

**The Value of Political Connections:
Evidence from Korean Chaebols**

Myung Sub, Choi

Bachelor of Business in Finance, *Queensland University of Technology*

Submitted in partial fulfilment of the requirements for the degree of
Master of Business (Research)

The School of Economics and Finance
Faculty of Business
Queensland University of Technology
Brisbane, Australia

March 2014

Keywords

- Political Connections
- Politically Connected Firm
- Politically Connected Business Group
- Spill Over Effect
- Business Group
- Chaebol
- Family Networks
- Korea

Abbreviations

CAR	Cumulative Abnormal Return
FISL	Financial Industry Structure Law
KIS	Korea Investor Service
KOSDAQ	Korea Securities Dealers Automated Quotation
KOSPI	Korea Composite Stock Price Index
KSE	Korea Stock Exchange
KFTC	Korea Fair Trade Commission

Abstract

This thesis examines the value of political connections for business groups by constructing a unique dataset that allows us to identify the form and extent of the connections. Results show firms' membership to family-controlled business groups (South Korean chaebol) play a key role in determining the value of political connections. Politically connected chaebol experience substantial price increases following the establishment of the connection than other firms, but the reverse is found for other (non-family-controlled) connected business groups. The results are robust when we define political connection at the business group level, suggesting that there is a spill over in the value of connections from the connected firms to other affiliate members in the same business group. Political connections established through marital networks and to powerful politicians are most valuable.

Table of Contents

Keywords	ii
Abbreviations	iii
Abstract	iv
List of Tables	vii
List of Figures	viii
List of Appendices	ix
Statement of Original Authorship	x
Acknowledgement	xi
Chapter 1 Introduction	1
1.1 Background and Motivation	1
1.2 Research Aims and Questions	5
1.3 Findings and Contributions	8
1.4 Thesis Layout	10
Chapter 2 Literature Review	11
2.1 Introduction	11
2.2 Definition of Political Connection	12
2.3 Benefits and Costs of Political Connections	15
2.4 Stock Market Reaction to Political Connections	21
2.5 Summary and Conclusion	26
Chapter 3 The Institutional Setting	29
3.1 Introduction	29
3.2 The Political System in Korea	29
3.3 Business Groups in Korea	31
3.4 Chapter Summary	37
Chapter 4 Hypotheses	38
4.1 Introduction	38
4.2 Hypotheses	39
4.3 Chapter Summary	49
Chapter 5 Data and Research Method	50
5.1 Introduction	50
5.2 Measuring Connections with Chaebols and Politicians	50

5.3	Research Method.....	63
5.4	Control Variables	70
5.5	Descriptive Statistics	71
5.6	Chapter Summary.....	76
Chapter 6 Empirical Results		78
6.1	Introduction	78
6.2	Univariate Results	78
6.3	Multivariate Results	86
6.4	Summary and Conclusion	98
Chapter 7 Conclusion.....		99
References.....		102
Appendices.....		108

List of Tables

Table 3.1:	List of Presidents and National Assembly of Korea.....	30
Table 5.1:	An Example of Political Connections in Business Groups.....	54
Table 5.2:	Political Connections in Hyosung Group and Hankook Tire group.....	55
Table 5.3:	Top 30 Large Business Groups Ranked by KFTC in 2008.....	58
Table 5.4:	Classification of Political Connections.....	60
Table 5.5:	Variables for Political Connections.....	62
Table 5.6:	Sample Composition based on Event Date.....	66
Table 5.7:	Skewness/Kurtosis Tests for Normality of Average CAR (-10, +10).....	69
Table 5.8:	Descriptive Statistics.....	75
Table 6.1:	Cumulative Abnormal Returns (CARs) around the Establishment of Firm-Level Political Connections.....	82
Table 6.2:	Cumulative Abnormal Returns (CARs) around the Establishment of Business Group-Level Political Connections.....	84
Table 6.3:	Cumulative Abnormal Returns (CARs) around the Establishment of Firm-Level Political Connections for Each Political Event.....	86
Table 6.4:	Regressions of CARs around the Establishment of Firm-Level Political Connections.....	88
Table 6.5:	Regressions of CARs around the Establishment of Business Group-Level Political Connections.....	92
Table 6.6:	GLS Regressions of CARs around the Establishment of Political Connections.....	94
Table 6.7:	Regressions of CARs around the Establishment of Firm-Level Political Connections: Types of Connections.....	96

List of Figures

Figure 5.1:	Types of Relatives based on KFTC's Classification.....	53
Figure 5.2:	A Family to Family Connection.....	55
Figure 6.1:	Mean Cumulative Abnormal Returns (CARs) around the Establishment of Firm-Level Political Connections.....	80
Figure 6.2:	Mean Cumulative Abnormal Returns (CARs) around the Establishment of Business Group-Level Political Connections.....	80

List of Appendices

Appendix 1: Data Source for the Identification of Political Connection.....	109
Appendix 3: Pair-wise Correlations between the Dependent Variable and Independent Variables.....	111
Appendix 3: Cumulative Abnormal Returns (CARs) around the Establishment of Firm-Level Political Connections for Each Industry.....	113

Statement of Original Authorship

The work contained in this thesis has not been previously submitted to meet requirements for an award at this or any other higher education institution. To the best of my knowledge and belief, the thesis contains no material previously published or written by another person except where due reference is made.

QUT Verified Signature

Signature

Date

19 / 03 / 2014

Acknowledgement

First and foremost, I especially wish to express my deep gratitude to my principal supervisor, Professor Janice How, who has suggested this project to me and remained intellectually engaged with it right to the end. This thesis would have never been produced without her continuous help and support. I am also very grateful to my associate supervisor, Associate Professor Peter Verhoeven, for his invaluable advice and insights on this research.

I would like to express my love and gratitude to my family: my father, mother, and sister. As always, my family never fails to provide all sorts of tangible and intangible support. I also want to take this opportunity to thank a number of friends who have given me kind encouragement over the period of my study.

A special thank you goes to Dr. Jonathan Bader and my QUT for their constructive criticism on my work at the weekly peer review academic writing workshop. In particular, I wish to record my appreciation to Dr. Junesung Park of Curtin Business School, who has provided helpful advice and discussions. My appreciation also goes to PhD. candidate Sangmo Koo at Yonsei University and Byeongung An for their help in constructing the data for this thesis.

Work on this research has been supported by Queensland University of Technology. I am indebted to QUT Business School for granting the award of a Faculty of Business Scholarship during the period of my research.

Finally, I send my sincere gratitude to my beloved grandmother who passed away during the course of my study. I strongly believe that she would be so happy and proud if she saw this achievement.

Chapter 1

Introduction

1.1 Background and Motivation

Corporate political connections are prevalent worldwide (Faccio, 2006). Despite the considerable research interest on political connections, the evidence on whether the connections enhance firm value is mixed. While for some firms the political influence they seek will be bound to matters that affect the sector of the economy in which they operate, others that operate across the entire economy may seek more extensive political favors. While there are many ways in which businessmen can influence government, in this paper we deal with just one selected aspect of business-government relations – the intimate ties between controlling owners of business groups and politicians.

The literature suggests two competing hypotheses on the value of political connections: value-adding and value-destroying. Under the value-adding hypothesis, political connections create potential resources that can add value to connected firms, for example, by providing them greater access to key resources from the government (Johnson and Mitton, 2003; Khwaja and Mian, 2005; Leuz and Oberholzer-Gee, 2006; Faccio, Masulis and McConnell, 2006; Claessens, Feijen, and Laeven, 2008; Goldman, Rocholl, and So, 2013;), and lowering taxation (Faccio, 2010) and risks (Boubakri, Guedhami, Mishra, and Saffar, 2012). The value-destroying hypothesis predicts the opposite, where political connections provide the means for rent-seeking politicians to accomplish policy goals (De Soto, 1990; Morck, Stangeland, and Yeung, 2000; Bertrand, Kramarz, Schoar, and Thesmar, 2007) and to potentially expropriate outside minority shareholders (Boubakri, Guedhami, Mishra, and Saffar, 2012; Qian, Pan, and Yeung, 2011). In fact, Shleifer and Vishny (1994) indicate that politicians are willing to provide subsidies to connected firms, but not for free.

In a capital market, investors will price the benefits or costs of political connections. Using the change in political landscapes, as marked by either the establishment or the termination of political connections, cross-country and country-specific evidence shows that political connections can either add value (Roberts, 1990; Fisman, 2001; Faccio, 2006; Claessens, Feijen, and Laeven, 2008; Goldman, Rocholl and So, 2008; Faccio and Parsley, 2009) or destroy value to the connected firms (Faccio, 2006; Fan, Wong, Zhang, 2007). The net effect of political ties is determined by a tradeoff between the marginal benefits and marginal costs of the connections (Shleifer and Vishny, 1994), so that if the marginal benefits exceed the marginal costs, the political connection leads to an increase in the equity value of the connected firm, and vice versa.

We continue this line of inquiry by testing which of the above two competing hypotheses prevails in Korea. Korea has several unique characteristics that make it particularly suited to investigate the impact of political connections on stock price. First, the perceived level of corruption in Korea suggests that the value of political connections is likely to be greater than in less corrupted countries.¹In a cross-country analysis, Faccio (2006) reports that political connections are more common in countries with a high level of corruption. Faccio and Parsley (2009) find connected firms in more corrupted countries experience a larger stock price decline around the termination of political connections, indicating that connections matter more to firm value in countries with a higher level of corruption.

¹ In the 2008 edition of Corruption Perception Index by Transparency International, Korea ranked 40th with a score of 5.6 and was thus perceived to be less corrupted than the following countries where political connections have been found to matter significantly to firm value: Malaysia (Johnson and Mitton, 2003), ranked 47th with a score of 5.1; China (Fan, Wong, and Zhang, 2007), ranked 72th with a score of 3.6; Brazil (Claessens, Feijen, and Laeven, 2008), ranked 80th with a score of 3.5; Indonesia (Fisman, 2001), ranked 126th with a score of 2.6; and Pakistan (Khwaja and Mian, 2005), ranked 134th with a score of 2.5. Korea was however perceived to be more corrupted than the following countries where political connections have also been found to matter to firm value: Denmark (Amore and Bennedsen, 2012), which was ranked 1st with a score of 9.3; Canada (Morck, Stangeland, and Yeung, 2000), ranked 9th with a score of 8.7; the United States (Roberts, 1990; Goldman, Rocholl and So, 2009), ranked 18th with a score of 7.3; and France (Bertrand, Kramarz, Schoar and Thesmar, 2007), ranked 23th with a score of 6.9.

Second, large and family-controlled business groups known as chaebols are ubiquitous in Korea (Ferris, Kim, and Kitsabunnarart, 2003), accounting for 62.57% of the country's total market capitalization. One notable feature is that the ownership of chaebols is heavily concentrated in founding families who have almost complete control over all firms within the group even though the chaebols can be highly diversified (Bae, Kang, and Kim, 2002). With such an ownership structure, investors may regard all chaebol affiliates in the same group as a single entity in response to corporate events that directly affect only one member firm (Bae, Cheon, and Kang, 2008).² This ownership structure provides the opportunity to test the role of chaebols in the valuation of political connections. Our tests capitalize on this unique feature of chaebols by shedding new light on whether the effect of political connections spills over to the whole business group or is concentrated only on the individual firm that is directly affected by the connection. About 11.24% of our sample of Korean listed firms from 2007 to 2011 belongs to chaebols, all of which account for 62.57% of the country's total market capitalization.

Third, Korea has often been labelled as *crony capitalism*, together with other Asian countries like Malaysia (Kang, 2002). Evidence on *crony capitalism* suggests that dominant political leaders use their power to the advantage of their families and friends. Extant literature shows that shareholders of politically connected firms obtain benefits from their close ties to politicians (e.g., Johnson and Mitton, 2003 for Malaysia; Leuz and Oberholzer-Gee, 2006 for Indonesia). Korea is particularly well known for odious relationships between politicians and chaebol founding families. Upper class families tend to form business and/or political alliance through marriage exchanges among themselves. Through marriage of family members, chaebols have developed extensive connections with the country's inner circles and many high-

² Bae, Cheon, and Kang (2008) investigate the effect of earnings releases by a chaebol affiliate on the share price of other member firms in the same group. They find that the announcement of an increase in earnings by a chaebol firm has a positive effect on the abnormal returns for other affiliates within the same group. The abnormal returns for the announcing affiliates are also positively associated with those for non-announcing affiliates.

ranking politicians (Kim, 2007). The Monopoly Regulation Fair Trade Act requires Korean firms to report the status of affiliate shareholders including family owners and their relatives. This regulatory system allows us to construct a unique database which identifies the family networks between politicians and chaebol founding families.

The specific relationship between politicians and chaebols is best exemplified using the recent government where President Lee Myung bak (2008-2012) is connected to six chaebols through the following family networks. The Hyosung group (ranked the 33rd largest business group in 2008) is connected through the marriage between Lee's daughter and a member of the controlling family of the Hyosung group. Through the marriage of Lee's niece, Lee is connected to the LG group (ranked the 5th largest business group in 2008) and the LS group (ranked the 24th largest business group in 2008). Lee is also connected to The Hyundai Motor group (ranked the 3rd largest business group in 2008) and the Hyundai Department group (ranked the 37th largest business group in 2008) where he previously held directorship. Finally, the Kolon Group (ranked the 40th largest business group in 2008) is connected through Lee's brother.

The shift in the political landscapes in Korea due to changes in the government also provides a natural experiment for testing the impact of political connections particularly in association with chaebols. Traditionally, the Conservative Party has maintained a close relationship with chaebols, while the opposing Liberal party is often against chaebols. Chaebols were the creation of the Conservative government of Park in the 1960s in order to boost the economy and to pursue the government political goals. Since then, the Conservative government has openly supported chaebols and granted exclusive rights in profitable industries and monopolistic access to resource (Kang, 2002).

With the onset of the 1997 Asian crisis, a finger of blame was pointed at the Conservative Party and chaebols. This has resulted in a major shift in power as the Liberal party began taking

over major positions in the government and National Assembly from the Conservative party. The Kim (1998-2002) and Roh (2003-2007) regimes for example undertook policies on the alleviation of economic concentration by and restrictions against chaebols. However, the Korean economy suffered under the Roh government, and this resulted in the reinstatement of the Conservative party at the 2007 presidential and 2008 general elections. The new shift in politics marked the third era for the relationship between the government and chaebols in Korea.

1.2 Research Aims and Questions

This thesis aims to test which of the two competing hypotheses – the value-adding and value-destroying – on the value of the establishment of political connections prevailed in Korea during the period 2007 through 2011. To achieve this, we calibrate the shareholder's wealth effect of the establishment of political connections by firms in Korea. To capitalize on the dominant role played by chaebols in the Korean economy, the analysis extends to a comparison of the wealth effect of political connections between chaebol and non-chaebol firms.

To test whether political connections impact value, we are empirically challenged to identify and define political connection. To do this, we carefully assemble a new hand-collected database demonstrating the political connection of nonfinancial firms listed on the Korea Stock Exchange (KSE), measured at both the firm and business group levels separately, using a modified method in Faccio (2006).³ Specifically, we define a firm to be politically connected if i) a family member of a businessperson (controlling shareholder or top director) is an immediate relative (blood relative or in-law relative) of an incumbent politician; ii) a businessperson is closely related to a prominent politician (through formal directorship held by

³ Faccio (2006) classifies a company as politically connected if at least one of its large shareholders or top executives is a minister, a member of the parliament, or a head of a state, or is closely related to the politicians.

a politician or friendship); or iii) a business person is an incumbent politician. Further details are described in Chapter 5.

We define a business groups as a collection of firms that operate in various industries and are bound together through managerial, operating, and financial interlocks (Granovetter, 1994). In Korea, the definition of a business group is provided by the Korean Fair Trade Commission (KFTC): “A business group is defined as a group of companies where more than 30% of the shares are owned by the group’s controlling shareholder and related persons that are relatives and other affiliated companies of the same business group (Bae, Kang, and Kim, 2002; Baek, Kang, and Lee, 2006; Bae, Cheon, and Kang, 2008).” The Monopoly Regulation Fair Trade Act by the KFTC designates a large business group as “chaebol” if its total assets exceed 5 billion Korean won and has a controlling family-shareholder (with greater than 30% ownership of shares across the group of companies (member firms). Business group rankings (by total assets) are updated each year (Almeida, Park, Subrahmanyam, and Wolfenzon, 2011).

