14.75 : Corruption Lecture 4

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Outline

- Do we care?
  - Magnitude and efficiency costs
- The corrupt official's decision problem
  - Balancing risks, rents, and incentives
- Embedding corruption into larger structures
  - The IO of corruption: embedding the decision problem into a market structure
  - **Corruption and politicians**
    - **How politicians are corrupt: political influence on state firms**

Value of political connections
Fisman 2001: "Estimating the value of political connections"

- Setting: Indonesia under Soeharto
- Empirical idea:
  - Use stock market event study to gauge the "market value" of political connections to Soeharto
  - Idea: when Soeharto gets sick, what is the effect on stock price of Soeharto-connected firms relative to unconnected firms
    - *"Whenever Mr. Soeharto catches a cold, shares in Bimantara Citra catch pneumonia" – Financial Times*
  - So when Soeharto gets sick, we compare the change in stock market value for connected vs. unconnected firms.
- What does this tell us? Why is this still perceptions? Does this buy us anything over just asking people?

Data and estimation

- Data on connections to Soeharto
  - Indonesian political consultancy rates each firm on scale of 0-4 of how close they are to Soeharto
  - Examples of "4" firms are those owned by Soeharto's children, Soeharto's cronies from childhood, and his relatives
- Data on dates of 6 Soeharto health shocks from Lexis-Nexis
- Then run a stock market event study for each event

$$R_{ie} = \alpha + \rho POL_i + \varepsilon_{ie}$$

- Since events are heterogeneous, measures total effect of event with net return of Jakarta stock exchange $(NR(JCI))$, then estimates

$$R_{ie} = \alpha + \rho_1 POL_i + \rho_2 NR_e(JCI) + \rho_3 POL_i \times NR_e(JCI) + \varepsilon_{ie}$$

Results
Event by event

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HUV˙Y˙&˙!˙9ŻYWﻫcŻ Dc˙]hﻫWU˙7cbbYWﻫcbg˙cb˙7\Ub[Yg˙]b˙G\UfY˙Df]WŻ˙GYdUfUhY˙9ghﻫa Uhﻫcb˙Żcf˙9UWX˙9j Ybh
HUV˙Y˙'˙˙!˙9ŻYWﻫcŻ Dc˙]hﻫWU˙7cbbYWﻫcbg˙cb˙7\Ub[Yg˙]b˙G\UfY˙Df]WŻ˙Df]WU˙

The value of connections

- Need to examine the counterfactual event where Soeharto died and firm connections went to 0.
  - Fisman uses JCI return to benchmark this, since JCI also declines whenever Soeharto gets sick
  - Specifically, he asked investment bankers what would happen to JCI if Soeharto died and value of connections went to 0 – their estimate was a decline of 20%
  - This implies that coefficient on *POL* would be $.28 * -20 - .19 = -5.8$ in such a scenario.
  - So for a firm wit maximum connections ($POL = 4$), Soeharto's death would reduce firm value by about 23 percent.
- What do we infer from this?

An international comparison
Fisman, Fisman, Galef and Khurana (2006)

- One can repeat the same exercise in different countries to gauge the value of political connections in that country
- Fisman et al. (2006) do the exact same exercise in the US– they look at the value of connections to Dick Cheney
- Definitions of connections:
  - Halliburton (Cheney was CEO)
  - Board ties (Cheney was on board, or overlap with Halliburton's board)
- Events:
  - Heart attacks
  - Self-appointment as VP-nominee
  - Changes in probability of Bush-Cheney victory
  - Changes in probability of war in Iraq

Results: No detectable impact

Images removed due to copyright restrictions. See: Fisman, David, Raymond J. Fisman, et al. "Estimating the Value of Connections to Vice-President Cheney." *The B.E. Journal of Economic Analysis & Policy* 13 no. 3 (2012).

Table 2. Average excess returns for Cheney-connected firms over the two-day period following an event that affects Cheney's ability to provide political favors.

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.

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.

An empirical example
Khwaja and Mian (2005): "Do Lenders Favor Politically Connected Firms? Rent Provision in an Emerging Financial Market"

- Setting: Banking in Pakistan
- Empirical questions:
  - Do state-owned banks channels rents to politically connected firms through preferential loans?
  - How socially costly is this?
- Data:
  - Every single loan in Pakistan from 1996 to 2002.
  - Includes information on identity of borrower, amount, and repayment status
  - Also includes all members of the board of directors of borrowing firm
- Political connections:
  - Match board of directors to list of all candidates for national or provincial office

Estimation

- Estimation:

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

including bank FE (α_j), firm size dummies, number of creditor dummies, city dummies, industry dummies. Convincing?Are these firms different?

- Estimation 2: compare differences between state banks and private banks:

$$Y_{ij} = \alpha_i + \alpha_j + \beta_1 Political_i + \beta_2 Political_i \times Gov_j + \gamma_1 X_i + \gamma_2 X_{ij} + \varepsilon_{ij}$$

Does this solve the problem?

- Estimation 3: use time-differences in political connections based on whether your connected politician is in office:

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

- Convincing?

Results

- Connected firms default more with government banks, but not once fixed effects included. Does this mean there is no corruption?

Efficiency costs

- Calculate two types of efficiency cost
  - Deadweight loss of taxation
    - 24.8 percentage point excess default rate compared to private banks. $3.2 billion in total lending * 38 percent connected firms * 24.8 percent additional default = $300 million
    - 0.40 deadweight loss implies $120 million in deadweight loss = .16 percent of GDP
  - Investment distortions
    - Assume private lending has standard 'market to book' returns of 2.96, and defaulted government lending has return of 1 (no productive return)
    - So (2.96 - 1) * $300 million excess default = $588 million = .78 percent of GDP. Higher if all government lending has lower return.
- Total cost: 0.94 percent of GDP.Huge!!!

Future directions

- Very useful – but by no means the last word on politician corruption
- In particular, a key open question is the interaction between controlling corruption and the inefficiency of corruption
  - e.g., tighter controls of politician corruption may reduce total corruption, but may increase social efficiency (Shleifer-Vishny model)
- Related questions:
  - How else do politicians steal? Bureaucratic influence, legislative influence, etc
  - More direct measures of efficiency costs
  - Relationship between legalizing some forms of corruption (e.g., campaign contributions, employment upon leaving office) and the efficiency or inefficiency of corruption

14.75 Political Economy and Economic Development

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