

Institutional Barriers to Decentralization at the Firms: Evidence from Russia

1. Introduction

How can weak institutions impede decentralization of the firms? Decentralization is important for firms' successful growth and development in modern quickly changing, open and competitive economic environment. Delegation of some responsibilities from the CEOs and top managers down along the managerial hierarchy opens room for implementing more projects, quicker taking competent decisions and reacting to the challenges of market economy. However, in the countries with weak institutions decentralized decision-making is not common at the firms. Data indicate that share of decentralized firms in post-Soviet and developing countries is low. In Russia only 17% of manufacturing firms are decentralized, only 7% - combine decentralization with hiring for top positions on the competitive basis, without taking connections into account. Bloom et al. (2010) link low productivity of firms in developing countries with the inability of firms to successfully decentralize decision-making.

Existing literature addressing the question how can weak institutions limit decentralization at the firms, discusses the effect of institutions on risks of decentralization: weak institutions can increase agency risks associated with decentralization (see e.g. Bloom et al., 2010; Bloom et al., 2012; Aghion et al., 2014), and risks of information leakage (Athanasouli, Goujard, 2015). In this paper we argue, that there can be one more channel through which weak institutions can limit decentralization. Weak institutions can increase comparative benefits of building businesses out of political connections and corruption. As the business model of such businesses is based on their access to non-market privileges and does not require them necessarily to be efficient and competitive, decentralization is not needed for such businesses.

Existing empirical evidence on the influence of institutions on decentralization, surprisingly, is very limited. Bloom et al. (2012) using data about firms in 12 countries (USA, countries of Europe and Asia) demonstrate that probability of decentralization is higher for the firms with head offices situated in the regions with higher interpersonal trust. Authors also show that probability of decentralization is higher for the firms that operate in the countries with better rule of law. Athanasouli and Goujard (2015) use data about firms in 10 post-Soviet countries of

Eastern and Central Europe to demonstrate that in the more corrupt regions more contract-dependent firms tend to be more centralized.

This paper adds to the literature on the influence of institutions on decentralization of the firms. The paper explores the influence of different facets of institutional environment – interpersonal trust, social tolerance to corruption, quality of judicial system, business corruption – on decentralization of decision-making at Russian firms. Furthermore, the paper aims to understand the concrete channels through which weak institutions limit decentralization of Russian firms. Results of the empirical analysis presented in the paper demonstrate the strong negative influence of business corruption on decentralization of Russian firms, and are consistent with the hypothesis that weak institutions can limit decentralization at the firms by increasing comparative benefits of building businesses out of political connections and corruption.

2. Theory

Through which channels can weak institutions limit decentralization at the firms? First, weak institutions can increase risks associated with decentralization. Agency risks of decentralization are widely discussed in the literature (see e.g. Bloom et al., 2010; Bloom et al., 2012; Aghion et al. 2014). Delegating some of the decision-making responsibilities to employees, even to key employees, firms' CEOs have to take the risk that employees can use delegated responsibilities in their own interests, not in the interests of the firm (e.g. take bribes for promoting non-optimal suppliers, partners or projects, steal, or cheat the firm in some other ways). Weak institutions – low trust, weak social norms, poorly functioning judicial system, corruption – increase agency risks of decentralization. High agency risks of decentralization are believed to be a major obstacle to decentralization for firms that operate under weak institutions¹. Athanasouli and Goujard (2015) mention one more type of risks associated with decentralization in weak institutional setup. In the environment with high corruption, typically many firms are forced to be involved in corruption at least to some extent. For such firms, decentralization may imply larger access of employees to information about firms' involvement in corruption activities, and, thus, may be associated with risks of leakage of information about firms' involvement in illegal activities.

Second, weak institutional environment, especially high corruption, can increase comparative advantages of building businesses grounded in political connections and corruption.

¹ E.g. Bloom et al. (2010) state that “in developing countries owners tend to make almost all major management decisions because of fears of expropriation by their managers”.

Objectives of such connected businesses can be strongly distorted relative to the conventional objectives of non-connected firms in a competitive market economy. Therefore, advantages of decentralization (such as quicker competent decision-making) can be just not relevant and not valuable for such firms. If comparative advantages of building business grounded in connections become sufficiently high, this can lead to crowding out of decentralized firms by centralized firms that benefit from political connections and corruption in weak institutional environment. This mechanism is novel to the decentralization literature.

Following the said above, we formulate two hypotheses to understand how weak institutions limit decentralization at Russian firms:

Hypothesis 1: Weak institutions limit decentralization at Russian firms by increasing risks associated with decentralization (either agency risks or risks of information leakage)

Hypothesis 2: Weak institutions limit decentralization at Russian firms by increasing comparative benefits of building businesses out of political connections and corruption.

