14.75 : Corruption Lecture 4

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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

Table 2 - Effect of Political Connections on Changes in Share Price, Separate Estimation for Each Event
Table 3 - Effect of Political Connections on Changes in Share Price
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 $0.28 \times -20 - 0.19 = -5.8$ in such a scenario.
  - So for a firm with maximum connections ($POL = 4$), Soeharto’s death would reduce firm value by about 23 percent.

- What do we infer from this?
An international comparison

- 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

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.
Setting: Banking in Pakistan

Empirical questions:
- Do state-owned banks channel 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

An empirical example
Estimation

- Estimation:
  \[ Y_{ij} = \alpha_j + \beta_1 Political_i + \gamma_1 X_i + \gamma_2 X_{ij} + \epsilon_{ij} \]
  including bank FE \((\alpha_j)\), 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:
  \[ Y_{ij} = \alpha_i + \alpha_j + \beta_1 Political_i + \beta_2 Political_i \times Gov_j + \gamma_1 X_i + \gamma_2 X_{ij} + \epsilon_{ij} \]
  Does this solve the problem?

- Estimation 3: use time-differences in political connections based on whether your connected politician is in office:
  \[ Y_{ijt} = \alpha_{ij} + \alpha_t + \beta_1 WIN_{it} \times Gov_j + \beta_2 WIN_{it} + \epsilon_{ijt} \]
  Convincing?
Results

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


Table IV: Are Politically Connected Firms Favored by Government Banks Only? Default Rate
Table V Are Political Firms Favored by Government Banks Only? Access to Credit
Table VII Time Series Test of Political Strength
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