Politically connected firms

PhD workshop presentation

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Politically connected firms

Definition

Politically connected firms are companies colluding with public officials in order to extract rent through their activity.

Efficiency

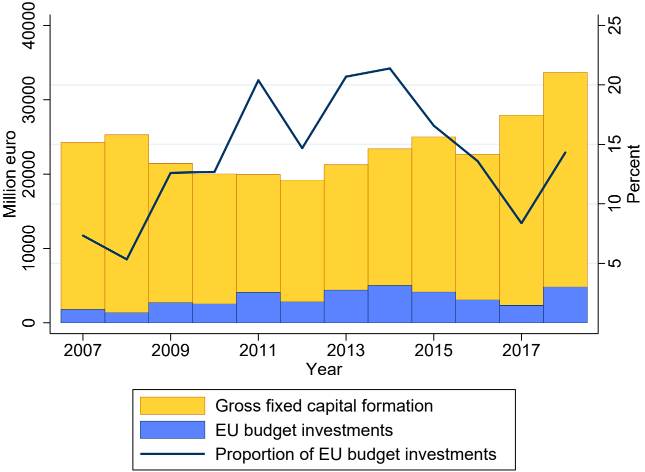
Ethical concerns aside, is it problematic if connected firms win more public procurements?

Identification

How is it possible to find a setting, where statistical inference is feasible?

Motivation

Figure: European Union funded investments in Hungary



Source: Eurostat

Why can it be good?

Greasing wheel hypothesis

- Kaufmann–Wei (1999):
  Does "Grease Money" Speed Up the Wheels of Commerce? (NBER)
- Dreher–Gassebner (2013): Greasing the Wheels?
  The Impact of Regulations and Corruption on Firm Entry (PC)
- it can be difficult to enter excessively regulated markets
- so-called "red tape" can prevent firms to launch new investments
- political connections can facilitate access to credit
- firms can save time and resources by paying a bribe to speed up the bureaucratic process
- consumers can benefit from lower prices, wider variety of products or more advanced technology
- low-paid bureaucrats can complement their salaries instead of quitting
- mixed evidence in extant literature

Why can it be bad?

Sanding wheel hypothesis

- outright stealing by officials is a clear misuse of funds
- public resources are not allocated to the most efficient firms
- governments can subsidise loss-making enterprises
- states can provide lower quality goods and services to citizens
- firms with superior products or better prices cannot enter the market
- Faccio (2010): connected firms pay lower taxes and have poorer accounting performance
- Fisman–Wang (2015): workplace fatalities are higher in case of politically connected Chinese firms
- Schoenherr (2019): more delays, complaints and cost overruns in case of public procurements won by connected firms

Extant empirical literature

Fisman (2001): Estimating the Value of Political Connections (RES)

- analysing stock exchange effects of bad news about the leader's health in Indonesia
- semi-natural experiment, as such pieces of bad news are published randomly

Johnson–Mitton (2003):
Cronyism and Capital Controls: Evidence from Malaysia (JFE)

- effect of the 1997 Asian financial crisis on companies with strong ties to the government after cutting back subsidies

Faccio (2006): Politically Connected Firms (AER)

- sample of 20 202 publicly traded firms in 47 countries
- connected firms are more common in countries with lax conflict of interest regulation, which are perceived to be more corrupt and are more transparent

Extant empirical literature - *continued*

Faccio (2010):
Differences between Politically Connected and Nonconnected Firms:
A Cross-Country Analysis (Financial Management)

- uses the database in the previous article
- connected firms enjoy lower taxation, have higher leverage, greater market power, lower returns and market valuation on average

Cingano–Pinotti (2013): Politicians at Work
The Private Returns and Social Costs of Political Connections (JEEA)

- Italian local administration data
- greater market power due to greater sales to the public administration
- no significant difference in productivity
- higher misallocation of funds in regions with higher public spending
- larger effect in economic sectors with higher share of public procurements

Extant empirical literature - *continued*

Goldman–Rocholl–So (2013):
Politically Connected Boards of Directors and the Allocation of Procurement Contracts (RF)

