



NOTA DI LAVORO

144.2010

**The Public Management of
Risk: Separating Ex Ante and
Ex Post Monitors**

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INSTITUTIONS AND MARKETS Series

Editor: Fausto Panunzi

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Summary

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Keywords: Risk Regulation, Monitoring, Capture, Integration, Separation

JEL Classification: L51, D82

Financial and intellectual support from the French Ministry of Ecology and Sustainable Development are acknowledged. We are grateful to Bernard Caillaud, Giacinta Cestone, David Encaoua, David Ettinger, Denis Gromb, Jean-Pierre Ponsard, Bernard Salanié, Wilfried Sand-Zantman, Jean Tirole, participants at various seminars, two referees and one Editor for helpful comments. All errors are ours.

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The Public Management of Risk: Separating Ex Ante and Ex Post Monitors*

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23rd June 2010

Abstract

When a firm undertakes risky activities, the conflict between social and private incentives to implement safety care requires public intervention which can take the form of both monetary incentives but also ex ante or ex post monitoring, i.e., before or after an accident occurs. We delineate the optimal scope of monitoring depending on whether public monitors are benevolent or corruptible. We show that separating the ex ante and the ex post monitors increases the likelihood of ex post investigation, helps prevent capture and improves welfare.

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1 Introduction

Although much debated and often criticized, the view that our societies are 'at risk'¹ has certainly pushed both scholars and practitioners to reconsider the role of public intervention in the field of risk regulation.² Consumers should be protected against buying defective products, patients against medical malpractice, workers against accidents in the workplace, the environment against major industrial or transportation hazards, etc. In all these circumstances and although risk tolerance may vary, public intervention is called for to control private actors involved in activities that put humans or the environment at risk. As risks spread over the whole spectrum of economic activities, more effort and expertise should be allocated to assess their true impact on society. The adequate design of incentives for key players involved in the management of these risks should be put at the forefront of the public debate.

Maintaining risk at levels which are socially acceptable does require systems of control. This issue has attracted much attention in the public management literature with a strong motivation being to explain the great variety of regimes in risk regulation across fields and countries.³ However, little is known on the design of adequate institutions for risk regulation. Institutions do vary significantly across fields. Casual evidence suggests that, sometimes, administrative agencies are staffed with experts able to assess specific risks and these agencies have strong enforcement powers. A typical example is that of nuclear power plants, which are routinely checked for maintaining safety. In other fields, such as defective products, agencies are more generalist and most of the enforcement power resides with Courts of Law that perform their own investigation in case of prosecution following an accident. Most of the time however, risk regulation involves an intricate combination of both kinds of intervention taking place either *ex ante* or *ex post*. Transportation, road and navigation safety, or occupational safety are good illustrations.

One might argue that risk regulation fits into the general grid already available to discuss regulatory policies and institutions for market regulation.⁴ However, there is some value in distinguishing agencies and regulations which are used *ex ante*, i.e. before any accident occurs, from agencies, Courts of Law and other enforcement devices which may intervene *ex post*, i.e. after an accident. This time line naturally distinguishes the roles of different public officials involved in risk monitoring.

In this respect, an important but largely unexplored issue is to delineate the optimal scope of *ex ante* and *ex post* control in a world plagued with informational constraints. This paper discusses the costs and benefits of splitting the tasks of *ex ante* and *ex post* monitoring of a firm, the activity of which generates some risk. This is done in a context where moral hazard on safety care calls for explicit monetary incentives but also for setting up auditing mechanisms to force compliance with safety standards. When

¹Beck (1992).

²For instance, Hood, Rothstein and Baldwin (2001) recognized that "The idea of the 'regulatory state' is that a new institutional and policy style has emerged, in which government's role as a regulator advances (...)".

³Hood, Rothstein and Baldwin (2001) and Power (1997).

⁴Noll (1989) and Baron (1989).

capture of monitors by the very interests they are supposed to control is a concern, separation of monitoring tasks between two independent bodies is preferable.

Overview of the model. Consider a risk-neutral firm which can cause an accident of substantial scale affecting third-parties. This firm undertakes a nonverifiable prevention effort. A high level of effort is socially optimal. Compliance with this standard of due care can be induced through monetary incentives and the threat of random inspections. Such monitoring might either be preventative (*ex ante*) or only occur *ex post*, following an accident, and uncovers whether the firm did perform sufficient care. Fines can be imposed if investigation reveals misconduct, but the firm is protected by limited liability. This access to privileged information gives discretion to public officials. The firm may attempt to capture monitors to prevent them from revealing its misbehavior.

Had monitors been non-corruptible, monitoring would unambiguously improve the firm's incentives. Things are different when monitors are corruptible.

Consider first the case where *ex ante* and *ex post* monitoring is performed by a single entity. Such an integrated organization opens large opportunities for collusion. The long-term relationship between an integrated monitor and the firm facilitates collusion by expanding the set of contingencies in which bribes can be exchanged. Under integration, the monitor's close contact with the firm significantly reduces the transaction costs of side-contracting. Postulating convex transaction costs in side-transfers, average transaction costs decrease as bribes are spread over more contingencies.⁵ Intervening both *ex ante* and *ex post*, an integrated agency reduces such transaction costs and reaches more efficient collusive deals with the regulated firm.

Under separation, different monitors are used *ex ante* and *ex post*. Each monitor anticipates that the other receives enough benefits from adopting an uncorrupted behavior. When striking their collusive deal, the firm and the *ex ante* monitor anticipate that another monitor may intervene *ex post* to unveil both the firm's misconduct and evidence of corruptible deals. Bribes can only be transferred when they cannot be detected by an *ex post* investigation. Smoothing bribes with the *ex ante* monitor becomes harder and transaction costs of collusion increase. Diseconomies of scale in side-contracting appear, making it easier to prevent capture.⁶

Because it reduces the social cost of preventing capture, *ex post* monitoring takes place more often under separation than under integration. As its capture is less likely under separation, the *ex ante* monitor is called upon more often. This highlights a complementarity between *ex ante* and *ex post* monitoring. Taking a broader perspective, tougher *ex ante* regulation and *ex post* judicial prosecution should come together.

Practical relevance. Our analysis sheds some light on a number of recent institutional changes.

⁵Transaction costs are convex when it is increasingly harder to transfer larger bribes or when such illegal side-transfers can be detected and punished at an increasingly higher rate.

⁶Faure-Grimaud, Laffont and Martimort (2002) also deal with the consequences of *ex ante* and *ex post* collusion, but they address different issues.

Transportation. Air transportation offers an illustration of primary interest for our analysis. The investigation of airplane transportation accidents in Canada was, for many years, fully carried out by the Department of Transport. It set the safety standards for the industry, operated elements of the system such as airports and air traffic control, licensed the carriers and the crews, and enforced its own regulations. At the same time, it analyzed the safety failures in the industry in which it had such a pervasive presence. The concern about the independence of the regulator from the industry grew so heatedly that the government proceeded with the creation of the Canadian Aviation Safety Board, an independent regulatory body with an accident investigation mandate. In the framework of our model, this institutional reform is a move towards separation.

The management of nuclear wastes. In this sector, a broad set of precautionary activities can be implemented at the firm level to reduce the likelihood of an accident: care during transportation, employee training programs and radiation competency tests, adoption of best-practice for containment and radiation shielding, integrated safety management, etc. The U.S. Department of Energy (D.O.E.) has inherited the task of cleaning up the radioactive refuse from uranium mines, munitions facilities and other sites around the country. Inside D.O.E., until recently, the Office of Environment, Safety and Health (O.E.S.H.) developed safety policy guidance and provided support to D.O.E. sites, while the Office of Security and Safety Performance Assurance (O.S.S.P.A.) conducted safety oversight. The former office mainly ensures that regulated firms comply with the safety standards whereas the latter office mainly investigates accidents. Recently, the D.O.E. has announced the creation of a new office (the Office of Health, Safety and Security) which will undertake enforcement activities previously carried out by both the O.E.S.H. and O.S.S.P.A. This decision is clearly a move towards integration of the tasks of ex ante and ex post monitoring. Our results below cast doubts on the wisdom of such a move.

Literature. The idea that splitting access to privileged information between specialized agencies reduces the costs of capture has previously been investigated by Laffont and Martimort (1998, 1999, thereafter LM). Several important differences exist with the present setting. First, both the ex ante and ex post monitors have access to the same piece of information (albeit at different points in time due to the specific features of risk regulation), namely the agent's level of safety care, whereas separated agencies get access to different pieces of information in LM. Second, another difference comes from the source of the economies of scale in side-contracting. In LM, "Chinese walls" between regulators create asymmetric information in side-contracting. This undermines the efficiency of the side-deals that each regulator reaches with the firm. Here instead, the collusive gains from integration come from the fact that a single regulator can better smooth bribes over the different states of nature.⁷ Third, in LM, the monitoring technologies that give informative signals to the firm's monitors are exogenously given whereas we devote some attention to the impact of different institutional choices

⁷This desire for bribes smoothing to reduce transaction costs of side-contracting comes from their assumed convexity. Faure-Grimaud and Martimort (2003) present another model building on that assumption.

on the endogenous likelihood of each round of investigations.⁸

Other contributions have highlighted the costs and benefits of splitting public bodies. On the benefits side, Kofman and Lawarée (1993) show that bringing an uncorruptible monitor may limit the scope for capturing corruptible ones. Our model instead does not assume a priori that this extra monitor is uncorruptible but derives the benefits of separation in a model where both ex ante and ex post supervisors can be captured. Kofman and Lawarée (1996a) find that competing agencies may be useful in a yardstick model where they acquire correlated signals. In our model, monitors have instead access to different signals which are conditionally independent and such yardstick mechanisms lose appeal. On the costs side, Shleifer and Vishny (1993) study the optimal number of public officials controlling a given firm. Public officials choose non-cooperatively the bribes they require. In equilibrium, excessive bribery occurs with several officials. Although such a result might be convincing in weak institutional environments, the stake for bribery in Shleifer and Vishny (1993) is exogenous and no attention is given to possible institutional responses aimed at limiting the wasteful competition between bureaus. Instead, in our model, this stake arises endogenously from asymmetric information. We give a particular attention on the institutional response to the threat of capture, not only in terms of incentives for public bodies, but also in terms of their overall organization.

