

# Defeating Competition together: Cartels and Corrupt officials are allies in Public Market



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A mounting body of empirical evidence shows that collusion and corruption often go hand in hand in public procurement. Is this simply a coincidence, or are there strategic reasons for the association? **We argue that there are strong strategic complementarities between cartel agreements aimed at containing competition and corrupt deals whereby the public officials abuse power to extract rents.**

## PUBLIC AND PRIVATE INTERESTS IN PROCUREMENT PROCEDURES

The aim of procurement procedures is to create competition between firms in order to reduce the cost of public works and purchases, i.e., to reduce firms' rents. **The conflicting interests of the government and the firms create a stake for corruption:** the procurement official may abuse his power to protect firms' rents in exchange for bribes. But we are not dealing with a simple bilateral relationship. Procurement procedures involve a number of firms that compete with each other. That competition is costly to firms; therefore, they often attempt to form a cartel to avoid competition. But cartel cooperation is difficult to sustain which opens the way for a valuable contribution from the side of a corrupt procurement official.

An example of the kind of situations we have in mind is in France where, practitioners and investigators in courts of accounts, competition authorities, and in the judiciary have long been aware of the close links between collusion and corruption in public tenders. J. C. Mery, a City Hall official, left a video tape before he died. On the tape he describes how for almost ten years (1985–1994), **he organized and arbitrated collusion in the allocation of construction and maintenance contracts for the Paris City Hall**<sup>1</sup>. In exchange, firms paid bribes that were used to finance political parties. The co-occurrence of collusion and corruption has also been extensively documented in a recent World Bank report on road construction.

## THE NECESSITY OF STUDYING THE LINKS BETWEEN COLLUSION AND CORRUPTION

Besides empirical evidence, there are theoretical reasons for studying the links between collusion and corruption in competitive procedures. First, **any cartel must solve a series of problems** including agreeing how to share the spoils, securing enforcement, and deterring entry. A corrupt auctioneer can help solve some of these problems - for example, by providing a means of retaliation against a defector. Second, **many cartels persist over time**, and they operate in a stochastically changing environment<sup>2</sup>. A cartel of firms must devise a mechanism that, although responsive to changes in an uncertain environment, does not induce opportunistic behavior.



Favoritism can help maintaining a cartel of bidders operating in a stochastic environment by "smoothing out" variations in the environment. Third, **corrupt auctioneers seek to extract rents**. Common provisions in competitive procedures provide them with ample opportunities to support collusion thereby creating rents that they can appropriate.

## OUR STUDY DEMONSTRATES THE POWER AND THE COSTS OF THIS COMPLEMENTARITY

In a series of papers and a chapter in Handbook, we have systematically explored the links between corruption and collusion in common procurement situations including the case where firms compete in price for a single well-defined contract. Another typical case is when firms compete for multiple lots. Yet, another often encountered situation is when firms are invited to compete not only in price but also along other dimensions, the so called "best offer" procedures. **In all three environments, we could expose a complementarity between firms' interest to defeat competition and the bureaucrat's interest to extract rents from his power.**

1. The case concerns the procurement of a 4.3 billion euros construction market (see Le Monde, January 26, 2000).

2. Public demand for e.g., construction works typically depends on a number of factors that are difficult to predict. These include social needs, the political agenda of elected representatives, internal budget concerns, etc. In addition, firms' technologies change over time. Together, these factors result in significant uncertainty about the profitability of future contracts.

In a one shot setting or when the discount factor is too low, cartel members have incentives to free ride to harvest large profits. This makes collusive agreements unsustainable. We demonstrated that it can be in the corrupt agent's own interest to use his information and discretionary power to punish a firm that deviates from the cartel agreement thereby serving as an enforcement mechanism. **With corruption collusion becomes sustainable.** In a repeated setting the cartel may be able to solve the enforcement problem on its own, but it faces other serious problems. From one period to the other the environment changes in an unpredictable manner. In order to be able to respond optimally to those changes, the cartel needs information about firms' cost in the current period. But firms do not generally have the incentives to reveal information truthfully. The presence of a corrupt agent changes the picture. In most complex tenders the formulation of the selection rule i.e., the way non-price aspects of the offer are quantified and weighted against the price factor is a key feature of the allocation procedure. By force of his private information, the corrupt auctioneer has discretion to fine-tune the selection rule in favor of a particular firm. This fine-tuning can solve the cartel's problem because thanks to corruption, it needs not adapt to the environment. Instead **"the environment" adapts to the cartel.**

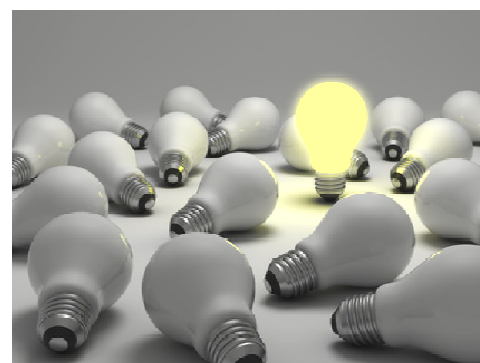
We thus find that **the complementarities between collusion and corruption have far reaching consequences.** The mere presence of a corrupt agent can induce collusion where one may not expect it, because it is not sustainable on its own. Because it generally facilitates collusion, the cost of corruption goes far beyond letting an inefficient firm win, the price paid can also be much higher and the project that is implemented may have a relatively poor social economic value: a lot of public money is spent with little benefit to the society. The cost of the combination of collusion and corruption in public tenders is thus larger than simply adding their respective social economic costs.

### WHAT ARE THE POLICY IMPLICATIONS ?

A first and central policy implication is that the fight against anti-competitive cartels and against corruption must be addressed simultaneously. In particular, **we critique the common institutional separation between the authority in charge of fighting anti-competitive behavior and the one in charge of anticorruption – close cooperation is needed.** We also suggest the need for the development of market design that limits both corruption and collusion. This means that we should develop a practice of adapting the fine details of competitive procedures to the specific risks of corruption/collusion that characterize the market under consideration.

Other policy implications are more specific to the particular context. They include the role of controls. In particular **controlling firms' ability to give bribes may be a very efficient means to restore competition** in a one-shot single contract tender.

Other results suggest that one should be particularly careful with provisions that give the auctioneer the right to let all firms legally readjust their bids. Yet other results invite one to **revisit from a new perspective the question of the bundling versus the unbundling of multiple lots.** We also provide arguments against the much advocated rotation of bureaucrats and emphasize the need for highly qualified procurement agents who can be held accountable.



### References

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