

Politicians and firms

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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.
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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 political environment matters: firms with "stronger" politicians on their boards benefit even more.

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Data

- ▶ The authors have data on the full universe of corporate loans made in Pakistan between 1996 and 2002, as well as electoral outcomes for the two elections that overlap the loan period.
- ▶ 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 bank 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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Empirical evidence: Loans and political connectedness

TABLE III
ARE POLITICALLY CONNECTED FIRMS GIVEN PREFERENTIAL TREATMENT?

Dependent variable	Log loan size (1)	Rate of return (2)	Default rate (3)	Recovery rate (4)	Interest rate (5)
Politically connected	0.37 (0.08)	-6.08 (2.46)	6.22 (1.98)	-1.09 (1.14)	0.09 (0.05)
Controls	YES	YES	YES	YES	YES
R^2	0.26	0.28	0.29	0.24	0.43
No. of Obs.	112,685	89,223	112,685	24,562	89,223

Results are based on cross-sectionalized data. A unit of observation is a loan (bank-firm pair). There are 89,223 observations instead of 112,685 in columns (2) and (5) as interest rate data are not available for all banks. There are 24,562 observations in column (4) because the data are conditional on a firm having defaulted. Rate of Return = $(1 - \text{Default Rate}) * (1 + \text{Interest Rate}) + \text{Default Rate} * \text{Recovery Rate}$. Standard errors reported in parentheses are clustered at bank level. Regressions in columns (2)–(5) are weighted by loan size. Controls in column (1) include dummy for whether borrower is a foreign firm, 91 bank dummies, 134 dummies for each of the city/town of firm. Columns (2)–(5) include column (1) controls plus 8 dummies for the number of creditors the firm has, 5 loan-type dummies and 3 group size dummies, 5 firm size dummies. Firm-level control variables are described in the Appendix.

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

- ▶ 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 may be investment distortions: connected firms that obtain their loans cheaply obtain lower rates of return to investment than they would otherwise.
- ▶ Moreover, the authors argue that this pattern is consistent with corruption, in the sense there do not seem to be any criteria that would justify the loan pattern **other** than politicians utilizing banks to benefit their personal financial interests; there's not much direct evidence of this personal financial benefit, however.

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Estimating costs of rents

- ▶ The authors conclude that rent provision costs around 1.9% of GDP 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 incur – 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.
- ▶ The author seeks to infer the value of political connections for firms by exploiting a series of rumors about Suharto's health.
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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.
- ▶ The key insight of the paper can be captured graphically: more politically connected firms (POL score higher) lost more value on the stock exchange when the rumors circulated.

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Effect of political dependence on returns

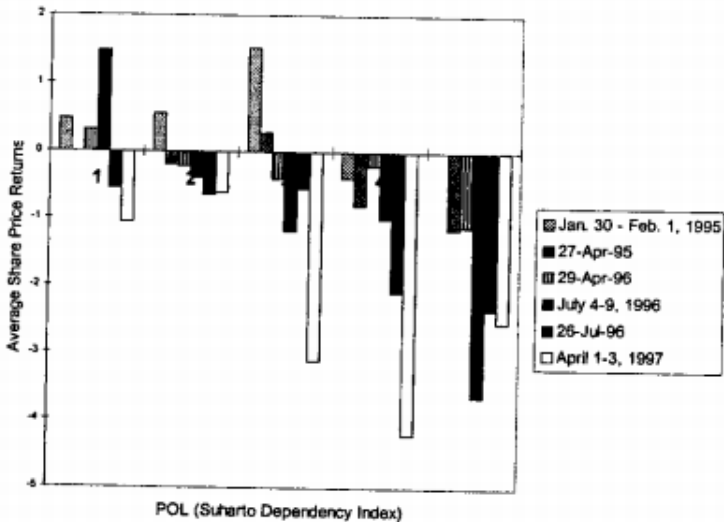


FIGURE 1. EFFECT OF POLITICAL DEPENDENCE ON SHARE PRICE RETURNS

Empirical specification

- ▶ 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 the return on the Jakarta exchange net of broader Southeast Asian effects, denoted $NR_e(JCI)$.
- ▶ The equation of interest is thus:

$$R(P_{it}) = \alpha + \rho_1 \times POL_i + \rho_2 \times NR_e(JCI) + \rho_3 \times [NR_e(JCI) \times POL_i] + \epsilon_{it}$$