Using the firm level-definition, we are able to identify a total of 468 politicians (1 president; 4 prime ministers; 48 cabinet ministers; 81 vice-cabinet ministers; 330 parliamentarians; and 4 heads of a local government during the Lee regime) and 87 politically connected firms. To establish the presence of a link between politicians and chaebols, we divide the sample into two groups: chaebols and non-chaebol firms. Among the 87 connected firms, 41 belong to chaebols.

Faccio (2006) and prior studies define political connection at the individual firm level. This is to say that, for our sample, if the connected firm belongs to a chaebol, none of the affiliates within the same business group are considered to be connected unless the affiliates themselves have direct political ties. The firm-level definition, thus, assumes that the wealth effect of political connections does not spill over to other firms within the same business group as the connected firm. This study, thus, departs from the literature by also considering this spill

over effect in defining connections. In business group level connections, the benefits or costs from political connections are shared amongst the group members so that as long as any firm within the chaebol is connected, all its affiliates in the business group are deemed to be (indirectly) connected as well.

Using the business group-level definition, we identify 49 business groups with a total of 139 affiliates that are politically connected. Of the 49 connected business groups, 17 are chaebols with 79 member firms and the rest (32) are non-chaebols with 60 affiliates.

Given our unique data set, our next task is to find a setting that allows us to test whether connectedness does indeed affect company value. We employ the standard event study to test the impact of political connections on stock prices. Identifying the correct event date is crucial to event studies, and so we painstakingly perform this task and identify the date of the following five events that mark the establishment of political connections in Korea during the period 2007-2011: the presidential election; two cases on the appointment of ministers; the election for members of parliaments; and the election for the head of a local government. The integration of these five events gives us 6,096 observations.

To understand better the cross-sectional variation in abnormal returns of politically connected firms, we use ordinary least squares (OLS) regressions of stock returns on dummy variables for political connections (*Politically Connected*); whether the firm belongs to a large business group (*Chaebol*); and control variables (*Firm Size*, *Book-to-Market*, and *Leverage*) which include fixed effects for *Industry*, *Event Time*, and *Exchange*. For the political connection variable, we also create dummies to denote *Connected Chaebol* and *Connected Non-Chaebol* firms.

1.3 Findings and Contributions

The empirical analyses show support for both the value-adding and value-destroying hypotheses in Korea. On average, the establishment of political connections is only marginally positive. However, when we partition the sample into chaebol and non-chaebol firms, results show that firms' membership to chaebols plays a key role in determining whether political connections are valuable or not. Around the establishment of political connections, we find results consistent with the value-adding hypothesis only for chaebol firms. Specifically, chaebol firms with connections have a stock return that is 4.98% higher than other firms after controlling for several firm characteristics. In contrast, non-chaebol firms with connections suffer a significant price drop (the average cumulative abnormal return (CAR) is -3.14%), consistent with the value-destroying hypothesis.

The results are robust when we define political connections at the business group level. Controlling for several firm-specific factors, chaebol firms with connections have an average 4.28% higher stock return than other firms whereas the average stock return for non-chaebol firms with connections is 3.93% lower. These results indicate that new political connections by an affiliate firm have a "spill over" effect on the share price of other members within the same business group, and that more importantly, only chaebol firms stand to gain from the political connections.

Additionally, we find the value of the connections depends very much on how the firm is connected to the politician. First, connections through a marital network between a member of the controlling family and a member of the politician's family add more value (by about 6%) to chaebol firms than other forms of connections. Second, the value of the connections increases linearly with the power held by the connected politician. To be precise, chaebol firms that are associated with a president have the largest increase in stock price, followed by chaebol firms connected with ministers and then members of parliament.

This research belongs to the literature that looks at the intersection of politics and finance. It contributes to the literature in several important ways. First, it adds to the growing body of literature on the effect of political connections on firm value by adding new evidence from firms in a country with a high level of corruption and a weak legal system. In doing so, this study complements the work by Fisman (2001) and Faccio (2006), who analyse the shareholder wealth impact of political connections through personal relationships between firms and politicians, and John and Mitton (2003) and Leuz and Oberholzer-Gee (2006) by providing evidence on *crony capitalism* that dominant political leaders do indeed use their power to benefit their families.

Our contribution also lies in providing an insight into the effect of political connections in business groups. In spite of the considerable breadth and depth of research on political connections, there has rarely been any study on the role of business groups in the context of political connections. To the best of our knowledge, this is a first study that differentiates political connections at the firm level from the business group level, and provides strong evidence of a “spill over” effect of political connections within business groups.

This research also contributes to the literature on the economic value of marriages and social networks. Family networks can be especially valuable to firms in countries where legal institutions are weak (La Porta, Lopez-de-Silanes, and Shleifer, 1999; Burkart, Panunzi, and Shleifer, 2003). In particular, our finding corroborates the recent study by Bunkanwanicha, Fan and Wiwattanakantng (2013) who present the first empirical evidence showing that the marriage of a member of the controlling family adds value to public corporations, especially when the partner is from a prominent political or business family.

Finally, our line of inquiry helps to put together a major puzzle about chaebols: if minority shareholders in member firms know that the controlling shareholder would expropriate their wealth (Bae, Kang, and Kim, 2002; Baek, Kang, and Lee, 2006), why are they

still willing to buy securities in these firms? One answer that we provide in this research is that all investors, including outside minority investors, of chaebol firms are the main beneficiaries of political connections. Additionally, we provide evidence that the benefits of political connections “spill over” from the firm with direct connections to other member firms (indirect connections).

1.4 Thesis Layout

The rest of the thesis is structured as follows. Chapter 2 provides a comprehensive review of the extant literature on the topic of political connections. Chapter 3 describes the institutional framework of the Korean political economy, which sets the backdrop for this study. Chapter 4 develops the research hypotheses, followed by Chapter 5 which describes the data and research method. Chapter 6 presents the empirical results. Chapter 7 concludes.

Chapter 2

Literature Review

2.1 Introduction

Corporate political connections are prevalent around the world. Prior evidence suggests that political ties affect corporate value not only in developing markets, but also in developed economies (Faccio, 2006). However, it is difficult to interpret empirical evidence across countries due to differences in the level of economic development, legal protection and enforcement, and institutional and regulatory frameworks including corporate governance practices. Accordingly, it is conceivable that the form and value of corporate political connections would vary across countries.

In this literature review, we focus on two different forms of political connections – explicit and implicit ties between politicians and corporations. Especially, we call attention to the question what decisively differentiates between explicit ties from implicit ties, and which of these represents a more durable and reliable measurement of political connection.

Political connections are crucial for both corporations and politicians because they enable both the firms and politicians to achieve their goals. Essential to the notion of political connection is a systematic exchange of favours between politicians and the connected firms. We explore this mechanism with two important questions: i) what are motivations leading to the establishment of the connection between both politicians and firms? and ii) do connections add to company value? We provide a comprehensive review of theoretical and empirical evidence in relation to these questions, centering around various political interventions that positively or negatively influence firm value and performance.

In what follows, this study also points out how political connection can exacerbate the potential conflicts of interest between managers/controlling shareholders and minority shareholders. In the context of agency problems, political connection can be a form of

perquisite consumption by top managers or controlling shareholders (Aggarwal, Meschke, and Wang, 2009). Political ties can therefore impose costs outside minority shareholders. We provide empirical evidence in support of this argument, which suggests that political connection may have an important role in corporate governance practices.

Lastly, we discuss the method used in the literature to measure the net effect of political connection. Many studies use changes in stock return to capture the net impact of political connection, and analyse the variation in the market reaction to different political events across countries. We highlight the evidence on the effect of political connections as well as the extent of political connectedness. For example, the stock price response to connection differs across politicians, firms and countries.

This review is organized as follows. Section 2.2 clarifies different measures of political connection and their relative importance. Section 2.3 deals with the benefits and costs of political ties. Section 2.4 presents the empirical evidence to exhibit the variation in market reactions to different political events across countries. Section 2.5 provides a summary and conclusion.

2.2 Definition of Political Connection

As the outset, it is imperative to clarify the definition of political connection in prior literature. Corporate political connection can take many forms. As the precise form varies across firms and countries, it is challenging to identify and define a viable measure of political connection. Regulatory environment such as disclosure regulations or restriction on ownership or board membership by politicians differ across countries. The challenge is not made easier by the limited information necessary to identify the politician who is connected to the firm. Further, the instruments for campaign contribution are not observable for all countries. Campaign contribution being a common means to identify firm connections with politician or

political parties. This lack of data often limits the sample size and provides an incomplete picture of political associations. For example, Faccio (2006) excludes many interesting connections in her international sample such as those involving several companies connected to Indonesian president Suharto, who is the primary source of political connection for an earlier study by Fisman (2001).⁴

The literature generally focuses on firms that establish a specific connection with politicians. These connections are often classified as either explicit or implicit. Explicit connections are often characterized as personal ties between politicians and businessmen, and implicit connections are financial ties identified from tracking the firm's contribution to politicians. For example, an explicit connection arises when a politician joins the firm or its board of directors or becomes a large shareholder in the firm (e.g., Fisman, 2001; Khwaja and Mian, 2005; Faccio, 2006; Fisman, Fisman, Galef, and Khurana, 2006; Fan, Wong, and Zhang, 2007; Goldman, Rocholl, and So, 2008). Historical friendships are also recognized as another form of explicit political ties.⁵ Implicit connections arise when a company makes political donations to the politicians' election campaign (e.g., Roberts, 1990; Jayachandran, 2006; Claessens, Feijen, and Laeven, 2008; Aggarwal, Meschke, and Wang, 2009; Cooper, Gulen, and Ovtchinikov, 2010).

Political connections identified via personal ties are likely to be more durable than those related to contributions to politicians. One reason why firms establish connections with politicians is to influence the political process in ways that can enhance firm performance. Explicit connections have an important role in this political intervention. Politicians may sit on

⁴ Fisman (2001) identifies politically connected firms based on the Suharto Dependency Index developed by the Castle Group, which is a leading economic consultant in Indonesia. The index ranges from one (least dependent connections) to five (most dependent connections). Faccio (2006) includes only groups rated five in her definition of connections.

⁵ Some members of the business elite have long-standing relationships with political official in many countries. For instance, President Suharto maintained close relations with business people who assisted early in his career in Indonesia during the 1990s (Fisman, 2001; Leuz and Oberholzer, 2006). At the same time, there are long-standing relationships between corporate leaders and leading politicians and some of these relationship were established when they were in early age (Johnson and Mitton. 2003).

corporate boards or businessman can decide to go into politics. Hence, businessman in power may be able to influence legislation, gather privileged information, or even influence government expenditures in a way that is favourable to their firm. Most of all, personal relationships between politicians and businessmen tend to develop into long-term relationships until the removal of the connection due to say the death of the connected politicians (Fisman, 2001; Leuz and Oberholzer-Gee, 2006).

The literature offers two views of political donations. First, contributions to politicians represent an investment in political capital. Firms that donate money to politicians appear to obtain better quality and more frequent access to politicians (Langbein and Lotwis, 1990; Krozszner and Stratmann, 1998). Many studies show that political donations are positively associated with firm value and performance (Roberts, 1990; Claessens, Feijen, and Laeven, 2008; Cooper, Gulen, and Ovtchinikov, 2010). In contrast, Ansolabehere, de Figueiredo, and Snyder (2003) suggest that political contributions should be regarded primarily as a type of consumption good, since contributors obtain relatively little leverage from their contribution. Aggarwal, Meschke, and Wang (2009) also find no evidence to support that contributions represent an investment, arguing that political donations mostly establish short-term and transactional relationships. Thus, political contributions may not process in the same way or have the same impact as political connections established through personal ties. The literature also leaves open an important question of how contributions and connections are related to each other, e.g., whether firms contribute to politicians whose intrinsic view is aligned with the interest of the firms or whether contributions influence politicians' behaviour.

Other research takes an alternative approach by defining connections through geographic ties. The proposition is that politicians systematically favour "local" companies similar to the portfolio home bias effect where politicians or their constituencies are driven by the need for re-election; links between friends, local firms, and family; and concerns for local jobs. Thus,

geographic settings offer an influential basis for political connectedness. For example, Faccio and Parsley (2009) and Kim, Pantzalis, and Park (2012) focus on companies headquartered in the town where the politician was born or the town where the politician lived.

2.3 Benefits and Costs of Political Connections

The literature suggests that there is a systematic exchange of favours between politicians and the connected firms. In this *quid pro quo* relationship, business leaders can count on the politicians for help in times of needs and politicians in return receive various kinds of assistance from the business leaders.

A number of papers document the economic benefits that companies can obtain from connections with politicians (Fisman, 2001; Johnson and Mitton, 2003; Faccio, Masulis and McConnell, 2006). Politicians can use their authority to grant favours to connected firms, and these political favours can come in many forms including preferential access to credit (Johnson and Mitton, 2003; Khwaja and Mian, 2005, Faccio, 2010); lighter taxation (Faccio, 2010); government contracts (Goldman, Rocholl, and So, 2013); capital control (Johnson and Mitton, 2003); regulatory protection (Kroszner and Stratmann, 1998); and government aid for financially troubled firms (Faccio, Masulis, and McConnell, 2006). In the context of the resource-based theory, a firm has a competitive advantage when it possesses tangible and intangible resources that are difficult or costly for other firms to obtain. Therefore, political connections are regarded as potential resources that add value to the connected firms.

One of the most pervasive and important forms of benefits is preferential lending. In the literature, political connection provides firms access to resources like bank financing. It is crucial that firms are able to secure capital to fund future investment opportunities. So, it is important to establish connection with politicians or the government that can provide the firms with preferential access to credit from banks owned or controlled by government which may

also charge an interest rate often lower than the prevailing market rate (Johnson and Mitton, 2003; Khwaja and Mian, 2005; Charumilind, Kali, and Wiwattanakantang, 2006).

Another way political connection can translate into preferential access to finance is through state banks (Leuz and Oberholzer-Gee, 2006; Claessens, Feijen, and Laeven, 2008). Faccio, Masulis, and McConnell (2006) show that private lenders facilitate lending to connected firms. However, they do not rule out the possibility that the government pressure private banks to provide favourable loans to connected firms, consistent with the view that private banks show no such political bias (Khwaja and Mian, 2005). Finally, Faccio (2010) complements and generalizes prior results from single-country analysis by a conducting a cross-country analysis. She finds that, on average, connected firms have 2.7% higher leverage than non-connected firms.

An implication of political interference in bank loan allocation is that loan decisions can be insensitive to the risk and governance of the borrowing connected firms. Although connected firms may have an unprofitable forecast, banks are often under pressure from government to extend loans to them (Khwaja and Mian, 2005). This suggests that political connection via preferential lending can lead to increased firm value only when there is a wealth transfer from banks or consumers to the connected firm. In addition, political interference is more pronounced in countries where government control the banks, as is the case in most emerging countries (Dinc, 2005). This explains why the magnitude of the benefits from connections varies across countries, with connected firms gaining the most in countries with weak legal systems and high levels of corruption (Faccio, 2006). Taken together, connected firms can increase value if they are able to extract economic rents from competitors and citizens as a whole.

Politically connected companies also gain benefits from direct government support and resources, including reducing regulatory requirements, lowering taxation, the awarding of

lucrative government contracts and the imposition of tariffs on competitors. For example, Agrawal and Knoeber (2001) report that politically experienced directors have important roles in companies that export, lobby, and sell to the government. Goldman, Rocholl, and So (2013) find that government procurement contracts are more likely to be allocated to firms connected to the winning party in the United State. Bertrand, Kramarz, Schoar, and Thesmar (2007) show firms with connected CEOs receive more subsidies, and enjoy, on average, lower corporate taxation in France. Faccio (2010) also shows that politically connected companies experience a lower corporate tax rate by 0.76% points, and thus benefit from lower operating costs. Overall, political connections provide economic advantages to firms by channelling to them key resources and support from the government.

Finally, politically favoured firms are associated with lower their risk than non-connected firms. When faced with financial distress, political connection becomes more valuable. Johnson and Mitton (2003) show that imposing capital control in Malaysia during the Asian financial crisis attributes approximately 32% of the estimated \$5 billion gain in the market value of politically connected firms. Rajan and Zingales (1998) argue that capital controls are one of the most important parts of government policies in ‘relationship-based’ capitalism. In this system, politicians make banks channel their lending towards favoured companies; this is easier to do if the country is relatively isolated from the international market. In this context, the evidence in Johnson and Mitton (2003) suggests that capital controls provide a channel where connected firms can be assisted.

