“Leakage” in International Regulatory Regimes: Did the OECD Anti-Bribery Convention Increase Bribery?*

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Abstract

When do well-intended regulatory regimes have unintended consequences? We examine one obstacle to successful regulation, “regulatory leakage,” in the context of the OECD Anti-Bribery Convention (ABC). Leakage occurs when regulated behavior decreases for actors under a regime's jurisdiction, but increases among those outside of it. We analyze a formal model that demonstrates how the ABC may simultaneously reduce bribery among firms from member countries, while increasing bribery by firms from non-ABC member countries. We also show how the ABC may lead firms from ABC member countries to shift to bribery through intermediaries. New empirical evidence of MNC activity in Vietnam shows evidence of both regulatory leakage and bribery through intermediaries.

*The authors thank audiences at Indiana University, the University of Texas at Austin, the 2016 International Political Society Conference, two anonymous reviewers and the editors of QJPS for helpful suggestions.
When do well-intentioned multilateral regulatory regimes produce unintended consequences? Regulatory regimes face well-known challenges, such as free-riding, imperfect monitoring, and lax enforcement. This means that in many areas, seemingly good regulatory policy can produce outcomes at odds with stated goals. In this paper we focus on one class of unintended consequences that highlights something of a paradox: when regimes successfully curtail a proscribed behavior among some actors, it may incentivize other actors to increase that behavior. Drawing parallels to work on sanctions, environmental policy, and foreign direct investment, we label this obstacle “regulatory leakage.”

Efforts to regulate undesirable behavior or control market externalities often suffer from some form of leakage. When undesirable behavior is well-regulated in one jurisdiction, actors may engage in forum-shopping, moving to less well regulated jurisdictions where consequences are absent or less severe. The globalization of production and the voluntary nature of treaty law make this a central problem in multilateral governance, as regulatory environments vary across countries. Regulatory leakage can also hinder domestic efforts to curtail negative externalities, as actors simply relocate to jurisdictions with more lax regulation. These patterns have been observed in the regulation of carbon emissions (Eichner and Pethig 2011, Babiker 2005), multinational corporations’ (MNCs’) evasion of environmental regulations (Eskeland and Harrison 2003, Dijkstra et al. 2011, Levinson 1996) or labor protections (Ayoub 1999; Mosley and Uno 2007, Mosley 2010), and in the application of multilateral sanctions (Early 2009, Early and Spice 2015, Tostensen and Bull 2002, Drezner 2000).

Our starting point is a puzzling empirical pattern associated with the OECD Anti-Bribery Convention (ABC), an international convention requiring countries to criminalize bribery for firms investing abroad. Jensen and Malesky’s (2018) list experiment in Vietnam, an emerging market host country for FDI from firms of heterogeneous nationalities, uncovers a curious empirical pattern. After the inception of the
ABC, bribery decreased (as intended) among firms from countries subject to the ABC. Yet bribery appeared to increase among non-subject firms after the ABC came online. This increase may have completely offset the reduction among ABC-subject firms. The ABC was effective, but only for firms from countries voluntarily subject to its regulations. It appears that an unintended consequence of the ABC was to incentivize bribery for firms from non-member countries. This finding is related to fears among U.S. firms that the 1977 passage of the U.S. foreign corrupt practices act (FCPA) would disadvantage them abroad. What is particularly surprising in the Jensen and Malesky (2018) study is that the ABC increased the bribery behavior of non-subject firms. Firms from subject countries are disadvantaged, while bribery by non-subject firms has increased.

We develop a game-theoretic model of bribery behavior that explains this pattern and speaks to larger challenges of regulatory leakage in multilateral regimes. In our model, $n$ firms decide whether to (a) bribe to gain access to a potentially lucrative market, (b) attempt access without bribing, or (c) stay out of the market. The market is competitive for firms that enter, but entry is restricted, which generates rents for market entrants. These rents dissipate as more firms enter. The benefits of entry are thus a function of the number of other firms that enter. However, firms possess private information about some aspects of their own productivity, which we model as directly affecting the costs of market entry. This means that individual firms’ entry decisions are conditional on their own costs for entry and their beliefs about other firms costs for entry.

We show that when a subset of firms is subject to an anti-bribery convention (or other form of regulation) that brings with it some probability of being caught engaging in bribery and subsequently fined, the entry decisions of the two groups diverge. Subject firms will be deterred as the probability of being caught or the severity of the sanction increases. This deterrent effect is consistent with Jensen and Malesky’s
(2018) findings. But because market rents are a function of the expected number of firms entering, in equilibrium non-subject firms enter at a higher rate. Indeed, this rate of entry, including the rate of bribery itself, increases as the number of subject firms goes up and as the strength of monitoring and enforcement of the regime increases. This points to an unintended consequence of treaties like the ABC. Although conventions with teeth—in this case, extraterritorial enforcement—can successfully deter bribery, they come with a tradeoff in competitive markets, where the deterrent effect on subject firms can translate into a permissive effect for non-subject firms.

We also analyze an extension in which subject firms can contract with a non-subject firm as a form of regulatory evasion. We explore how such a decision to bribe through an intermediary, a form of subcontracting, depends on the level of monitoring and enforcement in a firm’s home country and the cost-sharing required to bring in a partner firm for the purpose of evading the regime. When firms face a strong possibility of costly enforcement at home, they are more likely to engage in this form of regulatory evasion, especially if it requires only a small transfer to subcontracted firms. While laws like the FCPA forbid this sort of evasion, recent NGO reports and academic studies see it as an ongoing concern as firms have developed strategies to maintain “plausible deniability.”

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In the next three sections, we discuss existing literature on leakage in multilateral governance, provide background on the ABC, and discuss the empirical finding from Jensen and Malesky (2018). We then introduce the formal model. Next, we empirically examine the effect of productivity and home country enforcement on bribery. Finally, we analyze new survey data on subcontracting with foreign firms to evade ABC regulation. We close by discussing the implications of these results for anti-corruption efforts and regulatory regimes more generally.

Regulatory Leakage

We define regulatory leakage as the tendency of a proscribed behavior to move from an area where it is highly regulated, or from agents who are subject to more stringent regulation, to less well-regulated areas or agents. Leakage occurs across issue areas. Local police, for instance, have long understood that demand for illicit activities is hard to suppress: they can simply relocate when police presence increases in a particular area (cf. Ratcliffe 2005, Gabor 1981, Collins and Judge 2011). But the general phenomenon is possible in almost any arena in which there is differential enforcement or jurisdiction-specific rules.

Despite the prevalence of regulatory leakage (sometimes called “spillover”), the phenomenon has received more attention in economics and climate policy than in political science or international relations. Babiker (2005), for example, analyzes a formal model of firm competition against the backdrop of the Kyoto Protocol, concluding that pollution reduction targets may result in considerable relocation of firms to jurisdictions with less stringent restrictions. Likewise, anti-globalization activists have long been concerned about the possibility of MNCs evading environmental regulations and strict labor laws, possibly even driving governments to a regulatory “race to the bottom,” though empirical research finds mixed evidence (Mosley 2010, Mosley and Uno 2007, Chung 2009, Eskeland and Harrison 2003, Hallerberg and Basinger 2004). This scholarship often finds not a race to the bottom but standards increasing through patterns of diffusion. This “California effect” could lead to the diffusion of higher anti-bribery standards across the world (Vogel 1995).

The literature on economic sanctions identifies a similar phenomenon, sometimes known as “sanctions-busting” (Early 2009, Early and Spice 2015, Tostensen and Bull 2002, Drezner 2000). Sanctions regimes rely on individual countries monitoring and enforcing their own firms, and each other. Yet countries devote varying levels of ef-

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2See also Kukik and Gerlagh (2003), Paltsev (2001), Aichele and Felbermayr (2015).
fort, which means that sanction targets may simply seek alternative sources of illicit materials. Here, again, the culprit is differential monitoring and enforcement. A reduction in activity from firms in well-enforced areas works to the benefit of those in more lax jurisdictions. Firms from sanctions-busting states seize on profit-making opportunities generated by reduced activity from firms in sanctions-abiding states.

Differential enforcement allows some actors a competitive advantage if they can adapt their behavior in response to new opportunities or evade enforcement. Our theory and evidence point to a similar process after the implementation of the OECD’s ABC Convention. The ABC uses an “extraterritoriality” approach; countries must criminalize bribery in their domestic legal codes and hold their own firms accountable for illicit behavior abroad. In practice, countries vary in their efforts to monitor bribery, and the severity of punishment can likewise vary according to domestic law (Kaczmarek and Newmann 2011). And since the ABC is an international treaty, countries join voluntarily, leaving firms from non-participating countries outside its jurisdiction. These two features—enforcement differentials not only between member countries, but also between member and non-member countries—creates the potential for regulatory leakage.

The OECD Anti-Bribery Convention

In 1988, the United States amended the 1977 U.S. Foreign Corrupt Practices Act (US-FCPA). This amendment of one of the strongest existing anti-corruption acts formally required Congress to negotiate with other governments to coordinate anti-bribery efforts (George et al. 2000, 495) as a means of leveling the playing field between American firms that were constrained in their ability to bribe and firms from other countries that have few or no laws preventing their firms from bribing abroad (Pacini et
al. 2002; Schmidt 2009; Tyler 2011). Legal scholars have examined the motivations for the regulation for bribery. For example, Davis (2011) highlights that moralism, self-interest, and altruism can motivate the passage of anti-bribery laws. In many cases, firms prefer strong anti-bribery laws, which tie the hands of managers and reduce bribery demands from government actors (Perlman and Sykes 2017). Thus, the United States, in an effort to reduce an extreme form of regulatory leakage resulting from the FCPA, was actually the driving force behind a broad OECD initiative combating business bribery.

