Honest Agents in a Corrupt Equilibrium*

ALEX HENKE†

Department of Economics
University of Washington
November 2015

Abstract

I construct a principal – agent – auditor taxation model with adverse selection in which the principal optimally allows bribery to occur due to the potential for extortion. This result mirrors the moral hazard model of Khalil, Lawarrée and Yun (2010). I introduce a probability that the agent is "honest" insofar as she cannot collude with the supervisor. Because the principal cannot distinguish who is honest and who is not a priori, he faces an additional dimension of adverse selection. Honest agents cannot reduce their expected penalties through bribery, and strategic agents can pretend to be honest, so the principal must allow additional rent for all dishonest agents. Or, he may shut down honest, low-income agents, avoiding the new adverse selection issue but losing revenue. In this way, honesty hurts the principal. Furthermore, I find that the principal may wish to audit the more productive, corrupt agent and induce extortion as a screening device to reduce the high-income honest agent's rent. I also explore how different types of honesty affect the principal's decision.

Keywords: Auditing, Corruption, Honesty, Multidimensional Screening

JEL Codes: D82, D03, H26

* I would like to thank Fahad Khalil, Jacques Lawarrée, Lin-chi Hsu, Phillip Bond, Quan Wen, and seminar participants at the University of Washington for their comments and suggestions. All errors are my own. The latest version of the paper can be found on the author's website at http://alexhenke.weebly.com/
† Email: henkear@uw.edu.