



The stained China miracle: Corruption, regulation, and firm performance



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HIGHLIGHTS

- Regional corruptiveness has a positive effect on the profitability of private firms.
- The effect does not exist when state-owned firms are concerned.
- A natural experiment shows that corruption helps private firms circumvent regulation.
- We offer an understanding of the high-growth miracle of China with high corruption.

ARTICLE INFO

Article history:

Received 25 April 2013

Received in revised form

24 March 2014

Accepted 30 March 2014

Available online 8 April 2014

JEL classification:

H8

L2

L5

P3

Keywords:

Corruption

Regulation

Ownership

China

ABSTRACT

Regional corruptness in China has a positive effect on the profitability of private firms, but not that of state-owned firms. A natural experiment of exogenous trade policy change suggests that corruption may help private firms circumvent government regulation.

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1. Introduction

Corruption is a longstanding problem and is believed to have posed one of the most serious challenges to the overall health of the working of a nation's political and economic institutions. However, accumulated anecdotal and formal statistical evidence has yet to be fully convincing in supporting the detrimental effect of corruption on economic development as an established empirical

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regularity. First, existing studies are often based on cross-country data wherein the potentially positive effect of corruption in developing countries could be offset by the negative effect in developed countries if one admits that corruption may exert heterogeneous influences on countries at different stages of development. Second, most of the firm-level survey data only have a single cross-section, making it impossible to take account of firm fixed-effects and investigate the dynamic effect of corruption on firm performance. Third, the condemnation of corruption can hardly be reconciled with two apparently contradictory stylized facts of China, the largest developing country in the world. China has been enjoying an annual GDP growth rate of 10% on average for the past three decades. In the meantime, China has found itself stuck in an embarrassing middle position on the ranking table of freeness from corruption based on the “Corruption Perceptions Index” designed

by Transparency International ever since the organization started to publish results in 1995.¹

The few research that does claim corruption can “grease the wheels of commerce” also faces a major difficulty of disentangling the causes of corruption from its consequences. It could certainly be the case that corruption abounds in places where rogue officials in public sectors simply find it lucrative to levy bribery.

Using a large panel data set of Chinese manufacturing firms, this paper observes a positive correlation between regional corruptness and the profitability of private firms, but the correlation ceases to exist when we switch our attention to state-owned firms (SOEs). We argue that the heterogeneous effects of corruption on firm performance are best explained by the heavy-regulation nature of the Chinese economy and distinct reactions to government regulation from firms with different ownership types. Private firms have to buy off regulators to evade legal restrictions and thereby make profit out of more flexible business operations, while SOEs have generally been treated preferentially by the government and have little incentive to bribe bureaucrats. Therefore corruption is efficiency-enhancing to a certain extent for private firms, but not for SOEs. This causal interpretation is lent credence to by a natural experiment of foreign trade policy change in China. Import and export business used to be licensed by the government and trade quotas were strictly controlled, which affected private firms most severely. This regulation was abolished in 2004 when an exogenous policy change took place. Consistent with the theoretical prediction, we find nonlinearity in the effect of regional corruptness on firm profitability around the year of 2004, with the positive effect being more pronounced for private exporting firms prior to that year. On the contrary, this nonlinear effect is absent in the SOE subsample. To strengthen our point, we also show that the positive effect of corruption on profitability is stronger for private firms in a more competitive market.

The remainder of the paper is organized as follows. The next section briefly reviews the literature. Section 3 describes the data, discusses the empirical strategies and presents our main findings. Section 4 concludes.

2. Literature

In the literature, corruption is defined as the sale of government property (Shleifer and Vishny, 1993), the breaking of a rule (Banerjee et al., 2012), or the misuse of public office (Svensson, 2005) by government bureaucrats for private gain. We focus on one specific dimension that is commonly identified as a corruptive act, a practice whereby government officials demand or receive bribery from firms and provide a service in return such that the firms can circumvent unfavorable regulation or survive competitive pressure in marketplace. For example, the service can take the form of offering a tax cut, providing a procurement contract, or granting a license for entry into a regulated market, all of which the firms may not be qualified to obtain under a fair and open process.

Researchers have starkly divided opinions on how corruption might affect economic efficiency. One strand of literature stresses that corruption distorts resource allocation and hinders long-run economic growth (Mauro, 1995), because in a business environment where corruption prevails, entrepreneurs have to divert their talents and efforts from R&D activities to rent-seeking attempts (Murphy et al., 1991); the entry of new firms is impeded and inefficient incumbents survive (Djankov et al., 2002); protection for intellectual property rights is inadequate and firms are disincentivized to invest optimally (Claessens and Laeven, 2003);

firms spend excessive management time in bureaucratic procedures (Kaufmann and Wei, 1999) and therefore experience productivity loss (De Rosa et al., 2010). The other strand of literature argues that in countries with a low quality of governance, corruption can actually improve resource allocation and enhance productivity growth. Efficiency gain is achieved when government intervention is socially undesirable (e.g., centrally-planned pricing in socialist economies) and firms find it profitable to pay a bribe premium to bypass dysfunctional regulation and ministerial incompetence. For one thing, corruption can essentially be regarded as an auction mechanism allocating scarce resources to more efficient firms that can afford the higher price of business opportunities (Lui, 1985; Beck and Maher, 1986). For another, corruption reduces the moral hazard risk by providing government functionaries with an implicit subsidy that induces them to put more effort into public service (Egger and Winner, 2005).

This paper is more sympathetic with the second strand of literature where, to our knowledge, no firm-level panel data analysis has been conducted. But it differs in an important respect by offering a new perspective on the relationship between corruption and firm performance. Corruption does not affect all firms uniformly. The ownership structure matters because it defines the extent of potential gain from being involved in a corruptive act.

3. Data and results

3.1. Data

The main data set we use is Chinese Industrial Enterprise Database collected by the National Bureau of Statistics of China that spans from 1999 to 2007 and has coverage for all state-owned enterprises and all non-SOEs with annual sales above five million RMB. Following the standard practice in the literature (Cai and Liu, 2009), we trim the data to alleviate potential measurement error problems. And for our purpose we only keep firms with the majority state capital share or the majority private capital share. In the end we construct a nine-year panel of 127,755 firms of which 17,521 (13.7% of total) are SOEs.

To measure the overall extent of corruption on the provincial level, we use as a proxy graft cases filed per 10,000 public officials in a province in a given year. This data is from the Procuratorial Yearbooks of China published by the Supreme People's Procuratorate of China and is by far the only provincial-level panel data for corruption available to researchers. Similar measures have been adopted in numerous previous US-related studies (Goel and Rich, 1989; Fisman and Gatti, 2002; Adsera et al., 2003; Glaeser and Saks, 2006).

Since we use fixed-effects models, the effect of corruption is primarily identified off variation across years within provinces. A preliminary check of the corruption series is necessary. First, we observe systematic differences in the mean levels of corruption among provinces. Province dummies are statistically significant in a simple regression of corruption on both province and year dummies. Second, the patterns of year-to-year changes in corruption among provinces are remarkably different and cannot be simply considered as white noise. After purging out province and year fixed effects, we test the equality of variances of the residual series among provinces using Levene's (1960) robust test, and the null hypothesis of equality is rejected at the 1% significance level. Third, corruption is positively correlated with a dummy indicating whether in the previous year there is a replacement of the Secretary of the Provincial Commission for Discipline Inspection who is the provincial leader of the anti-corruption work (after controlling for the age and career background of the individual, as well as province and year fixed effects). Fourth, if the corruption measure was to reflect anti-corruption efforts rather than corruption

¹ See <http://www.transparency.org/research/cpi/> for details.

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