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Foreign ownership and bribery: Agency and institutional perspectives

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ABSTRACT

In this study we examine the effectiveness of formal institutions (as the macro-level mechanism) and external auditing (as the micro-level mechanism) in controlling multinational firms' engagement in bribery. We adopt World Bank's data and investigate 38,673 firms in 113 countries. Our results suggest that a firm's engagement in bribery is positively related to its foreign ownership. Furthermore, we demonstrate the substitute effects of formal institutions and external auditing in controlling this unethical activity. We argue that in a situation whereby formal institutions are weak, a firm's internal governance mechanism plays a vital role in controlling bribery.

1. Introduction

Corruption and bribery have drawn enormous attention in the international business field (Birhanu, Gambardella, & Valentini, 2016; Cuervo-Cazurra & Genc, 2008; Cuervo-Cazurra, 2016; Luo & Han, 2009; Puffer, Mccarthy, & Peng, 2013). The illegal nature of corruption and bribery imposes high costs on business and ultimately hurts firms' performance. This has led to the emergence of a large set of studies analyzing the best ways for eliminating or at least controlling corruption (Ashforth, Gioia, Robinson, & Trevino, 2008; Beets, 2005; Gorsira et al., 2016; Lange, 2008).

In the corruption literature, there is an on-going debate about the antecedents of bribery and ways of controlling. Neo-institutional theory emphases on the importance of the institutions and proposes that managers are confronted with different environments where bribery and corruption are socially and culturally acceptable norms though they may have cognitive pressure to implement an ethical and legal behavior (Cuervo-Cazurra, 2006). Enormous studies have shown that non-transparent institutions, under-developed market mechanisms, together with social and cultural norms are the roots of corruption (Luo, 2005a; Martin et al., 2007; Zheng, El Ghoul, Guedhami, & Kwok, 2013). This stream of study emphases on the role of formal institutions in the form of law in controlling bribery supply and demand across intuitional settings (Cuervo-Cazurra, 2006; Cuervo-Cazurra, 2008). By contrast, agency theorists view corruption as the results of managerial conflict and stresses managers at headquarters in home country can hardly establish control to deter managers at the foreign subsidiaries from engaging in unethical activities because of information asymmetry. Under this view, managers at the foreign subsidiaries are self-interest opportunists and tend to serve their personal objectives at the expense of the firm's long-term performance (Cuervo-Cazurra, 2016). Based on this reasoning, the root of corruption has shifted from the normative and institutional pressures to goal conflicting organizational members and internal information asymmetry. Hence, appropriate governance mechanisms should be designed to discipline self-interested management from engaging in the unethical and illegal activity.

Neo-institutional theory and agency theory offer macro and micro mechanisms in coping with corruption and bribery. However, limited studies have explicitly discussed the effectiveness of these two mechanisms and explored the possible interplay between them in controlling bribery in the international business field (Cuervo-Cazurra, 2016; Kwok & Tadesse, 2006; Spencer & Gomez, 2011). Agency theory explains the antecedents of bribery by addressing the potential conflicts between a firm's headquarter and its foreign subsidiaries. But what left unexplained from an agency perspective is the question of "why are bribery being conducted at different levels across nations?" A large number of scandals regarding corporate bribery have revealed the fact that multinational corporations' subsidiaries are more likely to bribe in emerging economies than in developed economies. Institutional perspective addresses the role of formal and informal institutional factors in shaping firms' activities. Existing literature on corporate governance goes beyond the simple agency relationship and suggests the agency relationship and corporate governance mechanisms are shaped by external institutional factors across nations (Bruton, Filatotchev, Chahine, & Wright, 2010; Filatotchev, Jackson, & Nakajima, 2013; Kogut, Walker, & Anand, 2002). However, as Kim, Prescott and Kim

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(2005) argue, the external environment sets up universal and minimum standards. It is down to the multinational firms to foster good micro-level governance mechanisms to minimise the agency costs and control agent's unlawful behavior, such as bribery.

Our paper endeavors to fill in these gaps and hence makes two contributions. First, in contrast to the rich and fruitful findings on the antecedents of bribery (Collins, Uhlenbruck, & Rodriguez, 2009; Martin et al., 2007) and the consequences of bribery (Lee & Weng, 2013; Uhlenbruck et al., 2006; Zhou & Peng, 2012), few studies have adopted multiple-level analyses and offered a comprehensive understanding of bribery and corruption control. In this study, we argue that the firm-level bribery varies significantly with the institutional environment in the firm's host country and the individual firm's governance strength. We integrate agency theory with institutional perspective to explicitly explain the efficiency of bribery control under varied institutional environment settings. In specific, we highlighted the importance of the distinct contextual environment in which firms are embedded, and articulated the interplay of macro-institutions and micro-level governance mechanism in controlling bribery in international business.

