



Research Paper

Open for innovation or bribery to secure bank finance in an emerging economy: A model and some evidence



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ABSTRACT

In an emerging economy like China characterized by scarce financial resources, excessive red tape, and rampant corruption, firms are advised to bribe bank officials to grease the wheels of bank lending in order to secure the fund they need for innovation, business venturing, and growth. Drawing on the literature on corruption and open innovation, we develop a model to illustrate that bribery fails to ease bank lending when red tape is endogenous whereas openness for innovation smooths bank lending no matter whether red tape is exogenous or endogenous. Openness for innovation is more effective than bribery in helping a firm reduce red tape to secure bank finance. Based on a dataset of Chinese firms provided by the World Bank, our findings strongly support the argument. We find that openness for innovation has a positive relationship with both the access to bank finance and the size of bank finance, whereas bribery is related to neither. Supplementary tests further suggest that the positive relationship is mainly driven by private firms and manufacturing firms. Our findings help firms make decisions to select an effective and yet socially responsible approach to securing bank finance.

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1. Introduction

Chinese firms have been advised to bribe bank officials to attain the fund they need for innovation and business venturing (Chen et al., 2013). This paper builds upon the literature on corruption and open innovation to compare bribery with openness for innovation in easing bank lending, and finds openness for innovation to be more effective than bribery in greasing the wheels of bank lending. The paper unveils a socially responsible and yet effective alternative to bribery in smoothing bank lending in an emerging economy like China beset with scarce financial resources, red tape, and corruption.

Open innovation refers to the opening-up of organizational boundary for information flows to enhance innovation. There are basically two types of open innovation. Inbound open innovation refers to a process by which a firm uses external actors and information in innovation but internal paths to commercialize innovation outcomes, while outbound open innovation refers to a process by which a firm uses internal actors and information in innovation but external paths (such as licensing) to commercialize innovation outcomes (West and Bogers, 2014). This paper focuses on inbound open innovation. The focus

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on inbound open innovation is a deliberate choice because it has been far more popular than outbound open innovation which is severely constrained by the underdeveloped market for intellectual property (Teece, 2010; Sisodiya et al., 2013; West and Bogers, 2014). Open innovation is hereafter referred to as inbound open innovation unless noted otherwise.

Extant research on open innovation has made significant progresses, but suffers from two major limitations. Firstly, it focused on the effect of openness for innovation on innovation outcome as measured by new product development, and did not pay adequate attention to the effect of openness for innovation on other aspects of business operations (Chesbrough and Bogers, 2014; Vanhaverbeke et al., 2014; Vanhaverbeke and Cloudt, 2014; West et al., 2014). Secondly, it focused on firms in developed economies, and did not pay sufficient attention to firms in emerging economies which are characterized by scarce financial resources, excessive red tape, and rampant corruption (Chesbrough and Bogers, 2014; Vanhaverbeke et al., 2014; West et al., 2014). We intend to address the two limitations by focusing on open innovation in the largest emerging economy of China, and on the effect of openness for innovation on easing the difficulties Chinese firms face in obtaining bank loans for innovation, business venturing, and growth.

China has opened up to the outside world since the late 1970s, and Chinese firms have been embracing new ideas and practice, including open innovation, generated by their western counterparts ever since. Evidence indicated that an increasing number of Chinese firms have opened up for innovation (Fu and Xiong, 2011). However, scholars found that, different from what happened in developed economies, openness for innovation did not significantly contribute to the innovation outcome as measured by new product development in Chinese firms. They therefore argued that “there is no need for emerging-economies like China to mimic the emergence path from closed to open innovation followed by developed countries” (Huang et al., 2015, p. 594). A question arises: if Chinese firms do not benefit from open innovation in terms of enhanced innovation outcomes, why do they engage in open innovation?

An answer may be found in the difficulties Chinese firms face in securing bank finance for innovation and business venturing. As is in many other emerging economies, financial resources are scarce in China. To allocate the scarce resources, the government introduced complex administrative policies to regulate commercial activities, resulting in excessive red tape and rampant corruption. This is especially the case in the banking sector. The banking sector is under tight control of the state. The Chinese government not only directly owns the largest banks and financial institutions, but also requires banks and other financial institutions to follow government policies and regulations in commercial operations. Bank officials hold the power to allocate scarce financial resources, and often abuse these policies and regulations to explicitly or implicitly force firms to offer kickbacks in exchange for bank loans. Firms compete with each other for bank finance, and are willing to pay bribes to obtain bank finance for innovation and business venturing. The widespread bribery in bank lending has been noted by many, and considered by some as necessary for overcoming the red tape in the banking sector or, in other words, for “greasing the wheels of bank lending” (Chen et al., 2013, p. 253). As such, bribery is said to be “conducive to efficient lending in a second-best world” (Chen et al., 2013, p. 2534).

We contend that the bribery grease thesis is theoretically flawed and ethically problematic. Theoretically, the bribery grease thesis is based on the assumption of exogenous red tape, and is untenable when red tape is endogenously imposed (Myrdal, 1968; Shleifer and Vishny, 1993; Banerjee, 1997; Bardhan, 1997; Kaufmann and Wei, 1999; Tian and Lo, 2009). That is, a bank official can intentionally impose red tape on a firm manager to extract bribery, and makes it harder for firms to get bank loans. Ethically, bribery negatively affects both the company and the society. It cultivates a culture of corruption inside the company, encourages petty theft and other wrongdoings by employees, and thus “sap the ethical foundations of organizations” (Argandona, 2005, p. 251). It induces bank officials not to carry out their duty as swiftly as it is to be expected, set bad examples for other public servants, and lead to “the deterioration of standards of honesty in the public administration” (Argandona, 2005, p. 257; also Follett, 2015). It is therefore necessary for firms to search for alternatives to bribery to secure bank finance.

We suspect that openness for innovation is such an alternative. Openness for innovation helps reduce red tape and smooth bank lending no matter whether red tape is exogenously or endogenously imposed, and it does so in a socially responsible way. The lack of transparency is a major reason for bureaucrats to introduce red tape in the form of complex qualification justification and lengthy delay of approval. Openness for innovation increases the transparent exposure of firm information to the external environment, and thus reduces the need for red tape. Moreover, firms that ally with universities, research institutions, and other firms in innovation demonstrate to banks that they have support from these allies in business venturing and growth, and thus have a great chance to succeed in utilizing the bank loans they borrow. Openness for innovation thus helps a firm win the trust from banks. The suspicion motivates us to undertake this research project.

We develop a simple model to distinguish between endogenous red tape and exogenous red tape. We first discuss the greasing effect of bribery on red tape and bank lending, and explain why the greasing effect of bribery vanishes when red tape is endogenously imposed. We then examine the effect of openness for innovation on red tape and bank lending, and explain why openness for innovation is effective in greasing the wheels of bank lending no matter whether red tape is exogenously or endogenously imposed. Based on a dataset of Chinese firms provided by the World Bank, we find that openness for innovation has a positive relationship with both the access to bank finance and the size of bank finance, whereas bribery is related to neither. The supplementary tests further suggest that the positive relationship between openness for innovation and bank finance was mainly driven by private firms and manufacturing firms.

The contribution of the study is twofold. Firstly, the study develops a model to take into account endogenous red tape. The model demonstrates why openness for innovation helps firms secure the bank loans they need for innovation, business venturing, and growth and does so in a socially responsible way, and why bribery fails to do so. Secondly, the study tests

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