Politicians and firms

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Introduction

- Up to this point, we have focused on officials who are engaging in corrupt acts: again, defined as the breaking of government rules for private gain.
- There is a much broader range of phenomena, often deemed rent-seeking or clientelism, in which officials offer benefits to individuals or firms – government contracts, privileged access to services, etc. – either because they stand to benefit personally, or in exchange for political support.
- Depending on the nature of the quid pro quo and the local laws, these acts may or may not be illegal (and thus constitute corruption by our definition).

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- Rent-seeking may be welfare-decreasing even if legal, however, if resources are diverted to activities where the social return is not maximized.
- The papers examined today present empirical evidence about the extent to which rent-seeking is dominant in the private sectors of developing countries, as well as some evidence from the U.S.
- More specifically, we examine whether politically connected firms appear to profit from their political connections, first in Pakistan and Indonesia.

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Question of interest

- This paper seeks to analyze whether politically connected firms (more specifically, firms with politicians serving on their boards) receive preferential treatment in the allocation of credit from government banks.
- The authors have a panel dataset; thus they include firm fixed effects and examine how changes in a firm's political connectedness is correlated with changes in its access to credit.
- In addition, they have unusually complete and accurate measures of a firm's political connectedness.
- Finally, they present evidence that the local political environment matters: firms with "stronger" politicians on their boards benefit even more.

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Data

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- The loan data includes names and addresses of directors, allowing the authors to match the names to politicians.

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Empirical strategy

- The basic regression is the following for firm i borrowing from firm j, estimated using OLS.

$$Y_{ij} = \alpha_j + \beta_1 * Political_i + \gamma_1 X_i + \gamma_2 X_{ij} + \epsilon_{ij}$$

- Y_{ij} is a measure of preferential treatment (amount borrowed and effective loan price), and X_i and X_{ij} are controls for characteristics of the firm and loan; α_j is a bank fixed effect.

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Identification challenges

- The previous specification raises the concern that there could be unobserved characteristics of firms that are correlated with both their level of political connections and their access to credit: e.g., politicians seek to connect themselves with high-performing firms, and those high-performing firms also attract credit.
- Accordingly, the authors also estimate a specification that includes firm fixed effects α_i and tests whether the same firm receives (greater) preferential treatment when it is politically connected and borrowing from a government bank, compared to a private bank.

$$Y_{ij} = \alpha_i \alpha_j + \beta_1 * Political_i \times GOV_j + \gamma_1 X_{ij} + \gamma_2 X_{ij} \times GOV_j + \epsilon_{ij}$$

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Dif-in-dif

- This is a dif-in-dif specification: comparing loans across connected and unconnected firms, comparing across government and private banks.
- Identifying assumption: loan trends for firms that are politically connected and unconnected would be the same in government and private banks, **except because** of a pattern of political favoritism.

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Identification challenges, part II

- The final strategy used by the authors is to use a time-varying measure of political connectedness and introduce firm fixed effects, by considering changes experienced by a firm when its politician or the politician's party wins or loses an election.
- The estimating equation is the following:

$$Y_{ij} = \alpha_{ij} + \alpha_t + \beta_1 \times WIN_{it} \times GOV_j + \beta_2 \times WIN_{it} + \epsilon_{ijt}$$

  where α_{ij} are bank by lender fixed effects.
- This is a triple difference specification: allows for unobservable characteristics of the bank-firm relationship to affect credit, as long as they are constant over time (before and after elections).

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Results: summing up

- Loans to politically connected firms are 45% larger; politically connected firms also default 42% more.
- The higher default rates arise **entirely** due to loans from government banks.
- In addition, while all politically connected firms can borrow more from government banks, an increase in the number of votes obtained by a politician is still associated with a further increase in the amount his firm can borrow.

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Costs of rents

- In the final part of the paper, the authors attempt to estimate the economy-level costs of the rents identified, in several categories.
  - Deadweight loss of taxation: loans that default due to political corruption are a transfer payment to politicians. When the government bails out government banks, they use public funds raised through taxation; this is costly.
  - In addition, there are investment distortions: connected firms that obtain their loans cheaply obtain lower rates of return to investment than they would otherwise.
- The authors present evidence that government loans are in fact funneled to "lower-quality" firms (less likely to export, lower values of export, etc.)

