Corruption and Public Investment Under Political Instability: Theoretical Considerations

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[1] I am grateful for comments from my former colleagues at Essex University Tatiana Damjanovic, Gordon Kemp, Adrian Masters, Suresh Mutuswami and Sam Wilson. All remaining errors are mine. – Comments most welcome

1 Introduction

Political instability makes governments behave myopically, because beneficial effects of their policies may not accrue to them in the future. This may lead to underinvestment in infrastructure or reluctance in promoting structural change. Political instability may also explain the lack of determination in some governments' fight against corruption, even in cases when those governments do not benefit from corruption themselves.

This paper studies public investment under political instability. The main result is that there is a political instability threshold below which the government is so myopic that it does not want to invest at all. Going above the threshold leads to a strong increase in investment, at first, because additional political stability effectively increases the discount factor for the future. However, the additional investment increments (for more and more political stability) become smaller because marginal investment profitability goes down.

The result is obtained in a parsimonious model framework. The paper investigates a government's optimal choice between (i) public goods spending and (ii) public investment. To keep the revenue side as simple as possible a proportional income tax is modelled. Other sources of revenue could also be incorporated as done in other papers on political instability: seigniorage as in Cukierman, Edwards and Tabellini (1992), domestic debt as in Devereux and Wen (1998), or seigniorage and foreign debt as in Bohn (2000)[2]. However, the idea is to show a fundamental mechanism. The results do not primarily depend on economic, but rather on political (stability) conditions.

Sections 2 and 3 present the intertemporal framework of the theoretical model. Sections 4 and 5 summarize and simplify the government maximization problem. Interior and corner solutions are discussed in sections 6 and 7. Section 8 concludes.

2 Government Preferences and Political Instability

The model captures the intertemporal decision problem of the government. It consists of two periods: period 1 (current period) and period 2 (next period). There are two sectors in the economy: (i) the government and (ii) the private sector. The model is specified in real terms.

Government preferences over periods 1 and 2 are given by the following utility function:

$$W = V_1(C_1) + H_1(G_1, F_1) + E\{\rho(V_2(C_2) + H_2(G_2, F_2))\} \qquad (1)$$

The V.(•) functions are concave and twice continuously differentiable utility functions of the government in private sector consumption C. The H.(•) functions

[2] As in this paper, Svensson (1998) also models public investment, but interprets it as property rights investment and studies its impact on private investment.