Corruption is Expensive, But Who Pays the Bills?

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One often must look no further than today's headlines to find examples of personal failure, corporate financial woes and political corruption. But how does political integrity affect the bottom line? A University of Missouri researcher has found that state corruption and political connections have strong effects on the economy and that higher state corruption is associated with greater credit risk, higher bond yields, increased use of external credit enhancements (such as bond insurance) and the utilization of lower quality underwriters.

"Corruption is expensive," said Sandra Mortal, assistant professor of finance in MU's Robert J. Trulaske, Sr. College of Business. "Corruption affects the cost of finance. To avoid or decrease the effects of corruption, issuers are paying for credit enhancement, such as bond insurance. Who's paying for the higher yields and the underwriter's fees? It may eventually be the taxpayer."

The study supports the bulk of theory and evidence that indicate corruption is costly because it impedes transactions, hinders trade and retards financial and economic growth and development. Mortal's research examined how political integrity, and lack thereof, affects the interactions among governments, financial intermediaries and financial markets—specifically how corruption and political connections affect primary security market transactions and the issuance of municipal bonds.

In the study, researchers measured corruption using actual per-capita federal corruption convictions and the amount of municipal bond underwriting that involved “pay-to-play.” Pay-to-play is a practice whereby investment banks seek to win underwriting business by making campaign contributions to legislators who are involved in the process of selecting underwriters for municipal bonds.

Mortal found that less corruption is associated with better bond ratings, corrupt states pay significantly higher yields on municipal securities and issuers in corrupt states use lower quality underwriters. She also found that the issuers in corrupt states were more likely to use bond insurance to improve credit ratings and reduce yields.

“Our findings should be of interest to financial economists because we show issuers can outsource corruption-induced default risk to institutions that provide credit enhancement,” Mortal said. “Our findings also should be of interest to development economists because we identify a way to mitigate the damaging effects of corruption even if or when corruption itself cannot be completely eliminated.”

Mortal, with researchers Alex Butler (University of Texas at Dallas) and Larry Fauver (University of Tennessee), presented the paper “Corruption, Political Connections and Municipal Finance” at the 2008 American Finance Association meeting in New Orleans. The paper also was named “Best Paper in Fixed Income Research” by the Financial Management Association.

Source: University of Missouri