In 1999, representatives from a group of advanced industrialized economies negotiated an ambitious global agreement to combat business corruption. The ABC, eventually signed and ratified by all OECD nations plus an additional six non-OECD countries, requires signatory states to pass domestic anti-bribery legislation that criminalizes bribery by their own firms in other countries. In so doing, signatories implemented the judicial concept of extraterritoriality, which tasks countries with policing the behavior of their own citizens and firms abroad. Business executives from Australia, for example, are legally forbidden from paying bribes to government officials in any country in the world. With 41 signatories as of 2016, the agreement is seen as a stunning legal achievement, institutionalizing the belief that both limited capacity to enforce anti-bribery laws (Kaczmarek and Newman 2011), and the incentives of government officials that may be the recipient of bribes, can be overcome with home-country policing of foreign investment (Stephan 2012; Tyler 2011; Spahn 2012; Spahn 2013; Hatchard 2013). By making this agreement binding for all firms from OECD countries as well as additional signatories, the convention intended to produce a level playing field for firms from signatory countries (Duvanova 2007; Magnusson

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3This impetus is similar to Oatley and Nabor’s description of the Basle Accord as “redistributive cooperation.”

4Domestic legislation to improve the US-FCPA continues today, as lawmakers introduced legislation in August 2019 to criminalize bribery demands by foreign officials (see Richard L. Cassin, “To plug gap in FCPA, Congress considers ‘Foreign Extortion Prevention Act,’” The FCPA Blog 5 August 2019).
For some firms, the potential for reducing global bribery dramatically reduced the costs of doing business abroad. Bribery can see seen as a tax on business that is both illegal and uncertain (Mauro 1995; Wei 2000; Habib and Zurawicki 2002; and Cuervo-Cazurra 2008). This “tax” can include both the high cost of hiding the illegal activity (Schleifer and Vishney 1993) and the unpredictability of bribery due to political changes (Samphantharuk and Malesky 2008). For other firms, the net impact of this agreement is mixed. Firms often bribe to win government contracts or obtain land and licenses, trading bribes for access to rents (Bliss and Di Tella 1997; Ades and Di Tella 1999; Hellman et al. 2000), and the impact of this convention on their business is partially a function of how effective these bribes are in winning contacts and the effectiveness of their competitors’ bribes. Even with strong enforcement, the expected costs of anti-bribery actions, relative to the benefits, is modest for most firms. For example, Karpoff, Lee, and Martin (2017) find that the benefits of bribery often exceed the costs as well as the reputational consequences for bribery, although if bribery includes financial fraud, the costs can be considerably higher.

The ABC’s version of extraterritoriality relies at least in part on the concept of “peer review.” Each state party to the treaty is examined periodically by an OECD Working Group, which produces a report intended to “name and shame” governments with lax enforcement of their firms’ practices. Phase 1 involved examining whether parties to the treaty have successfully criminalized proscribed behavior in domestic law. Phase 2 examined the application of these laws. Phase 3, which examined the de facto behavior of firms and the country’s application of appropriate extraterritorial enforcement, led to scathing reports of some countries’ enforcement efforts in 2010 (Stevenson 2014; Tyler 2011).\footnote{This oversight activity takes a variety of forms. For instance, the OECD recently publicly recommended that Hungary increase its domestic enforcement of bribery laws. See Claudia Patricolo, “OECD concerned over Hungary’s lack of bribery investigations,” Emerging Europe 5 August 2019.}
How effective is the peer review mechanism? In previous research, Jensen and Malesky (2018) examine the case of business bribery in Vietnam, a country host to foreign investment from a diverse set of home countries, including both ABC signatories and non-signatories. On the surface, the findings from this study point to the effectiveness of the convention in limiting bribery. Simply signing the ABC had no impact on host firms, but once countries became subject to peer-review of anti-bribery enforcement efforts that began with Phase 3 of the convention at the end of 2009, firms from signatory countries dramatically reduced their bribery in Vietnam. An anti-bribery convention armed with the teeth of peer-review had a substantial impact on reducing bribery in Vietnam, pointing to a seeming success of international law.

Jensen and Maleksy’s (2018) technique shields respondents from incriminating themselves or their firm over bribery (see also Malesky et al. 2015). Unlike perception-based surveys that can be subject to bias (Treisman 2007; Olken 2009), corruption is measured based on firm experiences during business registration and the process of obtaining a government procurement contract. Their “list experiment” sidesteps this problem by presenting both a treatment and a control group with a list of activities, asking respondents to identify the number of activities they’ve engaged in (Ahart and Sackett 2004; Coutts and Jan 2011). The treatment group has a list that includes the sensitive behavior, while the control group does not. The analyst can then use the difference in means between treatment and control to identify how often firms engage in the sensitive behavior. Jensen and Malesky (2018) find that the ABC, after the peer-review phase (Phase 3 at the end of 2009), dramatically reduced bribery for signatory country firms. Prior to the ABC, signatories and non-signatories bribed at equally high rates. Over 20% of foreign firms paid bribes during registration and over 40% of firms paid bribes during government procurement bidding.

However, the study also uncovered a puzzle unnoticed by previous research: the ABC led to a reduction in bribery relative to non-convention signatories. For exam-
ple, South Korean firms (ABC signatories) bribe at far lower rates than Taiwanese firms (ABC non-signatories) after the convention. But this relationship is partially driven by the increased bribery behavior of non-signatory firms. South Korean firms reduced bribery after the peer review process in the ABC, while Taiwanese firms increased their bribery. More generally, ABC signatories dramatically decreased their bribery as expected. The frequency of bribing behavior decreased from a remarkable 23.1% of firms to 11.5% of firms, providing clear evidence for the effectiveness of the convention for signatories. Nevertheless, these positive findings were coupled with a disturbing pattern among the firms from non-signatory countries, who more than doubled their propensity to bribe, from an already high 18.6% to a shocking 40.7% of firms. It appears that the ABC achieved its objective of decreasing bribery by subject firms while perversely increasing bribery by non-subject firms—potentially offsetting the Convention’s positive effects. It appears as if much, if not most, of the bribery formerly accounted for by firms subject to the treaty shifted to non-subject firms after the treaty came into force.

Model

We analyze an $n$-firm model of market entry in which (a) rents dissipate as the number of entrants increases and (b) firms can enter either cleanly or via bribery, the latter of which ensures access at an additional up-front cost. Firms differ in their productivity, such that more productive firms pay a lower marginal cost for entry than less productive firms, rendering the former relatively less willing to pay a bribe to improve their chances of entry. A firm’s productivity is private information, but other firms’ priors are informed by a uniform type distribution. In practice, some elements of productivity are observable; firms pay close attention to their competitors, after all. But it’s also reasonable to assume that some features of productivity, such
as proprietary technologies, specialized management practices, or financial strategies are known only within the firm (Kreps 1990). These factors are important to firm success in a market but unobservable to the competition.

We also consider two extensions. First, we allow $k$ firms to be subject to an anti-bribery treaty, like the OECD ABC. Firms subject to the treaty risk their home countries catching and fining them if they bribe. We can think of the probability of being caught as the quality of monitoring a firm faces, while the cost of a fine can be thought of as the severity of enforcement. We examine how the bribing behavior of $k$ subject firms as well as the remaining $n-k$ firms changes in response to these parameters. Second, we allow subject firms the option to subcontract with a non-subject firm that can pay an entry bribe. Subcontracting avoids detection and fines but entails profit-sharing with the subcontracted firm. Thus, the decision over whether to evade the treaty by bribery through an intermediary depends on the tradeoff between (a) reducing the chance of detection and sanction and (b) the degree of necessary profit-sharing with a non-subject firm or subsidiary.

Our model bears some similarity to others that study coordination in market entry games, in that we examine the strategy of $n$ firms who do not communicate and enter simultaneously. Like those models, we also assume the payoff to entry depends on the number of other entrants. We deviate from such models by examining the affect of asymmetric incentives on some firms as a function of their jurisdictions being party to the ABC. By making firm type private information, our model resembles Laffont and Tirole’s (1987) classic auction model, though we do not model a government actor and are not concerned with identifying optimal procurement strategies. Instead, we take the likelihood of firm success as given, and use the structure to generate leverage over how the Convention alters firm incentives and equilibrium rates and means of entry. Ours is thus a specific case of a more general class of models about simultaneous entry

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6See, for example, Anderson and Eggers 2007, Gary-Bobo 1990, Selten and Guth 1982, Sundali et al. 1995,
entry among many firms.

**Baseline Model**

**Actors and Timing**

We consider \( n \) firms with privately-known productivity \( \theta \). The timing of the game is:

1. Nature draws \( n \) firm types \( \theta \sim U[0, \bar{\theta}] \).

2. Firms choose whether to not enter, enter “cleanly,” or enter via bribery.

3. Nature determines whether clean entry is successful, but bribery ensures successful entry.\(^7\)

**Payoffs**

Profits decrease in the number of other successful entrants. This gives us the following payoff function for firm \( i \) taking action \( a \),

\[
u_i(a) = \begin{cases} 
0 & \text{if } a = \text{out} \\
(R - E[f]) - \theta(c + b) & \text{if } a = \text{bribe} \\
p(R - E[f]) - \theta c & \text{if } a = \text{clean},
\end{cases}
\]

(1)

where \( \theta \) is firm \( i \)’s type, \( R > 0 \) is the value of market entry, \( E[f] \) is the expected number of other entrants (clean and bribing), \( c > 0 \) is the cost of entry, \( b > 0 \) is the cost of a bribe, and \( 0 < p < 1 \) is the probability of successful clean entry.