Finally, the literature on corruption in law enforcement (Becker and Stigler, 1974; Mookherjee and P'ng, 1995; Garoupa, 1997; Polinsky and Shavell, 2001) analyzes the impact of corruption on the likelihood of investigation in various contexts but does not draw, as we do, the implications of corruption for institutional design. Corruption is an equilibrium phenomenon in these models. In our context instead, the Collusion-Proofness Principle⁹ always holds so that institutions are robust to the threat of capture. The best institutional form minimizes the cost of preventing capture. This institutional perspective is also the focus of Boyer and Porrini (2001, 2004) who compare ex ante regulation and various liability rules enacted ex post. They postulate a priori that the legal system viewed as an ex post monitor is immune to capture, whereas we derive this result from equilibrium behavior. In addition, they analyze separately the costs and benefits of the two systems whereas we model their joint use.¹⁰

Section 2 presents our theoretical model. Section 3 studies the benchmark without collusion. Section 4 describes our modeling assumptions for capture and studies the impact of collusion on monitoring under integration and separation. Section 5 performs a welfare comparison between institutional modes and highlights the possible complementarity between ex ante and ex post monitoring that might arise endogenously under separation. Section 6 discusses some implications of our results and presents several extensions. Section 7 concludes. All proofs are in the Appendix.

⁸Last, we focus here on moral hazard as the source of the rent that the firm wants to protect by capturing its monitors, whereas LM deal with adverse selection.

⁹See Tirole (1986) for instance.

¹⁰Earlier contributions, like Wittman (1977), Shavell (1984a, 1984b), Kolstad, Ulen and Johnson (1990), and Mookherjee and P'Ng (1992) compare the use of ex ante regulation and ex post liability rules but impose exogenous constraints on instruments, on information gathering technology, or on both. These institutional issues are instead at the core of our analysis.

2 The Model

Consider a firm running a socially risky technology. The probability of an accident affecting third-parties is reduced when this firm implements some safety care. Moral hazard in choosing this variable calls for controlling whether the firm abides to a standard of due care or not.

2.1 Incentives, Information and Control

Moral hazard. Following an accident, third-parties suffer from a damage of social value $D > 0$. The probability of such an accident, $1 - \pi(e)$, is decreasing in the firm's effort e . For simplicity, effort takes only two values, $e \in \{0, 1\}$, so that these probabilities are $1 - \pi_1 < 1 - \pi_0$ (we denote $\Delta\pi = \pi_1 - \pi_0$). Implementing effort $e = 1$ costs ψ to the firm whereas $e = 0$ is costless.¹¹

Moral hazard stems both from the non-verifiability of effort and from the conflict between social and private incentives to exercise care. Provided that the damage is large, i.e. $D \geq \frac{\psi}{\Delta\pi}$, efficiency calls for implementing the high level of effort; but the firm prefers to save on the compliance cost.

The firm is protected by limited liability and has no further assets that could be seized in case of an environmental accident.^{12,13} However, it has some hidden wealth $w > 0$ that can be used for bribery purposes if needed.

Contracts. A regulatory incentive scheme stipulates the firm's payments conditional on its environmental performances, i.e., whether an accident has taken place or not. Because of limited liability, the only relevant payment consists of a non-negative incentive reward t following a good environmental performance.¹⁴

Although we focus on monetary rewards and punishments, a broader interpretation of regulatory incentive payments should be kept in mind so that our model also fits institutional contexts where regulatory rewards are banned. For instance, industrial accidents sometimes come with damages to the fixed capital of the firm or/and to some stakeholders (e.g., workers). Costs may also be indirect and include tightened future regulations, permit refusals by the government, new taxes or future boycotts by environmentally-oriented consumers. Rewards may also involve the firm's implicit reputational gains vis-à-vis customers, potential contracting partners, the government,

¹¹The cost of effort is non-monetary for simplicity although our modelling could easily be modified to take into account monetary costs without changing our main results.

¹²We could allow for a positive amount of seizable assets as long as it is not too large so that the firm only exercises effort when given some positive liability rent.

¹³Firms running risky activities are generally protected by limits on their liability since the consequences of large scale accidents are so staggering that no insurance companies would fully insure them (see, e.g., the Price-Anderson Act in the U.S. for nuclear activities). Moreover, on top of institutional restrictions, risky ventures often enter into various activities ("flight-by-night" techniques, spin-offs of subsidiaries, ...) whose goal is to hide seizable assets. Pitchford (2001) and Hiriart and Martimort (2006) analyze the issue of extended liability when ex post legal intervention unveils new funds to compensate victims.

¹⁴In full generality, a contract should also stipulate a payment in the event of an accident. However, given the firm's limited liability, this payment would optimally be equal to zero at the optimum.

shareholders and the financial community.¹⁵ Along the same lines, the regulator's choice of incentive fines and rewards could be replaced by his ability to harden or soften future regulations when either canceling or permitting the firm's new products and activities for instance.¹⁶ With these interpretations in mind, it becomes easier to map our findings with existing regulatory practices. For instance, a regulatory agency that only controls safety standards and, a priori, does not directly affect the firm's financial incentives, may implement lax standards in the future as an imperfect substitute for monetary rewards.

Monitoring. Monitoring by public bodies might occur either before or/and after an accident. To gather hard evidence on whether the firm complies with standards, on-site random inspections are often used in the regulation of risky activities. Such investigations take place *ex ante*, i.e. before any accident ever occurs. Instead, *ex post* audits are run by an accident investigation commission or by the judiciary system following accidents. Of course, this intervention is relevant only when the *ex ante* investigation did not take place or failed to release how much effort was undertaken by the firm.

At a cost $C(p_r)$ standing for the cost of resources allocated to *ex ante* monitoring, an *ex ante* monitor observes a signal σ_r on the firm's effort level with probability p_r . To focus on interior solutions, $C(\cdot)$ is strictly increasing, sufficiently convex to ensure concavity of the optimization problems below, with $C(0) = 0$, and the Inada conditions $C'(0) = 0$, $C'(1) = +\infty$. The signal $\sigma_r \in \{e, \emptyset\}$ either reveals the firm's effort or is uninformative with respective probabilities $\epsilon \in (0, 1)$ and $1 - \epsilon$. The probability ϵ captures the precision of the signal.¹⁷

When its misconduct has been detected by the *ex ante* monitor, the firm is punished with some fines f_r . These punishments simply consist in suppressing part of the regulatory incentive payment that the firm would have received in case of a good environmental performance, i.e. $f_r \leq t$. Of course, the *Maximal Punishment Principle*¹⁸ applies in our context so that incentives for compliance are fostered when $f_r = t$. This Principle is used throughout to simplify exposition.¹⁹

¹⁵Lesourd and Schilizzi (2001) discuss the various indirect costs and benefits of environmental risks.

¹⁶Hiriart and Martimort (2006) provide more motivation for the short-cut of using monetary transfers between the Agency and the regulated firm.

¹⁷We thus assume that the monitor may either get perfect information on the effort or no informative signal. This assumption is standard in the collusion literature in vertical hierarchies since the seminal paper by Tirole (1986). It ensures that collusion takes place only when monitors have complete information on the agent's effort. If instead the monitor had a noisy signal on the firm's effort, collusion would take place under asymmetric information which might introduce further inefficiency. The corresponding transaction costs due to asymmetric information in side-contracting would induce effects close to those already stressed by LM. Those new effects would superimpose on those we highlight below. We chose thus to follow a simpler modeling path focusing on the novel insights due to the convexity of transaction costs.

¹⁸Quite intuitively, this Principle states that incentive constraints are all the more relaxed that punishments are set at their maximal value in case a noncompliant behavior is detected. See Becker (1968) and Baron and Besanko (1984) for earlier analysis.

