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Bribes and Firm Value

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Corruption reduces levels of investment and, ultimately, economic growth. Indeed, the World Bank estimates that corruption costs $2.6 trillion (5 percent of global GDP) per year, with $1 trillion paid in bribes every year. Corruption in the form of bribery is also widespread across firms. According to a survey of more than 11,000 firms from 125 countries, one in three firms believes competitors use bribes to secure public procurement contracts. In an attempt to fight corruption, some developed nations have implemented unilateral regulation punishing the use of bribes; other nations—most notably, China and India—have not. Opponents of anti-bribery regulation argue that such regulation puts affected firms at a competitive disadvantage vis-à-vis competitors on the grounds of bribes facilitating doing business in certain regions or industries.

Despite their prevalence in business transactions around the globe, we know relatively little about the causal effect of bribes on firm value. An important challenge with this research agenda is that bribes are largely unobserved. From 1978 to early 2013—that is, over more than three decades—only 143 bribery-related enforcement actions were initiated against publicly listed firms by the Securities and Exchange Commission (SEC) or the Department of Justice for violations of the U.S. Foreign Corrupt Practices Act.

My research studies whether the ability to use bribes creates value. To this end, I exploit a quasi-experimental design that allows me to study the market reaction of firms that are subject to a plausibly exogenous increase in their cost of doing business in perceivably corrupt regions. Specifically, I exploit the passage of the draft of the UK Bribery Act 2010 on March 25, 2009. This Act, which has been in force since July 1, 2011, imposes substantial increases in penalties for firms and managers found to be using bribes. Moreover, the Act requires firms to implement internal controls aimed at preventing the use of bribes. If firms use bribes as an investment to increase the probability of winning contracts, then the passage of costly anti-bribery regulation should reduce firm value. If, however, managers use bribes for their personal benefits, anti-bribery regulation that punishes managers for bribe activity should increase value.

Exploiting the passage of the UK Bribery Act is appropriate only if it came as a surprise and had a substantial effect on firms. One can plausibly argue that these conditions are met. In the first place, the Act was not covered by the media until its passage on March 25, 2009. Second, the fines assessed for violating the Act are much higher than the fines stipulated in previous UK legislation, by the Organization for Economic Co-Operation and Development (OECD) Anti-Bribery Convention, and by comparable U.S. legislation. The Act imposes potentially unlimited fines on corporations found not to have implemented internal anti-bribery controls, as well as on firms found to have paid bribes and on the individuals responsible for

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bribery, both inside and outside the United Kingdom. Third, the Act unexpectedly ran counter to precedent as it applies also to foreign firms with UK operations. This provision made it harder for UK industry lobbyists to argue that the Act placed UK firms at a disadvantage vis-à-vis foreign competitors. Taken together, the Act imposes substantial fines on the use of bribes and therefore facilitates an investigation of the extent to which bribes affect firm value.

To test for the importance of bribes for firm value, I focus on publicly listed firms. I measure firm value by abnormal returns around the time of passage of the UK Bribery Act. I try to capture firms' propensity to engage in bribery by accounting both for firm-level subsidiary locations and Transparency International's Corruption Perception Index to measure firms' exposure to high-corruption regions. My findings are based primarily on roughly 1,100 UK firms and 9,500 non-UK firms. I further explore channels through which the UK Bribery Act affects firms using data on subsidiary revenues, merger and acquisition activity, and joint venture activity between 2007 and 2012.

Using these data, I report three main results. First, passage of the UK Bribery Act did indeed adversely affect the value of UK firms: those 20 percent of UK firms most exposed to perceivably corrupt regions lost at least \$10 million each. This negative effect on firm value is also present in prior attempts by UK regulators to pass such regulation. On seven such events prior to 2010, UK firms exposed to perceivably corrupt regions also experienced lower returns.

Second, the Act had positive effects on direct competitors of UK firms that do not fall under the provisions of the UK Bribery Act. I document that, around the time of passage of the Act, such direct competitors had 0.5 percent higher abnormal returns than comparable non-UK firms. This effect is almost twice as large for direct competitors headquartered outside of the OECD, suggesting that competitors headquartered in the least-regulated countries benefited the most.

Third, I document real implications of the UK Bribery Act. I find that UK firms opened fewer subsidiaries outside the OECD and their revenues from that region grew 12–15 percentage points more slowly than those of non-UK firms. These effects are even stronger in more corrupt regions outside of the OECD. I further document that, relative to non-UK firms, merger activity by UK firms outside the OECD increased 6–8 percentage points more slowly. One might suspect that UK firms substituted direct ownership with third-party transactions; however, I do not find evidence that UK firms circumvented the Act by engaging increasingly in joint ventures in perceivably corrupt regions.

The empirical setting—passage of the UK Bribery Act—might subject my results to alternative interpretations that are unrelated to bribes. First, it is possible that UK firms found it optimal to withdraw from perceivably corrupt regions in face of substantial costs of implementing effective internal anti-bribery controls without having used bribes in the first place. However, one of the Act's features specific to non-UK firms allows me to alleviate this concern. Notably, non-UK firms are exempted from the internal control requirements spelled out in Section 7 of the Act; that is, they are not required to implement costly control systems. Nevertheless, I find that non-UK firms with UK exposure through subsidiary presence are negatively affected by the passage of the Act.

A second potential alternative interpretation, which certainly merits consideration, is that negative market response and subsequent withdrawal from perceivably corrupt regions reflect expectations of higher expected legal costs and penalties associated with operating in such regions. I examine revenue data on subsidiaries that existed throughout the sample period in order to alleviate concerns that this interpretation explains all results. Notably, if passage of the Act solely lead to higher legal costs and penalties, revenues of *surviving* subsidiaries should be unaffected by the passage. Yet, I find that surviving subsidiaries experienced a relative decline in revenue growth after passage of the Act. This decline is similar in magnitude to that of nonsurviving subsidiaries.

It is, of course, not clear ex ante that bribes always create firm value. Thus, in the presence of principal-agent conflicts, bribes may destroy firm value. This is true where, for example, corruptible agents choose inefficient subcontractors who are offering bribes. In this case, anti-bribery regulation can serve as an external monitoring device that makes accepting bribes costly to agents, thereby aligning incentives between principals and agents. To this end, my results suggest that such value created through improvements in governance is outweighed by the costs associated with anti-bribery regulation—though my setting does not allow me to quantify each of these potentially offsetting effects.

Taken together, the evidence put forward in my work supports the notion that bribes facilitate doing business in certain regions—imposing unilateral anti-bribery regulation on some firms hurts these firms but benefits their unregulated competitors.

NOTE

This research brief is based on Stefan Zeume, "Bribes and Firm Value," Ross School of Business Paper no. 1273, January 2016, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2179437.