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Empirical evidence: Investment distortions

TABLE IX
ARE POLITICALLY CONNECTED FIRMS LESS PRODUCTIVE?

Data restricted to textile firms								
	Exporter?		Exporter?		Log exports		Log export productivity	
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Firm default rate	−0.22	−0.17						
	(0.051)	(0.060)						
Government bank borrower			−0.19		−0.79		−0.28	
			(0.08)		(0.44)		(0.18)	
Politically connected				0.05		0.05		−0.02
				(0.06)		(0.20)		(0.09)
Politically connected * government bank borrower				−0.13		−0.64		−0.24
				(0.07)		(0.31)		(0.15)
Constant	0.22							
	(0.029)							
Controls		YES	YES	YES	YES	YES	YES	YES
R^2	0.04	0.27	0.2	0.28	0.1	0.18	0.1	0.21
No. of Obs.	6,313	6,313	6,313	6,313	6,313	6,313	6,313	6,313

Estimating costs of rents

- The authors conclude that rent provision costs GDP around 1.9% annually.
- While many assumptions are required to generate this estimate, the exercise provides a useful guide to the types of costs that rent-seeking can occur – and an important clue that a broader set of clientelistic activities that may or may not be strictly illegal can nonetheless be extremely costly for developing economies.

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Discussion questions

- Do you find the identification strategy plausible? Are there potential sources of bias that aren't addressed?
- What about the welfare implications? The authors are clearly arguing this misallocation is very costly. Do you agree?
- Are there appropriate regulatory responses? If one believes that this is a significant problem, how can the problem be addressed?

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Fisman, Estimating the value of political connections

- Fisman seeks to analyze the value of political connections to the Suharto regime in Indonesia, a highly centralized and persistent quasi-authoritarian regime.
- Following the crash of the Indonesian economy in 1997, there was widespread speculation that capital that had flowed into Indonesia had not been used for productive purposes, primarily because of political favoritism.
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Data

- He uses accounting and share price data, and group affiliations and a measure of political connectedness generated by a consulting firm in Indonesia.
- Fisman also defines Suharto's health "events" using information about the dates on which those rumors hit the Jakarta stock exchange.
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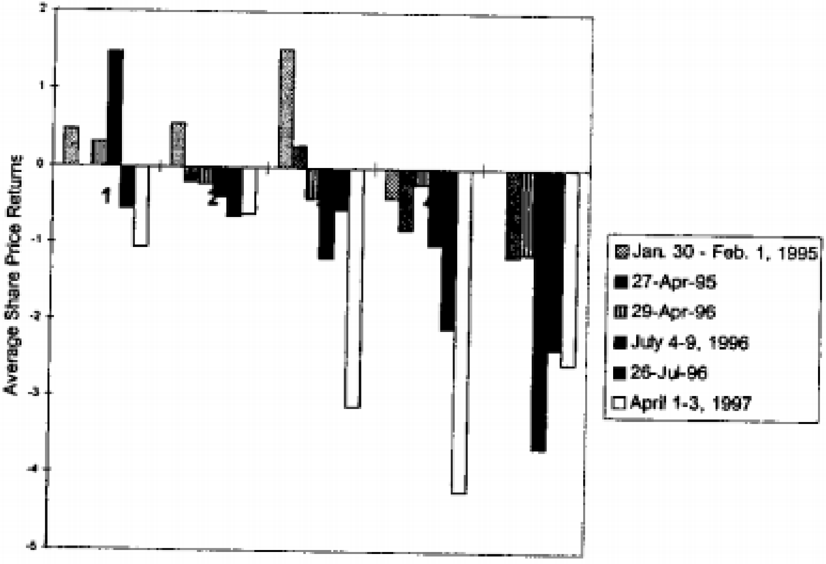
Effect of political dependence on returns



