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Should one hire a corrupt CEO in a corrupt country? ☆



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ABSTRACT

This paper examines the interaction between the propensity to corrupt (PTC) and firm performance. Using a unique data set of Moscow traffic violations, I construct the PTC of every Muscovite with a driver's license. Next, I determine the PTC for the top management of 58,157 privately held firms. I find that a 1 standard deviation increase in management PTC corresponds to a 3.6% increase in income diversion and that firms with corrupt management significantly outperform their counterparts. This study contributes to the literature that characterizes corruption using objective (instead of perception-based) measures and provides evidence regarding the positive aspects of corruption at the firm level.

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1. Introduction

Do corrupt managers deliver superior firm performance? The answer to this question is unclear from a theoretical perspective. Corrupt managers can advance shareholder interest in several respects. For instance, they can evade more taxes, generating de facto money transfers from the government to a firm. Corrupt managers can also obtain more government contracts and remove business impediments by paying bribes. [Leff \(1964\)](#) and [Huntington \(1968\)](#) suggest that corruption could help to maneuver around bad laws and institutions. In addition, [Lui \(1985\)](#) shows that bribery can be efficient in a queuing model if agents whose time has a higher value can use bribes to obtain a better place in line relative to other agents. However, corrupt managers could also use firm resources for their own private benefits and, therefore, destroy shareholder value. [Desai, Dyck, and Zingales \(2007\)](#) find that an increase in tax enforcement in Russia, which

decreased the private benefits of control extracted by company insiders, was followed by a positive market reaction. Mironov (2013) shows that income diversion not only leads to the transfer of money from shareholders to management but also deteriorates firm performance.

In this paper, I analyze the relation between managerial corruption and firm performance using micro-level data from Moscow firms. The key idea of the paper is that individual propensity to corrupt (PTC) can be inferred from recorded traffic violation data. Drivers occasionally commit traffic violations. However, not all traffic violations are recorded in corrupt countries. A driver who is stopped by police can often avoid a formal penalty in exchange for a bribe. Therefore, observing a person's recorded traffic violations for a long period of time allows an inference of individual propensity for corruption. To better understand my approach to PTC measurement, consider the following example. Two persons, A and B, have identical demographic characteristics, the same income level, and a similar driving style. For some reason, however, driver A has a much higher number of recorded traffic violations than driver B. One possible explanation is that A is simply unlucky and that the police caught A every time that he or she was speeding. Another possible explanation is that A and B were stopped for approximately the same number of traffic violations but that B paid more police bribes than A and, therefore, has a lower number of recorded traffic violations.

Russia provides a unique environment in which to study corruption-related issues. Russia is the sixth largest economy in the world, with a per capita gross domestic product (GDP) of \$23,549.¹ This figure is approximately equal to that of Eastern European countries, such as Estonia, Hungary, and Poland. However, the level of corruption in Russia is extremely high, similar to that of countries that are four to five times poorer. The 2012 Corruption Perceptions Index produced by Transparency International ranked Russia 133 out of 174 countries, slightly below Nicaragua, Uganda, Togo, and Honduras. In 2012, the World Bank Ease of Doing Business index ranked Russia 112 out of 185 nations, slightly above El Salvador and Guyana

Data availability is another important factor that makes Russia a unique case. Russia inherited a comprehensive system of government statistics from the Union of Soviet Socialist Republics. Different administrative agencies routinely collect large amounts of data at the individual and firm levels. The data used in this paper cover the entire population of Moscow and all its firms, which range from small firms to extremely large firms. Thus, a comprehensive analysis could be conducted of an economy with the size of a typical European country, such as Austria, Denmark, Greece, or Norway. It is difficult to imagine that such detailed data would become available for the US or any Western economy in the near future. Several recent studies have built on this comparative advantage of the Russian statistical system.²

This paper makes three contributions to the literature. First, I develop an individual measure of corruption

propensity for 3.1 million Muscovites (PTC). Second, I show that the PTC for firm management is positively related to income diversion and undeclared wages paid to employees. Finally, I find evidence that a positive link exists between management PTC and firm performance measured as revenue growth, revenue per employee, and the ratio of revenue to assets. This paper is closely related to the rapidly growing body of literature on managerial malfeasance, including Desai, Dyck, and Zingales (2007), Johnson, La Porta, Lopez-de-Silanes, and Shleifer (2000), Bertrand, Mehta, and Mullainathan (2002), Mironov (2013), and Braguinsky and Mityakov (in press).

I build a measure of individual PTC based on the data on traffic violations, traffic accidents, and other personal characteristics, including gender, income, and distance to work. The data on traffic violations and traffic accidents cover the city of Moscow and the surrounding region for the period from 1997 to 2007. The data contain information on 6,784,971 traffic violations and 159,054 traffic accident participants. The important difference between these two data sets is that nearly all traffic accidents are recorded, whereas the decision to record a traffic violation is determined by individual police officers, who are frequently bribed (in which case, the violation goes unrecorded). I estimate the expected number of recorded traffic violations for each driver, using driver demographic characteristics, personal income, driving distance to work, the number of traffic accidents in which the driver was involved, and car characteristics as the explanatory variables. The individual PTC measure is constructed based on the difference between the predicted number of traffic violations and the actual number of traffic violations. The economic intuition that stems from the expectation that a lower number of recorded traffic violations, given observable driver characteristics, indicates a higher probability that some traffic violations were not recorded in exchange for bribes. Using this approach, I build the measure of PTC for 3,136,839 Muscovites. Next, I determine management PTC for a sample of 58,157 firms and 145,695 firm-years during the 1999–2004 period. The PTC for a given company is estimated as the average of the individual PTC figures of the company's five best-paid employees.

I also analyze the relation between PTC and existing metrics of managerial malfeasance, such as the income diversion measure developed by Mironov (2013) and the personal income transparency measure developed by Braguinsky and Mityakov (in press). The measure of income diversion is based on transfers to illegitimate fly-by-night firms. The money that is transferred to these firms represents a combination of tax evasion and managerial diversion. I find that PTC and illegitimate transfers are positively related. A 1 standard deviation increase in management PTC corresponds to a 0.3% firm revenue increase in income diversion (on average, each firm transfers 8.7% of its revenue to fly-by-night firms).

I also examine the relation between PTC and the measure of personal income transparency developed by Braguinsky and Mityakov (in press), based on the assumption that it is relatively easy to misreport earnings but costly to drive an unregistered vehicle. Thus, a person's unreported income can be inferred from the discrepancy

¹ Source: WorldBank 2012 data.

² See, for example, Braguinsky (2009), Braguinsky, Mityakov, and Lisovich (2010), Braguinsky and Mityakov (in press), Guriev and Rachinsky (2006), Mironov (2013), and Mironov and Zhuravskaya (2014).

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