Trade Liberalization and Firms' Corruption Engagement: Theory and Evidence from China*

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Abstract

This paper studies the role of trade liberalization in shaping domestic corruption. I develop a model of trade with heterogeneous firms that features endogenous corruption and export participation decisions. In the model, firms face a trade-off between engaging in corruption, thereby obtaining higher profits in the domestic market, or preserving their non-corrupt status in foreign markets to obtain higher export profits. In equilibrium, there is an inverted U-shaped relationship between firm productivity/size and corruption engagement. This prediction is confirmed in firm-level and aggregate data on international trade. I then calibrate the model to China and evaluate the extent to which trade policy is an effective tool for fighting domestic corruption. My findings suggest that (i) the share of firms that are "missing from trade" due to domestic corruption is 1%; (ii) conditional on the same reduction in the level of domestic corruption, trade liberalization is preferable to direct anti-corruption campaigns in terms of the associated gains in consumer welfare.

Keywords: Firm Heterogeneity, Domestic Corruption, Destination Corruption Aversion, Trade Liberalization

JEL Codes: F0, F1, F5, F6

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