Faccio, Masulis, and McConnell (2006) show that private lenders facilitate lending to connected firms because they anticipate that government are more likely to bail out connected companies in financial distress or economic downturn. A consequence of the guarantee from political connections lowers the connected firm's overall exposure to market-wide risk. This drives down the covariance between the market and the connected firm's cash flows,

generating a lower cost of capital for the connected firm. Chaney, Faccio, and Parsley (2011) add to this evidence by showing that although the quality of earnings reported by politically connected firms is significantly lower than that of comparable non-connected peers, the market does not penalize the former since their cost of debt is lower than that of their non-connected counterparts. Finally, Boubakri, Guedhami, Mishra, and Saffar (2012) complement Chaney, Faccio, and Parsley's (2011) work by reporting that a lower cost of equity capital for politically connected companies. Therefore, these findings offer strong evidence that investors require a lower cost of capital for connected companies, suggesting that connected firms are regarded as less risky than non-connected firms.

In contrast, political connections can impose costs on the connected firms. For example, the incumbent politicians can use their power to influence business leaders to make corporate decisions that bestow favour affecting re-election outcomes for themselves. Hence connected companies may have to devote tremendous resources to politicians' rent-seeking extraction, which in turn may distort their own investment decisions and firm value. A number of papers document that rent-seeking activities are the main reason for government intervention (Stigler, 1971; De Soto, 1990; Shleifer and Vishny, 1998). Morck, Stangeland, and Yeung (2000) find connected firms in Canada exhibit lower industry-adjusted operating performance, labor capital ratios, and R&D costs relative to non-connected peers. Bertrand, Kramarz, Schoar, and Thesmar (2007) add to this evidence by showing that connected firms in politically contested areas exhibit lower stock performance and rates of return on assets (ROA) than non-connected firms, especially during the election years in France. They explain that this lower profitability is due to connected CEOs having to create more jobs to secure more supporting votes for the connected politicians.

Numerous studies find that political connections are more prevalent in larger firms (Agrawal and Knoeber, 2001; Johnson and Mitton, 2003; Goldman, Rocholl, and So, 2008;

Cooper, Gulen, and Ovtchinnikov, 2010; Faccio, 2010; Boubakri, Guedhami, Mishra, and Saffar, 2012). This is not surprising since politicians gain the most (in terms of maximising their policy goals) from granting favours to large firms. Consequently, the cost of political connection is when affiliated politicians extract political or private benefits from other stakeholders in the firms. However, Faccio (2004) argues that the rent-seeking activities by politicians cannot explain fully the overall underperformance of connected firms.

The cost of political connections can be exemplified in corporate governance. Politically connected companies care less about governance, which is important for external capital raising, due to their privileged access to loans from banks controlled by government (Leuz and Oberholzer-Gee, 2006; Claessens, Feijen, and Laeven, 2008). The reduced reliance on external financing means that important external monitoring by the market is avoided. Chaney, Faccio, and Parsley (2011) show that the quality of accounting information of politically connected firms is poorer than that of non-connected peers because of advantages of having political ties in the debt market. This evidence suggests that political intervention can weaken managerial practices, leading to worse corporate governance. Aggarwal, Meschke, and Wang (2009) find that firms with better corporate governance, such as the separation of CEO and chairman, smaller boards, and larger ownership by insiders, blockholders, and financial institutions, are less likely to be connected, arguing that political ties represent a symptomatic agency problem.

As political connection represents an agency problem, it can be considered as a perquisite consumption by top directors or controlling shareholders (Aggarwal, Meschke, and Wang, 2009). In this perspective, political connection subtracts from corporate value as it represents a cash outflow without any corresponding benefit to minority shareholders. Boubakri, Guedhami, Mishra, and Saffar (2012) show firms with connected boards do not have managerial incentives that maximize minority shareholders' wealth. Fan, Wong, Zhang (2007) find that firms with politically connected CEOs show a lower degree of professionalism and

have poorer three-year post-IPO earnings growth, sales growth, and returns on sales. In addition, Qian, Pan, and Yeung (2011) report that political connections, especially those that secure bank loan access, affect the incentive of controlling shareholders to expropriate minority shareholders through self-dealing and tunnelling, resulting in lower performance by connected firms. This evidence is consistent with the perspective by Lemmon and Lins (2003) that controlling shareholders expropriate minority shareholders.

When firms benefit economically from political favours, these benefits should be factored in firm fundamentals, such as increased profitability, creating positive net present value. Cooper, Gulen, and Ovtchinnikov (2010) find a positive and significant relationship between political connection and future profitability as measured by the rate of return on equity (ROE). Their results are consistent with Faccio and Parsley (2009) who show that connected firms experience a significant decrease in sales growth when the connection terminates due to, for instance, the sudden death of the connected politician.

In contrast, when politically connected firms experience poor performance, it may be due to the high level of rent-seeking activities by politicians and/or agency problem faced by the connected firms. However, it is also possible that the connected firms are simply ex ante bad performers – these firms are more likely to build political connection as they have more to gain from the connection (Faccio and Parsley, 2009; Faccio, 2010; Faccio, Masulis, and McConnell, 2006). The question of whether political connection leads to poor performance remains unanswered in the literature.

Political connection is thus a double-edged sword that can either enhance or jeopardize a company's value and performance. As noted by Shleifer and Vishny (1994), the net effect of political ties is determined by the difference between marginal benefits and marginal costs of the connections. In equilibrium, connected firms may not obtain higher profits although they can earn substantial political benefits if they were willing to devote to the cost of rent-seeking

activities by politicians. Shleifer and Vishny (1994) argue that politicians have the capability to extract most or all of the rents from lenders, borrowers, and other stakeholders so they can become the ultimate net beneficiaries of political connections. Most of all, when all or more of the increase in firm value is consumed by politicians and their connected managers or controlling shareholders, less of the remaining value is available to minority shareholders.

It is difficult to measure the net effect of political connections directly. Many studies use the stock price reaction as a proxy for the net impact of political connection. However, it is hard to maintain that the positive stock response to the announcement of political events itself is a signal that the government will start to implement policies that are favourable to the connected firms. Therefore, the effect of political connection on corporate value is more likely to be derived from investors' belief and perception of the value that these connections can bestow on the firms (Claessens, Fijen, and Laeven, 2008). If the perceived marginal benefits of political ties exceed the marginal costs, then the connection will lead to an increase in the equity value of the connected firm.

2.4 Stock Market Reaction to Political Connections

There is a growing body of evidence showing that political ties affect corporate value. Some cross-country and country-specific studies find that the equity value of politically connected firms is sensitive to political events such as the establishment or the termination of political connections. The main argument is that investors are able to price *ex ante* the value of such connection, which is reflected in the stock price around the announcement of a nomination, election, or other political events. For example, a number of papers that take a short-term event-study approach find the removal of connections leads to a decrease in equity value (Roberts, 1990; Fisman, 2001; Faccio and Parsley, 2009), while the establishment of connection

generates an increase in equity value (Faccio, 2006; Claessens, Fijen, and Laeven, 2008; Goldman, Rocholl and So, 2008).

The termination of political connection affects the stock price of connected firms negatively. Roberts (1990) tests the effect of Senator Henry Jackson's sudden death on the U.S. stock market. The announcement of the death negatively affects the share price of firms that made campaign contributions to Senator Jackson, while firms connected to his successor experience a positive abnormal return. However, the effect of Senator Jackson's sudden death is quite small, implying that the small response suggests that this particular political connection only provided a small benefit. Therefore, although Robert (1990) provides direct evidence that connections have an influence on firm value, it does not give a convincing answer to the question how much do connections matter to firm value.

Fisman (2001) answers this question in his study. He estimates the value of political connectedness by examining stock price reactions of companies related to Indonesian President Suharto in response to rumors that his infirmity was worsening during his final year in office. He finds that the stock price response of connected firms is larger when the rumor is more negative. The results suggest that a considerable part of the value of connected firms stems from political connection. However, one problem associated with focusing on events is that the full value of the connection cannot be estimated in the absence of actual sudden regime shifts. To estimate the full value of political connection in this instance would require the occurrence of an event that is associated with Suharto's sudden termination from office.

The studies described above provide independent evidence that political connections create value to connected firms. However, as these studies use only a small sample, their results may understate the true value of the connection and are thus not generalizable. To overcome this problem, Faccio (2006) and Faccio and Parsley (2009) use a cross-country analysis. Faccio's (2006) complements the work of Fisman (2001). She finds the market value of firms

with political connection is affected by unexpected electoral outcomes in a broad cross-section of 35 countries. The result shows that the announcement of officers or large shareholders entering into politics significantly increases the value of connected firms; connection through large shareholders and officers results in a five-day CAR of 4.47% and 2.29% respectively. Faccio and Parsley (2009) also use unanticipated events represented by the sudden death of incumbent politicians. They report an average decline in the value of connected companies by 1.7% (market-adjusted) in response to 122 sudden deaths of politicians from around the world between 1973 and 2004. Especially interesting is the finding that all connections including personal, financial, and geographical have a similar magnitude of impact on firm value, suggesting that the various forms of political connections are equally economically significant (Roberts, 1990; Fisman, 2001; Faccio, 2006; Faccio and Parsley, 2009).

More recent studies show similar results that political connections are valuable to shareholders. Claessens, Fijen, and Laeven (2008) find that political donations are associated with higher stock returns around the date of election, suggesting that investors predict future political favours to connected firms. In addition, Goldman, Rocholl, and So (2008) analyse stock price reactions to the announcement of board nomination of a politically connected director. They find a positive abnormal stock return around the announcement. Although connections appear to be important to investors, most of these studies silent investigate the exact source of the positive stock reaction. Only Faccio and Parsley (2009) and Claessens, Fijen, and Laeven (2008) find evidence that preferential access to credit is positively associated with abnormal returns.

In contrast, some studies in the United States find intriguing results. Paralleled to Robert's (1990) study, Fisman, Fisman, Galef and Khurana (2006), Jayachandran (2006), and Acemoglu, Johnson, Kermani, Kwak, and Mitton (2010) use news and events related to prominent American politicians. They show that Geithner-connected financial firms

experience an average CAR of 15% around the announcement (from day 0 to day 10) of Timothy Geithner as President Obama's nominee for Treasury Secretary in November 2008. The result is consistent with the value-adding view, but the magnitude is much higher than previous findings. However, Jayachandran (2006) finds much lower effects. She uses corporate soft money donation to proxy how much corporations are aligned with political parties. She reports that in response to Senator Jim Jeffords switching parties in May 2001, which gave the Democrats power to take over the chairmanships of the Senate committees and other leadership positions and gained influence over the legislative agenda, confirmation of Presidential appointees, and more. With this move, connected firms lose on average 0.8% of market value for every \$250,000 they contribute to the Republicans in the previous election cycles. Paralleling the earlier literature that uses the health status of leaders (Fisman, 2001) as a shock to connections, Fisman, Fisman, Galef, and Khurana (2006) examine unexpected changes in Cheney's health as a shock to the value of connections. Contrary to conventional expectation, the value of connections to Cheney is estimated as zero.

However, some studies show that political connections may indeed decrease shareholders' wealth. Fan, Wong, and Zhang (2007) find that politically connected firms experience three-year post-IPO stock returns of -18% relative to those without connections. The negative effect of CEO's political connections also appears in the first-day stock return. For announcements of politicians to a board, Faccio (2006) finds that connected firms experience an average CAR of -0.53%. She interprets this result as implying that, for this subsample of announcements, the cost of connections may exceed the benefits due to rent-seeking activities by politicians. However, Faccio (2006) and Fan, Wong, and Zhang (2007) do not show the source of the negative impact.

Prior studies have not only provided evidence on the impact of political connections but also exhibit the extent of political connections. Studies document that the stock price reactions

on political connections depend on politician-, firm-, and country-specific factors. First, the response is greater for family firms (Faccio and Parsley, 2009). This implies that political connection has a more important role for family firms than other firms, consistent with family firms being the likely candidate for establishing political ties (Morck, Stangeland, and Yeung, 2000; Morck and Yeung, 2004), and connected family firms caring less about market punishment than their counterparts (Chaney, Faccio and Parsley, 2011). Second, the price effect is more pronounced for larger companies (Claessens, Fijen, and Laeven, 2008; Goldman, Rocholl and So, 2008). Third, the stronger the political links, the greater the stock price response. For example, Faccio (2006) finds the stock price response to a new connection is larger when businessmen take on more powerful political positions. Fourth, stock reactions are particularly greater in countries with a high level of corruption and a weak legal system (Faccio, 2006; Faccio and Parsley, 2009).

Overall, the existing results on the value of political connection are intriguing. A number of papers document a stock price response to shifts in the political landscape, and that this response is larger in countries with a higher level of corruption (Faccio and Parsley, 2009), and in larger companies, family firms, and firms with stronger political power. However, despite extensive robustness checks of causality in prior literature, the endogeneity of political connections remains a thorny issue. Even in the best event-study setup with perfect measures of prior probabilities of events, it is difficult to rule out the possibility of unobserved firm characteristics affecting both a firm's outcome and political connections. In addition, results from prior studies may be hard to generalize because they are based on short-term isolated events.

2.5 Summary and Conclusion

It is challenging to provide a complete picture of political connections due to different regulatory environments and limited access to useful information across countries. These constraints often limit the size and bias in the sample of political connections. In the literature, corporate political connections tend to be personal, financial, or geographic. When politicians join the firm or its board of directors or become large shareholders, it leads to a long-term personal association between the politicians and businessmen until the removal of the connection. The literature suggests that this association has an important role in political intervention which can enhance firm value and performance.

Financial ties are identified by tracking down firms' contribution to politicians. Some researchers suggest that contribution to politicians represents an investment in political capital so that it is positively linked with firm value and performance. Others argue that political donations should be considered as a sort of consumption good as it leads to transactional and short-term relationship. Taken together, the personal association between politicians and businessmen represents a more explicit connection than political donations.

When companies establish connections with politicians, there is a systematic exchange of favours between them. Business leaders can count on the politicians for help in time of needs and politicians in return receive various kinds of assistance from the business leaders. Many studies show that connected firms can gain various economic advantages through political intervention including preferential access to credit, lighter taxation, and government contracts. Political interference in the allocation of government resource or bank loan allocation is often insensitive to firm governance and risk, potentially resulting in the firms extracting unfair economic rents at the expense of their competitors and consumers. When faced with financial distress or economic downturn, politically connected managers can obtain government support through bailouts or capital control, which in turn reduce the firms' overall exposure to market-

wide risk. Investors therefore require a lower cost of capital for connected companies. In short, political connection benefits the connected firms.

However, political connections can impose costs on corporations due to potential conflicts of interest between firms and politicians. In order to pursue social objectives of policy goals or private gains such as bestowing favour affecting re-election outcomes, politicians can extract political or private benefits at the expense of the connected firms. Connected companies may be compelled to devote substantial resources to rent-seeking activities by politicians that distort investment decisions or misallocate resources for firms. Consequently, the burden of implementing political policy is a channel through which connections adversely affect corporate value and performance. Many studies support the presence of rent-seeking activities as showing that politically connected firms experience poor operating performance. But it is also possible that the companies are simply *ex ante* bad performers with these type of companies being more likely to establish political ties. The literature leaves unanswered the question whether political connection leads to poor performance for connected firms.

Some studies insist that minority shareholders are the ultimate victims of political connections. When connected firms can afford not to pay attention to market punishment due to the guarantee they receive from politicians, it can weaken managerial practices. In this context, top managers or controlling shareholders have incentives to transfer increased (decreased) wealth generated by political intervention from minority shareholders (themselves) to themselves (minority shareholders). As a result, connected firms can suffer from relatively severe agency problem, suggesting that political connections may have a crucial role in corporate governance practices.

To measure the net effect of political connection, many studies document the variation in stock market reactions to different political events across countries. The main argument is that investors have the capability to value such connections, and this is reflected in the stock

price around the announcement of nominations, elections, or other political events. Some cross-country and country-specific evidence shows that the removal of a connection results in a decline in equity value, while the establishment of connection generates an increase in equity value. However, some studies insist that political connections have no value or are even harmful to shareholders. In addition, studies also document that the stock price response of connections varies across firms, politicians, and countries. The quantitative effect is greater in countries with a high level of corruption and a weak legal system, and in larger and family firms. However, the results may be difficult to generalize because the empirical evidence is based on short-term isolated events. Most of all, it is hard to argue that the positive stock response to the political event itself is a signal that the connected firms start materializing the benefits from the connection. The evidence is more likely to indicate the market's belief that the political intervention is favourable to the firms.

