Even in competitive markets, shareholders bear burden of corruption

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While the U.S. traditionally ranks low on worldwide corruption indices, domestic political corruption still imposes substantial costs on U.S. shareholders, according to new research co-written by Gies College of Business accounting professor Nerissa Brown. Credit: L. Brian Stauffer

A new paper co-written by a University of Illinois expert in the use of financial information in capital markets examines the relationship between political corruption and firm value in the U.S., and what prevailing forces potentially constrain or exacerbate the effects of corruption.

While the U.S. traditionally ranks low on worldwide corruption indices, domestic political corruption still imposes substantial costs on U.S. shareholders—but the relationship between political corruption and firm value can be moderated by several firm- and government-level factors and monitoring mechanisms, the authors report.

Nerissa Brown, a professor of accountancy at the Gies College of Business, and her colleagues at other institutions found that low-profit firms in competitive environments are particularly vulnerable when operating in corrupt areas.

Using Department of Justice corruption convictions data from 1996-2013 and a sample of U.S. firms, Brown and her co-authors found that the consequences of political corruption are exacerbated for firms operating in competitive product markets and mitigated for firms that are subject to external monitoring by state governments or monitoring induced by disclosure transparency.

"We know that corruption has a negative effect on firm value. It's a deadweight tax on firm value," said Brown, who also is a PricewaterhouseCoopers Faculty Fellow. "One key factor that exacerbates this negative effect is when firms operate in highly competitive industries. In such industries, the profit margins or economic rents that a firm earns are much lower because competition drives those margins down. If low-profit firms face corruption on top of that, they already have a small piece of the profit pie—and that slice will surely be smaller if they have to grease the palms of rent-seeking public officials."

While prior studies have looked at how corruption influences firm performance, "a lot of that research has been done on a global, cross-country basis," Brown said.

"There are well-known corruption indices that rank countries from most corrupt to least corrupt, and several studies examine how gross domestic product, foreign direct investment, and other country-level measures of growth vary with corruption. The U.S. typically ranks as a low corruption country, so the interesting thing we're able to show given our data is the variation in corruption across the states within the U.S. That was a very difficult thing to capture in prior U.S.-based studies, because corruption by its very nature is unobservable and hidden until exposed."

The results should inform managers and policymakers of the tradeoffs imposed on firms operating in areas of the U.S. that rank higher on the corruption scale, Brown said.

"The data that we use isn't perfect, but we can observe within a given geographic district court boundary the number of public officials that have been federally convicted of crimes that are of a political nature," Brown said. "And so the interesting result we show in this paper is that, when you peer inside district court boundaries, there are huge variations in corruption rates across the U.S. There are even huge variations within the same state."

Further analysis in the paper suggests that corruption is particularly harmful to shareholder value when state governments are controlled by a single party, consistent with the notion that interparty competition deters corruption, Brown said.

"State governments with split party control serve as a monitoring mechanism in that one party is closely watching the other party," Brown said. "If there are corrupt officials in either party who might have some proclivity to extract cash from firms operating in the area, having another party to shine a light on their activities functions as a check. It seems to tamp down the level of corruption, which then reduces the negative firm value effects that we show."

If you're a start-up and you're thinking about where to locate, "then the corruption culture is something you ought to take into consideration," Brown said. "This is no different from a multinational corporation that should assess a country's corruption culture before entering the market."

"Which states or areas would you be more likely to flourish in without having to deal with corrupting influences or corrupt officials? Know that if you do choose to operate or locate in those areas, then there needs to be greater vigilance over the effectiveness of internal control and compliance procedures that are put in place."

Being transparent to outside investors and other external parties is also important for companies, Brown said.

"We find that the costs of corruption are lower for firms that voluntarily disclose more information. Investors, financial regulators and the business press are key monitors or watchdogs for corrupt activities, and transparency facilitates these monitoring mechanisms. As they say, 'Sunlight is the best disinfectant.'"

More information: Nerissa C. Brown et al, Political Corruption and Firm Value in the U.S.: Do Rents and Monitoring Matter?, *Journal of Business Ethics* (2019). DOI: 10.1007/s10551-019-04181-0

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