¹⁹For the sake of simplicity, we assume that the firm, when found shirking by the *ex ante* audit, cannot change its effort level to adopt the standard. The implicit assumption here is that such an adoption requires major changes in the production technology and these changes take time. In a previous version of this paper, we showed that the qualitative conclusions are unchanged if the *ex ante* monitor could

Following an accident, and in case it is still unknown whether the firm has abided to the standard, an ex post investigation might occur with probability p_j . The ex post monitor gets a hard information signal $\sigma_j \in \{e, \emptyset\}$ which again perfectly reveals the firm's effort with probability $\epsilon \in (0, 1)$, or is uninformative. On top of detecting effort, this ex post investigation also unveils how much of the hidden funds w are used by the firm for bribery purposes if the ex ante and ex post monitors are two different bodies. To keep symmetry in modelling the ex ante and ex post rounds of investigation, the administrative cost of an ex post investigation is still given by $C(p_j)$.²⁰ If the ex post monitor figures out that there has been no compliance with the standard of safety care, the firm could a priori be fined. However, remember that the firm's payment is zero following a bad environmental performance so that no fines are actually available for the ex post monitor.

Institutional design. We consider two institutional settings. Under *integration*, the ex ante and ex post monitors are merged into a single entity. Under *separation*, monitors are kept apart and behave non-cooperatively. To fix ideas, one may think of the ex ante monitor as a regulator and the ex post one as a judge. Accordingly, in our analysis, regulators and judges differ along two dimensions: the timing of their intervention and the magnitude of the financial penalties they can impose to the firm. Note, however, that our model admits broader and less specific interpretations that are illustrated by the motivating examples stressed in Section 1.

Monitors' wages. If a monitor does not reveal information on the firm's effort, he gets a base-payment normalized at zero. When he reports evidence about the firm's effort, he may receive a positive wage. Let V_r denote the ex ante monitor's wage when he reports the firm's effort after an ex ante investigation. Let similarly V_j be the ex post monitor's wage.²¹ These wages should be broadly interpreted. They can stand for the share of the agency budget or resources that can be diverted for private use.²² Alternatively, they can also be considered as proxies for career concerns.²³

With probability $p_r \epsilon$, the ex ante intervention succeeds. When it does not and an accident occurs, the ex post monitor is called upon to inspect the firm. When the firm

force the firm to adopt immediately the high standard of safety care when $\sigma_r = 0$.

²⁰Note that the ex ante and ex post technologies are assumed to be identical to simplify exposition. Most of our results are robust to introducing asymmetries in the costs of monitoring ($C_r(\cdot) \neq C_j(\cdot)$) and differences in the probabilities of getting an informative signal at each round of investigation ($\epsilon_r \neq \epsilon_j$).

²¹In full generality, different wages could a priori be offered to the ex post monitor depending on whether an ex ante investigation failed or has not been performed. It turns out that this added degree of generality is not necessary since the optimal collusion-proof wages in those two cases are the same. Therefore, our findings below remain true when this possibility is a priori allowed. Henceforth, our presentation is simplified by assuming directly that those wages are equal.

²²Niskanen (1971) and Laffont and Tirole (1993).

²³If this latter perspective is taken, payments to monitors could simply be viewed as the product of the probability of getting a promotion times the private benefit associated to this new job. Whatever the interpretation behind these wages, they remain socially costly. For instance, rewarding a monitor for a zealous behavior by moving him towards higher positions in the bureaucratic hierarchy may come at the opportunity costs of not rewarding somebody more talented for this job.

complies with the standard, the expected wage left for monitoring is thus defined as:

$$V(p_r, p_j) = p_r \epsilon V_r + (1 - p_r \epsilon)(1 - \pi_1) p_j \epsilon V_j,$$

with

$$V_r, V_j \geq 0, \tag{1}$$

where the latter constraint ensures that monitors get more than their reservation wage.

Social welfare. The regulatory objective²⁴ incorporates the surplus S generated by the firm's activity,²⁵ the expected harm on third-parties, the firm's rent, the social cost of regulatory transfers and wages and, finally, the administrative costs of monitoring so that, overall, it writes as:

$$\begin{aligned} W &= S - (1 - \pi_1)D - \pi_1 t + \gamma U - V(p_r, p_j) - C(p_r) - C(p_j) \text{ where } \gamma \in [0, 1) \\ &\equiv S - (1 - \pi_1)D - \psi - (1 - \gamma)U - V(p_r, p_j) - C(p_r) - C(p_j). \end{aligned}$$

Following the tradition of the incentive regulation literature starting with the seminal paper by Baron and Myerson (1982), this objective puts a weight γ less than one on the firm's profit. This ensures that one euro pocketed by the firm is worth less than one euro left elsewhere in the economy. As it can be readily seen on the above expression, this ensures in turn that the firm's rent is socially costly and should be minimized under all contracting circumstances.²⁶

Of course, S is large enough so that the firm's activity is valuable, i.e. $W > 0$ at the optimum. Fines for misconduct should be pocketed by the State. But, since the firm is induced to comply with the standard and no such misconduct is detected at equilibrium, fines do not appear in this expression of social welfare. The existence of these fines nevertheless helps to relax the firm's incentive constraint and to reduce its liability rent.²⁷

We could easily generalize this objective function to take into account redistributive concerns. For instance, the regulatory charter could be more or less aligned with the harmed third-parties, depending on whether the risk at stake is global in nature or

²⁴In what follows, we will sometimes refer to the constitution in charge of designing the overall incentive package as the 'principal'.

²⁵Note that we make the simplifying assumption that the firm's effort does not affect social surplus. It would be a simple extension of our analysis to have the firm's effort also affect social surplus. For instance, we could incorporate a (maybe positive) impact of the firm's effort on social surplus under the form $S + \Delta S \pi_1$. Our analysis would go through by simply changing variables and defining $S' \equiv S - \Delta S$ and $D' \equiv D - \Delta S$.

²⁶We could slightly generalize this expression and have the regulatory (ex ante) and the judicial (ex post) bureaucracy's payoffs also be possibly weighted in the social welfare function. As long as these weights are less than one so that, overall, leaving payoffs above their reservation values to these public bodies is found socially costly, the same analysis as below could be carried over.

²⁷Our formulation of the government's objective is more general than it might appear at first glance. Suppose that the firm makes a profit Π which is taxed for an amount y_a in case of an accident and y_n in case no such accident occurs. Consumer's surplus is s so that our previous formulation applies provided one defines $S = \Pi + s$, $t = \Pi - y_n$ and observes that the binding limited liability constraint of the firm writes then as $y_a = \Pi$.

more local (i.e., whether it affects or not a significant share of the electorate).

Timing. For simplicity, we describe the sequence of events in the case of benevolent monitors. The case of non-benevolent monitors is analyzed in more details in Section 4.1.

- Date 0. The regulatory charter specifies the incentive transfer t , the respective probabilities (p_r, p_j) of ex ante and ex post investigations, fines when misbehavior is detected either ex ante or ex post, and wages for the monitors depending on their reported signals.²⁸
- Date 1. The firm exercises an effort $e \in \{0, 1\}$.
- Date 1⁺. The ex ante monitor inspects the firm with probability p_r . He learns signal σ_r about the firm's effort. If he detects misconduct ($\sigma_r = e = 0$), he imposes the fine $f_r = t$ that applies if no accident takes place later on.
- Date 2. An accident occurs with probability $1 - \pi(e)$.
- Date 2⁺. Following an accident and if nothing has been learned ex ante, the ex post monitor investigates with probability p_j .
- Date 3. Transfers and fines, if any, are paid.

2.2 Incentive Compatibility

To induce the firm to exercise care, the following incentive compatibility constraint must hold:

$$U \equiv \pi_1 t - \psi \geq (1 - p_r \epsilon) \pi_0 t. \quad (2)$$

The l.h.s. of (2) is the firm's expected profit if it complies with the standard since, in that case, the firm is never fined when monitoring (either ex ante or ex post) succeeds. The r.h.s. of (2) is the firm's expected profit if it does not comply with the standard. With probability $p_r \epsilon$, an ex ante inspection occurs and misbehavior is detected. The firm is then fined and loses the incentive reward t . With probability $1 - p_r \epsilon$, ex ante monitoring either does not take place or it takes place and fails. The transfer t is received if the accident does not occur. If it occurs, ex post monitoring might then be called upon and detect violation with probability $p_j \epsilon$ but, since the firm has no seizable wealth in that state, no fines are imposed.

The incentive constraint (2) yields a lower bound on the incentive payment t . Of course, the optimal regulation aims at minimizing the firm's rent and thus at minimizing this incentive reward so that, at the optimum, we have:

$$t^*(p_r, \epsilon) = \frac{\psi}{\Delta\pi + \pi_0 p_r \epsilon}. \quad (3)$$

There are two ways of providing incentives: through monitoring and through the incentive reward in the event of a good environmental performance. Moreover, as

²⁸We assume that there is full commitment to the regulatory charter. For the implications of limited commitment in an environment with corruptible auditors, see Strausz (1997), Khalil and Lawarée (2006) and Hiriart, Martimort and Pouyet (2010).

shown in the Appendix, the elasticity of the reward with respect to the ex ante audit probability is smaller than one, and decreases when the audit technology becomes less accurate.

Using this expression of the transfer, we may as well obtain the expression of the firm's expected profit as:

$$U = \mathcal{U}(p_r) = \frac{\pi_0(1 - p_r\epsilon)}{\Delta\pi + \pi_0 p_r\epsilon} \psi. \quad (4)$$

The firm's limited liability rent $\mathcal{U}(\cdot)$ is positive, decreasing and convex in p_r . Such a positive profit is a necessary ingredient to have a stake for capture when monitors are not benevolent, as we will show below.

