

The Rise of a Network:  
Spillover of Political Patronage and Cronyism to the Private Sector

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- Abuse of political power for patronage appointments is ubiquitous around the world
- Concentrates control over government resources with individuals from selected group
  - Facilitates rent transfers to cronies at high costs to society (e.g., Khwaja, Mian 2005)
- Cronyism also affects resource allocation in private markets (Haselmann et al. 2019)
- Literature treats distortions in resource allocation in government and private markets as independent sources of inefficiencies
- We document that they are linked in a way that drastically increases efficiency costs
- Specifically, following a presidential election in Korea, members of the new president's networks gain control over government *and private* banks
  - and use this power to allocate more credit at a lower rate to firms run by fellow network members (in-group firms)

## Main Insights

- Firms with links to a powerful politicians' networks gain better access to resources allocated by the government *and* in private markets
- In a simple financing and investment model we illustrate that this drastically amplifies allocative inefficiencies
- Intuitively,
  - if a group of firms receives cheaper credit from government banks only, they overinvest inefficiently but out-group firms sustain unbiased access to capital from private banks
  - if all banks provide cheaper credit to in-group firms they can invest in even less efficient projects, whereas out-group firms' lack of access to capital forces them to forego highly profitable projects
- Implications:
  - Allocative distortions and efficiency costs due to patronage and cronyism larger than previously thought
  - Privatization is not a panacea to project resource allocation from influences of access to political power

- Difficult to identify preferential access to private bank credit for politically connected firms as a separate channel
- Firms with links to politicians' networks may benefit in myriad ways:
  - Better access to government resources
  - Government bailouts
  - Laxer regulations
  - Alignment of policy preferences
- This could make them safer borrowers from banks' perspective:
  - Higher supply of private bank credit at a lower rate

- Election of Lee Myung Bak as Korean President in 2007
- Links to the new president's alumni network:
  - CEOs that obtained their undergraduate degree from Korea University
- A firm is connected to the president's network if its CEO is member of the network in the year of his election (2007)
  - Alternative definitions in robustness tests

# “Parachute” Appointments under the MB’s Administration

## ● **Ministers and Chief Political Advisers:**

- Share of ministers from **Korea University** increased by 13.68%, share of senior secretaries in Blue House from **Korea University** increased by 55.78%.

## ● **Prosecutors:**

- Kyunghang Shinmun, Oct. 4, 2011: Senior executives in the public prosecutors office during MB administration have shown a tendency to be promoted if they graduated from **Korea University** or are from Taegu & Kyeongbuk regions. According to the Department of Justices report that shows the present conditions of promotions, 17.6% of chief prosecutors who have been promoted for the last 4 years have graduated from **Korea University**. This is about twice the rate during President Roh Moo-hyuns administration.

## ● **Public Officers:**

- Hankyoreh, Oct. 6, 2011: Congress Land, Transport and Maritime Affairs Committee governs 20 public companies, and 70.5% of the non-executive directors at these companies had been identified as being pro-MB, had endorsed the Hannara Party, had graduated from **Korea University**, or were from Yeongnam.

## ● **National Intelligence Service, Police, National Tax Service:**

- Media Today, Feb. 21, 2012: JoongAng Daily also reported that most of 76 officers who were appointed in the 4 major authority institutions National Intelligence Service, prosecution, police, National Tax Service are from Yeongnam region or **Korea University**. All institutions generally increased the number of officers who are from Yeongnam region or graduated from **Korea University** as time passed. The newspaper also pointed out that it is an unprecedented event that three Seoul Central District Prosecutors in a row are from **Korea University**.