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\(^7\)Alternatively, we could model entry success via bribery as probabilistic, but the results only hinge on the assumption that bribery improves the chance of entry, so we fix the probability of bribery entry success at 1.
**Information**

Firm $i$’s privately known productivity defines its type, $\theta$, and shapes the marginal cost of entry, acting as a multiplier on both upfront costs and bribes. When $\theta$ is low, firm $i$ is relatively productive, or a low-cost type; when $\theta$ is high, firm $i$ is relatively unproductive, and thus a high-cost type. Some aspects of firm productivity are observable, but other aspects, such as proprietary procedures, particular organizational cultures, and management practices are known only within the firm.\(^8\) Yet these characteristics are important determinants of success in procuring entry into new markets, as they influence competitive bids. We assume $\theta \sim U[0, \bar{\theta}]$, which informs each firm’s prior beliefs over each other firm’s type.

**Equilibrium**

We look for Bayesian Nash Equilibria (BNE), at which each player-type chooses a strategy from which it has no profitable deviation, given the strategies of all other player-types and the probability distribution over the types. We identify an equilibrium in which firms play a cut-point strategy, with the least productive firms staying out of the market, moderately productive firms bribing to guarantee entry, and the most productive firms attempting clean entry.

**Proposition 1.** When $p > \frac{c}{c+b}$ and $R > E[f]$, there exists a Bayesian Nash Equilibrium at which firms enter cleanly when $\theta < \theta_l$, enter by bribing when $\theta_l \leq \theta < \theta_h$, and stay out when $\theta_h \leq \theta$. See appendix for proof.

In the Appendix, we identify $\theta_l$ and $\theta_h$ as the types indifferent between clean entry and bribery, and between bribery and no entry, respectively, where

\(^8\)Kreps (1990) provides a good analysis.
\[
\theta_h = \frac{bR\hat{\theta}}{(n-1)(b(2-p)p - c(1-p)^2) + b\hat{\theta}(b+c)}
\]

and

\[
\theta_l = \frac{(1-p)R\hat{\theta}(b+c)}{(n-1)(b(2-p)p - c(1-p)^2) + b\hat{\theta}(b+c)}.
\]

Some firms bribe at our baseline BNE, which exists as long as clean entry is sufficiently likely to be successful and the total pie to be shared by entrants is sufficiently large. The most productive firms (\(\theta < \theta_l\)) pay such low costs for entry that, for a sufficiently large chance of success (\(p > \frac{c}{c+b}\)), they accept the risks of clean entry. Moderately productive firms, however, choose to offset their relatively higher costs (\(\theta_l \leq \theta < \theta_h\)) with a bribe that guarantees entry. Finally, the least-productive firms (\(\theta \geq \theta_h\)) stay out, because the costs of entry are simply too great to offset the rent dissipation caused by the entry of other, more productive firms. The condition \(p > \frac{c}{c+b}\) has a straightforward interpretation, which is easy to see when rearranged as

\[
1 - p < \frac{b}{c+b}.
\]

The left side of the inequality represents the benefit of bribery, in terms of increased likelihood of entry success. The right side is the ratio of the price of a bribe to total entry costs. Thus, in order for the equilibrium to exist, the benefits of bribery must not exceed the ratio of the costs of clean entry to bribery.

At this baseline BNE, the expected number of entrants, or \(E[f]\), is

\[
n \left( \frac{\theta_h - \theta_l}{\hat{\theta}} \right) + n \cdot p \left( \frac{\theta_h}{\hat{\theta}} \right),
\]
where the first term is the expected number of entrants via bribery and the second is the expected number of successful clean entrants. This means that any exogenous parameter that increases (decreases) $\theta_h$ will increase (decrease) the number of expected entrants via bribery, and any exogenous parameter that increases (decreases) $\theta_l$ will increase (decrease) the number of expected clean entrants. Clearly, both $n$, the number of other firms, and $p$, the probability of successful clean entry, increase $E[f]$.

Next, we introduce a subset of firms subject to an anti-bribery convention.

**Anti-Bribery Convention**

We introduce the anti-bribery convention by adding two parameters that define a group of firms from ABC signatory countries. Suppose that being subject to the convention entails a probability of getting caught and sanctioned for bribing. Monitoring and enforcement are imperfect, so the probability of being observed making a bribe by the relevant authorities is $q \in [0,1]$, and the penalty is $s > 0$. The expected cost is simply $q \cdot s$, which we subtract from the expected utility of bribing for subject firms. Payoffs for non-subject firms are as defined in Equation (1), but for ABC subject firms,

\[
u_i(a|\text{subject}) = \begin{cases} 
0 & \text{if } a = \text{out} \\
(R - E[f]) - \theta(c + b) - q \cdot s & \text{if } a = \text{bribe} \\
p(R - E[f]) - \theta c & \text{if } a = \text{clean}.
\end{cases}
\] (2)

We study a cut-point BNE similar to that described in Proposition 1, but strategies differ for subject and non-subject firms.

**Proposition 2.** When $p > \frac{c}{b+c}$ and $R > E[f] + q s$, there exists a Bayesian Nash Equilibrium at which non-subject firms enter cleanly if $\theta < \theta_{nl}$, enter via bribery if $\theta_{nl} \leq \theta < \theta_{nh}$, and stay out when $\theta_{nh} \leq \theta$, while subject firms enter cleanly if $\theta < \theta_{sl}$, enter via bribery if $\theta_{sl} \leq \theta < \theta_{sh}$, and stay out when $\theta_{sh} \leq \theta$. See appendix for proof.
Here again, we derive cutpoints $\theta_{nl}$ and $\theta_{nh}$, and $\theta_{sl}$ and $\theta_{sh}$, which define the types of non-subject and subject firms that are indifferent between clean entry and bribery, and between bribery and no entry. To ease presentation we write the probabilities of a non-subject and subject firm entering successfully as

$$v = p \cdot \frac{\theta_{nl}}{\bar{\theta}} + \frac{\theta_{nh} - \theta_{nl}}{\bar{\theta}}$$

and

$$\sigma = p \cdot \frac{\theta_{sl}}{\bar{\theta}} + \frac{\theta_{sh} - \theta_{sl}}{\bar{\theta}},$$

respectively. The types that are indifferent are then:

$$\theta_{nh} = \frac{R - v(n - k) - \sigma k}{b + c}$$

and

$$\theta_{nl} = \frac{(1 - p)(R - v(n - k) - \sigma k)}{b}$$

for non-subject firms and

$$\theta_{sh} = \frac{R - v(n - k) - \sigma(k - 1) - qs}{b + c}$$

and

$$\theta_{sl} = \frac{(1 - p)(R - v(n - k) - \sigma(k - 1) - qs)}{b}$$

for subject firms. At this BNE, subject firms pay an additional expected cost compared to non-subject firms for entry via bribe, and the size of that cost is determined by $q$, the probability that a firm is caught bribing, and $s$, the size of the punishment.\(^9\) This extra cost ensures that firms from ABC countries must expect a greater chance of success and higher profits in order to attempt entry. At the equilibrium, subject firms are less likely to enter than they are at the baseline equilibrium, while non-subject firms are more likely to enter; that is, the highest-cost subject type that enters is lower than the highest-cost non-subject type that enters ($\theta_{sh} < \theta_{nh}$).\(^{10}\) Proposition 3 explains that this difference derives from the expected costs of bribery $q \cdot s$, which has the direct effect of discouraging subject firms from entering and the indirect effect of

\(^9\)This is an unrealized cost at the time of the entry decision. We refer to it as an expected cost because with probability $q$ the firm will have to pay $c$ at some future point. Thus it is separable from present productivity and entry costs.

\(^{10}\)It’s straightforward to show that $\theta_{sh} < \theta_{nh}$ when $R > E[f] + qs$.\)
encouraging non-subject firms to enter and claim abandoned profits for themselves.

**Proposition 3.** As \( q \cdot s \) approaches zero, \( \theta_{nl} \) and \( \theta_{sl} \) converge on \( \theta_l \), and \( \theta_{nh} \) and \( \theta_{sh} \) converge on \( \theta_h \). See appendix for proof.

Proposition 3 shows that as the quality of monitoring \( (q) \) and/or the severity of sanction \( (s) \) decrease, the “playing field” becomes more equal. The direct reduction in subject-firm entry and its indirect increase in non-subject entry both diminish, and cut-points for both subject and non-subject firms converge on the cut-points in Proposition 1. Conversely, as \( q \) or \( s \) increase, so does the gap in entry decisions between subject and non-subject firms, with subject firms requiring higher productivity to enter. In practice, this gap not only exists between subject and non-subject firms, but also within subject firms due to extraterritorial enforcement. That is, in our model, \( q \) and \( s \) do not vary across subject firms, but in practice home country enforcement regimes vary in quality and severity. This logic is well understood amongst parties to the convention, and it is part of the rationale behind the peer review system. For a given level of productivity, firms from high enforcement countries (where \( q \) and/or \( s \) are high) are less likely to enter because they have to take into account the potential costs of enforcement. This, in essence, places them at a competitive disadvantage relative to their peers from more lax enforcement environments.

This gap is the motivation behind calls to expand participation in multilateral anti-bribery efforts. Firms that are party to the convention may be at a competitive disadvantage to non-subject firms; this is the direct effect of the convention. This also means that non-subject firms may face less competition, making entry more profitable, which we identify as the convention’s indirect effect. To see why this is the case, recall that in the baseline model we can write the expected number of successful entrants via bribery as \( n \left( \frac{\theta_h - \alpha}{\theta} \right) \) and via clean entry as \( n \cdot p \left( \frac{\theta_l}{\theta} \right) \). With firms divided into subject and non-subject groups, the expected number of competitors must incorporate expectations over both sets of cut-points. The expected number of competitors
**Figure 1:** Cut-point strategies for non-subject and subject firms in the equilibrium with an anti-bribery convention, where types that bribe are highlighted in gray.