3. Data and Empirical Strategy

Empirical analysis of the paper is based on the data of large survey “Russian firms in a global economy” that was conducted by the Higher School of Economics Institute for Industrial and Market Studies in 2014. The survey sample includes about 2000 Russian manufacturing firms situated across 60 Russian regions, the questionnaire covers different aspects of firms’ organization and behavior, including organization of decision-making at the firms. We complement this data with the data on quality of institutions in Russian regions, estimated from the two sources: set of the GeoRating public opinion surveys run periodically in Russian regions by the Russian Public Opinion Fund, and the “Business Environment and Enterprise Performance Survey” (BEEPS), that was conducted in Russian regions in 2011-2012 by the European Bank for Reconstruction and Development in the collaboration with the World Bank. We estimate tolerance to corruption in Russian regions from 2011 GeoRating survey, interpersonal trust – from 2014 GeoRating survey, measures of quality of the judicial system and business corruption in Russian regions – from the BEEPS.

If Hypothesis 1, which assumes that weak institutions limit decentralization at Russian firms by increasing risks of decentralization (agency risks and/or risks of information leakage), holds, we can expect the share of decentralized firms to be lower in the regions with lower trust, worse quality of judicial system, higher social tolerance to corruption, higher business

corruption. Furthermore, for corruption, we can expect the negative effect of corruption on probability of decentralization to be higher for firms that are more prone to corruption (non-transparent firms, firms that receive support from government or state orders).

If Hypothesis 2, which suggests that weak institutions limit decentralization at Russian firms by creating conditions under which decentralized firms are being crowded out by centralized firms that benefit from political connections and corruption, holds, we also can expect share of decentralized firms to be lower in the regions with higher business corruption. In addition to this, we can expect centralized firms to be more successful in more corrupt environment.

4. Empirical results

Empirical analysis does not reveal any significant effect of trust, social tolerance to corruption, or quality of judicial system on probability of decentralization of Russian firms (see regressions presented in Table 1 in the Appendix). Analysis demonstrates strong negative influence of business corruption on probability of decentralization: firms situated in the regions with higher business corruption are less likely to be decentralized (see results in Tables 1 and 2 in the Appendix). However, no stronger effect of corruption on probability of decentralization for firms that are more prone to corruption (non-transparent firms, firms that receive support from the state or state orders) is observed. On the contrary, the negative effect of corruption on probability of decentralization is even smaller for more prone to corruption firms, though the differences are significant only for firms that receive state orders (see regressions in Table 3 in the Appendix). Therefore, data do not provide support to the Hypothesis 1, which assumes that weak institutions limit decentralization at Russian firms by increasing risks of decentralization (neither agency risks, nor risks of information leakage).

At the same time, data vividly support the Hypothesis 2, which suggests that centralized firms can be more successful in a more corrupt environment. Empirical analysis demonstrates, that for firms that accompany centralization with hiring for top positions by connections, a significant positive effect of corruption on the probability of firms' investment is observed (see regressions in Table 4 in the Appendix; note that for firms that are either decentralized, or hire for top positions on the basis of open competition, without taking connections into account, data indicate no significant effect of corruption on probability of investment). Moreover, for firms that accompany centralization with hiring for top positions by connections, higher corruption is associated with higher chances to implement large investment, i.e. to invest more than 10% of the

revenue (see regressions in Table 5 in the Appendix). Interpreting these results, we can imply that firms that benefit from corruption – these are, according to the data, firms that combine centralization with hiring for top positions by connections – are likely to be politically connected and to make business out of connections and corruption. For such type of firms, decentralization may be not valuable as their business model differs strongly from the standard business model of a firm in a competitive market economy. If, in the environment with weak institutions, comparative advantages of building such type of businesses become high enough, decentralized firms may be just crowded out by more successful connected centralized firms.

5. Conclusion

To summarize, this paper uses evidence from Russian firms to study the influence of institutions on decentralization of the firms, and to explore the concrete channels through which weak institutions limit decentralization at the firms. The paper demonstrates strong limiting influence of corruption on decentralization of Russian firms.

Decentralization literature that studies organizational choices of the firms in the post-Communist and developing countries focuses on costs of decentralization under weak institutions. Empirical analysis presented in this paper finds no support to the hypothesis that weak institutions limit decentralization of Russian firms by increasing costs of decentralization. However, analysis of this paper provides evidence for the existence of another, new to the decentralization literature, channel through which weak institutions can limit decentralization at the firms – by creating environment with high comparative advantages of building business grounded in connections and corruption, under which decentralized firms can be crowded out by centralized connected businesses.

References

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Appendix.