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Regression results

TABLE 3—EFFECT OF POLITICAL CONNECTIONS ON
CHANGES IN SHARE PRICE

	(1)	(2)
<i>POL</i>	-0.60** (0.11)	-0.19 (0.15)
<i>NR(JCI)</i>	0.25 (0.14)	-0.32 (0.28)
<i>NR(JCI) · POL</i>		0.28* (0.11)
Constant	0.88 (0.27)	0.06 (0.35)
R^2	0.066	0.078
Number of observations	455	455

Note: Robust standard errors are in parentheses.

* Significantly different from 0 at the 5-percent level.

** Significantly different from 0 at the 1-percent level.

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.
- ▶ None of the event dummies are significant, though they note that the small sample may limit power.

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

Cheney event study: Results

Table 3. Relationship between probability of a Bush victory and excess returns, across all connected firms, over both a one-day and five-day period: clustered at date level

Dependent variable	Returns over one-day period			Returns over five-day (weekly) period		
	Risk-adjusted returns (all connected firms)	Risk-adjusted returns relative to industry median (all connected firms)	Risk-adjusted returns relative to industry median (Halliburton only)	Risk-adjusted returns (all connected firms)	Risk-adjusted returns relative to industry median (all connected firms)	Risk-adjusted returns relative to industry median (Halliburton only)
	(1)	(2)	(3)	(4)	(5)	(6)
ΔBush	0.013 (0.028)	0.020 (0.019)	0.022 (0.099)			
ΔBush				0.057 (0.067)	0.059 (0.054)	-0.028 (0.160)
N	1,729	1,729	133	338	338	26
R^2	-0.004	-0.003	-0.007	-0.007	-0.016	-0.041

Values represent coefficient on ΔBush (change in Iowa Electronic Markets probability on date t of Bush victory) in a regression with dependent variable of excess returns (in column 1), excess returns net of median industry returns (in column 2), and excess returns for Halliburton only (in column 3). In columns 1-3, returns are over a period of one day following date t ; columns 4-6 repeat the same dependent variables but using a period of one business week following date t . The sample consists of all Cheney-connected firms (columns 1-2 and 4-5) and of Halliburton only (columns 3 and 6).

Robust standard errors, clustered at date level, are in parentheses.

Cheney event study: Results

Table 4. Relationship between probability of Saddam's capture and excess returns, across all connected firms in war-related industries, over both a one-day and five-day period: Clustered at date level

Dependent variable	Returns over one-day period			Returns over five-day (weekly) period		
	Risk-adjusted returns (all connected firms in war-related industries)	Risk-adjusted returns relative to industry median (all connected firms in war-related industries)	Risk-adjusted returns relative to industry median (Halliburton only)	Risk-adjusted Returns (all connected firms in war-related industries)	Risk-adjusted returns relative to industry median (all connected firms in war-related industries)	Risk-adjusted returns relative to industry median (Halliburton only)
	(1)	(2)	(3)	(4)	(5)	(6)
$\Delta\text{SaddamJ03}$	0.026 (0.041)	0.005 (0.028)	0.035 (0.071)			
$\Delta\text{SaddamJ03}$				0.001 (0.001)	-0.000 (0.001)	-0.001 (0.001)
<i>N</i>	392	392	92	76	76	18
<i>R</i> ²	-0.005	-0.006	-0.009	-0.002	-0.035	-0.041

Values represent coefficients on $\Delta\text{SaddamJ03}$ (change in Tradesports probability on date t of Saddam Hussein being captured by June 2003) in a regression with dependent variable of excess returns (in column 1), excess returns net of median industry returns (in column 2), and excess returns net of median industry returns for Halliburton only (in column 3). In columns 1-3, returns are over a period of one day following date t ; columns 4-6 repeat the same dependent variables but using a period of one business week following date t . The sample consists of all Cheney-connected firms in war-related industries (columns 1-2 and 4-5) and of Halliburton only (columns 3 and 6). Robust standard errors, clustered at the date level, are in parentheses.

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.
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Summing up

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