![Cut-point strategies diagram](image)

The expected number of subject entrants will be lower than non-subject entrants because \( \theta_{nl} > \theta_{sl} \) and \( \theta_{nh} > \theta_{sh} \). In other words, the proportion of subject firms that fall within the middling and high ranges of productivity will be larger than the number of non-subject firms that fall within the middling and high ranges of productivity.

Figure 1 illustrates how the cut-point strategies of subject and non-subject firms compare to the baseline model. Subject firms are disincentivized to enter via bribery, which reduces the range of types that are willing to bribe. As a result, non-subject firms are incentivized to bribe relative to their counterparts in the baseline model.

The expected number of non-subject and subject entrants can thus be written as:

\[
E[f] = (n - k) \left( p \frac{\theta_{nl}}{\bar{\theta}} + \frac{\theta_{nh} - \theta_{nl}}{\bar{\theta}} \right) + k \left( p \frac{\theta_{sl}}{\bar{\theta}} + \frac{\theta_{sh} - \theta_{sl}}{\bar{\theta}} \right). \tag{4}
\]

The first term shows the total number of expected non-subject entrants, while the second shows the total number of subject entrants. The expected number of subject entrants will be lower than non-subject entrants because \( \theta_{nl} > \theta_{sl} \) and \( \theta_{nh} > \theta_{sh} \). In other words, the proportion of subject firms that fall within the middling and high ranges of productivity will be larger than the number of non-subject firms that fall within the middling and high ranges of productivity.
The relative effect of this shift in firms’ expectations depends on $k$, or the number of subject firms. As the number of subject firms rises, more of the expected competition comes from the type distribution defined at subject firms’ cut-points, $\theta_{sl}$ and $\theta_{sh}$, which produces fewer expected entrants and encourages entry from non-subject firms relative to the baseline model. Both $\theta_{nst}$ and $\theta_{sl}$ both rise in $k$, but the latter rises more quickly, ensuring that $k$ not only increases entry among subject firms in general, but also specifically increases the rate of bribery as well, widening the range of non-subject firm types that bribe. Proposition 4 states the result.

**Proposition 4.** When $p > \frac{c}{b + c}$ and $\bar{\theta}$ is sufficiently high, non-subject firms are more likely to bribe as the number of subject firms ($k$) increases. See Appendix for proof.

This extension to the baseline model demonstrates that when some firms are subject to a bribery convention that entails a possible cost for bribing, non-subject firms will be (a) more likely to enter in general and (b) more likely to do so via bribery. Next, we turn to the possibility that even subject firms adapt to evade detection, a practice explicitly outlawed in the U.S. Foreign Corrupt Practices Act and in the ABC, but nonetheless is a growing concern among anticorruption experts.

**Subcontracting to Non-Subject firms**

When firms become subject to the convention, their incentives to enter the market are diminished at the margin, which makes market entry more lucrative for non-subject firms. Thus far, we’ve modeled firms as facing only three choices: enter via bribery, enter cleanly, or remain outside of a market. But subject firms may face a fourth option of subcontracting with consultants of law firms, usually domestic businesses, who assume responsibility for completing business registration, licensing, procurement, and inspection formalities, including handling any necessary bribes.\(^{11}\) Despite

\(^{11}\)See Bray (2005) for details. Sartor and Beamish (2018) find evidence that MNCs are more like to hire local intermediaries in corrupt states.
efforts to outlaw this strategy like the FCPA, identifying instances of bribery through intermediaries remains challenging. These firms can directly pay any entry bribes and thus inoculate foreign, subject firms from behavior considered illicit in their home jurisdiction. This fourth option — subcontracting for bribery — provides legal cover for subject firms, but at the cost of additional fees paid to the subcontracted firm.

How does the possibility of subcontracting affect rates of bribery?

Consider an extension to the above model with the following features: firms may stay out of the market, enter via bribery, enter via subcontracting, or enter cleanly. We model the cost to the subject firm of contracting with a non-subject consulting firm as simply increasing the cost of entry by some factor that represents the costliness of outsourcing with a non-subject firm. Let \( z \) be the cost of subcontracting. Like the models above, we fix the probability of successful entry via subcontracting at 1 identical to that under directly bribery. But under subcontracting, the subject firm avoids the possibility of being caught and sanctioned, so does not pay the expected cost \( q \cdot s \).

We assume the firm still provides the funds for bribery; subcontracting only provides plausible deniability of the exchange. This provides the following payoffs for firm \( i \), where we \( \sigma = 1 \) if \( i \) is a subject firm and \( \sigma = 0 \) otherwise:

---

12 See Lambsdorff (2013). Transparency International continues to flag this practice as a challenge to regulating corruption; see Transparency International (2010).
13 Assuming there is no chance of being caught subcontracting simplifies the analysis, but all that is required for the following equilibrium is that the probability of being caught when subcontracting is lower than the probability of being caught utilizing direct bribery.
14 This also means it is never superior for non-subject firms to subcontract, because in so doing they incur both costs \( b \) and \( z \), whereas they only incur cost \( b \) when directly bribing.
\[
    u_i(a) = \begin{cases} 
        0 & \text{if } a = \text{out} \\
        (R - E[f]) - \theta(c + b) - \sigma(q \cdot s) & \text{if } a = \text{bribe} \\
        (R - E[f]) - \theta(c + b) - z & \text{if } a = \text{subcontract} \\
        (R - E[f]) - \theta(c) & \text{if } a = \text{clean}. 
    \end{cases}
\]  

Equation (5) makes clear that the key decision for subject firms is now whether to bribe directly or subcontract, as their utility for one versus the other vary only in the cost of subcontracting and the cost of bribing. Non-subject firms do not resort to subcontracting in this formulation, as they have no incentive to evade the regulatory regime. For subject firms, the difference between subcontracting versus bribing hinges on the cost of subcontracting, \(z\), relative to the expected cost of sanctioning, \(q \cdot s\). This game has two Bayesian Nash Equilibria, identified in Propositions 5.

**Proposition 5.** When \(z < q \cdot s\), there exists a Bayesian Nash Equilibrium in which non-subject firms enter cleanly when \(\theta < \theta_{nh}\), enter via subcontracting when \(\theta_{nl} \leq \theta < \theta_{nh}\) and stay out when \(\theta_{nh} \leq \theta\). Subject firms enter cleanly when \(\theta < \theta_{sl}\), enter via subcontracting when \(\theta_{sl} \leq \theta < \theta_{sh}\), and stay out when \(\theta_{sh} \leq \theta\).

When \(z \geq q \cdot s\), there exists a Bayesian Nash Equilibrium in which non-subject enter cleanly when \(\theta < \theta_{nl}\), enter via bribery when \(\theta_{nl} \leq \theta < \theta_{nh}\), and stay out when \(\theta_{nh} \leq \theta\). Subject firms enter cleanly when \(\theta < \theta_{sl}\), enter via bribery when \(\theta_{sl} \leq \theta < \theta_{sh}\), and stay out when \(\theta_{sh} \leq \theta\). See appendix for proof.

The first equilibrium describes a situation in which subcontracting is more cost-effective. The benefit of evading the regime and avoiding potential sanctioning is worth the cost of subcontracting. The second equilibrium describes a situation in which the degree of profit-sharing or other costs associated with subcontracting exceed the expected costs of being caught and sanctioned for bribing. Here, subject
firms of middling productivity will enter via bribery rather than subcontracting, because it’s more cost effective to risk sanctioning than to enlist a non-subject firm in the illicit activity. This suggests that firms from high enforcement countries that are subject to the ABC will be more likely to engage in subcontracting, while firms from low enforcement jurisdictions may continue to bribe despite being subject to the regulatory regime.

**Implications**

The equilibria identified above lead to a number of empirical implications. First, firm strategies follow a common pattern. More productive firms (lowest entry costs) see the added benefit of bribery as small relative to the cost. Firms with middling levels of productivity may see a substantial enough increase to entry success that they deem bribery worth the cost, while firms at the low end of the spectrum face such high entry costs they opt to stay out. This implication is a new addition to the literature, though perhaps consistent with findings that bribery declines with firm size, which some authors have viewed as a proxy for productivity (Bai et al. 2019).

Second, Proposition 4 establishes that as the number of firms subject to the ABC increases, the rate of market participation (both through clean entry and bribery) of non-subject firms increases. This predicts the perverse effect of the convention. If subject firms are deterred, even at the margin, by the expected cost of being caught and sanctioned, some firms who would otherwise bribe and enter the market will instead stay out. This means analysts should observe less bribery by subject firms, which is, after all, what such agreements hope to accomplish. Because rents in markets with barriers for entry are decreasing in the number of entrants, however, the reduction in bribery from subject firms will create additional profit opportunities for non-subject firms. Bribery decreases amongst subject firms, but it increases amongst
Third, Proposition 3 shows that the degree to which these dual impacts of the convention obtain is a function of the quality of monitoring. Recall that the main effect of the convention is to generate some expected costs of bribery, represented by $q \cdot s$. As either or both of these parameters go to zero, the entry decision for subject firms converges to that of the non-subject firms. At the same time, the decision rule of the non-subject firms converges on that of the equilibrium with no convention. If enforcement varies across countries parties to the convention, it means that firms from weaker enforcement or no enforcement jurisdictions will behave more like non-subject firms.

These two propositions point to interesting overall welfare effects of any international regulatory convention generally, and any anti-bribery convention in particular. On the one hand, if $q$ and $s$ are greater than 0, meaning there is some positive probability of being observed bribing and sanctioned, the convention will work as intended and reduce bribery among subject firms. On the other hand, this will tend to increase bribery among non-subject firms, and this tendency will be magnified as more firms become subject to the convention and as the quality of monitoring and severity of enforcement go up. This logic should be cause for concern if the goal of the convention is to create general disincentives for bribery.