Table 1. Institutions and decentralization of the firms

	(1)	(2)	(3)	(4)
	Firm is decentralized			
Trust in the region	-0.49 (0.635)	-0.19 (0.631)	-0.22 (0.820)	-0.35 (0.723)
Tolerance to corruption in the region		0.53 (1.106)	0.39 (1.178)	0.75 (0.816)
Quality of courts in the region			0.33 (0.653)	0.06 (0.636)
Business corruption in the region				-1.40*** (0.483)
GRP per capita, log	-0.17 (0.132)	-0.18 (0.134)	0.04 (0.206)	0.14 (0.185)
Employment at the firm, log	0.10** (0.045)	0.09* (0.045)	0.11** (0.046)	0.10** (0.044)
Age of the firm, log	0.12** (0.051)	0.11** (0.052)	0.11* (0.060)	0.11* (0.059)
Share of employees with higher education	0.11 (0.254)	0.09 (0.259)	0.10 (0.300)	0.15 (0.290)
CEO has share in property	-0.26** (0.101)	-0.30*** (0.102)	-0.36*** (0.114)	-0.36*** (0.111)
CEO's age	-0.07 (0.061)	-0.06 (0.060)	-0.12** (0.047)	-0.11** (0.050)
CEO's gender: female	-0.13 (0.119)	-0.11 (0.117)	-0.24** (0.113)	-0.23** (0.118)
Firm has state share in property	-0.68*** (0.239)	-0.54** (0.246)	-0.49* (0.276)	-0.50* (0.285)
Firm has foreign share in property	0.46** (0.179)	0.35** (0.161)	0.17 (0.190)	0.20 (0.182)
Firm receives support from government	0.07 (0.124)	0.09 (0.122)	0.09 (0.150)	0.05 (0.152)
Firm receives state orders	0.24** (0.103)	0.28*** (0.100)	0.22* (0.124)	0.23* (0.130)
Control for sector, size of city / town / locality, respondent's position	Yes	Yes	Yes	Yes
Observations	1,628	1,599	1,277	1,277

Robust standard errors in parentheses

*** p<0.01, ** p<0.05, * p<0.1

Table 2. Corruption and decentralization of the firms

	(1)	(2)	(3)	(4)	(5)	(6)
	Firm is decentralized					
Business corruption in the region	-1.32*** (0.507)	-1.32** (0.525)	-1.40*** (0.483)			
Corruption is an obstacle for business in the region				-1.07*** (0.411)	-1.09*** (0.407)	-1.14** (0.490)
Quality of courts in the region		-0.02 (0.625)	0.06 (0.636)		0.37 (0.607)	0.40 (0.645)
Tolerance to corruption in the region			0.75 (0.816)			-0.03 (1.038)
Trust in the region			-0.35 (0.723)			0.09 (0.851)
GRP pc, log	0.16 (0.132)	0.16 (0.170)	0.14 (0.185)	0.15 (0.154)	0.20 (0.187)	0.22 (0.225)
Employment at the firm, log	0.10** (0.046)	0.10** (0.046)	0.10** (0.044)	0.10** (0.047)	0.09** (0.047)	0.10** (0.047)
Age of the firm, log	0.13** (0.057)	0.13** (0.058)	0.11* (0.059)	0.11* (0.058)	0.11* (0.058)	0.09 (0.059)
Share of employees with higher education	0.13 (0.283)	0.13 (0.285)	0.15 (0.290)	0.14 (0.282)	0.15 (0.287)	0.16 (0.291)
Control for CEO's characteristics, property structure, presence of support from government and state orders	Yes	Yes	Yes	Yes	Yes	Yes
Control for sector, size of city / town / locality, respondent's position	Yes	Yes	Yes	Yes	Yes	Yes
Observations	1,288	1,288	1,277	1,288	1,288	1,277

Robust standard errors in parentheses

*** p<0.01, ** p<0.05, * p<0.1

Table 3. Corruption and decentralization of the firms – extensions

	(1)	(2)	(3)	(4)
	Firm is decentralized			
Corruption * Firm hires for key positions competitively	-1.21** (0.499)			
Corruption * Firm hires for key position by connections	-1.39*** (0.481)			
Corruption * Transparent firms		-1.45*** (0.498)		
Corruption * Non-transparent firms		-1.38*** (0.484)		
Corruption * Firm doesn't receive support from government			-1.42*** (0.483)	
Corruption * Firm receives support from government			-1.25** (0.517)	
Corruption * Firm doesn't receive state orders				-1.53*** (0.476)
Corruption * Firm receives state orders				-1.08** (0.484)
Quality of courts in the region	-0.21 (0.568)	0.05 (0.639)	0.05 (0.638)	0.03 (0.631)
Tolerance to corruption in the region	1.18 (0.836)	0.76 (0.815)	0.77 (0.817)	0.78 (0.811)
Trust in the region	-0.51 (0.707)	-0.37 (0.729)	-0.35 (0.723)	-0.35 (0.710)
GRP per capita in the region, log	0.05 (0.173)	0.14 (0.185)	0.13 (0.186)	0.14 (0.184)
Control for firm's size, age quality of human capital, CEO's characteristics, property structure	0.10** (0.047)	0.10** (0.044)	0.10** (0.045)	0.10** (0.045)
Firm receives support from government	0.04 (0.162)	0.05 (0.151)		0.04 (0.153)
Firm receives state orders	0.24* (0.135)	0.24* (0.130)	0.22* (0.130)	
Control for sector, size of city / town / locality, respondent's position	Yes	Yes	Yes	Yes
Observations	1,256	1,277	1,277	1,277