2.3 Motivation for Contractual Restrictions

One could argue that the space of contracts available to the principal, as described above, is somewhat incomplete. Indeed, the firm's final payments in each state of nature, which are either t or 0 , only depend on the occurrence or not of an environmental damage or on whether shirking is detected by a round of monitoring (either ex ante or ex post).

Suppose instead that these payments could also be made contingent on the information revealed by monitoring when it is favorable to the firm. To simplify, let us first consider the information revealed by a round of ex ante monitoring. A simple contract that gives a reward $t(1)$ only when ex ante monitoring reveals that the firm has exercised an effort and there is no accident implements the first-best at no agency cost for the principal. Indeed, it then never pays off for the firm to deviate and exercise zero effort. Therefore, the firm's incentive constraint writes as follows:

$$p_r\epsilon\pi_1 t(1) - \psi \geq 0.$$

This incentive constraint is identical to the firm's participation constraint. At the optimum, this participation constraint is binding and the incentive constraint is automatically satisfied. Agency costs are thus null in that environment.

Intuitively, when the outcome of monitoring is verifiable, monitoring makes effort (indirectly) contractible even though it is only the case with some probability. We are then back to a setting where the non-verifiability of effort does not matter and the firm gets no liability rent for undertaking such effort. In such a setting, the scope for collusion between the firm and its monitors to protect the liability rent, which is our focus throughout the paper, would disappear.

To avoid such an unpalatable conclusion and stress the conditions under which our restricted space of contracts is relevant, suppose that the outcome of monitoring, although hard information, is nonverifiable. Clearly, the extended mechanism described above can be manipulated by the principal himself, by hiding any evidence favorable to the firm whereas such manipulations do not arise when unfavorable evidence is detected.²⁹ Indeed, if the principal observes through a round of ex ante monitoring that

²⁹McLeod (2003) makes a similar point in a simpler model with no monitoring and where the agent's

the firm has implemented some care, claiming that monitoring has not unveiled the firm's effort always saves the expected reward $\pi_1 t(1)$ left to the agent. Instead, had the firm deviated and exercised zero effort, the principal would still have incentives to report that unfavorable information to avoid paying anything to the firm. In other words, assuming that the signal revealed by monitoring is nonverifiable introduces a fundamental asymmetry between "good" and "bad" news on the firm's effort. "Good news" are hidden by the principal if the firm must be rewarded in that state, whereas "bad news" are readily revealed.

Avoiding these manipulations by the principal himself requires paying the same amount to the firm whether monitoring may unveil favorable evidence or not. The only remaining tool to provide incentives to the firm is to offer payments contingent on whether an accident occurs or not, and to suppress these rewards in case monitoring unveils shirking. This argument applies as well to ex post monitoring if any. Overall, the scope for the principal's manipulation requires to pay the firm a fixed payment t in case there is no environmental damage, and zero otherwise. This validates our initial focus on what could have been seen as an a priori ad hoc restriction on contracts.

An alternative formulation to avoid that incentive rewards are made contingent on the favorable outcome of an audit is to assume that the incentive payment t is not fixed by the 'environmental' principal in charge with organizing the control of safety care but, instead, by another 'economic' principal. This 'economic' principal does not have access to the information on the outcomes of those audits and cannot commit to rewards contingent on those outcomes. He only observes the environmental performances of the firm and whether damages occur or not. On top, the 'environmental' principal has no funds on his own and can certainly impose fines, but not reward the firm following "good" news on the level of safety care it has implemented. This alternative approach is particularly consistent with our interpretation of incentives rewards and payments as reduced-forms for the future benefits of a good environmental performance when direct regulatory rewards are banned.

3 Benevolent Monitors

Let us suppose that the ex ante and ex post monitors are both benevolent. There is no need to pay any positive wage to induce these monitors to reveal informative signals on the firm's effort. In such an environment, separation and integration are clearly equivalent.

Ex ante monitoring punishes the firm since it suppresses rewards following a good environmental performance when misconduct is detected. Ex post monitoring is useless because it does not help to relax the firm's incentive constraint and can only waste administrative resources.

Proposition 1 *With benevolent monitors, the optimal probability of ex ante investigation is*

performance itself is manipulable by the principal.

strictly positive whereas the probability of ex post investigation is zero:

$$p_r^* > 0 \text{ and } p_j^* = 0.$$

The optimal incentive payment for the firm is non-negative:

$$t^* > 0.$$

Wages for both rounds of monitoring are zero:

$$V_r^* = V_j^* = 0.$$

4 Preventing Capture

4.1 Collusion Technology

Collusive side-contracts. A firm might bribe its monitors so that they hide information on misconduct. Bribes might take the form of promises for future job opportunities in the private sector for current regulators, direct monetary bribes or campaign contributions targeted towards lawmakers and key elected officials who have influence at the various stages of the firm's monitoring.

As already mentioned, the firm has at its disposal some hidden wealth $w > 0$ for bribing its monitors.³⁰ The firm has all bargaining power in proposing bribes to the monitor(s).³¹ A corruptible monitor accepts bribes if he gets more by doing so and being lenient than by remaining honest and releasing misconduct that he may have observed through investigation. The ex ante monitor's discretion comes from his ability to report having observed $\sigma_r = \emptyset$ when indeed $\sigma_r = e = 0$. The firm avoids then paying fines. This collusive strategy may be attractive if the monitor gets a share of the corresponding gains pocketed by the firm. The ex post monitor could a priori also enjoy similar benefits by hiding ex post evidence of misconduct, i.e., reporting $\sigma_j = \emptyset$ when $\sigma_j = e = 0$.

The firm commits to offer the promised bribes to the monitor if he remains lenient. Reciprocally, the monitor commits to stay silent on misconduct.³²

Monitors only enjoy private benefit $k(\tau) \in [0, \tau]$ when they receive a bribe $\tau \geq 0$ (in particular, $k(0) = 0$). Such frictions are due to the existing transaction costs of side-contracting, including possibly the cost that firms may bear in organizing corruptible activities. The existence of such transaction costs is a standard assumption in the public choice and regulation literatures (see Congleton, 1984, and Faure-Grimaud

³⁰One can easily show that the regulatory agency cannot induce the firm to reveal w through any incentive mechanism.

³¹This assumption simplifies presentation but, given that collusion takes place under complete information between the firm and its monitor(s), nothing would be changed by considering alternative allocations of the bargaining power. Indeed, collusion is valuable whenever these parties get a greater collective surplus than by behaving.

³²See Vafai (2002) for another model of collusion in a moral hazard environment with a risk-averse agent based on similar enforceability assumptions.

and Martimort, 2003, among others). Importantly, the function $k(\cdot)$ is positive, increasing, and strictly concave. Convexity of the transaction costs $TC(\tau) = \tau - k(\tau)$ of side-contracting reflects the fact that collusive partners find it increasingly harder at the margin to transfer greater bribes. Colluding partners look for side-deals that minimize the dead-weight loss associated to these transaction costs.

Given the importance of our assumption on the convexity of transaction costs for our results, it is important to give it some background. Possible justifications behind this assumption may be found both on the demand and the supply sides of the market for bribes. On the demand side, first, we may assume that larger bribes are (exogenously) publicly detected with an increasingly higher probability $P(\tau)$, and that such detection inflicts a large (non-modeled) non-monetary punishment on violators. In this case, we have $k(\tau) = \tau(1 - P(\tau))$, $k'(\tau) = -\tau P'(\tau) + 1 - P(\tau)$, the latter being positive as long as $\tau \leq \tau^* = \frac{1-P(\tau^*)}{P'(\tau^*)}$,³³ and $k''(\tau) = -2P'(\tau) - \tau P''(\tau) \leq 0$ when $P''(\tau) \geq 0$.

On the supply side, these transaction costs of side-contracting capture all the frictions that the firm may face in organizing its corruptive activities. With that alternative interpretation in mind, convexity simply means that it becomes harder at the margin to siphon funds of the general budget of the firm for hidden illegal activities, an assumption that seems reasonable.

Finally, we stress that the technology for side-contracting is kept constant as one changes organizational mode. This allows us to focus on the sole role of the difference in the costs of preventing capture across organizations as a determinant of organizational choices.

Last, when investigating the organization with separation, we rule out the possibilities that monitors directly collude one with the other. This can be justified when the transaction costs of such side-contracts are prohibitively high, or when such collusion between public bodies would easily be detected.

Collusion-proofness. The possibility that the firm may enter into side-deals with monitors can be viewed as a new dimension of moral hazard.³⁴ Since side-contracts are non-verifiable by definition and thus cannot be directly banned, the regulatory charter must not only induce a high level of safety care, but also prevent the firm from offering collusive side-contracts.

When damages are large enough, restricting attention to collusion-proof regulatory policies is clearly optimal. It is akin to ensuring that the firm does not want to simultaneously deviate by exercising a low level of care and colluding with monitors.³⁵

³³Note that such τ^* is uniquely defined when the monotone hazard rate property $\frac{d}{d\tau} \left(\frac{1-P(\tau)}{P'(\tau)} \right) < 0$ holds.

³⁴Laffont (1990) pointed out this analogy between collusion and moral hazard.

