms to play the illegal way is magnified. A large corruption level and the efficient illegal structure produce an institutional policy oriented to the most corrupted environment. The government is willing to set the lowest institutional level because the value attached to the political contribution and the benefit of the foreign firms is significantly larger than any reduction in the income of the honest people. In this case, the optimal policy will maximize the income of the government, the dishonest people and the benefit of the incoming firms. A lax institutional policy incentives the entry on new firms and the increase in consumer surplus.

In this sense, the government consider that the loss produced by the inefficiency of the legal structure could be widely compensated with the use of the illegal structure in benefit of FDI, consumer surplus and the political contribution.

On the other hand, when the corruption level is relatively small, the effect of the political contribution on welfare is rather limited. In this case the optimal decision of the government will depend on the market size. An increase in the institutional level will reduce FDI and consequently the contribution given by the dishonest people.

However, since the weight of the political contribution is relatively small, the government consider significantly the benefit of the honest people through a direct effect of an increase in the institutional level. In this sense, when the market size is sufficiently large, the benefit of the honest people is larger than the loss in contribution offered by the dishonest people. The government set a positive institutional policy, $\alpha > 0$ despite the inefficiency of the legal option.

4 Conclusions

In spite of the effort to set a proper institutional reform, the result has been disappointing. Misunderstanding the action of the corrupted civil service, political corruption and the inefficiency of the legal structures on the society's interests may lead to unsuccessful institutional policies. The illegal structures may substitute inefficiencies in the legal structures and the producers can take advantage of that. In terms of economic efficiency the illegal way can be more profitable and suitable than the legal options.

On the other hand, corruption is more complicated. Historically in many developing countries bribery for example has not only been a way to compensate the low wage rates, but also has been inherent to their culture, idiosyncrasies and sometimes religion. Nowadays corruption is a survival strategy which represent a source of income for people and government of these countries. For the government it may seem easier to help the people through maintaining this illegal structures.

On the other hand, the same government may have a political interest in supporting the illegal structures since these structures provide monetary resources. The political competition between political parties imply the need to get contributions to secure the continuity in the power. These contributions come from corrupted lobbies and dishonest people who try to influence the political decision.

This paper attempted to explain why some institutional reforms have failed and why some others simply have been just cancelled despite the apparent economic and social benefit. The corruption in the government and the benefit obtained by dishonest people can inhibit any action led by the honest governors to set a clear and healthy institutional environment. Bribes are the origin and the result of corruption, the dishonest people make payments to the party in the power to guarantee the institutional level according to their needs. Likewise the governments have to consider the benefits of its citizens and a part of the benefits come from bribes in the illegal structures. The dishonest people lobby the government taking into account their interests, and the government takes into account both the interest of the honest and dishonest nationals.

We model lobbying following the common agency problem as developed by Grossman and Helpman (1994). In this framework the government accepts political contributions from the lobbyists and the level of contribution depends on the policy that the government pursues.

We analyze two cases: in the first case, the cost for using the legal structure to pay taxes is smaller than the cost for using the illegal structure. In this case the government will set a positive institutional level when the level of corruption is sufficiently small. However, when the level of corruption and the market size are sufficiently large,

the government will overweight the contribution paid by the dishonest people and will set the minimum possible institutional level.

In the second case, when the cost for using the legal structure is larger than the cost of using the illegal one, the government will tend to set the lowest institutional level. This effect is reinforced when the corruption level is large. However, when the corruption level is small, and we have a relatively large market size, the government will consider very valuable the benefit obtained by the honest people and even above the level of the contribution paid by the dishonest one. The government will choose a positive institutional level in order to magnified the benefit of the honest people.

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