In conclusion, the question of whether or not political connections enhance firm value has intriguing answers. Political connection is indeed a double-edged sword; it can either enhance or jeopardize a firm's value and performance.

Chapter 3

The Institutional Setting

3.1 Introduction

This chapter presents the institutional setting of the Korean political economy, which sets the backdrop for this research. It is organized as follows. Section 3.2 discusses the political system, and Section 3.3 highlights the prevalence of business groups, and the historical relationship between chaebols and government. Section 3.4 summarizes the chapter.

3.2 The Political System in Korea

We give a brief overview of the political and electoral system in Korea. Korea uses a hybrid system combining elements of both presidential and parliamentary democracy where a president and a prime minister coexist with both presidential and legislative elections held nationally (Julio and Yook, 2012). The Korean government is divided into three branches: executive, legislative, and judicial. The executive branch consists of the president and ministers, and is headed by the president who is vested with supreme executive control and power to propose legislation to the National Assembly.

The president is the chief executive of Korea and is the only elected member in the executive branch with a single five-year tenure by plurality vote, while the ministers are appointed by the president and serve up to 2 years. The Prime Minister is also appointed by the president and is the principal executive assistant to the President by supervising ministries. The Council, which consists of the president, the prime minister, and 16 cabinet-level ministers, is charged with deliberating on major policy decisions. The National Assembly represents the legislative branch of Korea. There are 299 elected members who are elected every four years through a supplementary member system. Local governments are semi-autonomous, and hold

executive and legislative bodies of their own. The local election is held every four years for seven mayoral and nine gubernatorial seats.

Unlike the United States, which has a two-party system, Korea has a multi-party system. For example, there are seven political parties represented in the 18th National Assembly of Korea. The Conservative Party consists of Grand National Party (GNP), Liberty Forward Party (LFP), and Pro-Park Coalition (PPC). Democratic United Party (DUP) and Creative Korea Party (CKP) compose the Liberal party. The Progressive Party is made up of Democratic Labor Party (DLP) and New Progressive Party (NPP). However, the National Assembly is effectively dominated by two single parties: GNP and DUP, which represent the Conservative and the Liberal Party respectively. In the 18th National Assembly, GNP holds a majority of seats (153), and DUP holds 81 seats.

Table 3.1
List of Presidents and National Assembly of Korea

Panel A. President by time in office				
Tenure	Position	Name		
1993-1997	Conservative	Kim Young-sam		
1998-2002	Liberal	Kim Dae-jung		
2003-2007	Liberal	Roh Moo-hyun		
2008-2012	Conservative	Lee Myung-bak		

Panel B. National Assembly				
Term	Ruling Party		Major Opposition	
	Position	Party	Position	Party
15th (1996)	Conservative	New Korea Party (Grand National Party)	Liberal	United Liberal Democrats
16th (2000)	Conservative	Grand National Party	Liberal	United Liberal Democrats
17th (2004)	Liberal	Woori Party	Conservative	Grand National Party
18th (2008)	Conservative	Grand National Party	Liberal	United Democratic Party

Traditionally, two major parties from the Conservatives and the Liberals represent the Korean politics. However, the Conservatives play a central role in the government for most of

time through history. For example, as shown in Table 3.1, all elected presidents have been from the Conservatives before 1997 and the Conservative Party maintains their ruling position except in the 17th National Assembly. In the next section, we provide a historical perspective on the relationship between politics and business, in particular, in the presence of chaebols.

3.3 Business Groups in Korea

Chaebols were the creation of the Conservative government of Park in the 1960s in order to boost the economy and to pursue their political goals. The Park government maintained its political legitimacy mostly through chaebols (Albrecht, Turnbull, Zang, and Skousen, 2010). The relationship between the government and chaebols is consistent with the notion that family connections to politicians allow connected firms access to substantial resources when the government plays a central role in the economy (Morck, Stangeland, and Yeung, 2000). The Park government preferred to deal with a handful of founding families in chaebols for obvious control reasons and made them enter risky undertakings. In return, the government supported chaebols and granted exclusive rights in profitable industries and monopolistic access to resources, including preferential lending, lower taxation, import and export licences, and foreign investment incentives and exchange allocations (Kang, 2002).

In particular, the chairman (Chung Ju-Young) of Hyundai Group and the chairman (Kim Woo-Jung) of Daewoo Group had close personal links with the former president Park, and have received extensive government support in the form of preferential foreign loans at low interest rates and domestic loans from government-controlled banks (Kang, 2002). The Park government also fostered the development of Hyundai Group by using tariff barriers on the industrial sector where Hyundai Group and other chaebols operated, resulting in Hyundai Group maintaining its position as the biggest chaebol in Korea until the 1997 financial crisis (Bloomberg, 2013).

Under the government's initiative, chaebols soon dominated the Korean economy (Kang, 2002). As chaebols diversified and expanded into various industries, founding families relied on a complex web of cross-shareholding to sustain their managerial control over the entire group, similar to the cross-holding web in keiretsu (Chang, 2003). However, chaebol and keiretsu can be distinguished in the following aspects. While Keiretsu has access to credit through direct ownership of banks, which play a central role in Japan, this is not the case of chaebols in Korea. Restrictions on ownership of banks in Korea call for "a separation between financial capital and industrial capital". Thus, chaebols rely on the state-controlled banking sector for external financing, and this easily allows the government to control chaebols.

During the 1980s, although the government and chaebols still endured an interdependent relationship,⁶ the rapid growth of chaebols became a burden to the Korean economy policy. For the government, chaebols have become too large to control. Many chaebols became financially independent of the government because of the operation of an internal capital market within the group. When the government liberalized the Korean financial market, chaebols started to increase their ownership of non-bank financial intermediaries (Shin and Park, 1999). Moreover, criticisms of unfair trade practices that favour chaebols were abound.

To address this concern, the government created laws and institutions to regulate the concentration of economic power by chaebols. In 1986, the Korean Fair Trade Commission (KFTC),⁷ whose role was to monitor chaebols, introduced a system that ranks chaebols according to their total assets annually. The Fair Trade Act was revised to restrict cross-shareholdings of intra-group affiliates in chaebols. As a result, to maintain their discretionary

⁶ Under the Roh regime, the former president Roh Tae-Woo had marriage alliances through siblings of political and bureaucratic elites and that of chaebol. Roh's son and daughter married into leading chaebol families (SK Group, the third biggest chaebol in 2008). The influence of these relationship quickly became a key factor in economic and industrial policy through the Roh regime, including the government's decision to lower interest rates to chaebols at the beginning of 1991 (Cotton, 1995).

⁷ The Korea Fair Trade Commission is a quasi-judicial regulatory agency and enforces The Fair Trade Act. The Commission is established under the jurisdiction of the Prime Minister for the purpose of independently promoting the objectives of the Act.

power, founding families in chaebols increased their political influence by increasing their continuous supply of illegal funds to politicians (Noland and Pack, 2003). This way, chaebols have gathered more centralized control than Japanese keiretsu (Shin and Park, 1999), and results in a weakening of the corporate governance of chaebols.

In 1997, Asia entered into one of its most devastating crises, the Asian Financial Crisis. At that time, listed firms belonging to the top 30 chaebols accounted for 45.8% of total market capitalization, 62.5% of the total assets, and 72.6% of gross sales of all firms listed on the Korean Stock Exchange (KSE) (Chang, 2003). Despite their significant economic size, the inefficiency of chaebols has been questioned. Lee and Kim (2000) and Joh (2003) find that chaebol affiliates underperform non-chaebol firms in the mid-1990s. Ferris, Kim, and Kitsabunnarart (2003) explain the loss in value of chaebol firms is consistent with the overinvestment view by Stulz (1990), i.e., an overinvestment in lines of business that have poor investment prospects adversely influences the value of diversified firms. Such evidence is a far outcry from the early study by Chang and Choi (1988), which credits chaebols with higher profitability than non-chaebol firms in the 1970s and 1980s.

The Conservative Party and chaebols were blamed for the 1997 economic downturn,⁸ and this has resulted in candidate Kim Dae-jung (1998- 2002) winning the 1997 election as the first president from the Liberal party. With the change in the political regime from the Conservatives to the Liberals, a major shift in the respective powers of government and chaebols occurred. In 1999, the Kim regime allowed Daewoo Group, which is the second biggest chaebol in Korea, to fail. The allowed bankruptcy of Daewoo Group changed the perception that chaebols are "too big to fail" is no longer valid. The Kim regime reformed

⁸ Causes of the 1997 financial crisis in Korea have been substantially investigated. Jwa and Lee (2004) trace the causes to an inefficient financial sector that was afflicted with moral hazard, lack of transparency in business operations, excessive diversification of chaebols via debt financing, low productivity and loss of international competitiveness, and rigid labour market practices. These are directly related to government intervention.

chaebols with the aim to improve their financial transparency and corporate governance structure.⁹

In particular, the separation between ownership and voting rights by the founding families in chaebols has been criticised as the cause of weakening corporate governance in chaebols (Bae, Kang, and Kim, 2002). As La Porta, Lopez-de-Silanes, and Shleifer (1999) argue, ownership is heavily concentrated in most business groups and controlling shareholders have control over member firms that exceed their cash flow rights. Through stock pyramids, dual-class share structure, and cross-shareholdings, chaebol families have full power over all member firms despite holding a relatively small portion of the total shares in the group (Almeida, Park, Subrahmanyam, and Wolfenzon, 2011). All major strategic and financial decisions of each affiliate lie in the hands of the founding family, rather than professional management (Shin and Park, 1999).

Thus, consistent with the tunnelling view of Friedman, Johnson, and Mitton (2003) and Bertrand, Mehta, and Mullainathan (2002), the controlling families with concentrated ownership can easily expropriate minority investors by transferring resources from member firms to other member firms within the same group in order to maximise their own private benefits. For example, Bae, Kang, and Kim, (2002) provide direct evidence of tunnelling in which the controlling shareholders of chaebols have incentives to transfer resources from firms where they have low cash flow rights to firms where they have high cash flow rights through acquisitions. Baek, Kang, and Lee (2006) also support the view of tunnelling within business groups by showing chaebol issuers in intra-group deals set the offering price in order to increase their controlling shareholders' wealth.

⁹ The Kim government implemented a policy to reform chaebols that emphasizes on the following four aims: i) chaebols are encouraged to hire professional managers in order to decentralize the founding families' involvement in management; ii) chaebols are pressured to focus on core businesses rather than further diversification; iii) accounting regulations are revised to improve transparency in operation of chaebols; and iv) inheritance taxes and antitrust laws were introduced to loosen the founding families' control over chaebols.

To loosen families' control, the Kim government reintroduced the "equity investment sum caption rule" to restrict the total sum of intra-corporate investment by chaebols in 1999. This regulation does not allow chaebols to invest more than 25% of their net assets in group affiliates. In 2000, chaebols were also required to unravel cross debt guarantees among affiliates within the same group.

The reform targeted at chaebols continued into the new government, when Roh Moo-hyun (2003-2007) from the Liberal Party became the 9th president. Through the April 2004 general election, the Woori Party became the first Liberal Party ruling the National Assembly in history. More recently, the Roh regime and the Liberal Party tried to undertake policies such as the alleviation of economic concentration and restrictions against chaebols. For instance, the Roh government reintroduced the Korean Fair Trade Commission to monitor chaebol's bank accounts for evidence of illegal inter-subsidiary dealings and illegal political funding. The revision of the Financial Industry Structure Law (FISL) of the Fair Trade Act proposed by the Roh regime and the Liberal Party in 2005 was one of the most controversial political issues involving all key players – the government, political parties, and business. The FISL limits conglomerates' voting rights in their financial firms to 15 per cent from 30 per cent. This regulation was finally complied in April 2006 session of the National Assembly, despite criticisms by the conservative Grand National Party which supports business groups.

Despite these restrictions under the Kim and the Roh regime, the dominance of founding families still remains in the management of major chaebols, and the extent of chaebol cross-shareholding also remains high. According to KFTC, total ownership by the owner and her family was less than 5%, but cross-shareholdings of affiliates accounted for approximately 44% in 2006. In particular, because a controlling family often funnels control over this pyramid or cross-shareholdings through a privately owned firm, it is very difficult for outside shareholders to exert any influence on the ownership structure in chaebols. Failure to tame controlling

families would mean that chaebols will remain the crucial drivers of the Korean economy, with each of them controlling numerous listed and unlisted companies.

On the political scene, the Roh regime encountered strong opposition from the Conservatives. During the Roh government, the Korean economy suffered low economic growth. The Conservatives accused the Roh regime and the Liberals of incompetence on Roh's policies. Consistent with rising criticisms of president Roh and the Liberals, candidate Lee Myng-bak of the Conservative Party, GNP, won the presidential election with 48.7% of the votes on 19 December 2007. Lee became the 10th president of South Korea on 25 February 2008. In the April 2008's general election, the Conservative Party became the ruling party for the 18th National Assembly with 52.87% of the votes, followed by 29.34% for the Liberal Party.

The presidential and general elections reinstated the Conservative Party. The shift in politics marks the third era for the relationship between government and chaebols. President Lee is particularly closely associated with chaebols. Lee's family has marital networks with chaebols including LG Group and Hyosung Group. The chairman of Hyosung Group has taken the post of chairman of the Federation of Korean Industries, a consortium of chaebols, from 2007 to 2011.¹⁰ In addition, Lee is the first president who has a business background; he was former CEO of chaebol affiliates in Hyundai Group before becoming a politician. The Lee government has implemented favourable policies which are "business friendly" to chaebols, such as high foreign exchange rates, low interest rates, tax cuts for large corporations, weakening of the separation of financial and industrial capital, and elimination of the equity investment limit. These changes have resulted in greater concentration and power over the Korean economy by chaebols while sustaining founding families' control over chaebols.

¹⁰ The Federation of Korea Industries is one of the four most prestigious economic organizations in Korea and it consists of the Korea International Trade Association, Korea Chamber of Commerce and Industry, and the Korean Federation of Small Business in Korea. These organizations are regarded as political pressure groups in Korea. The Federation of Korea Industries represents all industry sectors.

3.4 Chapter Summary

This chapter outlines the institutional framework for the Korean political economy. The Conservative Party and the Liberal Party represent politics in Korea. The Conservative Party has traditionally maintained a close relationship with chaebols, while the opposing Liberal Party is often against chaebols. In particular, the Conservatives openly supported and granted access to substantial resources for chaebols during the 1960s to 1980s when they maintained the ruling position in politics. Since the 1997 Asian crisis, a finger of blame was pointed at the Conservative Party and chaebols. This has led to a major shift in power from the Conservative Party to the Liberal Party. During the period 1998 to 2007, the Liberal Party undertook policies that aim to alleviate economic concentration of chaebols by imposing various restrictions on them. The economic turmoil under the Liberal Party resulted in the reinstatement of the Conservative Party at the 2007 presidential and 2008 general elections. This shift in politics marked the third era for the relationship between government and chaebols in Korea, and thus provides an ideal setting to investigate the impact of political connections in the presence of powerful business groups.

Chapter 4

Hypotheses

4.1 Introduction

Large and family-owned business groups, known as chaebols, are prevalent in Korea with operations across a wide range of industries (Bae, Kang and Kim, 2002; Ferris, Kim, and Kitsabunnarart, 2003). The average number of member firms including private and public companies in the top 30 chaebols is 26.8 in 1997. The minimum and maximum number of affiliates is 13 and 62 in Kohap Group and Hyundai Group respectively (Bae, Cheon, and Kang, 2008).

The economic power of chaebols is substantial. The top 30 chaebols produced about 16% of the country's GDP and about 12% of total GNP in 1998 (Baek, Kang and Park, 2004). The Korea Stock Exchange (KSE) is dominated by these chaebols, which represent more than half of total market capitalization, 62.5% of total assets, and 72.6% of total gross sales of all listed companies (Bae, Kang, and Kim, 2002). The big five largest chaebols – Hyundai, Samsung, Daewoo, LG, and SK – have dominant power in the Korean economy, contributing 9% of GDP and 27% of manufacturing GDP in 1995 (Yoo, 1998).