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- The regression analogue to these results is straightforward: he is interested in the interaction between politically connectedness and the threat to Suharto's health, which is empirically proxied using using the return on the Jakarta exchange net of broader Southeast Asian effects, denoted $NR_e(JCI)$.
- The equation of interest is thus:

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Fisman et al., Connections to vice-president Cheney

- Fisman and coauthors then went on to apply a similar empirical methodology to estimate the value of political connections to VP Cheney in the United States.
- They examine a number of events: his heart attack, his appointment as the chair of the VP search committee, the probability of reelection, etc.
- The universe of connected companies include Halliburton, companies where Cheney was on the board, and companies where a board member was on the board of Halliburton.

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Events examined

- The authors examine several events linked to his political fortunes (VP selection, invasion of Iraq) as well as a heart attack on 11/22/2000.
- They generate industry-adjusted returns over the period Jan. 2000 to April 2001 for Cheney-connected companies, and then regress these returns on indicator variables for the events.
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Cheney event study: Results

Table 2: The effect of Cheney's political fortunes on event returns: Time-series regression

VARIABLES	(1) Industry-adjusted euqal-weighted portfolio abnormal	(2) Industry-adjusted value-weighted portfolio abnormal	(3) Industry-adjusted Halliburton abnormal returns:
4/19/2000 dummy	-0.002	-0.011	-0.008
	(0.005)	(0.008)	(0.004)
7/21/2000 dummy	0.000	-0.006	-0.013
	(0.002)	(0.004)	(0.007)
11/22/2000 dummy	0.001	-0.005	0.000
	(0.001)	(0.004)	(0.011)
3/5/2001 dummy	0.003	0.012	-0.003
	(0.005)	(0.009)	(0.003)
AR_IndAdjusted (t-1)	-0.238	-0.238*	-0.351***
	(0.122)	(0.098)	(0.051)
AR_IndAdjusted (t-2)	-0.237*	-0.240***	-0.256***
	(0.109)	(0.050)	(0.039)
AR_IndAdjusted (t-3)	-0.088	-0.034	-0.159**
	(0.088)	(0.063)	(0.052)
Observations	330	330	330
Adjusted R-squared	0.014	0.103	0.156

Notes: Dependent variable, AR_IndAdjusted, is industry median adjusted portfolio return for connected firms. 4/19/2000: Cheney becomes head of running mate selection committee; 7/21/2000: Cheney appoints himself as running mate; 11/22/2000: Third heart attack; 3/5/2001: Fourth heart attack. Robust standard errors, clustered at the day level, are in parentheses. Abnormal returns are calculated using a standard market model. All regressions include year, month-of-year, week-of-month, and day-of-week fixed effects. *** p<0.01, ** p<0.05, * p<0.1

Rent-seeking in the U.S.: Absent?

- The authors thus conclude that, contrary to widely circulated anecdotes, there are no systematic advantages for companies with personal connections to Cheney.
- This sharply contrasts with the results in Indonesia and particularly Pakistan, where the estimated advantage was huge.
- The authors suggest that the U.S. political system seems to have appropriate mechanisms to control rent-seeking via ties with high political leaders.
- It is worth noting that they focus on ties only to one political leader, while Khwaja and Mian were able to evaluate the impact of political ties to a large sample of politicians in Pakistan; it is possible that the sample size of companies tied to Cheney is simply inadequate.

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Summing up

- The papers evaluated today have shown fairly robust evidence that political connections lead to large changes in firm fortunes in Pakistan and Indonesia, suggesting a substantial magnitude of political rent-seeking.
- Rent-seeking, even if legal, can have substantial costs by diverting public funds (and thus increasing the deadweight loss of taxation), and also by inducing distortionary investment in activities that are not high-return.
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Discussion questions - Fisman papers

- These studies are part of a literature known as “event studies”: analyzing the impact of discrete events on stock market returns as a measure of the implications of different political changes.
- What are the advantages of this strategy? The disadvantages?
- Do you find it plausible that the results in U.S. are so different from the results in Pakistan or Indonesia? If not, why not, and how could this hypothesis be tested further?

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