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Public governance and corporate finance: Evidence from corruption cases

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ABSTRACT

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Cross-sectional research finds that corporate financing choices are not only affected by firm and industry factors, but also by country institutional factors. This study focuses on the roles of public governance in firm financing patterns. To conduct a natural experiment that avoids endogeneity, we identify 23 corruption scandals involving high-level government bureaucrats in China and a set of publicly traded companies whose senior managers bribed bureaucrats or were connected with bureaucrats through previous job affiliations. We report a significant decline in the leverage and debt maturity ratios of these firms relative to those of other unconnected firms after the arrest of the corrupt bureaucrat in question. These relations persist even if we only focus on the connected firms that were not directly involved in the corruption cases. The relative decline in firm leverage is associated with negative stock price effects. We also examine the possibility that rent seekers are efficient firms and that corruption does not thus result in capital misallocation, but fail to find evidence to substantiate this postulation. *Journal of Comparative Economics* **36** (3) (2008) 343–364. Faculty of Business Administration, The Chinese University of Hong Kong, Hong Kong; Department of Finance, University of Alberta, Canada.

1. Introduction

It is well known that debt, and in particular short-term debt, is the dominant external financing source for companies in developing economies and emerging markets. The high corporate financial leverage in emerging markets, and more generally differences in corporate financing structures across countries, can only be partially explained by conventional theories that focus on firm or industry factors.[1] Several recent cross-country studies have revealed that a significant part of the corporate financing patterns that are unexplained by firm or industry factors can be explained by country-level institutional factors (Demirguc-Kunt and Maksimovic, 1996, 1998, 1999, 2001; Rajan and Zingales, 1995; Booth et al., 2001; Giannetti, 2003; Fan et al., 2005).

Cross-sectional studies, however, are subject to potential endogeneity. To address this concern, this study adopts an event study approach and focuses on the impact of public governance on corporate financing decisions in a country. In contrast to previous cross-country studies, the single-country event study allows us to focus on a specific institutional factor while holding constant other institutional factors that may be correlated with corporate financing decisions.

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[1] Such studies include those of Modigliani and Miller (1958), Miller (1977), Bradley et al. (1984), Myers and Majluf (1984), Titman and Wessels (1988), Barclay and Smith (1995), MacKay and Phillips (2001), and many others.

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In an economy plagued by poor public governance, firms are likely to raise finance through more debt, rather than equity. First, debt provides investors with a higher degree of monitoring and enforcement ability (Smith and Warner, 1979) than an open-ended equity claim, which provides little protection from expropriation by managers or bureaucrats. Second, it may be easier for self-interested bureaucrats to channel funds in the form of loans to firms with which they have connections through banks they control (La Porta et al., 2002; Sapienza, 2004), rather than through the equity market that they are less able to influence. Similar considerations apply to debt maturity. In a more corrupt system, short-term debts are more common because they provide better protection to lenders than long-term debts. However, politically connected or bribing firms are likely to have better access to long-term debt than unconnected firms.

We test the second explanation of firm financing—the rent-seeking hypothesis in emerging markets. A direct test of the hypothesis requires evidence of the misconduct of bureaucrats while avoiding the confounding factors and endogeneity problems that are typical of cross-sectional studies. To facilitate such a natural experiment, we collect a sample of 23 high-level (mostly provincial) corruption cases involving government officers in China during the period 1995 to 2003. Among the 393 publicly listed companies located within the jurisdiction of the corrupt bureaucrats, we identify 85 companies whose senior managers or directors bribed the bureaucrat in question (bribing firms) or were connected with the bureaucrat through past job affiliations (connected firms). We examine the leverage and debt maturity of the bribers and the connected firms and how these financing structures change relative to those of unconnected matching firms around the time of the relevant corruption case. Our empirical design is less subject to endogeneity concerns than previous studies because the corruption enforcement is exogenous to the firms and not directly caused by them. In particular, the connected firms did not necessarily actively invest in bribes, but rather gained their connections by chance, and therefore any change in their financing policy should not be directly caused by corruption but rather by lost connections.

We find that the financial leverage of both the bribers and the connected firms, as measured by total debt over total assets, was significantly less than that of the unconnected (or matching) firms subsequent to the arrest of the corrupt bureaucrats. The relative decline in leverage is more attributable to the decrease in long-term debt than to the decrease in short-term debt. Consistently, the debt maturities of the bribing firms and connected firms, as measured by long-term debt over total debt, were significantly shortened subsequent to the arrest of the bureaucrats. These results suggest that being connected with corrupt bureaucrats provides firms with a comparative advantage in obtaining access to debt, and in particular long-term debt. However, this debt financing advantage disappears when the connection is broken due to the arrest of the bureaucrat in question. Our results are robust to various leverage and maturity measures, the inclusion of supplier credits as an additional source of financing, the inclusion of various control variables, and several alternative interpretations.

We also perform an event study to examine whether any of the lost financing advantage is reflected in a lower firm value by estimating the cumulative abnormal stock returns (CARs) of the firms around the initial public release of the corruption news. We find that the CARs are positively related to change in leverage around the corruption events for various event windows, which suggests that stock markets discount the value of firms that experience a decrease in financial leverage (or an increase that is not as great as that of other firms) due to the corruption allegations.

Finally, we address the question of whether rent-seeking activities and capital allocation efficiency in China's financial system can coexist, given that more efficient firms are more likely to pay bribes or build connections to secure their access to capital. However, we are unable to find any evidence for this postulation.

Our findings suggest that public sector governance has an important effect on corporate financing behavior. This is broadly consistent with the economic literature, which shows that political rent-seeking explains firm behavior and value, financial sector development, and economic growth (Shleifer and Vishny, 1994, 1998; Fisman, 2001; Johnson et al., 2002; Johnson and Mitton, 2003; Ramalho, 2003; Acemoglu and Johnson, 2005; Faccio, 2006; Charumilind et al., 2006; Leuz and Oberholzer-Gee, 2006). Our evidence also corroborates the findings of several other papers. Khawaja and Mian (2005) report that politically connected firms in Pakistan receive abnormal lending from government banks and suffer from abnormal default rates. In a cross-country study, Dinc (2005) reports that government-owned banks tend to increase their lending in election years relative to private banks. Siegel (2005) reports that Korean firms that are connected to politicians gain better access to key outside resources through cross-border alliances. In another cross-country study, Faccio et al. (2006) report that politically connected firms are more likely to be bailed out by governments, and that their performance is worse subsequent to such bailouts than that of non-connected firms. Claessens et al. (in press) document that Brazilian firms that make large contributions to federal deputy election campaigns are more likely to have an increased bank leverage after such elections.

The remainder of this paper proceeds as follows. Section 2 provides an overview of the financial markets and rent-seeking activities in China. Section 3 presents the sample, data, and the empirical results of the effects of corruption events on capital and debt maturity structures. Section 4 analyzes the impact of financial policy changes on performance. Section 5 addresses the effects of corruption on capital allocation. Section 6 concludes the paper.

2. Institutional background

This section describes rent-seeking and corruption activities in China, the Chinese financial market, and how rent-seeking activities shape the financing decisions of firms.