- **DongA.com, Dec. 27, 2010: Some advisers even hold the theory of inevitability of parachute appointments, arguing that 1) it is a practice that has been done by past administrations, 2) realistically, the administration has to repay the people who have helped the president during the election and 3) the administration has to secure allies during the next presidential election.**

# Executive and Board Member Appointments in Private Banks

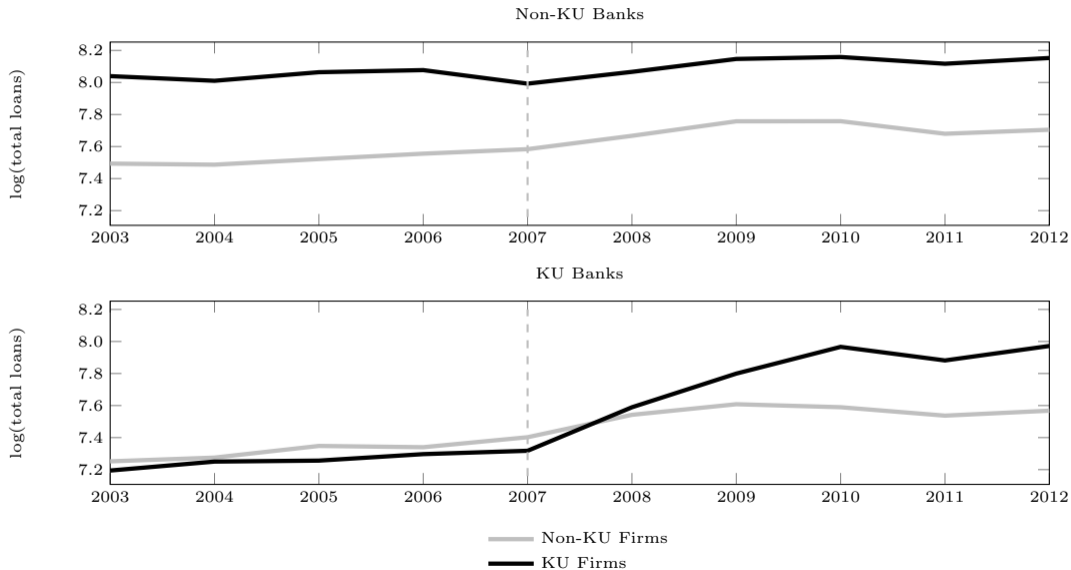
- Yonhap News, Jun. 2, 2011: 53 people with MB ties (presidential transition team, **Korea University**, Somang Church) were appointed in the financial sector as chairmen, board members, external directors, etc.
- Kyunghang Business, Jul. 18, 2010: In the non-governmental financial sector, numerous MB figures with **Korea University**, presidential campaign, and presidential transition team ties have been appointed. In fact, 3 out of 4 CEOs of major financial share holding companies (KB, Hana, and Woori) in Korea have all graduated from **Korea University**.
- eDaily, Mar. 20, 2012: Since the very beginning of his term as President, there has been controversy surrounding appointments to key government posts in particular, the administration established very strong ties with alumni of **Korea University**, Christians who go to Somang Church, and those from the Yeongnam region. These biased appointments were not just restricted to government roles, however. For example, the financial sector was heavily influenced by the MB administrations preference for **Korea University**, Somang Church, and Yeongnam personnel. In its analysis, E Daily News found evidence of a major transformation in the power structure among managers of major banks since 08.
- Sedaily, May. 14, 2012: As the current administrations poor performance was publicized through the investigation of major firms, it was also discovered that 73 out of 207 non-executive directors who were appointed during 4 years and 3 months of MB administration are MB figures or from the MB administration.
- **In our data of the 15 private banks in Korea, the number of banks with executives and board members from KU increased from 2 to 8 after the election.**

$$\log(\text{loans})_{it} = \alpha_i + \alpha_t + \beta \cdot \text{KU}_i * \text{election}_t + \epsilon_{it}$$