Prior studies document that large firms and family-controlled firms are more likely to have political connections than other types of firms. For example, politically connected firms in Malaysia, on average, are twice as big as unconnected firms (John and Mitton, 2003). Aggarwal, Meschke, and Wang (2009) find connected firms that make more political donations have more assets (larger size) in the United States as well. So do Goldman, Rocholl, and So (2008) for a sample of S&P 500 firms in 2000 whose political connection is through board members. Faccio (2010)'s cross-country analysis shows the market value of equity of connected firms are three times larger than non-connected peers on average. Morck, Stangeland, and Yeung (2000, 2004) find that family ties play an important role in relation to political ties

and influence in Canada where family controlled companies tend to have more political connections and power.

The prevalence of large business groups (chaebols) in Korea suggests the importance in considering them in tests of the effect of political connections in Korea. This chapter develops two sets of predictions about the value of political connections for both chaebols and other firms. These are outlined in Section 4.2. Section 4.3 provides a chapter summary.

4.2 Hypotheses

The literature suggests two competing hypotheses on the value of political connections: value-adding and value-destroying. Under the value-adding hypothesis, political connections create potential resources that can add value to connected firms. Economic benefits that firms can gain from the connections stem from government resources and supports. Preferential access to bank loans, for instance, is a common benefit that connected firms can receive from banks owned or controlled by government. These bank loans charge an interest rate that is lower than the prevailing market rate, as was observed in various countries including Brazil (Claessens, Feijen, and Laeven, 2008); Indonesia (Leuz and Oberholzer-Gee, 2006); Malaysia (Johnson and Mitton, 2003); and Pakistan (Khwaja and Mian, 2005). Chaney, Faccio and Parsley (2011) also find connected firms enjoy a lower cost of debt than comparable non-connected peers in 19 countries.

Other economic benefits of political connections include the awarding of profitable government contracts and lower taxation to connected firms, as well as imposing tariffs on competitors. For example, Goldman, Rocholl, and So (2008) report that, after the 1994 election in the U.S, firms associated with the winning political party were expected to get increased government awarded contracts. Bertrand, Kramarz, Schoar, and Thesmar (2007) and Wu, Wu, and Rui (2012) find firms with politically connected managers are more successful in gaining

government subsidies in France and China respectively. In addition, government can give tax benefits to connected companies by imposing tariffs on competitors include foreign competitors (Goldman, Rocholl and So, 2013). According to Mobarak and Purbasari (2006), Indonesian firms that supported the Suharto government received systematic benefits in the form of import licenses, and putting their competitors at a disadvantage. In France, Bertrand, Kramarz, Schoar, and Thesmar (2007) find that firms with politically connected CEOs have on average lower corporate tax payments. Using a cross-county analysis, Faccio (2010) also shows that connected firms are taxed at a lower rate (0.76 percentage lower than non-connected firms), and thus benefit from lower operating costs.

When faced with financial distress or economic downturn, political connections can also help connected firms to obtain government aid such as capital control or bailouts. Johnson and Mitton (2003) show the effect of imposing capital control in Malaysia during the Asian financial crisis. The government control increased the sum of the market value for politically connected firms by approximately \$1.6 billion. Faccio, Masulis, and McConnell (2006) find that government bailouts can be a preferential benefit that connected firms can enjoy. In a cross-country analysis of the likelihood of government bailouts, they report that politically connected firms have a higher chance to be bailed out by the government compared to unconnected firms. Given the assurance of corporate bailouts in periods of financial downturn, Boubakri, Guedhami, Mishra, and Saffar (2012) find that, in general, politically connected firms are deemed less risky than non-connected firms, as reflected by the former's lower cost of capital.

Overall, these findings suggest that political connections provide greater opportunity to the connected firms to obtain key resources from the government, and to lower operating costs and risks relative to non-connected firms.

In an efficient capital market, we expect investors to price these benefits derived from political connections. The probability of receiving these favorable outcomes may increase or decrease depending on the shift in the firm's political landscape, specifically the establishment or the termination of its connections. We expect these outcomes to be reflected in the stock price on the announcement of a new connection including a nomination or election, or removal from the office such as the unexpected death of politicians. Therefore, the value-adding hypothesis predicts either positive abnormal returns around the establishment of political connections or negative abnormal returns around the termination of political connections. Conversely, since the termination of political connections implies the end of the flow of political benefits that may accrue to the connected firms, the value-adding hypothesis also predicts a negative share price reaction around the termination of the connection.

Many studies support this argument. The establishment of a connection generates an increase in equity value. For a sample of 35 countries, Faccio (2006) examines how stock price changes in relation to a firm's stakeholders entering government service either through an election or appointment. She documents an average increase in firm value of over 2% on the announcement in the (-2, +2) window. Claessens, Feijen, and Laeven (2008) also find that the stock price reaction for politically connected firms in Brazil is significantly positive around the election, implying that investors predict future political favors for those firms. Goldman, Rocholl, and So (2008) find that the announcement of board nomination of a politically connected director of S&P 500 companies is associated with a positive abnormal stock. Aggarwal, Meschke, and Wang (2009) find positive one-day abnormal returns to companies connected to the winning party in the presidential election years when they assess whether ties to the winning party around an election are associated with higher event-study returns. Goldman, Rocholl, and So (2008) also report that the Republican Party's winning of the U.S.

2000 presidential election led to an increase in the value of firms connected to the Republican Party.

In contrast, the removal of connections leads a decrease in equity value. Fisman (2001) finds the Indonesian President Suharto's debilitating health conditions result in a loss in value of firms connected to the Suharto regime. Roberts (1990) examines the effect of Senator Henry Jackson's sudden death on the U.S. stock market. On average, while the announcement of his death negatively affects the share price of companies that supported Senator Jackson's campaign, companies connected to his successor gain a positive abnormal return. Faccio and Parsley (2009) also employ the sudden death of sitting politicians as a proxy for the termination of connections. Their analysis reports an average market-adjusted decline in the equity value of connected firms by 1.7% in response to 122 sudden deaths of politicians from around the world between 1973 and 2004.

Overall, cross-country and country-specific evidence suggests that political connections add value to connected firms. Since this study focuses only on the establishment of the connection, the value-adding hypothesis therefore predicts the following:

H1: Firms experience, on average, a significantly positive abnormal stock return around the establishment of political connections.

In Korea, chaebols firms are significantly larger in size. Ferris, Kim, and Kitsabunnarart (2003) report that with respect to total assets and sales, chaebol firms are 10 times larger than non-chaebol firms. Although chaebols have significant power in the economy with its sizable operations, firms within a chaebol are controlled by a single family. When it comes to decision making, the controlling family has more influence than professional managers of the company (Bae, Kang, Kim, 2002). According to the Fair Trade Commission, a chairman holds on

average 1.95% ownership in the country's top 36 chaebols as of 1 April 2003. If the ownership were extended to include the chairman's family members, the shareholding interest increases to 2.66%. However, the actual controlling power of the chairman's family is 41.71% via complicated cross shareholdings and reciprocal shareholdings within affiliates.

Prior studies document that the stock price reaction of political connections depends on firm characteristics. The value-adding of political connections is greater for larger and family-controlled firms. For example, Faccio and Parsley (2009) find connected firms with family domination are more negatively affected by the death of the politician – the average price drop is -1.41% for a sample of 491 family connected firms compared to -0.89% for a sample of 1,510 non family connected firms. Goldman, Rocholl, and So (2008) show that the announcement of the board nomination of a politically connected individual leads to the trend that stock prices respond positively, especially among the larger companies.

These results suggest that investors do not price the value of political connections equally for all connected firms. Specifically, the value-adding of political connections is greater for connected firms that are larger and controlled by family. Since chaebol firms are both large and family-controlled, we expect chaebol firms with connections to receive more benefits from political intervention than other firms in Korea.

The government's involvement in the economy suggests the important relationship between businessmen and public officials. This relationship can take the form of cooperation, or collusion and corruption, or both (You, 2005). Evans (1995) emphasizes the importance of collaboration between the government and business to form and implement a new policy, and to establish trust, leading to reduced transaction costs. Under the value-adding hypothesis, the close association between the government and chaebols is considered a positive collaboration, which allows chaebols to obtain more key resources and support from the government. Indeed, there is ample evidence supporting this, tracing back to the 1960s when the first chaebols were

created by the Conservative government of Park to boost the economy and to pursue the government's political goals (Kang, 2002). In return, the government supported chaebols and granted them exclusive rights to profitable industries and monopolistic access to resources, including preferential lending, lower taxation, import and export licences, and foreign investment incentives and exchange allocations (Kang, 2002). More examples of the close relationship between chaebols and the Conservatives, which traditionally equates big business interest with economic growth, are described in Section 3.3.

Overall, historical examples suggest that chaebols with connections can receive more benefits than other firms. Empirical evidence suggests the equity value of large and family firms with political connections is more sensitive to the establishment of political connections. The value-adding hypothesis therefore predicts the following for connected chaebols:

H2: Chaebol firms experience, on average, a significantly more positive abnormal stock return than other firms (including connected non-chaebol firms and non-connected firms) around the establishment of political connections.

In contrast, the value-destroying hypothesis predicts the opposite, i.e., investors associate political connections with rent-seeking activities by politicians to accomplish policy goals or their own interest by taking advantage of minority shareholders in the company. Shleifer and Vishny (1994) in fact indicate that politicians are willing to provide subsidies to connected firms, but not for free. The "payback" may take the form of firms creating employment, which in turn increases support for the incumbent government. Similarly, Bennesen (2000) theorises that in equilibrium the best policy for firms would be trading inefficient employment arrangements for government subsidies.

Conflicts of interest between shareholders and bureaucrats who oversee the firm arise when the latter gives priority to social objectives or private gains over the firm's interest. Thus rent-seeking activities by politicians may distort investment decisions or misallocate resources for firms, resulting in lower firm value (Shleifer and Vishny, 1998). Bertrand, Kramarz, Schoar, and Thesmar (2007) provide empirical evidence that firms with politically connected CEOs have higher rates of job or plant creation and lower rates of plant destruction so as to support votes for connected politicians in France. However, the rent seeking behavior of politicians results in politically connected firms exhibiting lower performance and lower rates of return on assets compared to firms with no connections, and this trend is most noticeable during election periods and in some political competition. Poor performance is therefore found despite connected firms receiving tax deduction and subsidies from the government. Morck, Stangeland, and Yeung (2000) also find that connected firms in Canada exhibit lower industry-adjusted financial performance, R&D spending, and labour capital ratios than non-connected counterparts.

Consequently, corporate political connections are costly when connected politicians try to pursue their own interest at the expense of other stakeholders in the firm. However, Faccio (2004) argues that politicians' rent-seeking activities are not the only reason for the overall underperformance of politically connected firms. The literature on corporate governance suggests that agency and weak governance issues can plague politically connected firms, resulting in other value-decreasing rent-seeking activities by controlling shareholders. For example, Qian, Pan, and Yeung (2011) claim that it is easier for controlling owners of connected firms to be involved in self-dealing and tunnelling as political connections help firms secure bank financing and exempt them from capital market punishment. Using an international sample, Chaney, Faccio, and Parsley (2011) find that managers of connected firms are not worried much about improving the firm's financial records compared to those of non-

connected firms. In fact, Guedhami and Pittman (2006) show that lower quality accounting information is used to hide their illegal activities such as embezzlement and prevent monitoring of these activities. Wahab, How, and Verhoeven (2007) also report that political connections have a significantly negative effect on the quality of corporate governance in Malaysia. Additional supporting evidence is provided by Chaney, Faccio, and Parsley (2011), who find that less accurate analyst forecasts are found in connected firms, which suggests that information asymmetry problems are more rampant in these firms.

In an efficient capital market, we expect investors to price the costs of political connections due to the rent-seeking activities of politicians and the ensuing potential expropriation of shareholders that may well exceed the benefits the firm receives from the connection. As political connections are negatively associated with abnormal returns around the establishment of political connections, the value-destroying hypothesis therefore predicts the following:

H3: Politically connected firms experience, on average, a significantly negative abnormal stock return around the establishment of political connections.

Consistent with the value-destroying hypothesis, Faccio (2006) finds that firms experience an average CAR of -0.80% around the announcement of the appointment of politicians to directorship in 35 countries. Fan, Wong, and Zhang (2007) report similar results for a sample of politically-connected IPO companies in China. They show firms with political connections underperform those with political ties by around 18% three years post-IPO. The first-day stock return also reflects the negative impact of political connections.

Mirroring the value-adding hypothesis for connected chaebol firms, the value-decreasing hypothesis predicts that the cost of political connections is more pronounced in large and

family-controlled firms. Rent seeking politicians may prefer large firms in granting favours since the likelihood of maximising their policy goals or private benefits is greater in these firms. Aggarwal, Meschke, and Wang (2009) find that political connections prevail in a company with weak corporate governance. Due to their significant economic power and weak governance by controlling families, chaebols provide a major source for rent-seeking activities by politicians.

Shleifer and Vishny (1994) argue that in many capitalist economies, there is close relationship between political connections and corruption. According to Treisman (2000), corruption is defined as the misuse of public office for private gain. He also notes that the risk of getting caught and punished help to determine and explain the different levels of corruption in different countries. Wedeman (1997) argues that Korea has had widespread, high-level corruption since 1945. You (2005) defines corruption as the abuse of power for private gain, and finds the close relationship between petty corruption and high-level political corruption in Korea. To be more specific, founding families in chaebols increase their political influence by continuing to supply illegal funding to high-level politicians (Kang, 2002; Noland and Pack, 2003).

Chaebols' informal political donations have been documented in Korea. Top businessmen's annual contributions to former president Park (1961-1979) have reached 20 billion won, in 1990 constant prices (Yoo, 2005). In particular, both former presidents Chun Doo-Whan (1980-1987) and Roh Tae-Woo (1988-1992) met frequently with heads of chaebols and received substantial amounts of illegal political donations. Some big corporations including Samsung, Hyundai, Tonga, LG, and Daewoo contributed illegally between 15 and 22 million won in 1990 constant prices to President Chun, and about 21 to 25 million won in 1990 constant prices were received by President Roh Tae-Woo (Kang, 2002). Kim young-Sam, the successor to President Roh Tae-Woo, received 60 million won (1990 constant prices) from

Hanbo Group, which was established by Chung Tae-Soo who was found guilty of illegal donations (You, 2005). Also Lee Hoi-Chang, the two-time candidate for the presidential elections in 1997 and 2002, illegally received a total of 44 billion won for the two elections from Samsung (You, 2005). More recently, President Lee Myung-bak's (2007-2012) older brother, Lee Sang-deuk, a member of parliament, was found to have taken 150 million won from Kolon Group, where he once served as the chief executive officer (Korean Times, 2013).

Aggarwal, Meschke, and Wang (2009) find a negative effect of corporate donations with regard to future excess returns. Their study shows that every \$10,000 made in donation results in a decrease in annual excess returns by 8.2 basis points.

In general, conflicts of interest between controlling and minority shareholders is an important issue in corporate governance in Korea (Bae, Kang, and Kim, 2002). Despite their small stake, family owners have effective control over all member companies in the chaebol due to cross-shareholdings among member firms (Ferris, Kim, and Kitsabunnarart, 2003). In terms of major decision making, member companies rely heavily on the controlling family and professional management does not have much influence in this process (Shin and Park, 2001). While having both ownership and control rights vested in one individual reduces potential agency problem that arises from the separation of ownership and control (Jensen and Meckling, 1976), there still remains a different kind of agency problem – the controlling shareholders can easily expropriate minority shareholders by tunnelling resources out of the firm to maximize their private gain (Lemmon and Lins, 2003). For example, Bae, Kang, and Kim, (2002) provide direct evidence of tunnelling in which the controlling shareholders of chaebols transfer resources from firms where they have low cash flow rights to firms where they have high cash flow rights through acquisitions.

Qian, Pan, and Yeung (2011) document that political ties impact on the incentive of controlling shareholders in order to expropriate minority shareholders through self-dealing and

tunnelling, leading to lower performance of political connected firms relative to non-connected companies. In conjunction with chaebols' weak governance issues, rent-seeking activities by controlling shareholders would be more severe in chaebol firms, leading to lower value for chaebol firms.

In light of the costs of connections to chaebol firms, which are typically large and family-owned, the value-destroying hypothesis therefore predicts the following:

H4: Chaebols firms experience, on average, a significantly more negative abnormal stock return than other firms (including connected non-chaebol firms and non-connected firms) around the establishment of political connections.

