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# Committing to Transparency to Resist Corruption

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This paper studies firms' incentives to commit to transparent behavior in a competitive procedure modeled as an asymmetric information beauty contest managed by a corrupt agent. In his evaluation of firms' offers for a public contract, the agent has some discretion to favor a firm in exchange for a bribe. While unilateral commitment to transparency is never incentive compatible, **under some circumstances a voluntary but conditional commitment mechanism can eliminate corruption**. It is only when the agent's discretion is strong and the market's profitability is small that a low quality firm may prefer not to commit. In that situation, the high quality firms commit when commitment decisions are kept secret, but some conditions on firms' beliefs are required when commitment decisions are publicly announced. A mechanism combining both conditionality and a reward (a transparent selection advantage that need not be large) allows to completely eliminate corruption.

## CORRUPTION IN PUBLIC CONTRACTS

Corruption in competitive procedures for public contracts is **an issue in both developed and developing countries**. The stakes involved in many public contracts (e.g., in the construction of infrastructure or in the extractive industry) can be huge, and the highly specific character of these large markets leaves significant room for discretion to the agents who administer the procedures. This discretion can be abused in corruption at large costs for the national economy. The consequences are most serious in developing countries where government accountability is low. Great efforts have been exerted by international organizations (e.g., the World Bank or the European Community) to improve the legislation in developing countries. Many countries have adopted new procurement legislation (satisfying international standards), started deep-reaching reforms of public administration, introduced conflict of interest laws, etc. **Yet, there is by now a consensus that good laws alone are not sufficient to combat corruption**.

At the same time, the business case for fighting corruption has never been so strong. It is now recognized that at the level of the individual firm corruption raises costs, introduces uncertainty, reputational risks and vulnerability to extortion and also makes capital more expensive. Among the instruments developed by the business community, **we have seen a proliferation of codes of conduct and ethical standards** (cf. Global Compact). The discussion of how the private sector can help to fight corruption has also been taken forward under the umbrella of the G20. Similarly, the anti-corruption community has since many years developed a variety of commitment mechanisms aimed at curbing corruption in competitive procedures. Of particular interest are the Integrity Pact (which comes in several variants) and the Extractive Industries Transparency Initiative (EITI). The United Nations Convention Against Corruption also calls for the private sector to adopt standards of transparency that preclude bribery.

Yet, to the best of our knowledge, the properties of all these instruments have not been investigated in a strategic perspective. **Our paper contributes to filling this gap**. We are interested in the properties of simple and voluntary mechanisms aimed at combating corruption in competitive procedures, in particular in the procurement of concessions for the exploitation of natural resources.

## OUR APPROACH

**We model competition for a public project as an asymmetric information beauty contest with two firms**. An example would be in the extractive industry when the government of the Republic of Congo wants to allocate extraction rights and the government greatly values the firm's contribution to the development of the industry's infrastructure. More generally, a beauty contest is an allocation procedure where the price is either fixed or plays a minor role in competition. Instead, **firms compete in "quality"**. This procedure can be motivated when firms' private value is viewed as a poor proxy of the social economic value of the allocation. One of the main criticisms leveled against the beauty contest is that the evaluation of offers is less transparent than in a first-price auction. **Consequently, it opens the way for favoritism and corruption**. We view this vulnerability as a special reason for investigating the potential of commitment to transparency to reduce corruption in beauty contests.

The competitive procedure is managed by an agent who may be corruptible. **Corruption is modeled as an auction game** where the firms compete in the bribes they offer to the agent in exchange for a selection advantage in the evaluation of submitted projects. In equilibrium, bribery is either pure extortion, i.e., it does not affect the allocation of the contract, or it is accompanied by social economic inefficiency: the bad project wins. **We introduce a commitment mechanism which allows firms to credibly commit not to bribe**.

The starting point for the analysis is that no firm has any incentive to commit unilaterally. Therefore, we first consider a mechanism where commitment is conditional: the commitment of one firm is valid only if the other firm also commits. Thereafter we investigate the impact of a reward for commitment and finally we consider a mechanism that combines the two.

## CAN FIRMS RESIST CORRUPTION, WHAT DO WE LEARN?

**Our first main finding is that a simple conditional commitment mechanism has powerful potential to deter corruption** when no firm benefits from it, i.e., when corruption boils down to pure extortion. In those cases, the firms face a cooperation problem: they all prefer the no bribery outcome, but individually they prefer to offer a bribe if given the opportunity. A conditional commitment mechanism provides them with an instrument to cooperate. When we introduce a selection advantage rewarding the decision to commit, the no-corruption regime becomes even more attractive. In contrast, **we find that the more widespread unilateral commitment mechanism has a much less powerful deterrence potential**.
Basically, it has no impact if used without bonus, and with a (sufficiently high but not prohibitive) bonus it can at best induce high-quality types to refrain from corruption. In the more difficult cases where the low-quality type can gain from corruption, we find that **a mechanism that rewards the commitment decision but where commitment itself is conditional on the other firm's decision has the potential to fully deter corruption and bribery**.

## POLICY RECOMMANDATIONS

**Two policy recommendations emerge from this analysis**. First, it may not always be necessary to make commitment compulsory to obtain significant or even full corruption deterrence. Next, it may be worthwhile to consider making commitment conditional and explicitly rewarding firms that choose to commit with a selection advantage.

These recommendations are a contribution to the public debate underlying the present powerful drive to promote corporate integrity and corporate social responsibility, in particular among multinational corporations operating in LDC. It also contributes to the research and development activity of the anti-corruption community in its concern to engage the civil society and the private sector in the effort to curb corruption. Indeed, the development of EITI arose from disappointment with unilateral commitment (the Corporate Social Responsibility approach). EITI puts emphasis on urging host governments to make commitment compulsory for firms. However, persuading governments is an onerous task, and not all countries are willing to sign up to the EITI. Moreover, it does not apply to all sectors. In those cases our results suggest that a conditional commitment may be a solution that firms can manage autonomously. Similarly, rewarding commitment with a bonus only requires a limited engagement from the government and yet, as we show, it has the potential to significantly reduce corruption.

**We believe that these two features, namely full autonomy and making limited demands on the government, together with their effectiveness make our recommendations realistic and attractive.**