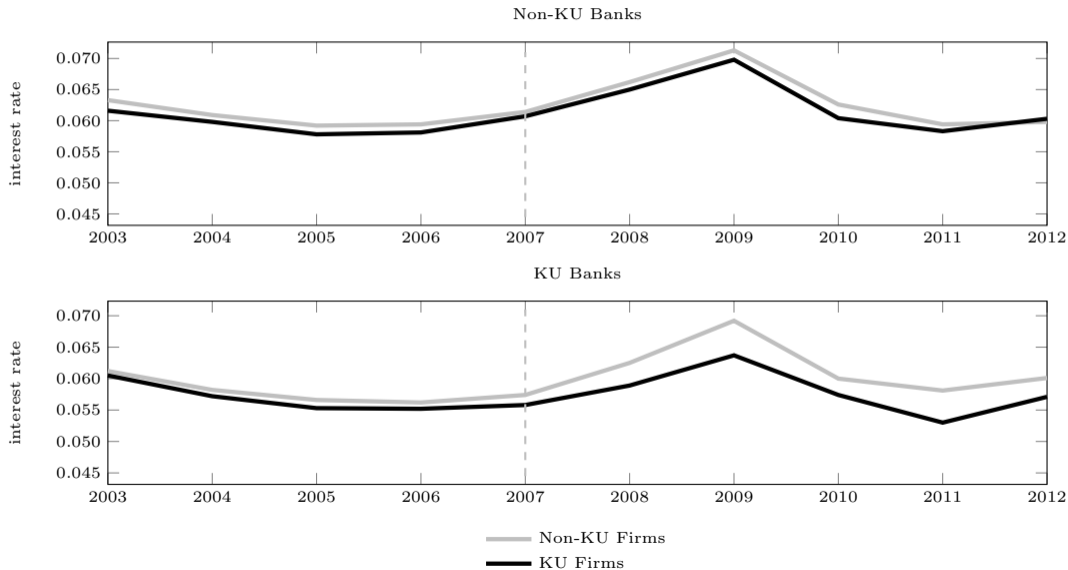
	I	II	III
Dep. Var.:	$\log(\text{loans})_{it}$	$(\frac{\text{loans}}{\text{assets}})_{it}$	$\text{IR}_{it}$
$\text{KU}_i * \text{election}_t$	0.2978** (0.1297)	0.0286* (0.0168)	-0.0018** (0.0008)
Observations	33,516	31,205	32,993
R-squared	0.716	0.706	0.755



# Changes in Credit - Relationship Level



# Changes in Interest Rates - Relationship Level



# Credit Allocation and Interest Rates - Relationship Level

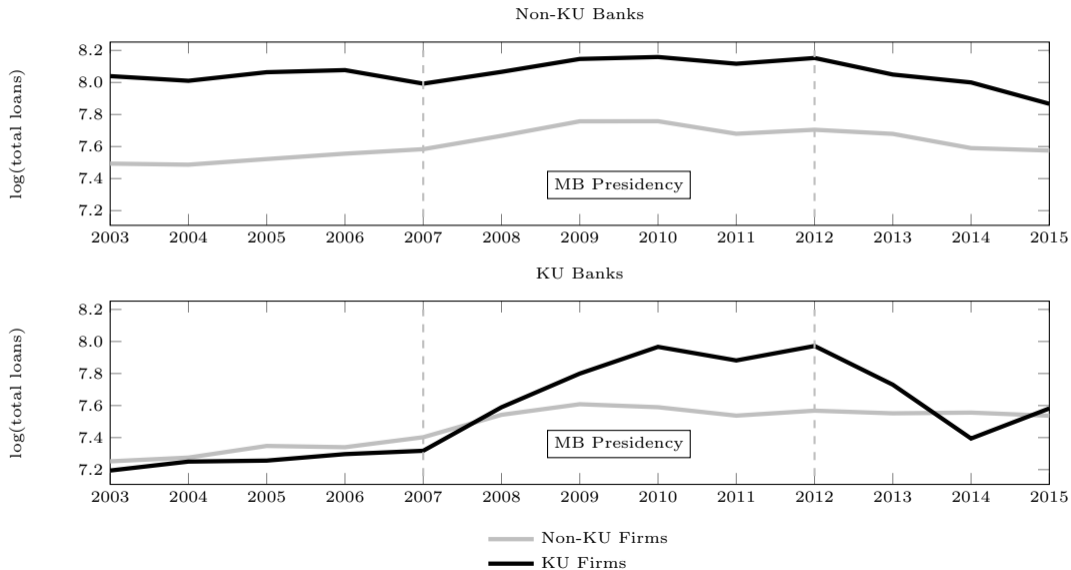
$$\log(\text{loans})_{ijt} = \alpha_{it} + \alpha_{jt} + \beta \cdot \text{KU}_i * \text{KU}_j * \text{election}_t + \delta \cdot \text{con}_{ijt} + \epsilon_{ijt}$$