Among state parties to the ABC, the peer review system is intended to “shame” one another into tougher enforcement, which, in theory should eliminate cross-country differences in enforcement levels. In practice some differences remain, however, due to variation in norms and the capacity of the legal systems and criminal investigators. At the same time, firms from countries that are not party to the convention face a different set of rules altogether. To be sure, by establishing common obligations and a system of peer monitoring, the treaty improves upon collective action in of combating bribery. But as long as national jurisdictions vary and treaty participation
rests on consent, the application of rules to some firms will alter incentives for others, resulting in spillover or leakage.

Fourth, the model also shows how firms might devise strategies that take advantage of differential enforcement. Proposition 5 shows that once the baseline model is extended to include the possibility of subcontracting out bribery, entry decisions will be contingent on the marginal costliness of subcontracting relative to the strength of monitoring and cost of enforcement. The degree to which firms pursue this evasive adaptation will depend on expectations about the strength of monitoring and enforcement for themselves, but also indirectly for other firms. That is, firms’ expectations about the number of competitors they’ll face upon entry are based on the aggregation of other firms entry rules, which are themselves shaped by their marginal cost of entry relative to the strength of enforcement and monitoring. The relative cost of subcontracting may be based on a number factors, but Proposition 5 shows that whether subcontracting is attractive or not cannot be considered in isolation, but rather relative to the attractiveness of entry via bribery, which entails some risk of being caught and sanctioned. This means that increasing the strength of monitoring and enforcement will tend to increase the evasive adaptation of subcontracting, thus further undermining the regime.

**Empirical Analysis**

To test these implications, we first revisit patterns of investment from subject and non-subject firms post-2009. The Vietnam Provincial Competitiveness Index (PCI) survey surveyed firm managers in eight waves from 2010-2017.\(^\text{15}\) This annual survey of over 1,500 investors in Vietnam provides a nationally representative of foreign investment in Vietnam. We constructed a dataset of repeated cross-sections of firms

\(^{15}\text{See http://www.pcivietnam.org/ for methodological details.}\)
for each wave. Further, to test our subcontracting extension, we were able to insert new questions into the 2017 survey with the permission of the Vietnam Chamber of Commerce (VCCI), which administers the survey, and US-AID, which funds it. The top investors in Vietnam include a mix of ABC signatories (Vietnam’s second largest investors of Japan and South Korea are both signatories) as well as non-signatories (top investor Taiwan as well as the fourth and fifth largest investors of China and Singapore). In total, investors from countries that are signatories of the ABC made up 42% of the foreign firms in the sample.

Our first set of results looks at how productivity affects bribery. The second set of results examines the effect of home country enforcement on bribery. We code ABC firms by their level of enforcement that Transparency International deem to be active enforcers. They use a four-point coding scheme, though the assessment has changed methodologically over time. To simplify, we use a two point aggregation and group countries into non-signatory, non-enforcer, and enforcer categories. Transparency International considers the number of anti-bribery cases, whether those cases involve “major” companies or set important precedent, and whether the cases carry substantial sanctions.\textsuperscript{16} The coding is thus based on observed cases of prosecution, though does attempt to account for relative rates of bribery across countries by controlling for a country’s share of world exports.\textsuperscript{17} The third set of results reports patterns of bribing through intermediaries, or subcontracting. We relegate some analysis to an online Supplemental Information document, and direct readers there when appropriate.

\textbf{Firm Productivity}

An initial implication of the model is that more productive firms should be less likely to bribe for all enforcement levels. This pattern is clearly shown in Figure 1. At


\textsuperscript{17} See Table 5 in the Supplementary Information (SI) for coding by country.
high levels of productivity, the bribery behavior of all three types of firm (from non-signatory, non-enforcer, or enforcer countries) should converge, as bribery is less important for successful business activity in all cases. Our theory therefore implies the model depicted in Equation 3 below, where we study the relationship between productivity and bribery controlling for enforcement regime.

1. Firm-Level Productivity

\[
\Pr(\text{bribe} = 1) = \beta_0 + \beta_1 \text{Non-Enforcer}_i + \beta_2 \text{Enforcer}_i + \beta_3 \text{Productivity}_i + \\
\beta_4 \text{LaborSize}_i + \phi_i + \gamma_i + \mu_i
\]

We test these implications of our analysis in Table 1. We measure the outcome variable of bribery during legislation with a direct question used in the PCI survey:

- Did you pay an informal charge to expedite the delivery of the registration license?\(^{18}\) Yes/No/Don’t Know

Of the 1,765 firms in the PCI 2018 survey, 57% answered “No”, 27% answered “Yes”, and 15% responded “Don’t Know,” because their registration took place too long before or because they were under a different manager. We drop these don’t know answers in our analysis.

In previous years, the PCI-FDI survey used a list experiment for this, but changed to a direct question in 2017 to preserve room and time for other experimental questions in the survey. One serious concern is that the change to a direct question increased social desirability bias that might lead to lower admission of bribery overall and that admission could correlated with ABC status. Thankfully, this does not appear to be the case. Figure 2 studies the predicted bribery in the PCI-FDI sample using the list experiment approach between 2010 and 2016 and the direct approach used

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\(^{18}\)Informal charges or “chi phí không chính thức” is the Vietnamese euphemism for bribery. See this article in Youth Magazine as an example https://tuoitre.vn/chi-phi-khong-chinh-thuc-van-de-doanh-nghiep-20191217133613823.htm.
between 2017 and 2019 for all firms and for firms from high enforcement regimes. The first thing to notice is these results recover the Jensen and Malesky (2018) finding that bribe rates declined among high enforcers after Phase 3 and remain lower than other firms today. Second, the direct question does not seem highly influenced by social desirability bias. In fact, for all firms, reported bribery is higher and the variance around the bribe frequency with the direct question than when using the list experiment. Third, for ABC enforcers in particular, bribe frequency is nearly exactly the same 21% using the list experiment in 2016 and the direct question in 2017 through 2019. While it does not solve the problem entirely, it does make us confident that we can use the measure in an illustrative test of bribe payments and productivity.  

We proxy for productivity by using the logged value of 2017 sales reported in USD. Sales responses ranged from $145,000 USD to $661 million USD with the median firm reporting $3.6 million USD (SD-$40.4 million USD). Because of the high left skew in the distribution, we use the natural log for our empirical analysis.

- Please estimate the total value of your sales of goods and services in LAST YEAR in USD

We chose sales, because while endogeneity is a concern with all measures of productivity, alternative measures such as profit and profit margin incorporate expenses, which is mechanically endogenous to bribes – higher bribes raise expenses and reduce profits. Sales also has the benefit of being less sensitive than profit margin to report for firms who are worried about additional attention from the tax authority. As a result, using sales provides a larger number of observations for analysis. Nevertheless, Figure 3 presents an added variable plot that demonstrates that our proxy is strongly

\[19\] As a robustness test, we replicate the analysis using the two-stage list estimator recommended by Blair and Imai (2012) on the list experiment for investment licensing in the Jensen and Malesky (2018) dataset. The results, which show a similar decline in ABC in non-enforcers and similar convergence among productive firms, are reported in the SI Table 8.
Figure 2: Average Bribe Frequency over Time by List Experiment or Direct Question
associated with a firm’s profit margin, measured as the natural log of the difference in sales and expenses in 2017 over the firm’s total investment when it started operations in Vietnam. Figure 3 shows that, all else equal, each 1% increase in sales is associated with a 2.9% increase in profits over investment. The regression is highly significant and demonstrates that sales is an appropriate proxy for productivity that is less likely than other measures to be influenced by mechanical endogeneity.

Equation 3 also controls for firm labor size at the time of entry, to address the potential that bribery is correlated with firm size, and introduces fixed effects for entry year (ϕ) and two-digit sector (γ) to address heterogeneity in licensing procedures over time and for variance in reporting requirements by narrow industry. Standard errors are clustered at the home-country level, as firms from the same country face the

\(^{20}\)See SI Table 7 for full regression results.
same reporting regime and home country culture, and therefore cannot be considered independent draws. We begin with unadjusted relationship in Model 1, add two-digit sector fixed effects (ISIC Rev 4) in Model 2, add controls for year of registration and size at origin in Model 3 to address different starting conditions, and drop China and Taiwan in Model 4. Results are shown in Table 1.

Consistent with our theory, we find that productivity is robustly associated with bribery. In the fully-specified Model 3, a 1% change in sales is associated with a 1.5% reduction in bribery during business entry. Consistent with our model, bribery is an attractive strategy for unproductive firms with little hope of surviving fair competition. Due to the costs and risk of detection, however, this strategy is unavailable for firms from high enforcement regimes. As productivity increases, however, the differential attractiveness of bribery dissipates.

In the online Supplemental Information (SI), we address two potential threats to this analysis – social desirability bias and endogeneity. First, to ensure that our results are not biased by the potential that reluctance to answer the direct entry question is also associated with sales, we re-run our analysis using the replication data Malesky and Jensen (2018), which used a list experiment to measure the probability of bribe at entry. Employing the Blair and Imai (2012) two-stage list estimator in SI Table 8, we also find a statistically significant relationship between logged sales and bribe at entry. The substantive size of the relationship is smaller, however. For each 1% increase in sales, firms are 0.7% less likely to bribe.

