How the Value of Political Connections Vary around the World: Firm-level Connectedness, Domestic Economic-Institutions, and the Cost of Capital in Competitive Financial Markets

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Abstract
This paper investigates the role firm-level political-connections and domestic economic-institutions play in determining a firm’s cost of capital around the world. Its empirical analysis is motivated by the construction of a simple theoretical model in which a price-taking, profit-maximizing firm faces varying political- and institutional- conditions. The model hypothesizes (1) that operating in an environment with higher quality property rights and contracting institutions reduces the cost at which firms can raise capital; and, (2) that the value of political connections is proportional to the quality of property rights institutions, such that they are worth the most in countries with the least secure property rights. The paper uses the structure and assumptions of the simple model to devise an identification strategy for the value of political connections in different contexts and applies that strategy to guide the analysis of an innovative multi-level dataset. That dataset contains information spanning 46 countries (of varying institutional quality), in which 12,395 firms belong to a wide range of industries, and have different political statuses (among other corporate financing characteristics) that influence their global financing (cross-listing) behavior. The model predicts and the empirics confirm that in a country with low quality property rights institutions, like the Philippines, a firm with strong political connections may earn a cost of capital reduction of as much as 26% compared to an equivalent firm without any political connections. This compares to 10% in a country with moderately secure property rights like Israel or close to 0% in a country with highly secure property rights like Switzerland.

Keywords: Property Rights, Contracting, Political Connections, Corporate Finance, Cross-listing, Cost of Capital, Economic Institutions, Political Economy, Development

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