	I	II	III	IV
Dep. Var.:	$\log(\text{loans})_{ijt}$	$\left(\frac{\text{loans}}{\text{assets}}\right)_{ijt}$	$\text{IR}_{ijt}$	$\text{rel}_{ijt}$
$\text{KU}_i * \text{KU}_j * \text{election}_t$	0.8044*** (0.2047)	0.0656*** (0.0188)	-0.0038*** (0.0012)	0.1430** (0.0682)
$\text{alum link}_{ijt}$	0.4405*** (0.1116)	0.0309** (0.0155)	-0.0041*** (0.0011)	0.1470*** (0.0447)
Firm FE	yes	yes	yes	yes
Bank FE	yes	yes	yes	yes
Clustered SE	firm	firm	firm	firm
Observations	61,618	58,123	60,105	61,618
R-squared	0.944	0.958	0.944	0.934

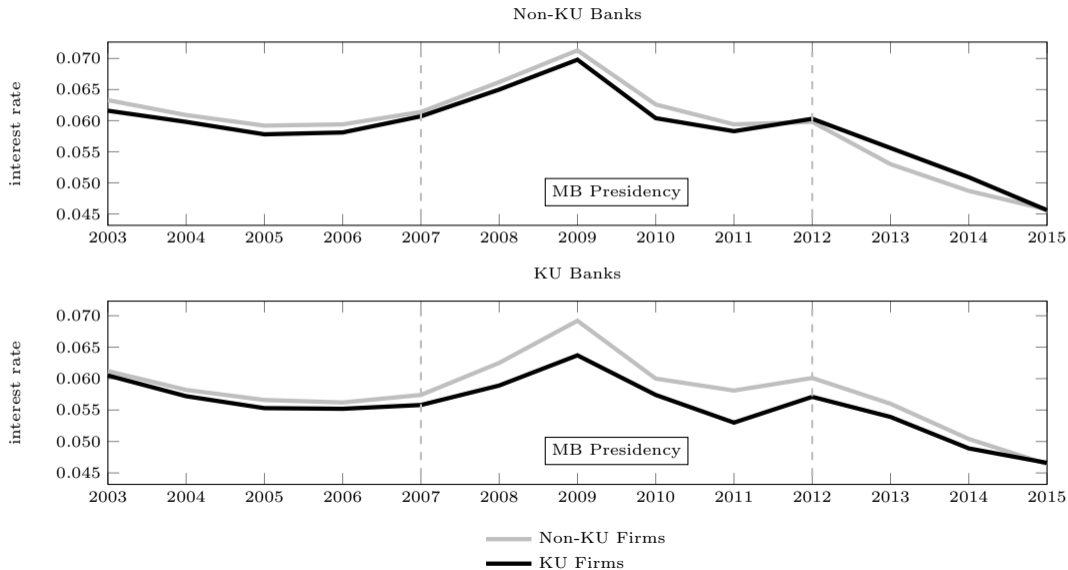
# Departure of Korea University Executives from Private Banks after 2012