Second, we address the potential endogeneity in the relationship between sales and bribery in SI Table 9 using a two-stage least squares regression (2SLS), where we instrument for bribery using an index of management quality. Nicholas Bloom has spearheaded a large literature documenting strong associations between management quality and firm productivity, profitability and survival rates (Bloom and van Reenen 2007, Bloom et. al, 2019, Bruhn et. al. 2010, Bloom et. al. 2013,
**Table 1**: Relationship between Productivity and Bribery

<table>
<thead>
<tr>
<th>Dependent Variable: Paid Bribe During Licensing=1</th>
<th>(1) Bivariate</th>
<th>(2) Sector FE</th>
<th>(3) Controls</th>
<th>Drop China/Taiwan</th>
</tr>
</thead>
<tbody>
<tr>
<td>Low Enforcement Regime=1</td>
<td>0.007</td>
<td>0.021</td>
<td>0.006</td>
<td>0.042</td>
</tr>
<tr>
<td></td>
<td>(0.036)</td>
<td>(0.031)</td>
<td>(0.035)</td>
<td>(0.034)</td>
</tr>
<tr>
<td>High Enforcement Regime=1</td>
<td>-0.147</td>
<td>-0.134</td>
<td>-0.117</td>
<td>-0.090</td>
</tr>
<tr>
<td></td>
<td>(0.050)</td>
<td>(0.050)</td>
<td>(0.049)</td>
<td>(0.054)</td>
</tr>
<tr>
<td>Sales (USD, ln)</td>
<td>-0.023</td>
<td>-0.022</td>
<td>-0.015</td>
<td>-0.013</td>
</tr>
<tr>
<td></td>
<td>(0.008)</td>
<td>(0.007)</td>
<td>(0.006)</td>
<td>(0.006)</td>
</tr>
<tr>
<td>Employees at origin (1-8)</td>
<td></td>
<td></td>
<td>-0.021</td>
<td>-0.021</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>(0.007)</td>
<td>(0.009)</td>
</tr>
<tr>
<td>Constant</td>
<td>0.693</td>
<td>0.680</td>
<td>0.407</td>
<td>0.386</td>
</tr>
<tr>
<td></td>
<td>(0.094)</td>
<td>(0.093)</td>
<td>(0.103)</td>
<td>(0.104)</td>
</tr>
<tr>
<td>ISIC Two Digit Fixed Effects</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Entry Year Fixed Effects</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Observations</td>
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<td>1,014</td>
<td>984</td>
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<tr>
<td>Clusters</td>
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<td>40</td>
<td>40</td>
<td>38</td>
</tr>
<tr>
<td>R-squared</td>
<td>0.012</td>
<td>0.037</td>
<td>0.059</td>
<td>0.073</td>
</tr>
<tr>
<td>RMSE</td>
<td>0.474</td>
<td>0.472</td>
<td>0.475</td>
<td>0.474</td>
</tr>
</tbody>
</table>

OLS with standard errors clustered at the country of origin level.
Bloom et. al. 2018). The 2018 PCI-FDI survey included a series of questions that allow us to replicate the Bloom (2019) measures on a four-point scale, capturing the average score on three indicators of management quality: performance monitoring (information collection and analysis); target-setting (the use of short- and long-run targets) and incentives (reward high-performing employees; and retraining or removing under-performers).

In SI Table 9, we present the first and second stage models for the IV-2SLS estimation using the same control variables as in Table 3 above. We find strong evidence in the first stage that management quality is a strong predictor of sales. A standard deviation improvement on the four-point scale (SD=0.55) is associated with 18.15% increase in sales. In the second stage, we find that predicted sales is indeed associated with declining bribe during business entry. Caution should be taking in interpreting this result, however, as the instrument is quite weak, which may be leading to bias in the second-stage coefficient on logged sales.

**Enforcement**

We began this paper with an empirical puzzle from previous work, which showed that the ABC led to an increase in bribery by non-signatory countries. Our theoretical model explains this pattern and shows that the ABC has a counter-intuitive effect due to the very effectiveness of the regime. By driving out firms from signatory countries, markets become less competitive and the available rents increase the returns to bribery. Thus, firms make decisions about bribery based on the relative risk of the activity versus the expected benefits: the higher expected rents, the greater the probability of bribery. And after the ABC, firms from non-signatory countries have a greater incentive to bribe due to the decreased competitiveness and greater rents in these markets (Proposition 4).

Previous work showed that the ABC leads foreign actors to curtail their behavior
in suspect environments, including reducing foreign direct investment and exports into highly corrupt countries. In this section we conduct additional empirical tests regarding the entry decisions and bribery decisions of firms. We begin with some simple descriptive analysis of patterns of foreign investment in Vietnam using the aggregate data on firm entry to explore Proposition 2. Do we see a decrease in entry of ABC signatories after 2009, when signatories were subject to peer review (Phase 3 of the Convention)?

Figures 4 and 5 draw upon data from the Vietnam General Statistical Office (GSO) to depict the share of foreign firms entering Vietnam, measured as a percentage of total projects and as a percentage of total dollars of foreign investment (GSO 2019). Note that the spike in 2009 in Figure 2 is largely due to a decline in FDI caused by the global sub-prime crisis and not an increase in ABC enforcers entering into Vietnam.

When we break down these investments into ABC signatory categories of enforcers and non-enforcers of the convention, we observe important differences in the patterns of investment. Investments from non-enforcer countries increase from 2009 while investments from enforcer countries actually slightly decline after 2009 in Figure 4. Figure 4, measured as a percentage of dollars of investment, tells a similar story but with more annual variance. Investment from non-enforcer countries grew in the period since 2009, while enforcer country investments see small declines. These patterns are consistent with Propositions 3 and 4. Proposition 4 states that as the number of subject firms increases, the number of non-subject firms entering the market increases, while Proposition 3 ties this pattern to the strength of enforcement of subject firms. Figures 4 and 5 show that investment from non-enforcing countries increased after the inception of the ABC. The pattern for firms from non-signatories is less clear, showing a decrease in Figure 4, when measured as a percent total FDI projects, but an increase in Figure 5, when measured as percentage of all dollars. The most likely explanation for the differential effects is that existing investors from non-
signatory firms increased the size of their investment projects after 2009 by renewing their licenses at the Ministry of Planning and Investment. These existing firms would be the best situated to take advantage of the reduction in competition. An alternative, but observationally equivalent explanation based on aggregate data, is that new firms from non-signatory countries invested more money in a fewer number of projects than other types of firms over this time period.\footnote{See SI Figures 1 and 2 depicting the logged total number of projects and new capital. The patterns are consistent with the share graphs here.}

In Table 2, we present 8 models, which are described by equations 2 and 3 below. The first four models provide a direct statistical modeling of Figures 4 and 5, described in equation 1 below. As in the figure, we aggregate all country scores to three
Figure 5: Percentage of Dollars of Investment by Home Country Enforcement, 2005-2015
enforcement levels (Non-Signatory, Non-Enforcer, and Enforcer), which are indexed by \( e \), and study the change in entry patterns for these three groups between and after the onset of Phase 3 at the end of 2009. The analysis covers eleven years for the three groups and therefore has thirty-three observations. Models 5-8, represented by equation 2, however, present a similar analysis at the country-level, studying an unbalanced panel of 41 countries over the eleven years with two-way country \( \gamma \) and year \( \phi \) fixed effects.

We present two outcome variables: 1) the share of new projects in year \( y \) from one of the enforcement groups; and 2) the share of new investment in year \( y \) from each of the enforcement groups. Studying the share of projects and investment has three attractive features for us. First, it allows for a close approximation of our theoretical predictions that investment from high-enforcement countries will be replaced with investment from non-enforcers and non-signatories. Second, standardizing by the total investment received that year side-steps modeling issues posed by inflation adjustments and serial correlation, as both the numerator and denominator include the price effect and therefore cancel each other out, allowing for easy comparisons across years. Third, the approach mitigates problems caused by serial correlation in the measurement overtime of FDI, because the shares are directly comparable from year to year.

Some readers, however, may be concerned that using share treats investment as a zero-sum game, and does not take into account that investment may be increasing at different levels for all groups. In the SI Figures 1 and 2 and Table 4, therefore, we replicate our figures and the regression table using the non-share outcomes of total new projects and logged, inflation-adjusted total investment in millions of USD.

The basic model is a straightforward differences-in-differences estimator for each enforcement level, modeled with OLS. \( \beta_0 \), the constant, provides the estimate for non-signatories prior to the onset of Phase 3 of the ABC. \( \beta_1 \) and \( \beta_2 \) provide the additional
share of investment of non-enforcers and enforcers prior to Phase 3. \( \beta_3 \) provides the change in share of investment for non-signatories after Phase 3, while \( \beta_4 \) and \( \beta_5 \), the diff-in-diff coefficients, depict the additional change in investment shares for non-enforcers and enforcers respectively.

2. Enforcement level:

\[
\text{share}_{ey} = \beta_0 + \beta_1 \text{Non-Enforcer}_{ey} + \beta_2 \text{Enforcer}_{ey} + \beta_3 \text{Phase3}_y + \\
\beta_4 \text{Non-Enforcer}_{ey} \times \text{Phase3}_y + \beta_5 \text{Enforcer}_{ey} \times \text{Phase3}_y + \mu_{ey}
\]

3. Country level:

\[
\text{share}_{cy} = \beta_0 + \beta_1 \text{Non-Enforcer}_{cy} + \beta_2 \text{Enforcer}_{cy} + \beta_3 \text{Phase3}_y + \\
\beta_4 \text{Non-Enforcer}_{cy} \times \text{Phase3}_y + \beta_5 \text{Enforcer}_{cy} \times \text{Phase3}_y + \phi_y + \gamma_c + \mu_{cy}
\]

Because of the out-sized role played by Taiwanese and Chinese investment in Vietnam during this time, we provide sensitivity tests that drop these countries in order to ensure that our results are robust to their exclusion. Models 3 and 4 do this by aggregating to the enforcement levels excluding these countries, while Models 7 and 8 drop them directly from the analysis.