Second, our findings contribute to corruption literature by highlighting the substitute effects of the internal governance (as the micro-level mechanism) and the external institution (as the macro-level mechanism) on controlling bribery. Though existing corporate governance studies have discussed the substituting and complementing effects of micro- and macro-level corporate governance mechanisms (Abdi & Aulakh, 2012; Hüttenbrink, Oehmichen, Rapp, & Wolff, 2014; Misangyi & Acharya, 2014), we extend the argument and place the agency relationship under circumstances where a multinational firm's headquarter and its foreign subsidiaries have different attitudes and interests in supplying bribery. Researchers have studied bribery control in both firm and country levels; but overlooked the possible interplay between the firm and country level elements in reducing bribery (Doh, Rodriguez, Uhlenbruck, Collins, & Eden, 2003; Montiel, Husted, & Christmann, 2012). In this paper, we suggest that in a situation whereby formal institutions are weak, a firm's internal governance mechanism plays a vital role in controlling the firm-level bribery.

2. Theoretical background and hypothesis development

Many researchers adopted a broad definition on corruption and considered corruption as the abuse (or misuse) of public power for private benefits (Bardhan, 1997). Corruption is however a complex and multifaceted phenomenon (Luo & Han, 2009) and has various forms under different contexts (Puffer et al., 2013). To examine the control of corruption, we first refine our research focus on corruption. Corruption occurs at the interface of the public and private sectors where a public agent has discretionary power over resource access and distribution to the private sector (Uhlenbruck et al., 2006). Therefore, illegal payment has to be paid to the public agent to obtain private benefits for an individual or a firm (Rose-Ackerman, 1999). The illegal payment or bribery is one specific form of corruption and is the focus of this study. In this paper, we study the control of corruption that aims to reduce the supply of bribes by managers. We adopt Luo and Han (2009)'s concept and define bribery as the extent to which the firm engages in various forms of payments to public officials to "get things done" with regard to government or public services, such as customs, taxes, licenses, regulations, services, etc.

2.1. Foreign ownership and bribery intensity

Based on agency theory, we argue that foreign ownership will lead to an increase of bribery in the host country. In this paper, we follow World Bank's definition and measure foreign ownership by the percentage of the total share owned by foreign individuals, companies or organizations. The central premise of agency theory is the separation of ownership and control where the principal delegates the work to an agent who then performs the work (Jensen & Meckling, 1976). Specifically, agency theory asserts that the agent can engage in decision-making and behavior that may be inconsistent with principal's interests (Fama & Jensen, 1983; Fama, 1980). Agency theory is concerned with resolving two problems. The first is the agency problem that arises when the desires or goals of the principal and agent conflict. The problem here is that the principal and the agent may prefer different actions because of the different preferences. The second is the problem of monitoring that arises when the principal has difficulties to verify what the agent is doing. The problem here is that the principal cannot verify that the agent has behaved appropriately due to information asymmetry.

Agency theory becomes applicable in bribery once a firm expands overseas. According to Roth and O'Donnell (1996), international investment has distinguished the universe managerial team into two groups, namely managers at headquarters in the home country and managers in the foreign subsidiary. Nohria and Ghoshal (1994) suggest that managers at headquarters, as the principal, cannot effectively make all the decisions; and hence delegate the work and responsibilities to foreign subsidiaries. This process creates an agency problem. First, managers at headquarters and managers in the foreign subsidiaries may have different goals. Subsidiary management thus may make decisions that are not congruent with those desired by headquarters. Managers at headquarters seek to gain competitive advantages and maximize financial return while minimizing additional costs and risks associated overseas operation in an ethical and legal way (Kostova & Zaheer, 1999). By contrast, managers in the foreign subsidiary act as self-interested agents whose interest is to improve the success of their business operations in the short term and thus enhance their career prospects (Cuervo-Cazurra, 2016). The principal-agent relationship between the headquarters and foreign subsidiary due to interest conflict has been well documented (Kim et al., 2005; Nohria & Ghoshal, 1994; Roth & O'Donnell, 1996). Second, it is hard for the headquarter to obtain detailed and accurate information about foreign subsidiaries' activities and multinational firm's global presence magnifies the information asymmetry problem (O'Donnell, 2000). Luo (2005b) for example suggests that a firm's global expansion creates a list of far-flung enterprises and aggravates information asymmetries between the headquarter and foreign subsidiaries.

It is well recognized that without proper governance, the agent will be more likely to deviate from the interests of the principal (Fama & Jensen, 1983). Following this logic, managers in the foreign subsidiary are more likely to serve their own interest due to information asymmetry and insufficient monitoring means following the geographical distance (Filatotchev & Wright, 2011). Because the actions and outputs of the foreign subsidiary become less verifiable and accountable, adverse selection and moral hazard may occur simultaneously (Kim et al., 2005). Following this line of research, we argue that foreign ownership leads to an increase of bribery in the host country. In specific, managers in the foreign subsidiary are more likely to bribe government officials to smooth the market penetration and enhance performance in the short term. Competition from other multinational firms and local firms impel the foreign subsidiary to resort to bribery as a means of seeking competitive advantages (Robertson & Watson, 2004). Kwok and Tadesse (2006) also admit that offering bribery to a public agent might be more financially meaningful in the short term than endeavoring to shape the institutional environment. Hence, we hypothesize:

Hypothesis 1. There is a positive relationship between a firm's foreign ownership and bribery intensity.

2.2. Institutions, foreign ownership, and bribery intensity

Institutions, which are defined as "the rules of the game" (North,