ABSTRACT
This paper develops a theory of regulatory enforcement in a multi-firm setting where enforcement intensity and aggregate investment are jointly determined by economic fundamentals. Enforcement disciplines firms’ misreporting of investment outcomes, which reduces the reporting bias as well as the market discount, and increases each firm’s stand-alone investment efficiency. However, the regulator is unable to commit to any long-term enforcement policy ex-ante but chooses the enforcement intensity after the aggregate investment is observed. Anticipating the ex-post optimal enforcement policy, firms face a coordination problem because it is the aggregate investment that determines the ex-post social benefit of enforcement. Hence the well-known positive correlation between regulatory enforcement intensity of securities laws and capital market development can be the manifestation of a two-way relationship between these two endogenous objects. As a consequence, the market can be over-sized and over-regulated or under-sized and under-regulated. The model also explains why regulatory enforcement intensity varies across markets and over time, as well as suggesting that aggregate investment (market-size) may not be a good measure of aggregate efficiency to evaluate alternative accounting policies.
(Copies of the paper are available in the AOIS Department offices)