Consistent with Figures 4 and 5, in Table 2 we find that the share of new projects increased dramatically among non-enforcers, who took advantage of the added restrictions on their competitors. As a group, non-enforcers increased their share of investment projects in Vietnam from 38.6% before Phase 3 to 49.3% afterwards, representing a 0.7 shift above their baseline level. This increase is significant at the .01 level. They also increased their monetary share of investment from 29.6% to 40.1%, representing a 0.5 standard deviation shift, although the diff-in-diff estimator is just shy of statistical significance for this estimation.
<table>
<thead>
<tr>
<th>Dependent Variable</th>
<th>Aggregated by Enforcement Level</th>
<th>Country-Level Analysis</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>All</td>
<td>Drop China &amp; Taiwan</td>
</tr>
<tr>
<td></td>
<td>Proj. Share (1) Inv. Share (2)</td>
<td>Proj. Share (3) Inv. Share (4)</td>
</tr>
<tr>
<td>Low Enforcement</td>
<td>-0.073 (0.024) -0.248 (0.076)</td>
<td>0.126 (0.030) -0.126 (0.070)</td>
</tr>
<tr>
<td></td>
<td>-0.003 (0.002) -0.002 (0.006)</td>
<td>0.003 (0.002) -0.002 (0.006)</td>
</tr>
<tr>
<td>High Enforcement</td>
<td>-0.306 (0.019) -0.384 (0.095)</td>
<td>-0.107 (0.026) -0.263 (0.090)</td>
</tr>
<tr>
<td></td>
<td>0.004 (0.001) 0.004 (0.006)</td>
<td>0.004 (0.001) 0.004 (0.006)</td>
</tr>
<tr>
<td>Phase 3</td>
<td>-0.086 (-0.022) -0.054 (0.073)</td>
<td>-0.021 (0.026) -0.065 (0.065)</td>
</tr>
<tr>
<td></td>
<td>(0.019) 0.001 (0.003)</td>
<td>(0.011) 0.001 (0.003)</td>
</tr>
<tr>
<td>Low *Phase 3</td>
<td>0.193 (0.034) 0.159 (0.106)</td>
<td>0.128 (0.036) 0.135 (0.101)</td>
</tr>
<tr>
<td></td>
<td>0.008 (0.003) 0.007 (0.007)</td>
<td>0.007 (0.007) 0.007 (0.007)</td>
</tr>
<tr>
<td>High*Phase 3</td>
<td>0.066 (0.025) 0.003 (0.109)</td>
<td>0.001 (0.028) 0.104 (0.014)</td>
</tr>
<tr>
<td></td>
<td>-0.001 (0.001) -0.004 (0.008)</td>
<td>(0.001) -0.001 (0.008)</td>
</tr>
<tr>
<td>Constant</td>
<td>0.460 (0.017) 0.544 (0.057)</td>
<td>0.260 (0.025) 0.422 (0.048)</td>
</tr>
<tr>
<td></td>
<td>0.012 (0.001) 0.011 (0.002)</td>
<td>0.009 (0.002) 0.010 (0.002)</td>
</tr>
<tr>
<td>Country Fixed Effects</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Year Fixed Effects</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Observations</td>
<td>33</td>
<td>33</td>
</tr>
<tr>
<td>R^2</td>
<td>0.953</td>
<td>0.953</td>
</tr>
<tr>
<td>RMSE</td>
<td>0.0345</td>
<td>0.0293</td>
</tr>
</tbody>
</table>

Robust standard errors in parentheses.
Similar results can be observed when we shift to the country level analysis, where we find that individual countries in the non-enforcement category, increased their share of new projects after Phase 3 by 0.8% to 1.5% of the total project share, about a 0.2 standard deviation change. The investment share increased by similar levels, but is not statistically significant.

It is noteworthy that the $R^2$ is in the share of new projects is above .95 for both the enforcement level and country level regressions. This is likely caused by the very strong bivariate correlation between ABC enforcement status and project share, which is −.76. The bottom line is that, consistent with our theory, Vietnam’s investment attraction has transitioned toward non-signatories and non-enforcers, and this explains the vast majority of the variation in investment pattern at the aggregate level, especially when we reduce the variation caused by year-to-year changes in levels by looking at overall shares.

**Subcontracting**

Finally, we turn to Proposition 5, where we theorize that some ABC signatories can subcontract bribery to other parties, avoiding paying direct bribes. We note that this subcontracting is costly for firms and thus not all ABC signatories will choose this option.

We tested this Proposition by fielding an additional question on the 2018 PCI-Survey. We asked managers the following question:

- “To avoid culpability for paying informal charges, have you ever (Check all that apply):
  - Hired a law firm or business facilitator to complete the business procedure
  - Subcontracted to another foreign firm to complete the business procedure
  - Subcontracted to a Vietnamese firm to complete the procedure
We present this data in Figure 6.

We find that businesses across all three categories of home countries hire lawyers and consultants 30% of the time on average. Firms subject to these different domestic bribery laws are also equally unlikely to hire foreign firms for the purposes of avoiding direct bribers. Where we find that most striking results are in the comparison of firms from signatory countries, which are more likely to hire domestic firms to minimize bribery than other firms. Firms from enforcing countries hire domestic subcontractors to avoid bribery 12.5% of the time, compared to only 4.7% and 6.9% for non-signatories and non-enforcers respectively. The difference between enforcers and signatories is significant at the .1 level, while the difference between enforcers and non-enforcers is just shy of statistical significance.
We more formally test this in Table 3. Model 1 includes only dummy variables for firms from countries that are signatories and strong enforcers and firms from countries that are weak enforcers. Model 2 includes two-digit sector fixed effects based on the International Standard Industrial Classification (ISIC) and Model 3 includes sector fixed effects plus controls for the year of registration (as understanding of the bribery schedule may change with age), and the size of the firm upon initial entry (as larger firms tend to bribe less, because they are more valuable to bureaucratic gatekeepers). Model 4 drops firms from China and Taiwan. All three models point to similar results: ABC enforcers are 8% more likely to sub-contract to domestic firms in order to avoid bribery than non-signatories and 6 percent more likely than non-enforcers. The difference between enforcers and non-signatories is significant at the .1 level.

We are careful in the interpretation of these results for two reasons. First, our models explain a relatively small amount of variance in subcontracting decisions. Second, as we have noted in previous work, these direct questions can lead to underreporting of bribery, in particular for countries subject to the ABC convention. Thus, our findings are likely to underreport the use of domestic firms to avoid bribery, in particular for firms coming from ABC enforcers.

These new empirical tests lead to further concerns about the effectiveness of the ABC. The convention doesn’t just provide additional benefits to firms that are not subject to the convention; we find evidence that firms from strong enforcer countries are also willing to subcontract with domestic firms to avoid paying bribes directly.

**Conclusion**

This paper was motivated by the previous empirical finding that the OECD’s Anti-Bribery Convention, while reducing bribery by firms from member countries, seems
Table 3: Sub-Contracting by ABC Enforcement Regime

<table>
<thead>
<tr>
<th></th>
<th>(1) Bivariate</th>
<th>(2) Sector FE</th>
<th>(3) Controls</th>
<th>(4) Drop China/Taiwan</th>
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</thead>
<tbody>
<tr>
<td>Low Enforcement Regime=1</td>
<td>0.022</td>
<td>0.021</td>
<td>0.025</td>
<td>0.028</td>
</tr>
<tr>
<td></td>
<td>(0.016)</td>
<td>(0.018)</td>
<td>(0.000)</td>
<td>(0.024)</td>
</tr>
<tr>
<td>High Enforcement Regime=1</td>
<td>0.079</td>
<td>0.080</td>
<td>0.089</td>
<td>0.092</td>
</tr>
<tr>
<td></td>
<td>(0.036)</td>
<td>(0.037)</td>
<td>(0.000)</td>
<td>(0.038)</td>
</tr>
<tr>
<td>Employees at origin (1-8)</td>
<td></td>
<td></td>
<td>0.003</td>
<td>0.003</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>(0.000)</td>
<td>(0.003)</td>
</tr>
<tr>
<td>Constant</td>
<td>0.046</td>
<td>0.047</td>
<td>0.976</td>
<td>0.975</td>
</tr>
<tr>
<td></td>
<td>(0.013)</td>
<td>(0.014)</td>
<td>(0.000)</td>
<td>(0.021)</td>
</tr>
<tr>
<td>ISIC Two Digit Fixed Effects</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Entry Year Fixed Effects</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Observations</td>
<td>1,151</td>
<td>1,147</td>
<td>1,082</td>
<td>865</td>
</tr>
<tr>
<td>Clusters</td>
<td>43</td>
<td>43</td>
<td>42</td>
<td>40</td>
</tr>
<tr>
<td>R-squared</td>
<td>0.007</td>
<td>0.020</td>
<td>0.055</td>
<td>0.061</td>
</tr>
<tr>
<td>RMSE</td>
<td>0.246</td>
<td>0.247</td>
<td>0.248</td>
<td>0.255</td>
</tr>
</tbody>
</table>

OLS with standard errors clustered at the country of origin level.
to increase bribery by firms from non-member countries. This result begged explanation. Why should firms that do not fall under the jurisdiction of a treaty be affected at all? We provide an answer rooted in the general logic of regulatory leakage, or the tendency of regulated behavior to shift to less well-regulated jurisdictions. Our game-theoretic model explores a market where which firms can enter through bribery or clean entry and rents depend on the number of competitors. In equilibrium, factors that increase the marginal cost of entry for a group of actors—even in expectation—can incentivize entry, and via bribery specifically, for other actors. The ABC may have done just this. By creating an effective form of peer-review enforcement it raised the costs of “paying to play” for subject firms. Yet, this increased the opportunity of acquiring rents for non-subject firms, incentivizing them to pay to play more often.