- Kyunghang Shinmun, Feb. 20, 2013: Kim Seung-yu [entered **Korea University** Finance major in same year as MB], board chairman of Smile Credit, has resigned, leaving one year in his term after resigning from the chairman position of Hana Financial Group. Because the board chairman position of Smile Credit is appointed by the president, he said, I thought it was reasonable to resign after the new president has been elected. With strong ties to President Lee, Board Chairman Kim has been considered one of the major 4 leaders of financial sector, along with Uh Yoon-dae [**Korea University** alumni], chairman of KB Financial Group, Lee Pal-sung [**Korea University** alumni], chairman of Woori Financial Group and Kang Man-su [First Minister of Strategy and Finance under MB], chairman of Saneun Financial Group.
- Newspim, Apr. 1, 2013: As the major leaders from financial sector who took office during MB administration are resigning without finishing their terms, the public is predicting that stock firms CEOs will follow. The leaders of public corporations affiliated with the stock market are also considered to be in the list of resignation. Chairmen of major financial groups that showed major ties to President Lee are resigning. While Saneun Financial Group has already chosen Hong Gi-taek as the next chairman following ex-Chairman Kang Man-su, KB and Woori financial groups are on their processes to choose their next leaders.
- **In our data of the 15 largest private banks, the number of banks with executives and board members from KU decreases from 8 to 3 after the election.**

# Changes in Credit - Relationship Level



# Changes in Interest Rates - Relationship Level



- Two banks were already linked to the KU network before the election
- Allows us to differentiate between links to bank executives and direct influence from administration
  - If the effects are driven by links to bank executives [unchanged after election], we expect no change
  - If the effects are driven by direct political influence [changed after election], we expect to see changes

# Credit Allocation and Interest Rates - Pre-Connected Banks

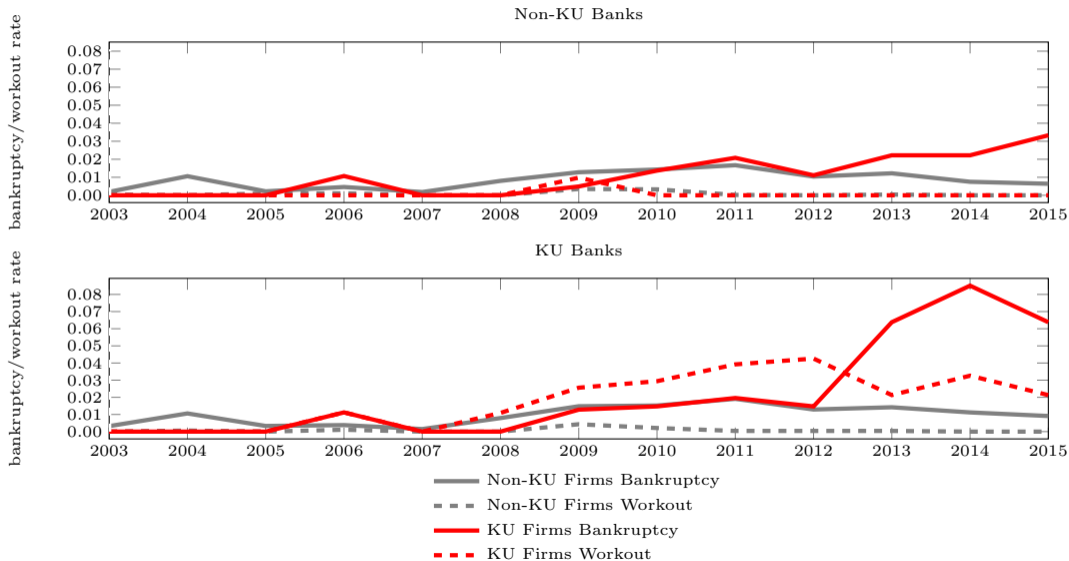
$$\log(\text{loans})_{ijt} = \alpha_{it} + \alpha_{jt} + \beta \cdot \text{KU}_i * \text{KU}_{j,\text{pre}} + \epsilon_{ijt}$$

