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Bribe payments under regulatory decentralization: Evidence from rights offering regulations in China

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ABSTRACT

This paper investigates why and how firms' bribe payments vary as a result of the interaction between firms and local public officials under the decentralized regulatory system for rights offerings implemented prior to 2001 in China. Using the gap between the estimated and reported total direct costs of rights offerings as a measure of firms' bribes payments in the process of rights offering applications under this system, we find that bribe payments are positively related to local governments' control rights, firms' opportunity costs of refusing to pay bribes, and the severity of firms' Jensen agency problems. We further show that after termination of the regulatory system, firms' bribe payments are substantially reduced, and local governments' control rights as well as the severity of firms' Jensen agency problems can no longer explain the variation in bribe payments.

1. Introduction

Decentralized regulation is widely implemented nowadays especially in developing countries (Bardhan and Mookherjee, 2006). By shifting regulatory power from the central government to local governments that have more local information, regulatory decentralization brings government "closer to people" (Fan et al., 2009), and may help improve efficiency in resource allocation. However, the delegation of authority under decentralization introduces a principal-agent relation, in which local officials are employed to make decisions based on the information that they have and the central government does not (Acemoglu and Verdier, 2000). As a result, there might be more room for local officials to be corrupt under decentralized regulation than under centralized regulation. Research on corruption under regulatory decentralization is of particular importance, as it can help us better understand the delegation problem within governments in a country/region and its impact on economic growth and government quality.

Previous studies on corruption under regulatory decentralization focus primarily on interactions between the central government and local governments. For instance, the hotly contested issues in the literature include whether the frequency and costliness of bribe extraction by corrupt officials are positively related to the number of government or administrative tiers and the number of local public officials in the country (Fan et al., 2009), and how local officials' corrupt behavior can be better monitored. To date, there has been little research on corruption as a result of the interactions between firms and local officials under regulatory decentralization. This is because the data utilized in most of the empirical studies in this area is country-level perception-based corruption indices or firm-level survey-based data on corruption (Fan et al., 2009; Olken, 2009). Both types of data can only capture aggregate corruption, and are not able to reveal sub-components of this country-level or firm-specific aggregate (Reinikka and Svensson, 2006). Thus, these data cannot be used to analyze the micro-dynamics of corruption (Reinikka and Svensson, 2006; Sequeira, 2012).

The purpose of this paper is to examine why and how firms' bribe payments vary as a result of the interactions between firms and local officials under regulatory decentralization. In particular, our work is motivated by three issues. First, we are interested in exploring how, under regulatory decentralization, local governments' control rights over local firms help explain the variation in bribe payments across firms. Second, we seek to understand

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how firms' costs of refusing to bribe impact bribe payments under regulatory decentralization. Third, we examine how agency problems arising from the conflicts of interest between executives and shareholders in firms are related to firms' bribe payments under regulatory decentralization.

The decentralized regulations for rights offerings implemented prior to 2001 in China present a unique regulatory setting for us to examine our research issues. Under this system, the Chinese central government pre-specified a set of requirements for rights issues, and assigned to each local government the maximum number of firms that could make rights issues, as well as the maximum shares that could be issued in a region. Then, each local government assessed whether firms located in the region under its jurisdiction met these requirements, and recommended the firms that were eligible for rights issues to the central government for final approval. This regulatory system created opportunities for local bureaucrats to be corrupt and extract bribes from the listed firms that competed for the limited quota of rights offerings in a region. Moreover, China's listed firms had a strong incentive to bribe local officials in order to obtain the privilege of rights offerings, given the fact that rights offerings were the dominant source of equity financing during this period. Thus, this regulatory and financing environment enables us to analyze how listed firms interact with local officials to determine bribe payments in the process of rights offering applications, as well as how the interactions help explain variations in bribe payments across firms. Importantly, termination of the decentralized regulatory system in 2001 presents a natural experiment for us to better understand how regulatory decentralization shapes firms' corrupt behavior by comparing their corrupt patterns before and after 2001. Analysis of the data after 2001 can enrich the evidence about the variation in firms' bribe payments observed before 2001 by ruling out alternative explanations.