³⁵The reader knowledgeable in the theory of collusion may recognize that this restriction to the collusion-proof regulatory policies is not as standard as in the literature. The latter has shown that there is no loss of generality in restricting the analysis to those incentive mechanisms that come unchanged through collusion. The bulk of the argument is that any other contracting outcome, where collusion is allowed and played on a continuation equilibrium following a given offer by the principal, yields payoffs that could as well have been reached through such a collusion-proof mechanism. This can be true of the optimal payoff, as in the literature on collusion with hard information (Tirole 1986,

4.2 Integration

Suppose first that both monitors are merged into a single entity. The latter's discretion comes from his ability to coordinate reports at the various stages of investigation. When collusion starts *ex ante*, an enforceable side-contract gives the colluding partners the opportunity to specify bribes following *ex post* investigation if any is called upon.

Ex post collusion. Let us begin by the simple case of an *ex post* collusion. If an *ex ante* investigation fails or is not carried out, the monitor can still intervene *ex post*. *Ex post* collusion might occur if the firm is found negligent and the monitor obtains a signal σ_j which is informative on the firm's misconduct.

With such an *ex post* collusion, a bribe $\tau_j = k^{-1}(V_j)$ is enough to leave the monitor just indifferent between colluding or not *ex post*. Remember now that the firm's net regulatory transfer following an accident is zero. Colluding secures payoff $w - k^{-1}(V_j)$ whereas not colluding, i.e. paying no bribes, yields w .

Therefore, *ex post* collusion does not take place as soon as the following *ex post collusion-proofness constraint* holds:

$$V_j \geq 0. \quad (5)$$

Ex ante collusion. When an *ex ante* investigation succeeds, the colluding monitor hides information on the low effort undertaken by the firm. The monitor commits not to reveal information if an *ex post* investigation takes place and also generates hard evidence on the firm's misconduct. In exchange, the firm offers a sequence of bribes $(\tau_r^0, \tau_r^1, \tau_r^2)$. These bribes are respectively offered when an accident does not occur (τ_r^0 with probability π_0), when an accident occurs but *ex post* investigation fails (τ_r^1 with probability $(1 - \pi_0)(1 - p_j\epsilon)$), and when an accident occurs and *ex post* investigation succeeds (τ_r^2 with probability $(1 - \pi_0)p_j\epsilon$).

The optimal side-contract $(\tau_r^0, \tau_r^1, \tau_r^2)$ thus solves:

$$(\mathcal{P}^I) : \quad \max_{\tau_r^0, \tau_r^1, \tau_r^2 \in [0, w]} w + \pi_0(t - \tau_r^0) - (1 - \pi_0)(1 - p_j\epsilon)\tau_r^1 - (1 - \pi_0)p_j\epsilon\tau_r^2$$

subject to

$$\pi_0 k(\tau_r^0) + (1 - \pi_0)(1 - p_j\epsilon)k(\tau_r^1) + (1 - \pi_0)p_j\epsilon k(\tau_r^2) \geq \max \{V_r; (1 - \pi_0)p_j\epsilon V_j\}. \quad (6)$$

To collude, the monitor's gain from accepting the side-contract must exceed his wage if he refuses it. Absent collusion, the monitor may either report evidence early and earn V_r , or hide evidence and wait until he is called upon *ex post* and learns a new signal. His expected earning is then $(1 - \pi_0)p_j\epsilon V_j$.

1992), or this can be true of any allocations (even suboptimal ones), as when collusion takes place under soft information (Laffont and Martimort 1997, 2000). Here instead, we do not show such general equivalence. Instead, we just posit that any scheme that might induce collusion generates an accident with a higher probability. Our assumption of a large damage D implies that welfare is strictly lower with such a mechanism.

We consider parameter values so that the monitors' wages satisfy:

$$V_r \geq (1 - \pi_0)p_j\epsilon V_j. \quad (7)$$

This condition will be checked at the optimum.³⁶ In that case, the best strategy for the monitor when not colluding is to report early the firm's misconduct.

Because transaction costs are convex, smoothing bribes and offering a same bribe τ_r^I under all contingencies reduces the dead-weight loss of side-contracting. Given that the firm has all bargaining power when designing side-contracts, it optimally offers a flat bribe that makes the monitor just indifferent between colluding or not:

$$\tau_r^0 = \tau_r^1 = \tau_r^2 \equiv \tau_r^I = k^{-1}(V_r).$$

Such a bribe is feasible when the firm has enough hidden wealth available, i.e., $w > \tau_r^I$ or, equivalently:

$$V_r < k(w). \quad (8)$$

With such a flat bribe, the firm's overall payoff from ex ante collusion is thus $w + \pi_0 t - k^{-1}(V_r)$. Instead, if the firm does not offer the bribe τ_r^I and misconduct is revealed, the firm keeps w . A regulatory scheme is *ex ante collusion-proof* when the firm prefers not to collude, i.e., when the wage V_r satisfies the following *ex ante collusion-proofness constraint*:

$$V_r \geq k(\pi_0 t). \quad (9)$$

Incentive compatibility and collusion-proofness. Let us now describe the firm's incentive constraint when collusion matters. As already stressed, the regulatory charter must not only induce the firm to comply with the standard but also not to collude with its monitor, be it either ex ante or ex post. The following *generalized incentive constraint* aggregates all possible deviations available to the firm:

$$U \geq p_r \epsilon \max \{0; \pi_0 t - k^{-1}(V_r)\} + (1 - p_r \epsilon) (\pi_0 t + (1 - \pi_0)p_j \epsilon \max \{0; -k^{-1}(V_j)\}). \quad (10)$$

Clearly, in the state where an accident takes place and ex post investigation unveils misbehavior, paying a bribe is useless since the firm has nothing to save.

Response to the threat of capture. Since giving up some extra rents to the monitor is socially costly, the collusion-proofness constraints (5) and (9) are both binding at the optimum. Avoiding capture requires to give up the following wages:

$$V_r^I = k(\pi_0 t) \quad \text{and} \quad V_j^I = 0. \quad (11)$$

With these wages, the firm's incentive constraint remains the same with or without collusion, i.e. (10) coincides with (2). Hence, for fixed investigation probabilities, the

³⁶The monitor's strategy consisting in waiting for some evidence ex post is also a possibility on the equilibrium path, i.e., when the firm exercises an effort. The corresponding constraint, $V_r \geq (1 - \pi_1)p_j\epsilon V_j$, holds a fortiori since $\pi_1 > \pi_0$.

firm receives the same liability rent $\mathcal{U}(p_r)$ and the same transfer $t^*(p_r, \epsilon)$ following a good environmental performance as if monitors were benevolent. Payments and rent are thus respectively given by (3) and (4).

Investigation probabilities. Turning now to the optimal investigation probabilities, we get:

Proposition 2 *The probabilities of investigation under integration are lower than with benevolent monitors when collusion is a concern:*

$$p_r^I \leq p_r^* \text{ and } p_j^I = 0. \quad (12)$$

Considering the probability of ex ante investigation, several opposite effects are simultaneously at play. For a given stake of collusion between the merged entity and the firm, reducing this probability helps decreasing the expected wage $V(p_r, p_j)$ needed to ensure ex ante collusion-proofness. As with benevolent monitors, reducing this probability increases the incentive reward $t^*(p_r, \epsilon)$ and makes the incentive constraint (2) more demanding. However, with corruptible monitors, the stake of collusion $\pi_0 t^*(p_r, \epsilon)$ is increased, making the collusion-proofness constraint (9) more difficult to satisfy too. Since the elasticity of the reward with respect to the ex ante audit probability is smaller than one, the first of these effects always dominates, making the impact of p_r on the stake of collusion less important. Overall, this pushes towards less ex ante investigation.

4.3 Separation

Consider now the case where each round of investigation is run by a different monitor. The key difference with the case of integration is that, when deciding whether to collude or not with the ex ante monitor, the firm anticipates the issue of side-contracting with the ex post monitor. More precisely, we will assume that the ex ante monitor and the firm, at the time of striking their deals, anticipate that the ex post investigator will not collude in a collusion-proof equilibrium. Reciprocally, the ex post monitor anticipates that the ex ante monitor is not corrupted. These simple behavioral assumptions, where both agencies choose ex ante whether to collude or not, will help us to get clear results on the benefits of separation.

Ex post collusion. Absent any ex ante investigation, or when such investigation has failed, the same logic as under integration applies and the corresponding ex post collusion-proofness constraint is again given by (5).

Ex ante collusion. A side-contract for the ex ante monitor stipulates a priori some non-negative bribes $(\tau_r^0, \tau_r^1, \tau_r^2)$ respectively when an accident does not occur and when an accident does occur but ex post investigation either fails or succeeds.

Consider the last possibility. Through his own investigation, the ex post monitor not only observes the firm's effort but also the bribe τ_r^2 exchanged if any, detecting

thereby possible collusion between the ex ante monitor and the firm. Anticipating that the ex post monitor is uncorruptible in equilibrium, the firm and the ex ante monitor should strike their best collusive deal knowing that the ex post monitor is committed to report information on their misbehavior when detected. In particular, we assume that the regulator would lose all collusive benefits (may it be under the form of reputational stigma or financial penalties) following such a detection. From the firm's viewpoint, transferring bribe to that ex ante monitor in the event where the ex post monitor investigates is thus just a pure loss. It does not raise the ex ante monitor's expected benefit from colluding and only reduces the firm's expected payoff. Hence, the firm finds it optimal not to bribe the ex ante monitor in case an ex post investigation succeeds.

