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# How do anticorruption measures affect executive incentive?

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## ABSTRACT

This paper investigates how anticorruption measures affect corporate governance, especially the executive incentive mechanism. The results of empirical tests show that in the short term, alleviating corruption does not enhance executives incentive, however, it significantly escalates pay-performance sensitivity. It is also found reductions in executive incentive in state-owned companies are more salient than in non-state-owned companies. The suggestion is that anticorruption measures at firm level should be a long-term strategy and focus on state-owned companies. It provides a new perspective for understanding how anticorruption affects firm behavior and performance and for the literature on executive incentives with political intervention.

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## 1. Introduction

Whether anticorruption measures have positive effects on an economy? According to the findings from macroeconomic perspective, efforts aimed at reducing or eliminating corruption in most countries have failed (Persson et al., 2013). This raises doubts for the effectiveness of anticorruption measures and stimulates more explorations from micro-level perspective recently. Some latest studies justify the effectiveness of anticorruption measures from perspective of innovation (Anokhin and Schulze, 2009; Dang and Yang, 2016; Xu and Yano, 2016), capital allocation (O'Toole and Tarp, 2014) and corporate fraud reduction (Zhang, 2016) in firms. This paper further investigates the effectiveness of anticorruption measures from the perspective of corporate governance, especially the executive incentive mechanism.

Corruption is one of the most important features of a modern economy and the literature on corruption's negative effects on economic performance at the country level is relatively well developed (Shleifer and Vishny, 1993; Mauro, 1995), but corruption research at the firm level is a relatively new subject that has not yet developed a consistent paradigm and theoretical foundation. Especially how corruption affects firm behavior and performance has not yet been fully understood and this may be one of the fundamental reasons why we still do not understand the persistent nature of corruption (Jong and van Ees, 2014). It is becoming a thriving area in the literature on corporate governance and this paper adds not only fresh evidence to the literature of corruption and corporate governance but also contributes to the literature on executive incentives with political intervention.

This paper takes China as an example to do the empirical test since the new leadership of the Communist Party of China (CPC) elected on its 18th National Congress launched an anticorruption campaign from 2013. As one of the "Four-Pronged

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Comprehensive Strategy"<sup>1</sup> of China in these years, this far-reaching action, especially whether it really benefits the Chinese economy attracts much attention. This paper affirms the effectiveness of it and provides practical implications for continuous anticorruption actions in China and other countries.

## 2. Theory and hypotheses

The extant literature on corruption's effect on firm behavior and performance has not yet reached a consensus. There are two dominant explanations: one is that corruption acts as "greasing-the-wheel" benefiting firms, and another is that corruption is "sand-the-wheel" harming firms (Pan and Tian, 2017; Dreher and Gassebner, 2013; Gauthier and Goyette, 2014; Heckelman and Powell, 2010; Jiang and Nie, 2014; Svensson, 2005; Tonoyan et al., 2010; Vial and Hanoteau, 2010; Wang and You, 2012; Zhou and Peng, 2012; Kato and Sato, 2014; Nguyen and van Dijk, 2012; Seker and Yang, 2012; La Rocca et al., 2017; Liu et al., 2016). Based on these perceptions, anticorruption measures may also have two kinds of effects on firms, either benefiting them or harming them. However, relevant theoretical and empirical studies on this query have been quite few until recently. This paper attempts to further spy into it from the perspective of corporate governance.

Because corruption<sup>2</sup> is regarded as unethical behavior to obtain private benefits through using public resources, for a firm, outside officials extorting bribes from the firm or employees using internal resources to extract private benefits can both be viewed as a kind of tax or rent for the firm. It is essentially a transaction cost even worse than a tax payment (Fisman and Svensson, 2007; Murphy et al., 1993). Based on theory of transaction cost economics, if anticorruption measures can reduce this type of cost, they can benefit the firm. As reported recently, anticorruption measures help firms transfer from seeking political connections to enhancing innovation (Anokhin and Schulze, 2009; Dang and Yang, 2016; Xu and Yano, 2016), reduce the level and incidence of bribery by public officials to facilitate a more efficient allocation of capital (O'Toole and Tarp, 2014) or reduce possible fraud of firms (Zhang, 2016), all of which reduce the transaction cost and ultimately benefit the firms. But how do they affect executive incentive?

Firstly, corruption detection at the firm level mainly focuses on the misbehaviors of executives. Like in China's ongoing anticorruption campaign, during discipline inspections implemented by the central and provincial committees of the CPC, many top executives in state-owned enterprises were placed under investigation. The charges mostly pertained to their misbehaviors on important issues of the company like major investment decisions. Engagement in fraudulent and unlawful practices for their own benefit, taking bribes and trading power for money during mergers and acquisitions, property rights transfers and bids and tenders were also detected in most of the cases. In addition to strictly inspecting these misbehaviors of executives, the CPC has also issued new norms on self-discipline and rules for disciplinary punishments for the members. These sanctions are "stricter than the law" for the purpose of regulating all members' behavior, especially those top officials in government and state-owned enterprises. For a firm, the behaviors and incentives of executives are very important determinants of firm performance. If anticorruption measures can effectively curtail executives' misbehavior and enhance their self-discipline and spirit of dedication, then they should obtain stronger incentives and work harder than before, and firm performance should be improved in spite of unchanged executives' pay level. Along this line, the first step of this study is to test:

**Hypothesis 1: anticorruption measures cause executive monetary incentives to have a stronger positive effect on firm performance**

Furthermore, many researchers deem that the incentive effect of executives in state-owned enterprises in China is quite disappointing because of low pay-performance sensitivity (Firth et al., 2006; Chen et al., 2010; Chizema et al., 2014; Firth et al., 2006). However, as noted by Murphy (2013), most of these analyses are focused on efficient contracting or managerial power rationales and ignore or downplay the causes and consequences of political intervention. Anticorruption measures are important political intervention and we wonder whether they have a significant impact on executive's pay-performance sensitivity. Therefore, the second hypothesis is:

**Hypothesis 2: anticorruption measures enhance the pay-performance sensitivity of executives**

Moreover, according to the inner-party regulations of the CPC, discipline inspections mentioned above, the major approach adopted in this campaign, are mandatory for state-owned companies and the CPC Central Commission for Discipline Inspection (CCDI) and the commission for discipline inspection in every province sent out discipline inspection groups to visit and inspect Party committees (composed by party member executives) of state-owned companies<sup>3</sup>. While private companies are encouraged to take their own internal inspections. No matter the inspections are conducted by external or internal forces, the target is the same to fight with corrupt behaviors within firms. But some latest literature have reported the

<sup>1</sup> This new leadership presented a strategic blueprint distilled into slogans known as the "Four-Pronged Comprehensive Strategy", one of which is to strengthen Party self-discipline through continuous anticorruption efforts. This campaign is regarded as the largest organized anti-graft effort in the history of contemporary China.

<sup>2</sup> Endogenous red tape and minor corruption within a firm is also a kind of corruption but this paper focuses those grand corruption behaviors like bribing and exploitation which are deregulations and illegal behaviors. These are what anticorruption campaign aims to eliminate.

<sup>3</sup> Discipline inspections has no judicial authority, but, if inspections found problems of executives, except for punishment within the Party like expulsion from the Party, when necessary, gathered evidence will be forwarded to judicial organs. For example, Jiang Jiemin, former president of China National Petroleum Corporation (CNPC) was investigated by CCDI in 2013 and then Supreme People's Procuratorate announced in 2014 to place his case on file with accusations of corruption.

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