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Firm characteristics and influence on government rule-making: Theory and evidence

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ABSTRACT

An adversarial game is used to model a firm's intrinsic and exerted influence over a regulator. Data from the World Business Environment Survey provide strong evidence in support of model hypotheses across a wide range of government agents, countries, and regulatory areas. Of particular relevance to public debate, the theory and econometric analysis show that large firms are more likely to be influential and to benefit from subsidies and low tax constraints. However, large firms are also likely to face greater regulatory constraint from environmental and safety rules.

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1. Introduction

"The scope, the extent, the insidious nature of corporate influence in regulatory agencies of government – this question of regulatory capture – is something we should attend to here. It is the lesson. And it raises the question, beyond the Minerals Management Service, how far does this corporate influence reach into our agencies of government?" Senator Sheldon Whitehouse (D-Rhode Island), June 17, 2010.

Are corporations able to use carrots such as campaign contributions to wriggle their way out of regulatory constraints? Public opinion, mirrored in the comments of Senator Whitehouse, certainly suggests that politically active firms are able to buy their way out of environmental regulations and other forms of scrutiny. But at the same time, many of the same firms complain they are subject to intense interference by regulators. Is this just political posturing? Or are these two world views compatible? Might some firms be simultaneously more influential and subject to more regulatory constraint?

It is well understood in the literature as well as in public debate that political influence is a means for interest groups and firms to achieve an ends. In the case of firms, the desired end is a more profitable operating environment — not necessarily a socially optimal outcome. For this reason there is an extensive political science literature which examines both the determinants of firm attempts to

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achieve influence — notably, contributions to political action committees (PAC) in the US – and the impacts of these transfers — notably, on US congressional voting patterns. The latter literature, while extensive, remains inconclusive and conventional wisdom is that there is little effect of firms' PAC contributions on voting behavior when models are well specified (Hall and Wayman, 1990; Potters and Sloof, 1996; Wawro, 2001; Roscoe and Jenkins, 2005).

We put forward three observations that are sufficient to explain why a consistent empirical relationship between PAC contributions and voting behavior has proved illusive. Firstly, PAC contributions are only one type of transfer. Transfers may come in many forms, including outright bribes, 'revolving door' employment promises, maintenance of excess staff in marginal electorates, and supportive media campaigns. Secondly, transfers are only one means of achieving influence. Our model highlights the difference between influence exerted through transfers and intrinsic influence due to alignment of firm and government objectives. Firms may have such intrinsic influence for a number of reasons including perceived positive spillovers, government shareholdings and personal connections (Faccio, 2006).

The third reason that it has been difficult to observe a consistent relationship between PAC contributions and voting behavior is that the contributions, like all transfers, are endogenous. Since they are chosen by the firm they may rise in response to a greater regulatory threat. Indeed, in our model the comparative statics for the change in transfer due to changes in firm characteristics are always ambiguous.

The dependence on PAC contributions data for studying firm influence has been somewhat alleviated in recent years by the emergence of the World Bank's World Business Environment Survey (WBES) and Business Environment and Enterprise Performance Surveys (BEEPs). These surveys ask managers of firms in a wide range of countries about their relationship with the national government, including how much influence the firms have over rules, laws, regulations and decrees of importance to the firm's operations. Careful survey design as well as professional implementation have ensured sufficient quality of the data despite the sensitivity of some of the issues it touches. The data have been used by a number of previous studies to examine questions about the determinants and impacts of influence for a range of countries (Hellman et al., 2003; Chong and Gradstein, 2010; Campos and Giovannoni, 2007; Desbordes and Vauday, 2007; Desai and Olofsgard, 2008). These papers have found influence to be correlated with firm characteristics including size and government ownership. Our contribution to this literature is to highlight the endogeneity of influence and to illustrate its impact on both regulatory constraint and subsidy receipt.

We illustrate the endogeneity of influence by building a simple principal-agent model in which a firm offers a transfer to a regulator[1] in exchange for a specified level of regulatory stringency. We assess how variation in the firm's type affects the regulator's participation constraint and the firm's payoffs from political activity, with implications for equilibrium regulatory stringency. We adopt several common modeling conventions so as to streamline our analysis. Like Bernheim and Whinston (1986), Grossman and Helpman (1994) and much of the common agency literature, we assume the principal (the firm) can commit to its offer[2]; we diverge from this literature by assuming there is only a single principal. Like Kirchsteiger and Prat (2001) we assume the principal makes a take-it-or-leave-it (TIOLI) offer.[3] We assume the government puts more weight on the transfer received than it does on the firm's cost of making the transfer (Grossman and Helpman, 1994; Besley and Coate, 2001). Our model also allows for unproductive lobbying costs, in that we assume that there are frictions associated with transferring rents to the regulator.

Exerted influence in our model is close to Becker (1983), who defined a group's influence as the deadweight costs to society of the subsidy the firm receives; Becker assumed the influence exerted by a group depends on endogenous variables, including a group's expenditures on achieving its political objectives. We define a firm's exerted influence as the gap between the equilibrium regulation and the regulator's threatpoint regulation, where the latter is the amount of regulatory interference to which the firm would be subjected but for the political relationship.

We integrate the different types of influence – exerted and intrinsic – into a single metric we call effective influence. We define effective influence as the gap between equilibrium regulation and the regulation which would be chosen if transfers were not allowed and the policy-maker were ignorant of the impacts of regulation on profits and positive spillovers generated by the firm.

Our model delivers predictions as to how primitive firm characteristics – i.e. the firm's type – such as size, ownership structure and number of competitors affect equilibrium regulation, receipt of subsidies, and the different types of influence. Our model suggests that the relationship between a firm's political influence and its level of regulatory constraint or government support depends on the source of its influence. For example, lowering the number of competitors and increasing firm size will both independently increase a firm's influence and receipt of subsidies. However, while lower competition is a source of regulatory slack, larger size may actually lead to increased regulatory constraint.

[1] The agent may be a political executive, member of legislature, part of a ministry or regulatory agency. Thus we use the terms "government", "regulator", "policy-maker" and "policy-setter" interchangeably throughout.

[2] Assuming commitment is innocuous if the principal and agent can sign legally binding contracts. For example, developers and governments frequently sign agreements allowing density on a parcel of land to exceed zoning restrictions if, in exchange the developer transfers title to a portion of the land to the government, or purchases a development easement on a separate parcel. We acknowledge, however, that in the commonly studied context of campaign contributions, it is hard to imagine how legally binding contracts exchanging contributions for tariff protection, for example, wouldn't be construed as bribery. In the absence of enforceable contracts, ensuring time consistency of the offers may require additional modeling elements, for example an infinitely repeated game, or asymmetric information and reputation effects as tested in Kroszner and Stratmann (2005).

[3] Many common agency models assume principals put forward menus – schedules of monetary transfers conditional on each action available to the agent – that are truthful in that the schedules have the same slopes as the principals' welfare functions. In contrast, Kirchsteiger and Prat (2001) argue in favor of TIOLI offers from each principal on the grounds that such strategies are simpler and thus more natural, and better predict actual outcomes in laboratory experiments. In our context, because there is certainty, full information, and only a single principal, the same equilibrium outcome occurs regardless of whether the principal puts forward a truthful menu or makes a TIOLI offer.

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