Therefore, the optimal side-contract (τ_r^0, τ_r^1) offered to the ex ante monitor when he observes $\sigma_r = 0$ and pretends that $\sigma_r = \emptyset$ must solve:

$$(\mathcal{P}^S) : \quad \max_{\tau_r^0, \tau_r^1 \in [0, w]} w + \pi_0(t - \tau_r^0) - (1 - \pi_0)(1 - p_j\epsilon)\tau_r^1$$

$$\text{subject to } \pi_0 k(\tau_r^0) + (1 - \pi_0)(1 - p_j\epsilon)k(\tau_r^1) \geq V_r. \quad (13)$$

Separation reduces the possibilities for smoothing bribes with respect to integration. Bribes with the ex ante monitor are now exchanged in two states of nature instead of three. This captures the intuition that, under separation, there are less points of contact and thus less collusion possibilities between the firm and its ex ante monitor.

Nevertheless, the dead-weight loss of side-contracting is still minimized with a flat bribe over contingencies where such a collusion is feasible:

$$\tau_r^0 = \tau_r^1 \equiv \tau_r^S = k^{-1} \left(\frac{V_r}{\alpha} \right)$$

where $\alpha = \pi_0 + (1 - \pi_0)(1 - p_j\epsilon)$ is the overall probability of no successful ex post investigation.

The firm's net benefit from ex ante collusion is thus $\pi_0 t - \alpha \tau_r^S$. The ex ante collusion-proofness constraint can thus be written as:

$$V_r \geq \alpha k \left(\frac{\pi_0 t}{\alpha} \right). \quad (14)$$

Response to the threat of capture. The overall cost of preventing capture is again obtained when the expected wage left to monitors is minimized, which implies that (5) and (14) are both binding:

$$V_r^S = \alpha k \left(\frac{\pi_0 t}{\alpha} \right) \text{ and } V_j^S = 0. \quad (15)$$

Proceeding as before, the generalized incentive constraint that induces the firm to implement some care and not to collude with both the ex ante and ex post monitors is

similar to (10). This incentive constraint writes as

$$U \geq p_r \epsilon \max \left\{ 0; \pi_0 t - \alpha k^{-1} \left(\frac{V_r}{\alpha} \right) \right\} + (1 - p_r \epsilon) (\pi_0 t + (1 - \pi_0) p_j \epsilon \max \{ 0; -k^{-1}(V_j) \}) .$$

It again boils down to the standard incentive constraint (4) when (5) and (14) are both binding. The optimal incentive transfer is thus unchanged and still given by (3). Hence, V_r^S becomes a function of (p_r, p_j) through the direct dependence of $t^*(p_r, \epsilon)$ on p_r and the dependence of α on p_j .

5 Welfare Comparison

Only the wages left for ex ante monitoring differ in both scenarios. For some fixed investigation probabilities (p_r, p_j) , the welfare difference between separation and integration is just the difference in these wages, which are respectively given by $V_r^I(p_r) = k(\pi_0 t^*(p_r, \epsilon))$ under integration, and $V_r^S(p_r, p_j) = \alpha k \left(\frac{\pi_0 t^*(p_r, \epsilon)}{\alpha} \right)$ under separation. We obtain:

$$\Delta W(p_r, p_j) = p_r \epsilon \left\{ V_r^I(p_r) - V_r^S(p_r, p_j) \right\} = p_r \epsilon \left\{ k(\pi_0 t^*(p_r, \epsilon)) - \alpha k \left(\frac{\pi_0 t^*(p_r, \epsilon)}{\alpha} \right) \right\} .$$

Since $\alpha < 1$, $t^*(p_r, \epsilon) > 0$ and $k(\cdot)$ is strictly concave, $\Delta W > 0$ and we can establish the main result of this paper:

Theorem 1 *Under the threat of capture, and for any probabilities of investigation (p_r, p_j) , separation improves welfare:*

$$\Delta W(p_r, p_j) > 0 .$$

Transaction costs of side-contracting are greater under separation than under integration. The mere fact that the ex ante monitor and the firm cannot exchange bribes in all the states of nature makes it more difficult to collude ex ante.

The convexity of transaction costs is key for this result. Had transaction costs been linear, non-benevolent monitors would not care about smoothing bribes and separation would be equivalent to integration. Indeed, let us compare the ‘‘potential’’ bribe that the firm provides to the ex ante monitor under separation and integration. It is straightforward to see that:

$$\tau_r^I = \alpha \tau_r^S . \tag{16}$$

Therefore, the ex ante monitor under separation earns the same expected bribe than the ex ante monitor under integration. Indeed, in both cases, the firm wants to secure the liability rent $\pi_0 t^*(p_r, \epsilon)$. Comparing separation with integration, having higher bribes but less often is not costly when $k(\cdot)$ is linear.

However, two different effects that reinforce each other ensure that separation dominates when transaction costs are strictly convex. To understand those effects, remember that, although the same expected amount of bribes has to be distributed under integration and separation, there are fewer points of contact between the colluding

partners under separation. Hence, the size of the bribe in each state of nature where collusion arises under separation increases significantly. This mechanically increases the deadweight loss of side-contracting, since it becomes at the margin harder to transfer such larger bribes. This is the first benefit of separation. However, a second benefit now appears since, compared with the case of integration, the distribution of those bribes exchanged with the ex ante monitor has also more variance (it is either 0 when ex post monitoring is successful or τ_r^S otherwise). This randomness increases the expected transaction costs because of their convexity.

Investigation probabilities. To give some preliminary insights on how the optimal probabilities of investigation under separation and integration can be compared, consider the simple case where $k(\cdot)$ is quadratic, namely, $k(\tau) = \kappa\tau - \frac{\mu}{2}\tau^2$ for some $\kappa \in [0, 1]$ and $\mu \geq 0$ such that $k(\cdot)$ is increasing on the relevant range. The welfare gain of separation can finally be written as:

$$\Delta W(p_r, p_j) = \frac{\mu\pi_0^2(1-\pi_0)(t^*(p_r, \epsilon))^2}{2(\pi_0 + (1-\pi_0)(1-p_j\epsilon))} p_r p_j \epsilon^2 > 0. \quad (17)$$

Those gains increase with the probability of an ex ante investigation since one can save on monitoring wages by splitting monitoring tasks under separation. In addition, when an ex post investigation is more likely, the transaction costs of side-contracting increase because the possibility of smoothing bribes under separation only occurs under contingencies which are relatively less likely. Bringing the ex post monitor in more often becomes thus more attractive. Denoting by (p_r^S, p_j^S) the optimal investigation probabilities under separation, we finally get:

Proposition 3 *Assume that $k(\cdot)$ is quadratic. Under separation, there is more ex post investigation than under integration and more ex ante investigation if ϵ is small enough:*

$$p_j^S > 0 \text{ and } p_r^S > p_r^I \Leftrightarrow \Delta\pi > \pi_0 p_r^S \epsilon.$$

From (17), we immediately deduce that the welfare gain from a marginal increase of the ex post investigation under separation is positive, i.e. $\frac{\partial \Delta W}{\partial p_j} > 0$. Instead, increasing p_r decreases the stake of collusion $\pi_0 t^*(p_r, \epsilon)$ by reducing the limited liability rent. However, increasing p_r also raises the probability of ex ante collusion, but it is less problematic under separation than under integration. The second of these effects dominates, and $\frac{\partial \Delta W}{\partial p_r} > 0$ when ϵ is small enough, since the elasticity of $t^*(p_r, \epsilon)$ with respect to p_r is then small.

A recurrent question concerning the use of regulators or judges is whether they are substitutes or complements. Our model sheds some light on this issue. The formula (17) shows under which conditions these two bodies are actually complements in improving welfare. Indeed, when ϵ is small enough, it becomes more valuable to use ex ante investigation under separation because the stake of collusion is reduced. At the same time, ex post intervention is more attractive. By raising at the margin the probability of bringing the judge in ex post, ex ante collusion with the regulator becomes

harder, making regulation more attractive.

When monitoring is not too efficient, either because the optimal ex ante audit probability is small or because the accuracy of the signal is weak, the condition $\Delta\pi > \pi_0 p_r^S \epsilon$ holds and ex ante and ex post interventions are complements.

It is striking that, even though the judge himself may be corruptible, an ex post investigation is now valuable, contrary to what happens in a collusion-free environment. There is an interesting division of tasks between public bodies: ex ante regulation helps relaxing the firm's incentive constraint whereas ex post judicial investigation helps relaxing the possible collusion between the firm and its regulator.

Finally, we close this section by considering more general formulations of our results.