4.3 Chapter Summary

This chapter develops the testable hypotheses on the value relevance of political connection in Korea. Two competing hypotheses are examined. The first, which is the value-adding hypothesis, hypothesizes that political connections increase corporate value. In light of the power role played by chaebols in the Korean economy and politics, the value-adding hypothesis also hypothesizes that chaebol firms have more to gain from political connections than other firms. The alternative hypothesis predicts the opposite. That is, political connections reduce firm value, and that the decline in value of connected chaebol firms is greater than other firms.

Chapter 5

Data and Research Method

5.1 Introduction

This chapter discusses the data and research method. As the research focus is on chaebol firms that are politically connected, it is imperative to identify firms that are connected to both chaebol and politicians in our sample. We carefully construct a new database demonstrating political connections at the firm level and business group level separately for a sample of non-financial firms listed on the Korea Stock Exchange. We explain the procedures in the next section. Research method is provided in Section 5.3. Section 5.4 and Section 5.5 discuss the control variables and descriptive statistics respectively. Section 5.6 summarizes the chapter.

5.2 Measuring Connections with Chaebols and Politicians

This section explains how we identify and measure firms' connections with chaebols and politicians.

Our initial sample consists of all listed non-financial firms from 2007 to 2011 since banks and other financial institutions are excluded from large business groups or chaebols by the Korean law. Further, these financial institutions are subject to different regulations. For each firm, we collect financial data, daily stock returns, and index prices from the Korea Investors Service (KIS) database.

Based on the definition of chaebols in Section 3.3, we track each listed firm to see if it is a chaebol using the KIS database. The KIS database provides all group membership classifications for listed companies, as defined by The Monopoly Regulation Fair Trade Act. We match the business group names against the list of chaebols provided by the KFTC annually. Following Almeida, Park, Subrahmanyam and Wolfenzon (2011), we focus only on chaebols owned by a natural person (i.e., founding family business groups) and exclude other business

groups such as government-owned business groups. We then classify the listed firms into chaebol firms and non-chaebol firms, and create a dummy variable that equals one if the firm is connected to a chaebol, and zero otherwise. The choice of the sample period is driven by the presidential and congressional cycles in Korea, which occur every 5 and 4 years respectively, beginning with the Lee Myung-Bak regime, the 17th presidency of Korea, and the 18th National Assembly in 2008. However, we include years prior to the Lee government in order to test the 2007 presidential election.

For the purposes of this study, we categorize the politicians into four types: (i) a president; (ii) a minister (including the prime minister, cabinet ministers, and vice-cabinet ministers); (iii) a member of the parliament; and (iv) a head of a local government. We obtain politicians' names and the period of their tenure from official government websites (Appendix 1, Panel A). We identify a total of 468 politicians: 1 president; 4 prime ministers; 48 cabinet ministers; 81 vice-cabinet ministers; 330 parliamentarians; and 4 heads of a local government.

To establish the presence of a link with politicians, we classify a firm as being politically connected if it has a controlling shareholder or top officer who: (i) is a serving politician; (ii) has a family member that is an immediate or in-law blood relative of a serving politician; or (iii) is related to a serving politician through either formal directorship held by the politician or friendship (Fisman, 2001; Johnson and Mitton, 2003; Faccio, 2006).¹¹ As in Faccio (2006), top officers are a firm's CEO, president, vice-president, chairman, vice chairman, and secretary.

The Code of Conduct in Korea prohibits politicians from holding directorship or ownership in business firms; thus cases of direct connections between politics and business are rare. Therefore, in addition to direct connections, we also focus on indirect political connections, e.g., when a firm is connected through a relative (Fisman, 2001; Johnson and

¹¹ The Code of Conduct in Korea has strong restrictions on politicians from holding directorship or ownership in business firms; thus cases of direct connections between politics and business are rare.

Mitton, 2003; Faccio, 2006). Unlike Faccio (2006), who defines a relative as a spouse, child, sibling, or parent, we adopt the broader definition of KFTC.

Firms nominated as belonging to large business groups by KFTC are governed by special regulations that are generally more restrictive on the operation of businesses within the group. Such laws include restrictions on equity holding and loan guarantee within the affiliated companies. KFTC also requires firms listed on KSE to report their ownership structure including the status of affiliated shareholders and persons with special interest, and the financial status of group companies. More importantly for our research, KFTC mandates the disclosure of the identity of the controlling shareholders, which is to be grouped into seven types: family owner; relatives of the family owner; affiliates; non-profit affiliates; executives; reacquired stocks; and others (Almeida, Park, Subrahmanyam, and Wolfenzon, 2011). Relatives of the family owner are further classified into four types as given Figure 5.1.

Figure 5.1: Types of Relatives based on KFTC’s Classifications

Family Owner	Family Owner’s Relatives			
	Spouse/ Blood relative within a cousinship (1)	Blood relative within second - fourth cousinship (2)	Blood relative within fifth - eighth cousinship (3)	One's in law with fourth cousinship (4)

Based on these regulatory classifications of relatives, we classify connections through immediate relatives as blood relatives or in-law relatives (marital networks). A firm is said to be politically connected through blood relatives if any of the politician’s blood relatives are a controlling shareholder or top director in the firm. To identify the politician’s blood relatives, we use the largest searching website in Korea, Naver (<http://www.naver.com>), which provides the profile of politicians and business people including their name, age, close family members, directorships for business people, and positions for politicians. Since having social capital and networks is one of most important abilities for politicians and businesspeople (Faccio and

Parsley, 2009) in Korea, we also search the top 10 daily newspapers in Korea (Appendix 1, Panel B) using the politicians' names and "*in-maek*" as keywords. The Korean word "*in-maek*" is often used in the media to describe politicians' social networks.

Table 5.1: An Example of Political Connections in the Business Groups

The Name of Company (Listed on the KSE)	The Name of Business Group	Chaebol	Relation with Vice- Minister Park	Ownership by Park's family	Directorship by Park's family
Kumho Tire Co.Inc.	Kumho Asiana	Yes	Nephew	No	Yes
Asiana Airlines, Inc.	Kumho Asiana	Yes	Brother	No	Yes
Kumho Industrial Co. Ltd.	Kumho Asiana	Yes	Brother	Yes	No
Kumho Petrochemical Co.Ltd.	Kumho Asiana	Yes	Brother	Yes	Yes
Daesang Holdings Co.,Ltd.	Daesang	No	Sister	Yes	Yes
Daesang Corporation	Daesang	No	In-law	Yes	Yes

We collect the names of the blood relatives which we then cross-check with the ownership structure data from KIS. This procedure allows us to verify the top directors who are blood relatives of politicians as well as identifying political connections for both chaebol and non-chaebol firms. For example, Park Jong-gu, who is a vice-cabinet minister of Ministry of Education and Science Technology, is the younger brother of the chairman of Kumho Asiana Group, Park Sam-koo. The Park's family owns and manages Kumho Asiana Group, which is the 14th largest chaebol with affiliates in various industry sectors including leisure, automotive, logistic, chemical, and airline fields. Park Jong-gu's elder sister, Park Hyun-ju, is vice president and controlling shareholder of Daesang Holdings Corporation, one of the affiliates in a non-chaebol business group, the Daesang Group. The Park's blood tie results in five politically connected firms at the individual firm-level, and one chaebol and one non-chaebol at the business group-level. Details are shown in Table 5.1.

Figure 5.2 shows the level of family members we include in our description of a marital networks. To illustrate, we provide the marital networks between President Lee Myung-Bak's family and the Cho's family, who owns and manages Hyosung Group and Hankook Tire Group. The network was established when Cho Hyun-beom, vice-president/controlling shareholder of

Hankook Tire Corporation, married the third daughter of President Lee, Lee Su-young. Table 5.2 shows the ownership and directorship by Cho's family. Cho Yang-rai, the father of Cho Hyun-beom, is chairman of Hankook Tire Group and his brother, Cho Seok-rae, is chairman of Hyosung Group. In 2008, Hyosung Group was ranked the 33rd largest business group (chaebol), and Hankook Tire Group was ranked 57th although it was not a chaebol.

Figure 5.2: A Family to Family Connection

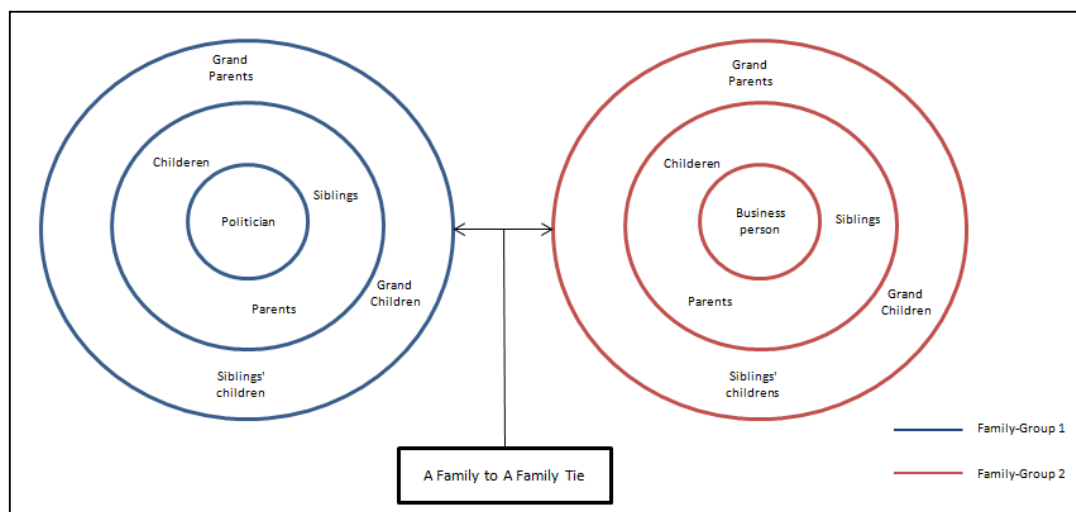


Table 5.2: Political Connection in Hyosung Group and Hankook Tire Group

The Name of Company (Listed on the KSE)	Business Group	Chaebol	Relation with President Lee	Ownership by Cho's family	Directorship by Cho's family
Hyosung Corporation	Hyosung	Yes	In-law	Yes	Yes
Hyosung ITX Co., Ltd.	Hyosung	Yes	In-law	Yes	No
Galaxia Communications Co., Ltd.	Hyosung	Yes	In-law	Yes	No
Chin Hung International, Inc.	Hyosung	Yes	In-law	No	No
IB Sports Inc.	Hyosung	Yes	In-law	No	No
Hankook Tire Co., Ltd.	Hankook Tire	No	In-law	Yes	Yes
Atlasbx Co., Ltd.	Hankook Tire	No	In-law	Yes	No
Celltrion Pharm Inc.	Celltrion Holdings	No	In-law	Yes	No

Third, we consider close relationships that consist of cases of well-known friendships between politicians and business people, and former directorships held by politicians during the Lee regime. Similar to prior studies (Agrawal and Knoeber, 2001; Fisman, 2001; Johnson and Mitton, 2003; Faccio, 2006), we rely on publicly available sources for information on close

relationships, which are the top 10 Korean daily newspapers and Naver (<http://www.naver.com>) in our case.

In short, a firm is said to be politically connected if i) a family member of a businessperson (controlling shareholder or top director) is an immediate relative (blood relative or in-law relative) of an incumbent politician; ii) a businessperson is closely related to a prominent politician (through formal directorship held by a politician or friendship); or iii) a business person is an incumbent politician.

Unlike Faccio (2006) and prior studies that define political connections only at the individual firm level, we consider political connections at both the firm and business group levels. Firm level political connection is identified by whether a firm has direct personal or financial ties with the politicians. If the connected firm belongs to a chaebol, none of its affiliates within the business group are considered to be connected unless the affiliates themselves have direct political ties. The firm-level definition thus assumes that the wealth effect of political connections does not spill over to other firms within the same business group as the connected firm. This spill over effect, where the benefits or costs from political connections are shared amongst the group members, however is considered in our definition of business group level connections. Specifically, as long as any firm within a chaebol is connected, all its affiliates in the business group are (indirectly) connected.

Using the example in Table 5.2, we can see that the identification of firms as being politically linked is different, depending on whether we define connections at the individual firm level or business group level. Hyosung Group consists of five firms listed on the KSE but only three of them are directly connected through the Cho's family who owns and/or manages these firms at the individual firm level. Although the other two firms are not owned and/or managed by the Cho's family, we consider them to be indirectly connected at the business group level as they both belong to Hyosung Group.

Table 5.3 shows the top 30 largest business groups ranked by KFTC in 2008. Of these, 13 are politically connected, with 12 of them identified as chaebols. Among the top five large business groups, three (Samsung, Hyundai Motor, and LG) are politically connected, suggesting the prevalence of political ties with chaebols in Korea.

Based on our definition of corporate political connections, we identify 87 companies and 49 business groups (with a total of 139 affiliates within these business groups) that are politically connected during the period 2007-2011. At the firm level, most of connections involve the president (25.29%), ministers (26.44%), and members of the parliaments (48.98%), while only two connections are through the head of a local government. For the purposes of this study, we categorize the politicians into four types: (i) a president; (ii) a minister (including the prime minister, cabinet ministers, and vice-cabinet ministers); (iii) a member of the parliament; and (iv) the head of a local government (2.04%), as shown in Panel A of Table 5.4. Sixty four connections (74%) are through elections and 23 (26%) are by appointments of politicians. Of the 87 connected firms in our sample, 41 firms belong to chaebols (47.13%).

Panel B of Table 5.4 shows that most of the political connections are indirect (94.25%), the most common being family connections (83.91%) and close relationships (26.44%), rather than direct through share ownership (5.75%). In our sample, 25 of the familial connections are through blood relatives (28.74%) and 48 involve in-laws (55.17%). While only five chaebol firms are connected through close relationships with a politician (5.75%), most chaebol firms are connected through relatives – specifically, 18 are through blood relatives (20.69%) and 23 (26.44%) through marital networks. Therefore, family members provide the most important source of connections with politicians for chaebols in Korea. Panel C of Table 5.4 indicates that three-quarters of the connections involve both the owner and the manager. This case is more pronounced in chaebol firms where four in five firms are connected in this manner.

TABLE 5.3
Top 30 Large Business Groups Ranked by KFTC in 2008

Rank	Name of Business Group	Political Connection	Type of Connection	Ownership		
				Owned by founding family	Owned by non-founding family	Owned by government
1	Samsung	Yes	Minister through in-laws	Yes		
2	Korea Electric Power Corporation					Yes
3	Hyundai Motor	Yes	1) President through former directorship; 2) MP through blood relatives	Yes		
4	SK			Yes		
5	LG	Yes	President through in-laws	Yes		
6	Korea National Housing Corporation					Yes
7	LOTTE	Yes	MP through in-laws	Yes		
8	Korea Expressway Corporation					Yes
9	POSCO				Yes	
10	Korea Land Corporation					Yes
11	GS			Yes		
12	Hyundai Heavy Industries	Yes	1) MP through direct ownership 2) MP through blood relatives	Yes		
13	KT				Yes	Yes
14	Kumho Asiana	Yes	Minister through blood relative	Yes		
15	Hanjin			Yes		
16	Hanhwa	Yes	MP through blood relatives	Yes		
17	Doosan			Yes		
18	Hynix	Yes	President through friendship		Yes	
19	Korea Railroad Corporation					Yes
20	Korea Gas Corporation					Yes
21	STX			Yes		
22	Shinsegae	Yes	Minister through In-laws	Yes		
23	CJ	Yes	Minister through In-laws	Yes		
24	LS	Yes	President through in-laws	Yes		
25	Dongbu			Yes		
26	Daerim			Yes		
27	Hyundai	Yes	MP through in-laws	Yes		
28	Daewoo Shipbuilding & Marine Engineering				Yes	Yes
29	KCC	Yes	MP through blood relatives	Yes		
30	GM Daewoo				Yes	Yes

In Panel D, the distribution of politically connected business groups by types of politicians is similar to that at the firm-level: president (26.53%), ministers (22.45%), member of parliaments (48.98%), and the head of a local government (2.04%). Among 49 business groups with connections, there are 17 chaebols (34.69%) that are connected, suggesting that chaebols are less likely to be connected than non-chaebols. However, when we include the affiliate firms, 79 member firms within the chaebols are connected (56.83%) compared to 60 affiliates in non-chaebols that are politically connected (43.17%). This can be explained by chaebols being much more diversified business conglomerates than non-chaebols (Bae, Cheon, and Kang, 2008).

