Journal of Comparative Economics 41 (2013) 279–293

Contents lists available at SciVerse ScienceDirect

Journal of Comparative Economics

journal homepage: www.elsevier.com/locate/jce

Social networks and bribery: The case of entrepreneurs in Eastern Europe ☆

Larry Chavis

Kenan-Flagler Business School, University of North Carolina at Chapel Hill, CB 3490, McColl Building, Chapel Hill, NC 27599-3490, United States

ARTICLE INFO

Article history:
Received 25 April 2011
Revised 1 November 2012
Available online 27 November 2012

JEL classification:
D37
K00
P26
P37

Keywords:
Corruption
Transition economies
Social networks
Property rights

ABSTRACT

Chavis, Larry—Social networks and bribery: The case of entrepreneurs in Eastern Europe

Using a survey of new firms in Poland, Romania, and Slovakia, I explore how an entrepreneur's social networks affect the amount paid in bribes to government officials. Lower levels of bribe payments are associated with ownership by a former manager of a state-owned enterprise (SOE), with being a spin-off from a SOE, and with trade association membership. The results also suggest that these networks have a larger impact on bribe payments than do firm characteristics such as profits, sales, or resale value. For the average firm, having a former SOE manager as an owner can be expected to reduce bribe payments by over 50%, while, by contrast, doubling the firm's profits results in only a 7% increase in bribe payments. *Journal of Comparative Economics* **41** (1) (2013) 279–293. Kenan-Flagler Business School, University of North Carolina at Chapel Hill, CB 3490, McColl Building, Chapel Hill, NC 27599-3490, United States.

1. Introduction

One of the most important property rights for an entrepreneur may be the right to retain the profits they earn. Unfortunately, in many countries with weak institutions, corruption and bribery impinge upon this right. The effects of bribery can be more distortionary than taxation (Svensson and Fisman, 2007), pushing firms to expend resources on evading bribery that could otherwise be used more productively.

To address these inefficiencies, it is important to understand the determinants of bribery. Svensson (2003) has shown that firms that interact more frequently with government officials and those with higher profits pay higher bribes. Hellman and Kaufmann (2004) found that firms that perceive themselves as having little political influence pay bribes in order to level the playing field and compensate for the connections they lack. This research examines how connections to the state and other social networks affect the outcome of bribe interactions, as compared to the effects of profits and other firm characteristics.

Using a 1997 survey of owners of small to medium-sized new firms in Poland, Romania and Slovakia, I estimate the impact of an entrepreneur's social networks on his bribe payments to government officials. The survey provides data on bribes paid by businesses to government officials and to organized crime. It also includes variables that can serve as proxies for an owner's social networks. A number of variables will be introduced in this paper, but the main proxies for such connections to the state are whether an owner was a manager in a state-owned enterprise (SOE) or whether a firm is a spin-off from an SOE.

☆ This research was sponsored by the generous support of the John M. Olin Program in Law and Economics, Stanford Law School. I have benefited from comments by seminar participants in the AEA Pipeline Conference, NC State Economics Department, the Property and Environment Research Center Lone Mountain Seminar, Stanford Law and Economics lunch series, the Stanford Center for Development, Democracy and Rule of Law student seminar. Phillip Leslie and John McMillan provided thoughtful guidance throughout early versions of this research. Patrick Inman provided extensive proofing and editing support. Coeditor Daniel Berkowitz and two anonymous referees also provided valuable feedback.

E-mail address: larry_chavis@unc.edu

0147-5967/$ - see front matter
http://dx.doi.org/10.1016/j.jce.2012.11.002

Having been a manager in an SOE is a reasonable proxy for connections, as appointments to such positions were based on a manager's "Communist party allegiances rather than their technical competence" (Lipton et al., 1990b, p. 314). Another important variable is membership in a trade association. The World Bank suggests that business associations in transition economies can be used "as legitimate instruments to represent collective interests in the formulation of law and policy" (World Bank, 2000, p. 51). Trade associations have been used in Eastern Europe to promote codes of ethics and to adopt "no-bribery" pacts among firms (ibid). Thus there are two possible ways in which trade associations could reduce bribe payments. First, trade associations can educate and thus empower companies to stand up to bribery. Second, trade associations can extend the social networks of firms and thus increase their chance of having personal connections to bribe takers.