	I	II	III	IV	V	VI
Dep. Var.:	$\log(\text{loans})_{ijt}$			$\text{IR}_{ijt}$		
	pre	post		pre	post	
$\text{KU}_i * \text{KU}_j^{\text{pre}}$	0.3325** (0.1576)	0.3795* (0.2254)		-0.0028** (0.0013)	-0.0034** (0.0017)	
$\text{KU}_i * \text{KU}_j^{\text{pre}} * \text{election}_t$			-0.0946 (0.1866)			-0.0013 (0.0016)
Firm-Time FE	yes	yes	yes	yes	yes	yes
Bank-Time FE	yes	yes	yes	yes	yes	yes
Firm-Bank FE	no	no	yes	no	no	yes
Clustered SE	firm	firm	firm	firm	firm	firm
Observations	26,146	23,382	49,528	25,732	22,604	48,336
R-squared	0.756	0.809	0.956	0.782	0.845	0.957



- Findings: In-group banks lend more to in-group firms at a lower rate
- Consistent with different mechanisms:
  - Better information (screening effect)
  - Better enforcement (monitoring effect)
  - Taste-based discrimination
- Strategy to assess alternative mechanisms:
  - Examine presence of information channel through distribution of credit and interest rates
    - Better information implies more dispersion
    - We find no evidence of this in the data
  - Examine enforcement channel through loan outcomes (defaults)
  - Examine the usage of funds

# Bankruptcy Filings and Workouts



## Return on Connected Loans

- Simple metric to compute return on loans
  - $\text{RoL} = P[\text{def}] * \text{rec}_B + P[\text{reneg}] * \text{rec}_W + (1 - P[\text{def}] - P[\text{reneg}]) * \text{IR}$
- Plug in values for 2008 to 2015 from data:
  - KU firms:  
 $\text{RoL}_{\text{in-network}} = (1 - 0.0340 - 0.0291) * 1.0582 + 0.0340 * \text{rec}_B + 0.0291 * \text{rec}_W - 1$
  - non-KU firms:  
 $\text{RoL}_{\text{out-network}} = (1 - 0.0131 - 0.0010) * 1.0613 + 0.0131 * \text{rec}_B + 0.0010 * \text{rec}_W - 1$
  - Risk-free rate: 0.0408
- Assuming  $\text{rec}_W = 1$ , and  $\text{rec}_B$  is zero for non-KU firms, recovery rates for KU loans need to be 0.79 for the RoL to be equal for KU and non-KU loans
- Assuming  $\text{rec}_W = 1$ , recovery rates for KU loans need to be 0.56 for their return to equal the risk-free rate
- Average recovery rates in bankruptcy cases are below 0.2

## Alternative Explanations

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- Renegotiation frictions
  - Inconsistent with high default rates
  - Requires implausible assumptions on recovery rates
- No funding constraints
  - Return on connected loans lower than risk-free rate for plausible recovery rates
- Unobservable costs (e.g., search costs)
  - Inconsistent with below risk-free rate returns
- Cross-selling
- Endogenous Executive Appointments
  - Firm executives from 2003
  - Inconsistent with below risk-free rate returns

$$\log(\text{loans})_{it} = \alpha_i + \alpha_t + \beta \cdot \text{KU}_i * \text{election}_t + \epsilon_{it}$$

	I	II	III
Dep. Var.:	$\log(\text{loans})_{it}$	$(\frac{\text{loans}}{\text{assets}})_{it}$	$\text{IR}_{it}$
$\text{KU}_i * \text{election}_t$	0.2426* (0.1416)	0.0307 (0.0188)	-0.0018* (0.0010)
Time FE	yes	yes	yes
Firm FE	yes	yes	yes
Clustered SE	firm	firm	firm
Observations	28,614	26,108	28,676
R-squared	0.737	0.691	0.783

- Cost of capital in the economy is  $f$ , firms have a project with return  $r$ , bank lending can be biased, reducing borrowing costs of in-group firms by  $\gamma_I$  and increasing borrowing costs of out-group firms by  $\gamma_O$
- No lending biases:
  - Invest if  $r \geq f$
- Government bank biased:
  - In-group firms: Invest if  $r \geq f - \bar{I}/I * \gamma_I$
  - Out-group firms: Invest if  $r \geq f + (I - \bar{I})/I * \gamma_O$
- All banks biased:
  - In-group firms: Invest if  $r \geq f - \gamma_I$
  - Out-group firms: Invest if  $r \geq f + \gamma_O$
- Government banks biased toward in-group firms, private banks toward out-group firms:
  - In-group firms: Invest if  $r \geq f - \bar{I}/I * \gamma_I + (I - \bar{I})/I * \gamma_O$
  - Out-group firms: Invest if  $r \geq f - \bar{I}/I * \gamma_I + (I - \bar{I})/I * \gamma_O$

