”The value of local political connections in a low-corruption environment”

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Outline

Motivation

Previous work

Faccio (2006) finds national political connections with publicly-traded firms in 35 of 47 countries.

- In high-corruption countries, political connections generate a significant abnormal return.

Several studies on the value of political connections

- In corrupt countries
- For powerful natoinal politicians
- In time of severe financial crisis

1st New contribution

The value of family connections in one of the least corrupt countries in the World

- Denmark scored 9.3-9.5 in the Corruption Perception Index through 2001-2011
- By 2017: A single 4th place as lowest placement since index started in 1995

E.g. the 2007 CPI placements:

RANK	COUNTRY/TERRITORY	CPI 2007 SCORE	SURVEYS USED	CONFIDENCE RANGE
1	Denmark	9.4	6	9.2 - 9.6
1	Finland	9.4	6	9.2 - 9.6
1	New Zealand	9.4	6	9.2 - 9.6
4	Singapore	9.3	9	9.0 - 9.5
4	Sweden	9.3	6	9.1 - 9.4
6	Iceland	9.2	6	8.3 - 9.6
7	Netherlands	9.0	6	8.8 - 9.2
7	Switzerland	9.0	6	8.8 - 9.2
9	Canada	8.7	6	8.3 - 9.1
9	Norway	8.7	6	8.0 - 9.2

2^{nd} New contribution

The 2005 administrative reform $\rightarrow$ a novel identification strategy

- Differences in differences: 238 municipalities merged into 65
- Counterfactuals: 33 municipalities were left unchanged

Background and data

The 2005 administrative reform

Municipalities pre-reform

Municipalities post-reform

The 2005 administrative reform

- The municipal level accounts for ~48% of public expenditures.

Panel A: Number of municipalities	Before		After
Total	271		98
Treatment	238		65
Control	33		33
Panel B: Number of municipalities by population size	Before		After
> 100,000	4		6
50,000–100,000	13		28
30,000–50,000	24		39
20,000–30,000	25		18
10,000–20,000	77		3
5,000–10,000	114		1
< 5,000	14		3
Panel C: Measures of political power	Before	After	Difference after-before
Population/politicians			
Treatment	776.9	1,798.7	1,021.8***
Control	2,323	2,344	21
Expenditures/politicians			
Treatment	30,066.6	88,474.2	58,407.6***
Control	106,093.9	122,154.4	16,060.5
Outsourcing/politicians			
Treatment	2,879.6	8,078.3	5,198.7***
Control	9,515.2	1,0352.3	837.1***

Data

Accounting and management data, 2002-2008

- All firms with non-negative book value of total assets.
- Profitability (operating and net income).
- Annual balance sheets are mandatory and approwed by external accountants.
- Obtain personal ID numbers of all managers and board members.

Electoral data for 2001, 2005, and 2009 local elections

- Electoral data on ID, party affiliation, votes and electoral success/failure

Family networks and political connections, elections

- Create family trees from merging administrative data
- Consider family relations: parent, child, sibling, current/former spouse(s).

Empirical strategy

Differences-in-differences

”How the increase in political power due to the enlargement of local governments increased the profitability of firms connected with local politicians before and after the reform” (Amore and Bennedsen, 2013)

- Premise: Merging of municipalities $\rightarrow$ positive shock to politicians’ power.
    - Merging more than doubled population/politicans and also tripled expenditures/politicians and outsourcing/politicians.
- Counterfactuals: Similarly connected firms in unchanged municipalities.

Potential endogeneity in other studies:

- Connections to *well-performing* firms can decide election outcomes.
- Thus, unnconnected firms or firms connected with unelected candidates $\rightarrow$ poor counterfactuals

Results

Operating return on assets (OROA)

Table 5: Difference-in-difference estimates

Differences between average for 2001-2004 and 2006-2008 for firms connected with reelected politicians. Treatment = merging municipality. Controls: Regional dummies. Depending on specification: lagged log(total assets), lagged industry-ajusted OROA.

Dependent variable:	OROA			Industry-adjusted OROA			ln(Sales)
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Treatment	0.0325**	0.0331**	0.0355**	0.0309**	0.0315**	0.0338**	0.3929*
	(0.0151)	(0.0152)	(0.0145)	(0.0152)	(0.0153)	(0.0147)	(0.2095)
$\ln(\text{Assets})_{t-1}$		−0.0022	−0.0011		−0.0020	−0.0010	−0.0432
		(0.0025)	(0.0021)		(0.0025)	(0.0021)	(0.0288)
$\text{Profitability}_{t-1}$			−0.2274**			−0.2189**	−0.8328
			(0.1029)			(0.1029)	(0.6326)
Number of firms	419	419	419	419	419	419	210

Table 6: Difference-in-difference estimates

Dependent variable:	OROA	Industry-adjusted OROA
	(1)	(2)
Treatment	–0.0026	–0.0050
	(0.0155)	(0.0158)
Treatment × high sectoral dependence	0.0591**	0.0610**
	(0.0285)	(0.0286)
High sectoral dependence	–0.0071	–0.0107
	(0.0234)	(0.0235)
Number of firms	419	419

Main results

Profitability more than doubled from treatment

- Difference in OROA is 3.25 pct.-points higher in treated municipalities.
- Average profitability was 2.25% in 2005.

Elasticity of connected firm performance is

- 1.07 wrt. changes in population per politician
- 0.78 wrt. changes in expenditure per politician
- 0.81 wrt. changes in outsourcing per politician

Difference in sales increased by 39% due to treatment

- Indicate that increased profitability is partly due to higher sales
- Only significant at 10% level, and selection bias as only half of the firms chose to report sales.

Even more important for firms in sectorws depending on public-demand

- Difference in OROA i 6 pct.-points higher in treated municipalities.

Causal validation

Falsification, robustness, selection bias, matching and discontinuity

1. Municipality mergers does not affect the profitability of non-connected firms
   - Even though the transition was backed by €160 mio. for merging municipalities only.
2. No significantly diverging firm-level pre-reform trends between treated and controls
3. Selection bias due to increased electoral competition in merging municipalities0
   - Bias could either be postive or negative as tougher competition could lead to re-elected politicians being of higher-quality or more reliant on economic support from firms.
   - Include aggregate party vote and share of politicians older than 65 years in pre-reform municipalities as indicators of toughness of competition.
4. Using sharp RDD
   - Comparing municipalities barely above and below the 20,000 inhabitans threshold.
   - Thus, results not affected by declining economic or demographic trends.

Heterogeneous effects

Sample split results show

1. Firms benefit more from being connected to stronger politicians.
2. Firms that benefit from political connections are characterized by
   - Being small firms, making little profit pre-reform.
   - Indicate that rent extraction does not increase overall welfare.

Strength and persistence of political institutions matter

1. A smaller effect of treatment in municipalities where electoral competition increased more.
2. Reduced ability to extract rent for connected firms in municipalities with strong institutions.
   - Former 'market towns' (Købstader) which as early as the medieval age received special privileges to self-administrate has persistently improved institutional quality.

Conclusion

Main takeaway

Family ties with politicians $\rightarrow$ more business with local government.

- Increase in political power highly improves performance of connected firms
  - A 100% increase in population per politician $\rightarrow$ 107% increase in firm's profitability.
- Greater effect for firms in industries that depend more on public demand.
- Tough electoral competition and strong institutions can reduce the effect.

The public sector is not perceived to be corrupt before nor after the reform.

- Could be because the individual cases are small in economical relevance? As indicated by Peña Miguel and Cuadrado-Ballesteros (2018).

References

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