Based on the data we build, we create a set of dummies for political connections. In addition, we also construct a set of dummies for politically connected chaebols with interactions between dummies for political ties and a dummy for chaebols. Table 5.5 shows these.

TABLE 5.4
Classification of Political Connections

Panel A. Connections by Politicians with Chaebols and Non-Chaebols at Firm Level

	No. of Firms Connected	(%)	No. of Chaebol Affiliates Connected	(%)	No. of Non- Chaebol Affiliates Connected	(%)
President	22	25.29	11	12.64	11	12.64
Ministers	23	26.44	11	12.64	12	13.79
Member of Parliament	40	45.98	19	21.84	21	24.14
The Head of Local Government	2	2.3	0	0.00	2	2.30
Total	87	100	41	47.13	46	52.87

Panel B. Connections by Direct and Indirect Relation with Chaebols and Non-Chaebols at Firm Level

	No. of Firms Connected	(%)	No. of Chaebol Affiliates Connected	(%)	No. of Non- Chaebol Affiliates Connected	(%)
Connection via Family	73	83.91	41	47.13	32	36.78
Of which						
Connected via Blood Relative	25	28.74	18	20.69	7	8.05
Connected via In-laws	48	55.17	23	26.44	25	28.74
Connection via Close Relation	23	26.44	5	5.75	18	20.69
Of which						
Cases of Friendship	13	14.94	0	0.00	13	14.94
Former Directorship	10	11.49	5	5.75	5	5.75
Direct Relation via Ownership	5	5.75	2	2.30	3	3.45

Panel C. Connections by Ownership or Directorship at Firm Level

	No. of Firms Connected	(%)	No. of Chaebol Affiliates	(%)	No. of Non- Chaebol Affiliates	(%)
Connected via Owner	74	85.06	37	42.53	37	42.53
Connected via Director	77	88.51	37	42.53	40	45.98
Connected via Owner-Director	64	73.56	33	37.93	31	35.63

TABLE 5.4 (Continued)
Classification of Political Connections

Panel D. Connections with Politicians for Chaebols and Non-Chaebols at Business Group Level

	No. of Business Group Connected	No. of Chaebol Connected	No. of Non- Chaebol Connected	No. of Business Group Affiliates Connected	No. of Chaebol Affiliates Connected	No. of Non- Chaebol Affiliates Connected
President	13	6	7	39	28	11
(%)	26.53	12.24	14.29	28.06	20.14	7.91
Ministers	11	4	7	45	26	19
(%)	22.45	8.16	14.29	32.37	18.71	13.67
Member of Parliament	24	7	17	46	25	21
(%)	48.98	14.29	34.69	33.09	17.99	15.11
The Head of Local Government	1	0	1	9	0	9
(%)	2.04	0.00	2.04	6.47	0.00	6.47
Total	49	17	32	139	79	60
(%)	100.00	34.69	65.31	100.00	56.83	43.17

TABLE 5.5
Variables for Political Connections

Variables	Description
Panel A. Politically Connected Firms	
<i>Politically Connected</i>	A dummy variable that takes a value of 1 if firm is politically connected and zero otherwise.
Panel B. Classification by Chaebols	
<i>Connected Chaebol</i>	A dummy variable that takes a value of 1 if a chaebol firm is politically connected and zero otherwise.
<i>Connected Non-Chaebol</i>	A dummy variable that takes a value of 1 if a non-chaebol firm is politically connected and zero otherwise.
Panel C. Classification by Specific Connections	
<i>Blood Relative</i>	A dummy variable that takes a value of 1 if a firm is politically connected through blood relatives and zero otherwise.
<i>Marital Relation</i>	A dummy variable that takes a value of 1 if a firm is politically connected through in-law relatives and zero otherwise.
<i>Cases of Friendship</i>	A dummy variable that takes a value of 1 if a firm is politically connected through close friendship and zero otherwise.
<i>Former Directorship</i>	A dummy variable that takes a value of 1 if a firm is politically connected through former directors and zero otherwise.
<i>Direct Ownership</i>	A dummy variable that takes a value of 1 if a firm is politically connected through direct ownership and zero otherwise.
Panel D. Classification by Types of Politicians	
<i>President</i>	A dummy variable that takes a value of 1 if a firm is politically connected with president and zero otherwise.
<i>Ministers</i>	A dummy variable that takes a value of 1 if a firm is politically connected with ministers and zero otherwise.
<i>Member of Parliament</i>	A dummy variable that takes a value of 1 if a firm is politically connected with member of parliament and zero otherwise.
<i>Head of Local Government</i>	A dummy variable that takes a value of 1 if a firm is politically connected with head of local government and zero otherwise.
Panel E. Classification by Owners and Directors	
<i>Owner</i>	A dummy variable that takes a value of 1 if a firm is politically connected through owners and zero otherwise.
<i>Director</i>	A dummy variable that takes a value of 1 if a firm is politically connected through directors and zero otherwise.

TABLE 5.5 (Continued)
Variables for Political Connections

Panel F. Classification by Specific Connections with Chaebols

<i>Blood Relative_Chaebol</i>	A dummy variable that takes a value of 1 if a chaebol firm is politically connected through blood relatives and zero otherwise.
<i>Marital Relation_Chaebol</i>	A dummy variable that takes a value of 1 if a chaebol firm is politically connected through in-law relatives and zero otherwise.
<i>Former Directorship_Chaebol</i>	A dummy variable that takes a value of 1 if a chaebol firm is politically connected through former directors and zero otherwise.
<i>Direct Ownership_Chaebol</i>	A dummy variable that takes a value of 1 if a chaebol firm is politically connected through direct ownership and zero otherwise.

Panel G. Classification by Types of Politicians with Chaebols

<i>President_Chaebol</i>	A dummy variable that takes a value of 1 if a chaebol firm is politically connected with president and zero otherwise.
<i>Ministers_Chaebol</i>	A dummy variable that takes a value of 1 if a chaebol firm is politically connected with ministers and zero otherwise.
<i>Member of Parliament_Chaebol</i>	A dummy variable that takes a value of 1 if a chaebol firm is politically connected with member of parliament and zero otherwise.

Panel H. Classification by Owners and Directors with Chaebols

<i>Owner_Chaebol</i>	A dummy variable that takes a value of 1 if a chaebol firm is politically connected through owners and zero otherwise.
<i>Director_Chaebol</i>	A dummy variable that takes a value of 1 if a chaebol firm is politically connected through directors and zero otherwise.

5.3 Research Method

Our next task is to find a setting that allows us to test whether political connectedness does indeed influence corporate value. If connections add (destroy) value, as hypothesized, the announcement of new connections should be associated with a positive (negative) abnormal return, which is more pronounced in chaebols firms with connections than other firms. We therefore examine the short-run stock performance of politically connected firms for the whole sample as well as subgroups of chaebols and non-chaebols in univariate and multivariate settings; in the latter, we control for other factors that may also affect stock performance.

First, we define the event dates for the establishment of political connections as the election (Claessens, Feijen, and Laeven, 2008; Faccio, 2006) or appointment (Faccio, 2006) dates of the politicians. For example, if a businessperson or her family member becomes a politician through an election or by appointment, we consider the date of the election or appointment as the date when the new connection is established. We identify the dates of the following five events during our sample period: the presidential election; two cases on the appointment of ministers; the election for members of parliaments; and the election for the head of a local government.¹² The event day is determined by the event time so that if the announcement is made after trading closes, we select the next trading day as the event day.

Table 5.6 presents our sample composition based on the event date. Panel A shows the five events we examine. In the case of the presidential election, we have three possible event dates to capture the market reaction. The first event date (President Event 1) is May 10, 2007 when Lee Myung-bak officially declared to run for the nomination of Grand National Party (GNP) as its presidential candidate. Subsequent to the official declaration, from 16 May 2007

¹² There were two appointments of ministers during our study period. The first appointment took place on 29 February 2008 and the second on 28 September 2009. These are our second and third events. The fourth event is the election for members of parliament on 9 April 2008. The final event is the election for the head of 7 local governments on 3 June 2010.

to 12 December 2007, the opinion polls showed that candidate Lee led the majority vote with a huge margin, about 17 times more than his opponents. The poll results therefore suggest that the outcome of the election could easily be called in advance. The popularity of candidate Lee suggests that the market is likely to factor in his impending election to presidency on the day when he officially declared to go into election. Therefore, we focus on this first event date (President Event 1) to measure the market reaction to the establishment of connections with the president Lee.

The second event date (President Event 2) is August 20, 2007 when candidate Lee defeated Park Geun-hye in GNP's primary to become the party's nominee for the 2007 Presidential election. The third event date (President Event 3) is December 19, 2007 when candidate Lee won the presidential election. For robustness, we also use these two event dates in the event study. In sum, we construct three data sets with different event dates (President Event 1-3) for the establishment of connections with President Lee, as shown in Panel A of Table 5.6.

Panel B of Table 5.6 shows the frequency distribution of politically connected companies and affiliates in business groups for each event date. In our measurement of political connection, we first assume that the five events are independent, as shown in Panel B. That is, for each event, we screen all sample firms to see if they are politically connected.

However, in Panel C, we allow the benefits (or costs) of prior connections to “spill over” to subsequent events. For example, as the prime minister and members of cabinet are appointed by the president, they are individually and collectively accountable to the president. Therefore, for events 2 to 4, our sample of connected firms includes firms with an existing connection with the President (event 1) as well as firms that establish a new connection with the minister or members of the cabinet. For robustness, we recalibrate our measure of connection to reflect this.

TABLE 5.6
Sample Composition based on the Event Date

Panel A. Sample Composition By Three Different Event Dates for the Presidential Election					
Event Order	Event 1	Event 2	Event 3	Event 4	Event 5
Event Description	Presidential Election	Appointment of first cabinet	General Election	Appointment of minister	Local Election
Event Date (President Event 1)	May 16, 2007	February 29, 2008	April 9, 2008	September 28, 2009	June 3, 2010
Event Date (President Event 2)	August 20, 2007	February 29, 2008	April 9, 2008	September 28, 2009	June 3, 2010
Event Date (President Event 3)	December 19, 2007	February 29, 2008	April 9, 2008	September 28, 2009	June 3, 2010

Panel B. No. of Politically Connected Firms assuming No Spill Over in Connections					
Firm-level	22	23	40	2	2
Business Group-Level	40	43	46	2	9

Panel C of No. of Politically Connected Firms assuming Spill Over in Connections					
Firm-Level	22	40	75	2	2
Business Group-Level	40	76	114	2	9

Following prior studies on the value of political connections (Faccio 2006; Faccio and Parsley, 2009), we employ the standard event study methodology to calculate abnormal returns (Brown and Warner, 1985). When event dates or the test period of the sample are clustered in the same calendar time period, calendar time clustering of events may induce cross-sectional dependencies (Brown and Warner, 1980). Calendar time clustering thus causes the independence assumption for the abnormal returns in the cross-section to be incorrect (Collins and Dent, 1984, Bernard, 1987). Brown and Warner (1985) suggest that cross correlations from event time clustering are not a problem for abnormal returns on a non-cumulative basis (AR) as long as the sampled firms are diversified. However, the power of these tests decreases substantially with cumulated returns, suggesting that cross correlation problems may be aggravated in the CAR framework with clustered event time. Brown and Warner (1985) in their simulation analysis find that the methods that adjusts for market movements are superior

in the case of clustering than nonmarket-adjusted methods. Therefore, following Faccio (2006) and Faccio and Parsley (2009), we employ the market adjusted-return in our tests.

For daily stock returns, we use continuous compounding by taking the natural logarithm of the closing price P_{it} of security i and trading day t :

$$R_{it} = \ln\left(\frac{P_{it}}{P_{it-1}}\right). \quad (1)$$

We calculate daily excess returns:

$$AR_{it} = R_{it} - R_{mt}, \quad (2)$$

where R_{it} is the firm i 's daily stock return on day t , and R_{mt} is the return on day t for a benchmark index. As the Korea Stock Exchange consists of the Korea Composite Stock Price Index (KOSPI) and the Korean Securities Dealers Automated Quotations (KOSDAQ),¹³ we match firm i 's stock return with the index of the exchange that the firm is listed on. We create a dummy that equals one if company is listed on the KOSPI and zero for firms listed on the KOSDAQ to control for index-specific effects in our regressions. We then calculate cumulative abnormal returns (CAR) across time:

$$CAR_i(t_1, t_2) = \sum_{t=t_1}^{t_2} AR_{it}. \quad (3)$$

We compute the CAR for an event window (-10, +10) to estimate the market's valuation of the political connection, where time 0 is the event date. We then calculate the mean cumulative abnormal returns across firms for each event.

Since the price limit has been set at 15% for all stocks on the Korean exchange from April 5, 1995, Bae and Cha (1997) and Bae, Kang, and Kim (2002) suggest that a longer window length allows time for price adjustment to corporate announcements in Korea. Faccio and Parsley (2009) show that the sudden death of politicians results in a statistically and economically significant drop in the price of connected companies using the (-1, +10) window,

¹³ KOSDAQ was introduced in order to support small and growing IT venture firms to access the local capital markets easily with more eased listing requirements in 1996.

also supporting the idea that the market takes time to reflect the full value of political ties. Faccio and Parsley (2009) explain this phenomenon from a study by Loughran and Schultz (2005) that thin trading in small stocks partly leads to this effect.

As our sample consists of listed firms, including small and large firms, and are affected by the price limit rule and the small stock effect, we use a longer window length for computing the CAR. Since using a pre-event window helps to incorporate the effect of possible leakages of the announcement (Bae, Cheon, and Kang, 2008), we therefore select the (-10, +10) window in our main tests. For robustness, we also conduct tests based on various window lengths of (-1, +1), (-2, +2), and (-5, +5).

We test the null hypothesis of whether the mean cumulative abnormal return for connected firms is equal to zero. Brown and Warner (1985) show that the parametric t -test is well specified under the null hypothesis of no abnormal price performance. We use the following cross-sectional t -test:

$$T_{cross} = \frac{CAAR(t_1, t_2)}{\hat{\sigma}_{CAAR_t}}. \quad (4)$$

The variance estimator for this statistic is based on the cross-section of abnormal returns:

$$\hat{\sigma}^2_{CAAR(t_1, t_2)} = \frac{1}{N(N-d)} \sum_{i=1}^N [CAR_i(t_1, t_2) - CAAR_i(t_1, t_2)]^2. \quad (5)$$

Non-normality is a potential problem for studies using daily data since it is generally recognized that abnormal returns are generally not normally distributed (Brown and Warner, 1985; Berry, Gallinger and Henderson, 1990). This violation is typically associated with fat tails, but could also be attributed to other non-normal characteristics such as skewness (Brown and Warner, 1985).

TABLE 5.7
Skewness/Kurtosis Tests for Normality of Average CAR (-10, +10)

Panel A. Connections at Firm Level					
	Observation	Pr(Skewness)	Pr(Kurtosis)	Joint Test	
				adj chi2(2)	Prob>chi2
Politically Connected	87	0.7718	0.0761	3.34	0.1886
of which					
Chaebol connected	41	0.1846	0.4148	2.59	0.2738
Non-Chaebol connected	46	0.2975	0.0334	5.40	0.0674

Panel B. Connections at Business Group Level					
	Observation	Pr(Skewness)	Pr(Kurtosis)	Joint Test	
				adj chi2(2)	Prob>chi2
Politically Connected	139	0.0852	0.0103	8.54	0.0140
of which					
Chaebol connected	79	0.0011	0.0160	13.29	0.0013
Non-Chaebol connected	60	0.9271	0.0054	7.01	0.0301

To address these concerns, we conduct the skewness-kurtosis (Jarque-Bera) test for the mean CAR (-10, +10) to see whether our sample violates the normality of distribution assumption. The results are reported in Table 5.7. Overall, the mean cumulative abnormal returns are not normally distributed and the distribution has fat tails, a low peak, and is skewed to the right. These results indicate that the stated significance levels may not be taken literally due to the non-normality problem. To address this concern, Corrado (1989) suggests a non-parametric test for event studies in the face of distributional problems. Therefore, we also report the median cumulative abnormal returns and significance levels using the Wilcoxon-Mann-Whitney test in the univariate tests.