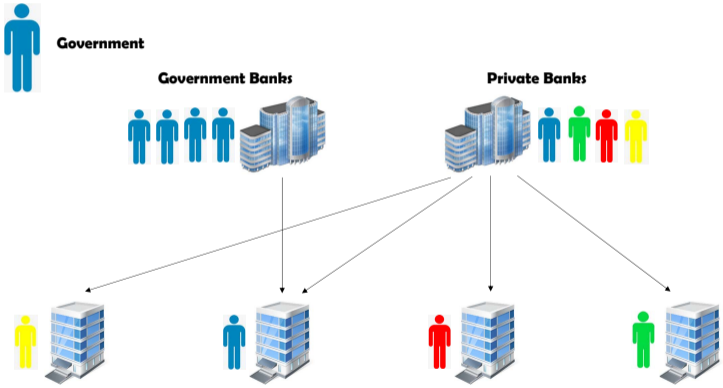
$$\log(\text{capex})_{it} = \alpha_i + \alpha_t + \beta \cdot \text{KU}_i * \text{election}_t + \epsilon_{it}$$

	I	II	III
Dep. Var.:	$\log(\text{capex})_{it}$	$\log(\text{assets})_{it}$	$\text{ROA}_{it}$
$\text{KU}_i * \text{election}_t$	0.2050** (0.1032)	0.0842** (0.0382)	-0.0116** (0.0048)
Time FE	yes	yes	yes
Firm FE	yes	yes	yes
Clustered SE	firm	firm	firm
Observations	30,840	31,205	31,205
R-squared	0.749	0.938	0.583

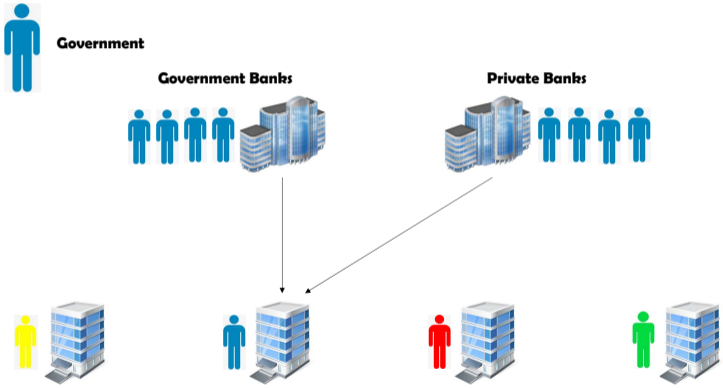
- ① Control over resource allocation in private markets:
  - Executive power of president/politicians to appoint people in important positions is widespread (Xu 2018, Colonelli, Teso, Prem 2018)
    - US: 353 appointments without senate approval, 1212 with senate approval (2016)
    - Similar powers in other countries
  - Incentive of private firms to hire politically connected individuals
    - Evidence from lobbyists [Bertrand, Bombardini, Trebbi 2014] - it matters who you know, not what you know
    - Revolving door hiring by firms and lobby groups [Blanes i Vidal, Draca, Fons-Rosen 2012]
- ② Different types of groups:
  - Race, ethnicity, gender, faith, etc.
- ③ Networks as conduits for favoritism:
  - US: Cohen, Frazzini, Malloy (2008)
  - Germany: Haselmann, Schoenherr, Vig (2018)



# Main Takeaways



# Main Takeaways



- Spillover of patronage and cronyism to private markets
- Firms linked to groups with access to political power benefit from better access to resources in government and private markets
- Magnifying allocative distortions and efficiency costs