Our theoretical model provides an explanation for the unexpected finding that the ABC increased bribery among non-subject firms. But the model generates additional observable implications about the relationship between productivity and bribery and how differential enforcement across member states might affect these patterns. The model suggests more productive firms are less likely to bribe, a prediction borne out in the data. In an extension, we analyzed how subject firms might be able to evade enforcement by subcontracting with firms who do not fall under the Convention’s jurisdiction. We examined these additional implications by looking at how patterns of FDI changed pre and post-ABC for firms from low enforcement and high enforcement home countries. The evidence suggests that the ABC’S bribery deterrent mattered most for firms from high enforcement environments and that such enforcement may have even encouraged increased participation by firms from low enforcement environments. We also analyzed results from a new question fielded in the Vietnam PCI and found that firms from these high-enforcement jurisdictions are most likely to engage in behavior likely designed to evade the Convention – namely, by subcontracting with non-subject firms who can engage in illicit behavior on behalf of the subject firms.
This result further emphasizes a general point about leakage: the creative agency of actors can lead to regulatory evasion.

Do our results mean that the ABC is a failure? Far from it. Previous work shows that the Convention works to deter corruption for firms subject to its jurisdiction. Our work simply provides the caveat that there are limits to the aggregate effect a treaty like the ABC can have on illicit activity. Those limits exist because of differential enforcement across jurisdictions, which allows that illicit activity to leak across jurisdictional boundaries. The solution is to expand the ABC’s jurisdiction when and where possible. Current member countries have an interest in seeing this happen, as do their firms, who may face a competitive disadvantage when forced to play by the rules in a dirty game.

The contribution of our regulatory leakage theory extends beyond the direct explanation for the countervailing effects of the ABC to other international regulatory efforts more generally. In a wide range of policy areas, efforts are being made to internationalize regulation in order to combat activity that is hard to police within individual countries. Important examples include environmental and labor protections, anti-money laundering efforts, and rules to combat profit-shifting by MNCs. In all of these cases, compliance by signatories to the agreement generates competitive opportunities for those outside the agreement, potentially leading to similar countervailing effects as agents of non-signatories increase their activity proscribed behaviors. The clear implications of our theory is that to reduce regulatory leakage efforts should be made at the design stage to include as many relevant parties as possible and to strengthen enforcement procedures for signatories. Doing so will reduce the number of actors who can exploit the regulatory constraints of competitors.

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22 See also Kelley et al. (forthcoming) on whether human rights pressure can cause rights violations in neighboring states.
Appendix

Proofs

Proof of Proposition 1. We proceed by identifying cut-points over $\theta$ that partition the type space into strategies $(\theta_l, \theta_h)$, then establish that $0 < \theta_l < \theta_h$. First, firm strategies imply that

$$E[f] = n \left( p \cdot \frac{\theta_l}{\theta} + \frac{\theta_h - \theta_l}{\theta} \right),$$

which enters each player-type’s payoffs for entry. Then, $\theta_h$ is the type indifferent over bribery and staying out, such that

$$0 = R - (n - 1) \left( p \cdot \frac{\theta_l}{\theta} + \frac{\theta_h - \theta_l}{\theta} \right) - \theta_h(c + b),$$

and $\theta_l$ is the type indifferent over bribery and clean entry, such that

$$R - (n - 1) \left( p \cdot \frac{\theta_l}{\theta} + \frac{\theta_h - \theta_l}{\theta} \right) - \theta_l(c + b) = p \left( R - (n - 1) \left( p \cdot \frac{\theta_l}{\theta} + \frac{\theta_h - \theta_l}{\theta} \right) - \theta_l(c) \right).$$

Solving this system of equations yields

$$\theta_h = \frac{bR\tilde{\theta}}{(n - 1)(b(2 - p)p - c(1 - p)^2) + b\tilde{\theta}(b + c)}$$

and

$$\theta_l = \frac{(1 - p)R\tilde{\theta}(b + c)}{(n - 1)(b(2 - p)p - c(1 - p)^2) + b\tilde{\theta}(b + c)}.$$

Next, $\partial\theta u(\text{clean}) < \partial\theta u(\text{bribe}) < 0$, ensuring that superior types enter cleanly and inferior types enter with bribes. Finally, $\theta_l < \theta_h$, ensuring the existence of types willing to bribe, when $p > \frac{c}{b + c}$. This gives the following equilibrium strategies: enter cleanly when $\theta < \theta_l$, enter via bribery when $\theta_l \leq \theta < \theta_h$, and stay out when $\theta_h \leq \theta$. 

Proof of Proposition 2. Again, we establish cut-points on $\theta$, though for both subject and non-subject firms. For this equilibrium,

$$E[f] = (n - k) \left( p \cdot \frac{\theta_{nl}}{\theta} + \frac{\theta_{nh} - \theta_{nl}}{\theta} \right) + k \left( p \cdot \frac{\theta_{sl}}{\theta} + \frac{\theta_{sh} - \theta_{sl}}{\theta} \right),$$

though to ease presentation we write the probabilities of a non-subject and subject firm entering successfully as

$$\nu = p \cdot \frac{\theta_{nl}}{\theta} + \frac{\theta_{nh} - \theta_{nl}}{\theta} \quad \text{and} \quad \sigma = p \cdot \frac{\theta_{sl}}{\theta} + \frac{\theta_{sh} - \theta_{sl}}{\theta},$$

(6)
Solving this system of equations yields

\[ R - (n - k - 1)(v - k(\sigma) - \theta_{nh}(c + b)) = 0, \]

and \( \theta_{nl} \) is indifferent over bribing and clean entry, such that

\[ R(n - k - 1)(v - k(\sigma) - \theta_{nl}(c + b)) = p(R(n - k - 1)(v + k(\sigma)) - \theta_{nl}(c)). \]

Among subject firms, \( \theta_{sh} \) is the type indifferent over bribing and staying out, such that

\[ R - (n - k)(v - (k - 1)(\sigma) - \theta_{sh}(c + b)) = 0, \]

and \( \theta_{sl} \) is the type indifferent over bribing and staying out, such that

\[ R - (n - k)(v - (k - 1)(\sigma) - \theta_{sl}(c + b) - qs = p(R - (n - k)(v + (k - 1)(\sigma)) - \theta_{sl}(c)). \]

Solving this system of equations yields

\[ \theta_{nh} = \frac{R - v(n - k - 1) - \sigma k}{b + c} \quad \text{and} \quad \theta_{nl} = \frac{(1 - p)(R - v(n - k - 1) - \sigma k)}{b} \]

for non-subject firms and

\[ \theta_{sh} = \frac{R - v(n - k) - \sigma(k - 1) - qs}{b + c} \quad \text{and} \quad \theta_{sl} = \frac{(1 - p)(R - v(n - k) - \sigma(k - 1) - qs)}{b} \]

for subject firms. Next, \( \partial \theta u(\text{clean}) < \partial \theta u(\text{bribe}) < 0 \) for both subject and non-subject firms, ensuring that superior types enter cleanly and inferior types enter with bribes.

Finally, we want to establish that \( \theta_{sl} < \theta_{sh} \) and \( \theta_{nl} < \theta_{nh} \) to ensure that some types bribe among both subject and non-subject firms. First, as long as \( R > E[f] \), \( \theta_{nl} < \theta_{nh} \) is satisfied when \( p > \frac{c}{b + c} \). Second, as long as \( R > E[f] + qs \), \( \theta_{sl} < \theta_{sh} \) is satisfied when

\[ p > \frac{c}{b + c} \left(1 - \frac{qs}{R - (n - k)v - (k - 1)\sigma}\right). \]

Therefore, \( p > \frac{c}{b + c} \) is the binding constraint ensuring existence. This gives the following equilibrium strategies for subject firms: subject firms enter cleanly when \( \theta < \theta_{sl} \), enter via bribery when \( \theta_{sl} \leq \theta < \theta_{sh} \), and stay out when \( \theta_{sh} \leq \theta \). Non-subject firms enter cleanly when \( \theta < \theta_{nl} \), enter via bribery when \( \theta_{nl} \leq \theta < \theta_{nh} \), and stay out when \( \theta_{nh} \leq \theta \).

**Proof of Proposition 3.** We proceed by simple demonstration that as \( q \) or \( s \) or both go to 0, the expected utility for bribery for subject firms, \( R - E[f] - \theta(c + b) - qs \) converges to that of non-subject firms, \( R - E[f] - \theta(c + b) \). It directly follows that entry strategies will also converge, as in the baseline model, in which no firms were subject to the treaty.
Proof of Proposition 4. Non-subject firm types bribe when \( \theta_{nl} \leq \theta < \theta_{nh} \), and this range increases in \( k \), or

\[
\frac{\partial(\theta_{nh} - \theta_{nl})}{\partial k} = \frac{pb - (1 - p)c(v - \sigma)}{b(b + c)} > 0,
\]

which is satisfied when \( p > \frac{c}{b + c} \) and \( v - \sigma \). The latter states that the probability of a non-subject type entering successfully is greater than the probability of a subject type entering successfully. Using Line (6)'s definitions of \( v \) and \( \sigma \), as well as the fully-characterized cut-points \( (\theta_{nl}, \theta_{nh}, \theta_{sl}, \theta_{sh}) \), \( v - \sigma \) is true when

\[
p > \frac{c}{b + c} \quad \text{and} \quad \bar{\theta} = \frac{bp(2 - p) - c(1 - p)^2}{b(b + c)}.
\]

Therefore, when \( \bar{\theta} \) is sufficiently high, a non-subject firm is more likely to bribe as the number of subject firms increases. \( \square \)

Proof of Proposition 5. We can construct the equilibria for the subcontracting extension identically to the procedure outlined in the proofs of Propositions 1 and 2. Because of the way subcontracting is modeled, as a cost \( z \) borne by subject firms in order to evade the expected cost of monitoring and enforcement \( q \cdot s \), two possible cases exist. Either \( z > qs \), in which it is never profitable to subcontract, or \( z \leq qs \), which is it always profitable to subcontract. Because it is an added cost to entry, it deters subject firms at the margins relative to the baseline case, as does the expected cost \( q \cdot s \). \( \square \)
References