A key empirical challenge in our research is to measure firms' bribe payments. Since bribes are primarily paid in the form of cash in rights offering applications, bribing local officials substantially boosted the total direct costs of rights offerings for listed firms. Thus, the anomalous patterns in the total direct costs of rights offerings are an indication of bribery practices, and can be used to detect firms' bribe payments. However, the direct costs reported in the rights offering prospectus include only underwriting fees and other direct fees, such as filing fees, legal and accounting fees, advertising expenses, and other costs. Given the fact that the underwriting fees, which are the main component of the reported direct costs of rights offerings, are typically low in China, it is unlikely for China's listed firms to hide bribe payments in these accounting items in the prospectus.[1] In fact, bribes are often hidden by managers as managing costs in various accounting categories in an effort to cover up their illicit behavior (Cai et al., 2011). For this reason, bribes are usually referred to as implicit costs (Xie and Lu, 2003). Unfortunately, in our context, the implicit costs of rights offerings are not readily available,[2] as it is practically impossible to isolate rights offering-related bribes under the management expense accounting category from real or other types of corruption-related records.

In this paper, implicit costs of rights offerings are estimated by comparing available reported direct costs with the actual direct cost predictions from theoretical models. More specifically, we first estimate actual direct costs of rights offerings based on a firm's investment Euler equation, which is derived from the firm's investment model. Then, we subtract the reported direct costs from the estimated direct costs to obtain implicit costs of rights offerings. This difference largely reflects total bribe payments for rights offerings, as there are essentially no non-cash forms of bribe payments in the context under consideration.

While our data on corruption is indirect, it is objective and replicable compared with the perception-based and survey-based corruption data (Sequeira, 2012). Moreover, our data is non-aggregate corruption data, as it contains the bribe payments only for rights offerings under the decentralized regulatory system for rights offerings. Thus, it is particularly suited to unveiling micro-dynamics of corruption, whereas tests of the determinants of bribe payments using aggregate data cannot easily exclude alternative explanations, given the fact that the perception-based and survey-based methods are not able to control for the regulatory setting in which a particular type of corruption data is generated. With detailed information about the context in which corruption occurs, our specific data could provide us with conclusive evidence about the determinants of firms' corrupt behavior under the decentralized regulatory system for rights offerings. Importantly, since China's listed firms were all involved in competition for the limited quotas of rights offerings in their respective regions under this system, our data reflects bribery practices of the listed firms operating in various industries and located in various regions in China. This allows us to investigate the cross-sectional variation in bribe payments across industries and regions under the same regulations.

Based on the estimated implicit costs, we find that China's listed firms pay substantial bribes under the decentralized regulatory system for rights offerings implemented prior to 2001. However, bribe payments vary across regions and firms, depending on local governments' control rights, firms' power of refusing to bribe, and the severity of firms' agency problems. More specifically, firms in regions with a high degree of local government intervention in the economy pay high bribes, as local officials in these regions have strong control over local firms and are better able to demand a high bribe. We also illustrate that firms located in regions with a highly market-oriented bank financing system tend to pay low bribes, as they are more capable of obtaining financing from sources other than rights offerings, implying that the opportunity cost of refusing to bribe is low. Finally, we find that firms with severe free cash flow agency problems (Jensen, 1986) pay high bribes, as these firms tend to over-value bribery benefits, due to the fact that non-pecuniary benefits will factor into managerial decisions.

Our results also show that after 2001, China's listed firms' bribe payments are greatly reduced and the variation in bribe payments can no longer be explained by the degree of local government intervention and the degree of severity of firms' Jensen-type agency problems. Our findings highlight some important characteristics of both bribe takers and bribe payers that influence their corrupt behavior in a given regulatory environment, and may have important policy implications for governments' anti-corruption endeavors.

While our research is primarily on the micro-dynamics of corruption under regulatory decentralization, it complements the previous work on the effects of partial privatization in China (Allen et al., 2005; Estrin et al., 2009; Fan et al., 2007; Sun and Tong, 2003; Wei et al., 2005). In China, the privatization reform of former state-owned enterprises (SOEs) in the early 1990s was only partial, in the sense that the government still maintains substantial ownership of SOEs after listing. Many previous studies document that the highly concentrated ownership structure of listed SOEs and the associated corporate governance problems, as well as the strong political connection with government, help explain firms' performance (Berkman et al., 2010; Chen et al., 2008, 2009). In contrast, we investigate the way in which government regulations shape partially privatized firms' investment and financing behavior from the bribery perspective.

[1] We find that the average reported direct costs of rights offerings are only 2.948% of the total proceeds raised during our sample period. In the robustness test, we also confirm that abnormal fees in the reported costs of rights offerings are unrelated to the major determinants of bribe payments.

[2] Implicit costs are different from indirect costs. In our context, implicit costs are the costs arising from firms' bribery practices in rights offerings, while indirect costs arise from information asymmetry or agency problems in rights offerings.