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Favouritism and corruption in procurement auctions[☆]

Krishnendu Ghosh Dastidar [a,*], Sonakshi Jain [b]

[a] Jawaharlal Nehru University, India
[b] Sri Venkateswara College, University of Delhi, India

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ABSTRACT

This paper analyses the impact of favouritism and corruption in procurement auctions in an emerging economy. In our model there are two firms: One is the favoured one, while the other is not. The firm that wins the contract needs to supply a good that meets a certain quality standard, failing which its payment would be withheld. There is corruption in the system: If the measured quality falls short of the minimum stipulated level, the winner can pay a bribe to inflate the reported quality. The same amount of bribe inflates the reported quality of the favoured firm by a higher magnitude as compared to the firm which is not in favour. It is shown that favouritism induces inefficient outcomes, reduces competition and leads to lower expected equilibrium quality. The favoured firm also earns a higher payoff. The welfare effects of favouritism are ambiguous and we illustrate our results with an example.

1. Introduction

Public institutions as well as state-owned enterprises need to procure goods and services to carry out their responsibilities and duties. Public procurement is a key economic activity of governments that represents a significant percentage of the Gross Domestic Product (GDP) generating huge financial flows. In OECD countries, public procurement is estimated to account for 12% of GDP. In many non-OECD countries, that figure is probably higher.[1]

An effective procurement system plays a strategic role in governments for avoiding mismanagement and waste of public funds. Public procurement is one of the government activities which is most vulnerable to corruption. In addition to the volume of transactions and the financial interests at stake, corruption risks are exacerbated by the complexity of the process, the close interaction between public officials and businesses, and the multitude of stakeholders. There is a lot of literature around corruption in public procurement.[2]

Besides corruption, it is favouritism that puts the public procurement in peril. It may be noted that favouritism has been a part of human society, and it has existed within the social structure for millennia. Most government organisations have diversified stakeholders. Besides satisfying the voters, the ruling political party often favours some specific groups of people—industrialists, people belonging to a certain caste or social group etc.[3]

Favouritism and corruption coexist in almost all developing economies. Corruption thrives on the lack of commitment to basic morality and professional ethics. Favouritism thrives either on *kinship* (same caste, family, same community etc.) or on *friendship* (favouring politically connected actors in return for some favour). For instance, there are evidences to demonstrate that African political leaders have a tendency to favour members of their own ethnic group.[4]

This paper tries to theoretically analyse the effects of both favouritism and corruption in public procurements in an emerging economy. In our exercise there are two firms: one is the favoured one while the other is not. The firms compete in a

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* Corresponding author.
E-mail addresses: krishnendu.dastidar@gmail.com, kgd12@yahoo.com (K.G. Dastidar), jainsonakshi13@gmail.com (S. Jain).

1 See «https://www.oecd.org/gov/public-procurement/».

2 See Dastidar (2017) and Dastidar and Jain (2021) for a survey of such papers related to corruption in procurement. Also see Lengwiler and Wolfstetter (2006).

3 Nepotism and cronyism are two facets of favouritism. Nepotism essentially refers to the act of favouring family members or one's relatives. In brief, it means favouritism towards the members of one's kinship. Cronyism, on the contrary to nepotism, refers to the act of favouring a friend. Thus, this means favouritism based on friendship. Crony capitalism is an extension of the generic concept of cronyism as it applies to businesses and firms in a nation or society. It is a deliberate, systematic use of public policy to rig markets in ways that benefit politically connected actors. For example, a political party in power may favour specific business houses while dishing out lucrative government contracts. Crony capitalism breeds political entrepreneurs and stifles market entrepreneurs.

4 See Dickens (2018).

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