This research finds that social networks play an important role in determining the size of a bribe or, to be more precise, social networks are highly correlated with lower bribe payments. Moreover the data reveal that such connections are more important than the size of the profits to be divided between the firm owner and the bribe-taker. For the average firm, having an owner who was a former manager of an SOE reduces bribe payments by over 50%, while doubling its profits results in only a 7% increase in bribe payments. The impact of these savings could be substantial given the data is based on a survey of new firms whose long run survival is more uncertain than more established firms. Thus the social networks that an entrepreneur cultivates prior to starting a new endeavor may have an impact on her ultimate success.

2. Literature review

Economists have long identified a negative correlation between economic growth and corruption at the country level. It is only recently that the issue of corruption and firm growth has begun to be explored. A group of studies using the same survey of Eastern European entrepreneurs as this current research has also contributed to understanding how firms react to the presence of bribery. Johnson et al. (2000) "find a significant association between the underreporting of sales and the bribing of corrupt officials" (p. 497). Thus firms may be wasting time avoiding the payment of bribes when that time could be spent on more productive activities. Johnson et al. (2002) provide another example of the possible inefficiencies caused by corruption. They show that the presence of bribery is associated with lower levels of re-investment of profits by firms. The authors use the bribery data to construct a property rights index and find that "insecurity of property rights, all else equal, reduces a firm's investment by over a third" (p. 1354). Thus the presence of bribery can lead firms to negatively change their behavior and operate at suboptimal levels of investment.

This article draws on two strands of the previous literature. The first focuses on the characteristics of a firm (such as profit, employee size and the gender of firm managers) to help identify the determinants of bribery (see Clarke and Xu, 2004; Safavian et al., 2001; Svensson, 2003; Swamy et al., 2001). The second strand of literature contends that firms without other means to influence the government resort to bribery (see Hellman and Kaufmann, 2004; Hellman et al., 2003; Gehlbach 2001).

In Svensson's (2003) study of Uganda, he lays out and empirically tests a two-stage model that shows the determinants of which firms pay bribes as well as how much they pay. Svensson finds that the likelihood that a firm will pay bribes increases with its contact with the government's regulatory system and that bribes increase positively with profits as well as with the specificity of a firm's capital stock. Hellman and Kaufmann (2004) have firms playing a more active role in the bribe interactions. They show that firm managers that feel they have less influence in shaping the business environment tend to make higher bribe payments. They contend that firms that perceive themselves as having little political influence pay bribes in order to level the playing field and compensate for the connections they lack. The availability of rich firm level data allows me to expand upon these ideas and compare the impact of social connections with the effect of profits and other firm characteristics on the size of bribes paid.

This relationship between social connections and bribery is further drawn out theoretically by Gehlbach (2001). Citing stylized facts from the data used for this research, he sets up a model of corruption where social networks imply "obligation to not act opportunistically, the connections that make up social networks substitute for money when dealing with corrupt officials. Thus, corrupt officials are less likely to demand of their friends the bribes they charge strangers" (p. 5). Similarly Hunt (2004), in examining the bribes paid by individuals across several countries, finds that when an individual and government official belong to the same "trust network" that bribery is lessened. "Bilateral trust permits the substitution of an implicit quid pro quo for a bribe, which reduces corruption" (p. 1).

This article examines social connections that alter the context for bribery in two distinct ways. Some connections can increase the level of trust between a bribe payer and a bribe taker, for example, ties to the state, if a state official is being bribed. Other connections can serve as a firewall between bribe payer and bribe taker, for example, trade association membership. In a survey of SME owners in Slovakia, Benfoddova et al. (2000) find that having well-placed friends and relatives can facilitate dealings with the state, speeding up both simple transactions (obtaining a loan) and complex processes (legal proceedings). A recent report on transition economies has shown that even in 2010, many years after the fall of the communism, having ties to the Communist Party increases the likelihood of becoming an entrepreneur and also the chances of succeeding (EBRD, 2011). Trade associations can also help mediate the relationship between managers and the state, Pyle (2011) reports: "members of business associations are more likely to appeal government predation, influence successfully the design of new rules and regulations, and invest in their capital stock" (p. 3). Along these lines, Duvanova (2007) argues that low-level corruption drives the formation of trade associations and that they work to "protect firms from predatory state