Asymmetric signal accuracies. Let us investigate in more details the role played by the relative accuracy of the ex ante and the ex post monitoring. Denote by ϵ_r and ϵ_j the respective precisions of the ex ante and ex post signals available to the monitors. It is straightforward to check that the optimal incentive reward remains $t^*(p_r, \epsilon_r)$, which only depends on the accuracy of ex ante monitoring. Intuitively, ex post monitoring does not relax the firm's incentive constraint, as we showed earlier on, and the precision of the corresponding signal plays no role in determining the firm's reward and liability rent. Instead, notice that the overall probability of no successful investigation ex post $\alpha = \pi_0 + (1 - \pi_0)(1 - p_j \epsilon_j)$ depends only and decreases with the ex post accuracy ϵ_j . Still in the quadratic case, the welfare difference between separation and integration now becomes:

$$\Delta W(p_r, p_j) = \frac{\mu \pi_0^2 (1 - \pi_0) (t^*(p_r, \epsilon_r))^2}{2(\pi_0 + (1 - \pi_0)(1 - p_j \epsilon_j))} p_r p_j \epsilon_r \epsilon_j > 0. \quad (18)$$

Of course, this expression confirms that the ex ante and ex post rounds of monitoring remain complements over some range and that the welfare gain from separation increases with both degrees of accuracy. However, equation (18) shows also that this welfare gain is more sensitive to an increase in ϵ_j . Indeed, such a change decreases the conditional probability α of the states where bribes might be exchanged between the ex ante regulator and the firm, and thus increases the potential bribe τ^S . This allows to benefit from larger transaction costs of side-contracting at those high levels of bribes under separation.

General transaction costs. Formula (17) and (18) are obtained with a quadratic $k(\cdot)$. To understand the gains from separation beyond this simple functional form, it is useful to consider the limiting case where α is close to one, i.e. ϵ is close to zero. In that case, conditional on collusion having started with the ex ante monitor (admittedly, a rare event), the ex post round of investigation is unlikely to bring any information. Taylor expansions in the neighborhood of $\alpha = 1$ immediately give us:

$$\Delta W(p_r, p_j) = (1 - \alpha) \underbrace{(k(\pi_0 t^*(p_r, \epsilon)) - \pi_0 t^*(p_r, \epsilon) k'(\pi_0 t^*(p_r, \epsilon)))}_{\text{First-order effect}}$$

$$+ \frac{(1 - \alpha)^2}{2} \underbrace{(\pi_0 t^*(p_r, \epsilon))^2 (-k''(\pi_0 t^*(p_r, \epsilon)))}_{\text{Second-order effect}}.$$

The first of these terms represents the first-order effect of reducing the overall probability of the states where bribes can be exchanged with the ex ante monitor by raising a bit the accuracy of the ex post signal. It captures the fact that the bribe possibly exchanged with the ex ante monitor being now higher under separation, transaction costs of side-contracting are higher at those higher levels. The second term represents instead the second-order impact of reducing this probability. It is related to the greater variance of the distribution of bribes exchanged under separation. These two effects always go in the same direction. The first-order effect and the second-order effect are equal in the quadratic case, but they may differ beyond.

6 Discussion and Extensions

Testable implications. Our analysis provides a number of testable implications. Suppose that separating ex ante and ex post monitoring requires setting up a new agency with a fixed set-up cost $K > 0$. The formula (17) shows that $\Delta W(p_r, p_j)$ is more likely to be greater than K under several circumstances which can be related to the monitoring and production technologies available in the public and the private spheres. First, separation is attractive when p_r and p_j are both large enough, i.e. when the administrative costs of monitoring are small enough. We expect thus separation to be more easily adopted in mature sectors, where routinized administrative procedures may have lowered those marginal costs of monitoring. Transportation may be an example in order. Second, separation is also more attractive when $t^*(p_r, \epsilon)$ is high enough, i.e, when regulation calls for high powered incentives, maybe because the firm's marginal cost of effort is high or significant investments are needed to reduce the likelihood of an environmental accident. The nuclear industry is an attractive example in this respect.

Another important implication of our findings is that splitting ex ante and ex post investigations should increase the likelihood to rely on either of those arms and, by the same token, their administrative costs. The flip side of separation is thus a possible increase in regulatory budgets.

Robustness 1: Monitors' anticipatory behavior. We have assumed so far that the ex ante monitor and the firm, at the time of striking their deals, anticipate that the ex post investigator will not collude. Reciprocally, the ex post monitor also anticipates that the ex ante monitor is not corrupted. These simple behavioral assumptions, where both agencies can commit on their choice whether to collude or not, helped us to get clear results on the benefits of separation.

Let us now turn to the more intricate hypothesis where the ex ante monitor and the firm design their collusive deal anticipating its impact on the incentives to collude or not with the ex post monitor. The firm may then be able to bribe the ex ante monitor under all circumstances if it also bribes the ex post monitor and thereby buys his leniency.

Of course, preventing such a behavior requires to increase the ex post monitor's wage, as we show below.

Based on our previous findings, it is relatively straightforward to compute the firm's overall payoff when buying the ex post monitor's services with a bribe $k^{-1}(V_j)$ if it also colludes with the ex ante monitor, giving the latter a flat bribe $k^{-1}(V_r)$ in all states of nature.³⁷ Since bribing the ex post monitor arises only with probability $1 - \alpha = (1 - \pi_0)p_j\epsilon_j$, the firm's payoff writes as:

$$w + \pi_0 t - k^{-1}(V_r) - (1 - \alpha)k^{-1}(V_j).$$

Instead, when not buying the ex post monitor's leniency, the firm can only exchange with the ex ante monitor a flat bribe $k^{-1}\left(\frac{V_r}{\alpha}\right)$ in the two remaining states of nature where this ex post monitor does not get information, i.e. with overall probability α . The firm gets thereby:

$$w + \pi_0 t - \alpha k^{-1}\left(\frac{V_r}{\alpha}\right).$$

Clearly, the firm does not find it attractive to collude with the ex post monitor when the second payoff dominates. This yields the following expression of the ex post collusion-proofness constraint:

$$V_j \geq k\left(\frac{1}{1 - \alpha}\left(\alpha k^{-1}\left(\frac{V_r}{\alpha}\right) - k^{-1}(V_r)\right)\right). \quad (19)$$

Together with the ex ante collusion-proofness constraint (14), this defines the set of wages ensuring that no collusion takes place either ex ante or ex post under separation.

Note that the strict convexity of $k^{-1}(\cdot)$, the fact that $k(0) = 0$ and $\alpha < 1$ altogether imply that the right-hand side of (19) is positive when $V_r > 0$. This condition is satisfied since (14) is binding. The ex post monitor must now receive a positive wage which is large enough to prevent a bribe exchange between the ex ante monitor and the firm in all states of nature. The benefits of lower payments to the ex ante monitor must be weighted against the cost of higher payments for the ex post monitor. The first effect dominates when $p_r\epsilon$ is large enough, in which case an ex post investigation is unlikely, and leaving a wage to the ex post monitor is not so costly.

As an example, assume that transaction costs of side-contracting are quadratic, $k(\tau) = \tau - 1/2\tau^2$, and that bribes are small enough.³⁸ Then, $k^{-1}(v)$ can be approximated (up to terms of order more than 2) by $v + 1/2v^2$. In equilibrium, the ex ante monitor and the firm do not collude (while anticipating that the ex post monitor is not corrupted because (19) holds) if the ex ante collusion-proofness (14) is satisfied. When bribes are small, the ex post collusion-proofness constraint (19) can be approximated as: $V_j \geq V_r^2/(2\alpha)$. Simple manipulations then show that the following approximation

³⁷Here, we assume for simplicity that the firm has enough funds to bribe both monitors ex post, i.e., $w > k^{-1}(V_r) + k^{-1}(V_j)$ for the equilibrium values of wages.

³⁸This arises, for instance, when ψ is small so that $\pi_0 t^*(p_r, \epsilon)$ is also small.

holds also:

$$\Delta W(p_r, p_j) \approx \frac{\pi_0^2 (t^*(p_r, \epsilon))^2}{2\alpha} [(1 - \alpha)p_r - (1 - p_r\epsilon)(1 - \pi_1)p_j]\epsilon.$$

When p_r is large enough, $\Delta W(p_r, p_j) > 0$. In this case, separation dominates integration, but it now requires to leave a positive wage to the ex post monitor.

Robustness 2: Monitors' wages. We have assumed implicitly throughout the exposition that monitors' wages do not depend on the firm's effort. This is without loss of generality when there is no collusion. This might seem a priori restrictive otherwise. Suppose indeed that the firm's effort, once observed, can be used to condition the monitor's compensation. With a wage dependent on the effort level, collusion can be prevented at no cost by offering a high wage \bar{V} to the monitor when he reveals that the firm has shirked. When the firm's individual incentive constraint is satisfied, this event does not occur along the equilibrium path and raising this wage has no cost for society (see Kessler, 2000). However, when evidence on effort can be manipulated by the monitor, things are different. Suppose that the signal $\sigma_i = e = 1$ ($i = r, j$) is only partially verifiable and can be manipulated into a report $\hat{\sigma}_i = e = 0$. The scheme above is no longer attractive. Indeed, inducing the monitor to reveal that the firm has actually complied with the standard requires to give him the wage \bar{V} . Now the wage \bar{V} is offered on the equilibrium path, which is socially costly. Hence, in settings where the auditor's information on the firm's effort is (partially) manipulable, the auditors' wages should not depend on the firm's effort.³⁹

7 Conclusion

This paper has stressed the benefits of splitting ex ante and ex post monitoring of environmentally risky ventures in a moral hazard environment. Having an independent ex post monitor intervening only upon an accident makes it more difficult for the firm to collude with the ex ante monitor whose control is more routinized. Regulatory capture is less of a concern under separation and this institutional choice improves social welfare.