Robust standard errors in parentheses

*** p<0.01, ** p<0.05, * p<0.1

Table 4. Corruption and firms' investment

	(1)	(2)	(3)	(4)	(5)
	Firm implements investment				
	All firms	Centralized firms		Decentralized firms	
		Hiring by connections	Competitive hiring	Hiring by connections	Competitive hiring
Business corruption in the region	0.32 (0.452)	1.31*** (0.456)	-0.42 (0.933)	2.28 (1.397)	-0.72 (1.259)
GRP per capita, log	-0.11 (0.228)	-0.26 (0.277)	0.29 (0.306)	-0.83* (0.490)	0.08 (0.540)
Employment at the firm, log	0.31*** (0.050)	0.38*** (0.086)	0.30*** (0.087)	0.25 (0.187)	0.12 (0.126)
Size of the firm, log	0.07 (0.088)	0.07 (0.126)	-0.05 (0.133)	0.51** (0.215)	0.04 (0.243)
Share of employees with higher education	-0.20 (0.224)	-0.57* (0.294)	-0.04 (0.299)	-1.25 (0.990)	-2.10*** (0.809)
State share in property	-0.53* (0.314)	-0.73** (0.323)	-1.34** (0.567)	-0.08 (1.233)	1.00 (1.639)
Foreign share in property	-0.25 (0.226)	-0.20 (0.566)	-0.81* (0.483)	0.75** (0.300)	0.75 (0.709)
Firm receives support from government	0.02 (0.131)	-0.10 (0.237)	0.37 (0.270)	-0.20 (0.421)	-0.67* (0.379)
Firm receives state orders	0.31** (0.132)	0.40** (0.191)	0.27 (0.296)	0.01 (0.400)	0.03 (0.409)
Control for CEO's characteristics	Yes	Yes	Yes	Yes	Yes
Control for sector, size of city / town / locality, respondent's position	Yes	Yes	Yes	Yes	Yes
Observations	1,293	629	390	132	103

Robust standard errors in parentheses

*** p<0.01, ** p<0.05, * p<0.1

Table 5. Corruption and firms' investment

	(1)	(2)	(3)	(4)	(5)
	Firm implements large investments				
	All firms	Centralized firms		Decentralized firms	
		Hiring by connections	Competitive hiring	Hiring by connections	Competitive hiring
Business corruption in the region	0.70 (0.485)	2.02*** (0.477)	0.06 (0.892)	0.29 (1.398)	-0.95 (1.527)
GRP per capita, log	-0.04 (0.229)	-0.22 (0.260)	0.32 (0.331)	0.15 (0.540)	0.39 (0.496)
Employment at the firm, log	0.20*** (0.045)	0.23*** (0.074)	0.17** (0.076)	0.03 (0.163)	0.38** (0.155)
Size of the firm, log	-0.01 (0.070)	-0.05 (0.096)	-0.05 (0.144)	0.52** (0.236)	0.03 (0.244)
Share of employees with higher education	0.04 (0.201)	-0.18 (0.279)	0.17 (0.366)	-0.38 (0.737)	-0.57 (1.004)
State share in property	-0.25 (0.320)	-0.42 (0.335)	-1.20*** (0.430)	0.07 (0.937)	-0.58 (1.294)
Foreign share in property	-0.16 (0.221)	-0.17 (0.499)	-1.08*** (0.397)	1.96** (0.821)	-0.13 (0.574)
Firm receives support from government	-0.04 (0.109)	-0.01 (0.228)	0.18 (0.245)	-0.64* (0.331)	-0.06 (0.433)
Firm receives state orders	0.18 (0.133)	0.39** (0.170)	-0.06 (0.197)	-0.84* (0.447)	-0.16 (0.386)
Control for CEO's characteristics	Yes	Yes	Yes	Yes	Yes
Control for sector, size of city / town / locality, respondent's position	Yes	Yes	Yes	Yes	Yes
Observations	1,294	630	390	132	103

Robust standard errors in parentheses

*** p<0.01, ** p<0.05, * p<0.1