- change in public procurement allocation after the 1994 midterm elections
- classification based on board of directors members

Lehrer (2018):
The Value of Political Connections in a Multiparty Parliamentary Democracy: Evidence from the 2015 Elections in Israel (EJPE)

- searching for cumulative abnormal returns on the Tel Aviv Stock Exchange after the 2015 legislative elections
- no significant effect on stock returns

An example

South Korea

The value of collusion and the role of personal networks

Schoenherr, David (2019)
Political Connections and Allocative Distortions
Journal of Finance, Vol. 74. No. 2. pp. 543–586

Background

2007 South Korean presidential election

- two main contenders: *Lee Myung-bak* and *Park Geun-hye*
- despite a scandal, Lee won the Grand National Party primaries
- eventually Lee Myung-bak won 48.7% of the votes on 19th December 2007 and became the new president

Role of networks

- Lee studied at the Korea University Business School
- he served as CEO of Hyundai between 1976 and 1992
- he entered politics and was mayor of Seoul between 2002 and 2006
- due to his business background it is easier to observe his connections compared to politicians

Data

Used databases

- 630 firms included in the Korea Composite Stock Price Index (KOSPI)
- 42 state firms purchasing goods and services from private companies
- accounting data from Mint and stock market data from Bloomberg
- register of CEO appointments with their curricula vitæ
- online database of public procurements

Connected and non-connected firms

- state firm CEOs are appointed by the president
- firm is considered connected if its CEO studied at Korea University or is a former Hyundai executive
- connected and non-connected firms do not differ in observables

Empirical strategy

Equation to be estimated

$$y_{it} = \alpha_t + \beta_t \cdot A_{it} + \mu_t \cdot D_i + \varepsilon_{it}$$

- y_{it}: contract volume, A_{it}: firm characteristics, D_i: connectedness dummy, α_t: time-specific effects
- collapsing data into two periods and first differencing

$$\Delta y_i = \Delta\alpha + (\beta_1 \cdot A_{i1} - \beta_0 \cdot A_{i0}) + \Delta\mu \cdot D_i + \Delta\varepsilon_i$$

Confounding factors

- connected firms benefiting from new economic policy ($\beta_1 - \beta_0 \neq 0$)
- better access to finance ($A_{i1} - A_{i0} \neq 0$)
- endogenous CEO appointments anticipating the win of Lee

Empirical strategy – *continued*

Exploiting variance

- through a new state firm CEO appointment a private firm can become connected to certain state firms but not to others
- it is possible to analyse the volume change on a state firm level

$$\Delta y_{ij} = \Delta\alpha + \Delta\alpha_i + \Delta\alpha_j + \Delta\mu \cdot D_{ij} + \Delta\varepsilon_{ij}$$

Fixed effects

- $\Delta\alpha_i$: controls for new policy benefiting connected firms and change in ability to apply for public procurements
- $\Delta\alpha_j$: controls for general volume increase of state firms
- $\Delta\alpha_j \cdot ind_i$: controls for specific agenda that benefits connected firms

Results

Contract volume

- connected firms experience a 0.33–0.39 percentage point higher increase in contract volume from state firms depending on specification
- no significant effect if the CEO was already connected before the elections

Contract performance

- contracts allocated to connected firms are 8.78–11.48 percentage points more likely to perform badly
- poor performance of contracts is not due to higher complexity
- contracts with connected firms are more prone to cost increases

As of 2020...

Lee Myung-bak

- Lee was arrested on 22nd March 2018 on charges of bribery, embezzlement and tax evasion
- he was sentenced to 15 years in prison on 5th October 2018
- he was ordered to pay a $11.5 million equivalent fine

Park Geun-hye

- Park was arrested on 31st March 2017, and was charged with abuse of power, bribery, coercion and leaking government secrets
- she was sentenced to 24 years in prison on 6th April 2018
- her sentence was increased later to 25 years in prison
- she got a fine of $16.8 million equivalent

Source: Wikipedia

Thank you for your kind attention!