State-level public corruption affects firm value, transparency: study

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State-level public corruption in the United States affects firms' value and disclosure policies, according to a new study from The University of Texas at Dallas.

Dr. Steven Xiao, assistant professor of finance, and Dr. Vikram Nanda, O.P. Jindal Distinguished Chair in Finance, studied state-level corruption in the U.S. and its effect on publicly listed firms.

The study, published in the *Review of Corporate Finance Studies*, found that firms have significantly lower value and informational transparency when located in areas that are more corrupt.

Using the Department of Justice's data on corruption-related convictions of public officials, the researchers found that from 1990 to 2011, firm value was substantially lower in more corrupt states and federal districts.

"We found that even if you compare neighboring counties on different sides of a state border, firms on the more corrupt side of the state have a lower firm value compared to firms on the other side," Xiao said. "The main differences are driven by the political environment."

The study also determined that local corruption has a less negative effect on industries that sell primarily to the government, suggesting a quid pro quo relationship in which firms pay bribes to public officials with the understanding that they will benefit in some way.

"It's surprising in the way that most people won't argue that public corruption plays a very significant role in the economy," Xiao said. "In the U.S., we tend to believe we have a strong institution in place."

Despite the high quality of legal and political institutions in the U.S., corruption can result in these firms becoming informationally opaque. The study found that in more corrupt areas of the U.S., firms provide less frequent managerial guidance on earnings, have lower financial reporting quality, and their stocks are less liquid.

"Transparency is an important factor for firm value for public firms," Xiao said. "If you are an investor, you feel more comfortable if you know more about the company—you're more willing to invest."

The researchers also examined market reaction to news of public corruption.

For example, Jack Abramoff's illegal lobbying conviction in 2006 generated a great deal of media coverage at the time, Xiao said, and the stock market reacted.

"We see that firms located in areas of corruption have a greater drop in stock prices in response to the news, and we believe this is because of the media coverage of the scandal and the public scrutiny," Xiao said.

In their follow-up study, the researchers are investigating whether public corruption is symptomatic of a local "culture" in which corruption is endemic in both public and private spheres. They hope to provide more of a complete picture of the role corruption plays in the U.S. and how it affects the overall economy.

Dr. Nishant Dass of the Georgia Institute of Technology is a co-author of the paper.

More information: Nishant Dass et al. Public Corruption in the United States: Implications for Local Firms, *Review of Corporate Finance Studies* (2016). DOI: 10.1093/rcfs/cfv016

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