Although our model generates some value for separation to improve the fight against capture, it is worth stressing other potential benefits from separation that could be added in a more complete model. First, separation may help to generate evidence because it allows to cross-check the monitors' announcements.⁴⁰ Second, duplication of expertise between ex ante and ex post monitors may facilitate specialization in gathering information on different dimensions of the firm's activities. The ex ante regulators are certainly more prone to gather technical information, whereas ex post judges

³⁹Another justification for ruling out compensations contingent on effort is that they may have a true cost if the firm shirks on effort with some probability on the equilibrium, either because it "trembles" a little bit or because the compliance cost is uncertain.

⁴⁰For a similar argument, see Laffont (2000).

would instead focus on testimonies by private parties. Investigating both the incentives for specialization and its consequences for institutional design would certainly be a valuable extension to our analysis.

From a theoretical viewpoint, our approach for modeling collusive behavior between the private sector and public bodies differs significantly from other studies of corruption in the regulation or law enforcement literature, which have instead stressed the equilibrium nature of corruption.⁴¹ In our paper, collusion is prevented by an adequate design of incentive rewards and comparison between institutions amounts to looking for the organizational form that minimizes the cost of preventing collusion. It would be interesting to investigate environments where collusion would be an equilibrium phenomenon. This could be done by introducing some non-observable heterogeneity among monitors, for instance, in terms of their willingness to collude or in terms of their psychological costs of being caught lying.⁴² How institutions change the equilibrium level of corruption is then an important topic that would be worth investigating.

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⁴¹Among others, Becker and Stigler (1974), Mookherjee and P'Ng (1995), Garoupa (1997), Polinsky and Shavell (2001).

⁴²See Tirole (1992) and Kofman and Lawarée (1996b) for such models.

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Appendix

Proof of Proposition 1. We first compute the agency cost necessary to implement the high level of safety care given the investigation probabilities. Second, we determine optimal probabilities taking into account agency and administrative costs.

For fixed probabilities of inspection (p_r, p_j) the high level of care is implemented at a social cost $\mathcal{C}^*(p_r, p_j)$ such that:

$$\mathcal{C}^*(p_r, p_j) \equiv \min_{\{U, V_r, V_j\}} (1 - \gamma)U + V(p_r, p_j) + C(p_r) + C(p_j) \text{ subject to (1) and (4).}$$

When monitors are benevolent and report truthfully any information they may gather on the firm's effort, wages are optimally set at zero ((1) is binding) so that $V(p_r, p_j) = 0$. The optimal probabilities of investigation (p_r^*, p_j^*) are given by:

$$(p_r^*, p_j^*) = \arg \min_{\{p_r, p_j\}} \mathcal{C}^*(p_r, p_j) = (1 - \gamma)\mathcal{U}(p_r) + C(p_r) + C(p_j).$$

First-order necessary (and sufficient given strict convexity of the objective function) conditions give us:

$$C'(p_r^*) = \frac{(1 - \gamma)\pi_1\pi_0\psi\epsilon}{(\Delta\pi + \pi_0 p_r^* \epsilon)^2} > 0 \text{ and } C'(p_j^*) = 0. \quad (20)$$

The expression for $t^* = t^*(p_r^*, \epsilon)$ is given by (3) with the optimal probability p_r^* above. ■

Proof of Proposition 2. Under integration, and for some fixed probabilities of investigation, the optimal regulatory charter solves:

$$\mathcal{C}^I(p_r, p_j) \equiv \min_{\{t, V_r, V_j\}} (1 - \gamma)U + V(p_r, p_j) + C(p_r) + C(p_j) \text{ subject to (5), (9) and (10).}$$

This immediately yields the expressions of wages for monitoring in (11). Taking into account those wages and the expression of the firm's liability rent, the optimal investigation probabilities solve:

$$(p_r^I, p_j^I) = \arg \min_{\{p_r, p_j\}} \mathcal{C}^I(p_r, p_j) \equiv \mathcal{C}^*(p_r, p_j) + p_r \epsilon k(\pi_0 t^*(p_r, \epsilon)).$$

The derivatives of this objective function w.r.t p_r and p_j are respectively given by:

$$\frac{\partial \mathcal{C}^I(p_r, p_j)}{\partial p_r} = \frac{\partial \mathcal{C}^*(p_r, p_j)}{\partial p_r} + \epsilon \left(k(\pi_0 t^*(p_r, \epsilon)) + \pi_0 p_r \frac{\partial t^*(p_r, \epsilon)}{\partial p_r} k'(\pi_0 t^*(p_r, \epsilon)) \right), \quad (21)$$

$$\frac{\partial \mathcal{C}^I(p_r, p_j)}{\partial p_j} = \frac{\partial \mathcal{C}^*(p_r, p_j)}{\partial p_j} = C'(p_j). \quad (22)$$

Note that

$$\eta_r \equiv -\frac{p_r}{t^*(p_r, \epsilon)} \frac{\partial t^*(p_r, \epsilon)}{\partial p_r} = \frac{\pi_0 p_r \epsilon}{\Delta\pi + \pi_0 p_r \epsilon} < 1.$$

Therefore, we get

$$\begin{aligned}
& k(\pi_0 t^*(p_r, \epsilon)) + \pi_0 p_r \frac{\partial t^*(p_r, \epsilon)}{\partial p_r} k'(\pi_0 t^*(p_r, \epsilon)) \\
&= k(\pi_0 t^*(p_r, \epsilon)) - \eta_r \pi_0 t^*(p_r, \epsilon) k'(\pi_0 t^*(p_r, \epsilon)) \\
&> k(\pi_0 t^*(p_r, \epsilon)) - \pi_0 t^*(p_r, \epsilon) k'(\pi_0 t^*(p_r, \epsilon)) > 0,
\end{aligned}$$

where the last inequality follows from the concavity of $k(\cdot)$. This implies $\frac{\partial \mathcal{C}^I}{\partial p_r}(p_r, p_j) > \frac{\partial \mathcal{C}^*}{\partial p_r}(p_r, p_j)$ and thus $p_r^I < p_r^*$. Also, we immediately get $p_j^I = 0$. ■

Proof of Proposition 3. Under separation, and for some fixed probabilities of investigation, the optimal regulatory charter solves:

$$\mathcal{C}^S(p_r, p_j) \equiv \min_{\{t, V_r, V_j\}} (1 - \gamma)U + V(p_r, p_j) + C(p_r) + C(p_j) \text{ subject to (5), (10) and (14).}$$

This immediately yields the expressions of wages for monitoring in (15). Taking into account those wages and the expression of the firm's liability rent, the optimal investigation probabilities solve:

$$\begin{aligned}
(p_r^S, p_j^S) &= \arg \min_{\{p_r, p_j\}} \mathcal{C}^S(p_r, p_j) \equiv \mathcal{C}^I(p_r, p_j) + p_r \epsilon \left[\alpha k \left(\frac{\pi_0 t^*(p_r, \epsilon)}{\alpha} \right) - k(\pi_0 t^*(p_r, \epsilon)) \right] \\
&\equiv \mathcal{C}^I(p_r, p_j) - \frac{(1 - \alpha) \mu (\pi_0 t^*(p_r, \epsilon))^2}{2\alpha} p_r \epsilon.
\end{aligned}$$

From this, we compute:

$$\frac{\partial \mathcal{C}^S(p_r, p_j)}{\partial p_r} = \frac{\partial \mathcal{C}^I(p_r, p_j)}{\partial p_r} - \frac{\mu \pi_0^2 (1 - \pi_0) \psi^2 (\Delta \pi - \pi_0 p_r \epsilon)}{2\alpha (\Delta \pi + \pi_0 p_r \epsilon)^3} p_j \epsilon^2$$

and thus $p_r^S > p_r^I \Leftrightarrow \Delta \pi > \pi_0 p_r^S \epsilon$. Also, we get:

$$\frac{\partial \mathcal{C}^S(p_r, p_j)}{\partial p_j} = C'(p_j) - \frac{\mu \pi_0^2 (1 - \pi_0) \psi^2}{2\alpha^2 (\Delta \pi + \pi_0 p_r \epsilon)^2} p_r \epsilon^2.$$

This yields also $p_j^S > 0$. ■

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(lxxxvi) *This paper was presented at the Conference on "Urban and Regional Economics" organised by the Centre for Economic Policy Research (CEPR) and FEEM, held in Milan on 12-13 October 2009.*

(lxxxvii) *This paper was presented at the Conference on "Economics of Culture, Institutions and Crime" organised by SUS.DIV, FEEM, University of Padua and CEPR, held in Milan on 20-22 January 2010.*

(lxxxviii) *This paper was presented at the International Workshop on "The Social Dimension of Adaptation to Climate Change", jointly organized by the International Center for Climate Governance, Centro Euro-Mediterraneo per i Cambiamenti Climatici and Fondazione Eni Enrico Mattei, held in Venice, 18-19 February 2010.*

(lxxxix) *This paper was presented at the 15th Coalition Theory Network Workshop organised by the Groupement de Recherche en Economie Quantitative d'Aix-Marseille, (GREQAM), held in Marseille, France, on June 17-18, 2010.*