To understand better the cross-sectional variation in the abnormal returns from political connections, we estimate the following multiple regression model:

$$CARs = \alpha + \beta_1(Connections) + \beta_2(Chaebol) + \beta_3(Controls) + Fixed\ Effects + \varepsilon \quad (6)$$

where the dependent variable is the cumulative abnormal return (CARs) for various window lengths: (1-, +1), (-2, +2), (-5, +5), and (-10, +10). *Connections* is a set of dummy variables that take a value of one if a firm or a business group is politically connected and zero otherwise. *Chaebol* is a dummy variable that takes the value of one if the firm belongs to a chaebol and zero otherwise. *Controls* is a set of control variables that may affect firm performance, and they are firm size, book-to-market ratio, and leverage. *Fixed Effects* is a set of dummy variables that control for the fixed effects of each industry based on Global Industry Classification Standard (GICS) of KSE, event time periods, and the location of the stock exchange.¹⁴ ε is the error term. We estimate the regression model separately for political connections measured at the individual firm level and the business group level.

In the base regression, we estimate our model for the five events as pooled ordinary least squares (OLS) with heteroskedasticity-consistent standard errors corrected for clustering at the firm level. We use the bootstrapping approach since non-normality and the small sample problem may result in statistical misspecification. As in Lyon, Barber, and Tsai (1999), we compute the bootstrapped skewness-adjusted t-statistics to address the cross-correlation and skewness biases. To bootstrap the distribution, we resample the observations 1,000 times.

Pooling has the benefit of increasing the sample size and thus results in a more precise estimation and test statistics with more power. However, it introduces serial correlation between observations within the different event time periods, thus violating one of the assumptions for OLS. The OLS coefficient estimate is consistent and unbiased. However, the variance-covariance matrix is biased and inconsistent and may cause the standard errors to be incorrect (Petersen, 2009). To address this concern, our bootstrapped samples are drawn in the unit of clusters at firm-level (Petersen, 2009).

¹⁴ GICS classifies 8 different industries: Health Care, Industrials, Material, Energy, Utilities, Consumer Discretionary, Information Technology, and Consumer Staples. Each event time dummy is the difference in the conditional expected value of the dependent variable between the base period (event period 1) and the other event periods (2–5).

Although we use market-adjusted returns to address the cross-sectional dependencies due to event time clustering, Collins and Dent (1984) propose a generalized least squares (GLS) method to estimate the mean effect of abnormal performance when there exists potential cross-sectional dependencies in returns due to clustered event time. The GLS approach incorporates estimates of the contemporaneous covariance in the estimation of the regression coefficients. Bernard (1987) also shows that the bias due to cross sectional dependencies can be a serious matter regardless of how well diversified the sample is, and concludes that the GLS approach might be useful. While prior studies suggest a variety of statistical methods, it is clear that there is no consensus agreement regarding the single best solution to address cross-sectional dependencies in event studies. For robustness, we estimate our test by the GLS method.

5.4 Control Variables

For control variables, we use firm-level characteristics that may affect the firm's stock performance apart from the event of interest, i.e., the establishment of political connections. The most common firm characteristics that are controlled for are firm size and book-to-market ratio. Banz (1981) investigate the relationship between the total market value of NYSE firms and its return over the period 1936-1975, finding the common stock of small companies has, on average, a higher risk-adjusted return than large firms. Fama and French (1992) provide evidence that the cross-sectional variation in expected returns is associated with the small firm effect. Consistent with the small firm size effect, Pontiff and Schall (1998) find small firms earn excess returns during the period 1926 to 1994.

In terms of the book-to-market ratio, Fama and French (1992) find a strong positive book-to-market ratio effect, indicating that companies with higher book-to-market ratios have on average a higher expected return. In contrast, Kothari and Shanken (1997) use a Bayesian framework and find the book-to-market ratio of the Dow Jones Industrial Index (DJIA)

sometimes predicts negative expected returns over the period 1926 to 1991. Pontiff and Schall (1998) also examine the book-to-market ratio effect of DJIA. They argue that the book-to-market ratio has predictive power because it contains information about future returns that is not captured by other variables including dividend yields and interest yield spreads.

Modigliani and Miller (1958) suggest that higher leverage raises the risk of a stock. As a result, they expect returns to increase with leverage. Later studies, however, show inconclusive results. Bhandari (1988) and Dhaliwal, Heizman and Zhen (2006) find a positive association between equity and leverage. In contrast, Arditti (1967) and George and Hwang (2009) find that stock returns and leverage are negatively related. On the other hand, Fama and French (1992) and Chen and Zhang (1998) argue that firm size and book-to-market ratio capture the informational content of leverage, absorbing the influence of leverage on stock returns.

Based on the discussion above, we therefore include these three firm characteristics as control variables. We include the logarithm of the market value of equity as a proxy for *Firm Size*. *Book-to-Market* is the ratio of book value of equity divided by the market value. *Leverage* is the ratio of total liabilities to total assets. All control variables are measured at the end of fiscal year that comes immediately before the political event.

5.5 Descriptive Statistics

Table 5.8 presents the descriptive statistics of our sample firms. The initial sample consists of all non-financial firms listed on the KSE during the following five events that mark the establishment of political connections in Korea from 2007 to 2011: the presidential election; two cases on the appointment of ministers; the election for members of parliaments; and the election for the head of a local government. The initial sample comprises 6,096 observations for these five events. The sample is divided into three groups based on whether the firms are (1) politically connected; (2) affiliated with a chaebol; and (3) politically connected and

affiliated with a chaebol. In groups (1) and (3), we provide the summary statistics for connections at the individual firm level and business group level separately.

Panel A of Table 5.8 shows the descriptive data for connected and non-connected firms when political connection is measured at the individual firm level. There are significant differences in firm size and leverage but not in book-to-market ratio between connected and non-connected firms. On average, connected firms are significantly larger and more highly levered, consistent with prior studies (Johnson and Mitton, 2003; Faccio, 2010). Faccio (2010) explains that either firms with these characteristics are more likely to have political connections or that political ties result in these firms having such characteristics. Our finding supports Faccio's first explanation as the firm characteristics we report are measured before the establishment of political connections.

Panel B of Table 5.8 shows the same for connections measured at the business group level. Extending the definition of connections to all member firms within the same business group echoes the above finding that politically connected firms (business groups) are larger and have higher leverage than non-connected firms. However, the average book-to-market ratio for connected firms (0.914) is significantly lower than that of non-connected firms (1.513). This result is consistent with Aggarwal, Meschke, and Wang (2009) who report that firms that make greater political donation have a lower book-to-market ratio.

Panel C of Table 5.8 presents the summary statistics for chaebol and non-chaebol firms. Interestingly, as with connected firms, chaebol firms also have larger size and leverage. Consistent with prior studies (Bae, Kang, and Kim, 2002; Ferris, Kim, and Kitsabunnarart, 2003; Baek, Kang and Park; 2004), chaebol firms are significantly larger than non-chaebol firms. Chaebol firms also appear to make greater use of financial leverage than non-chaebol firms, consistent with Baek, Kang and Park (2004) and Ferris, Kim, and Kitsabunnarart (2003).

The average leverage for chaebol firms (0.477) is significantly higher than non-chaebol firms (0.382).

Panels D and E of Table 5.8 show the profile of chaebol firms with connections and non-chaebol firms with connections, where connections are measured at the firm level and business group level respectively. Several features are noteworthy. Chaebols with connections have larger size compared to connected non-chaebols and non-connected chaebols at both firm level and business group level. However, when we define connections at the business group level, connected chaebols only appear to have the lower book-to-market ratio than non-connected chaebols.

TABLE 5.8
Descriptive Statistics

This table compares differences between 1) politically connected and non-connected firms and business groups; 2) chaebols and non-chaebols; and 3) chaebols with connections and non chaebols with connections. *Firm Size* is the logarithm of the market value of equity. *Book-to-Market* is the ratio of book value to market value of equity. *Leverage* is the ratio of total liabilities to total assets. All firm characteristics are measured at the end of fiscal year that comes immediately before the political event.

Panel A. Connected Firms versus Non Connected Firms for Connections at Firm Level

	No.of. Obs.	Mean	Median	Std.	Min	Maximum
<i>Firm Size</i> for connected firms	87	20.155	19.850	1.990	16.853	25.129
<i>Firm Size</i> for non-connected firms	5819	18.102	17.833	1.507	12.376	25.491
Difference	5906	2.052	2.017			
(p-value)		(0.000)	(0.000)			
<i>Book-to-Market</i> for connected firms	87	0.930	0.723	0.649	0.135	4.498
<i>Book-to-Market</i> for non-connected firms	5819	1.508	1.056	3.588	-15.258	215.456
Difference	5906	-0.577	-0.334			
(p-value)		(0.136)	(0.000)			
<i>Leverage</i> for connected firms	87	0.465	0.500	0.175	0.020	0.791
<i>Leverage</i> for non-connected firms	5819	0.392	0.383	0.206	0.001	2.673
Difference	5906	0.073	0.117			
(p-value)		(0.001)	(0.000)			

Panel B. Connected Firms versus Non Connected Firms for Connections at Business Group Level

	No.of. Obs.	Mean	Median	Std.	Min	Maximum
<i>Firm Size</i> for connected firms	139	19.986	19.743	1.882	16.314	25.129
<i>Firm Size</i> for non-connected firms	5767	18.088	17.820	1.498	12.376	25.491
Difference	5906	1.898	1.922			
(p-value)		(0.000)	(0.000)			
<i>Book-to-Market</i> for connected firms	139	0.914	0.775	0.603	-0.020	4.498
<i>Book-to-Market</i> for non-connected firms	5767	1.513	1.061	3.604	-15.258	215.456
Difference	5906	-0.600	-0.286			
(p-value)		(0.051)	(0.000)			
<i>Leverage</i> for connected firms	139	0.477	0.496	0.180	0.018	1.029
<i>Leverage</i> for non-connected firms	5767	0.391	0.382	0.206	0.001	2.673
Difference	5906	0.086	0.114			
(p-value)		(0.000)	(0.000)			

Panel C. Chaebols versus Non-Chaebols

	No.of. Obs.	Mean	Median	Std.	Min	Maximum
<i>Firm Size</i> for chaebols	664	20.376	20.470	1.793	15.199	25.491

TABLE 5.8 (Continued)

<i>Firm Size</i> for non-chaebols	5242	17.848	17.689	1.237	12.376	24.710
Difference	5906	2.528	2.781			
(<i>p</i> -value)		(0.000)	(0.000)			
<i>Book-to-Market</i> for chaebols	664	1.240	0.842	1.774	-2.790	27.870
<i>Book-to-Market</i> for non-chaebols	5242	1.532	1.083	3.728	-15.258	215.456
Difference	5906	-0.292	-0.241			
(<i>p</i> -value)		(0.047)	(0.000)			
<i>Leverage</i> for chaebols	664	0.477	0.478	0.188	0.007	1.176
<i>Leverage</i> for non-chaebols	5242	0.382	0.370	0.205	0.001	2.673
Difference	5906	0.094	0.108			
(<i>p</i> -value)		(0.000)	(0.000)			

Panel D. Chaebols with Connections versus Non Chaebols with Connections at Firm Level

	No.of. Obs.	Mean	Median	Std.	Min	Maximum
<i>Firm Size</i> for connected chaebols	42	21.378	21.544	1.550	18.437	25.129
<i>Firm Size</i> for connected non-chaebols	45	19.040	18.750	1.673	16.853	23.541
Difference	87	2.339	2.794			
(<i>p</i> -value)		(0.000)	(0.000)			
<i>Book-to-Market</i> for connected chaebols	42	0.822	0.682	0.440	0.163	2.036
<i>Book-to-Market</i> for connected non-chaebols	45	1.030	0.833	0.785	0.135	4.498
Difference	87	-0.208	-0.150			
(<i>p</i> -value)		(0.139)	(0.344)			
<i>Leverage</i> for connected chaebols	42	0.476	0.502	0.160	0.079	0.735
<i>Leverage</i> for connected non-chaebols	45	0.455	0.499	0.189	0.020	0.791
Difference	87	0.021	0.003			
(<i>p</i> -value)		(0.589)	(0.733)			

Panel E. Chaebols with Connections versus Non Chaebols with Connections at Business Group Level

	No.of. Obs.	Mean	Median	Std.	Min	Maximum
<i>Firm Size</i> for connected chaebols	79	20.861	20.960	1.629	17.621	25.129
<i>Firm Size</i> for connected non-chaebols	60	18.847	18.558	1.558	16.314	23.541
Difference	139	2.014	2.401			
(<i>p</i> -value)		(0.000)	(0.000)			
<i>Book-to-Market</i> for connected chaebols	79	0.799	0.690	0.441	-0.020	2.036
<i>Book-to-Market</i> for connected non-chaebols	60	1.063	0.844	0.741	0.195	4.498
Difference	139	-0.264	-0.154			
(<i>p</i> -value)		(0.010)	(0.051)			
<i>Leverage</i> for connected chaebols	79	0.484	0.492	0.184	0.018	1.029
<i>Leverage</i> for connected non-chaebols	60	0.468	0.508	0.176	0.020	0.791
Difference	139	0.016	-0.016			
(<i>p</i> -value)		(0.600)	(0.837)			

5.6 Chapter Summary

This chapter outlines the definition of political connections, research method, measurement of control variables, and descriptive statistics. A firm is said to be politically connected if i) a family member of a businessperson (controlling shareholder or top director) is an immediate relative (blood relative or in-law relative) of an incumbent politician; ii) a businessperson is closely related to a prominent politician either through formal directorship held by a politician or friendship; or iii) a business person is an incumbent politician.

Using this definition, we identify 87 politically connected firms among all non-financial firms listed on the KSE during the period 2007-2011. To establish the presence of a link between politicians and chaebols, we divide the sample into two groups: chaebol and non-chaebol firms. Among the 87 connected firms, 41 belong to chaebols. Using the business group-level definition of connections, we identify 49 business groups with a total of 139 affiliates that are politically connected. Of the 49 connected business groups, 17 are chaebols with 79 member firms and the rest (32) are non-chaebols with 60 affiliates.

We employ the standard event study to test the impact of political connections on stock prices. Identifying the correct event dates is crucial to event studies, and so we painstakingly perform this task and identify the date of the following five events that mark the establishment of political connections in Korea: the presidential election; two cases on the appointment of ministers; the election for members of parliaments; and the election for the head of a local government. The integration of these five events gives us 5,906 firm-event observations.

To better understand the cross-sectional variation in the abnormal returns around the events, we estimate the regression for the five events using pooled ordinary least squares (OLS) with heteroskedasticity-consistent standard errors corrected for clustering at the firm level and bootstrapped adjusted t-statistics by re-sampling observation 1,000 times. Our final sample size consists of 5,906 observations. Consistent with past studies, we find that firms with political

connections and belonging to chaebols are on average larger and have higher leverage than other firms.

Chapter 6

Empirical Results

6.1 Introduction

This chapter discusses the empirical results on the value of the establishment of political connections in Korea. Capitalizing on the dominant role played by large business groups in the Korean economy, the analysis extends to a comparison of the wealth effects of the connections between chaebol and non-chaebol firms. Univariate results are first examined in Section 6.2, followed by multivariate results in Section 6.3. A chapter summary and conclusion are provided in Section 6.4.

6.2 Univariate Results

In this section, we calibrate shareholders' wealth effects of the establishment of political connections by firms in Korea. We conduct the standard event study methodology to discriminate between the value-adding hypothesis of connections from the value-destroying hypothesis. Political connection is measured at the firm level in Figure 6.1, and at the business group level in Figure 6.2.

Figure 6.1 plots the mean CAR for a (-10, +10) days event window around the election or the appointment of politicians for the following groups of firms: (i) firms with political connection; (ii) firms without connection; (iii) firms belonging to a chaebol; (iv) non-chaebol firms; (v) connected chaebol firms; and (vi) connected non-chaebol firms. The market reaction (CAR) is by far the strongest and most positive for the sample of chaebol firms with connections, supporting the value-adding hypothesis. However, the reverse (strong and negative stock reaction) is observed for non-chaebol firms with connections, supporting the value-destroying hypothesis. The mean CAR increases by almost 6% for connected chaebol firms but drops to approximately -4% for connected non-chaebol firms over the 21 days around the establishment of political connections.

Figure 6.1 Mean Cumulative Abnormal Returns (CARs) around the Establishment of Firm-Level Political Connections

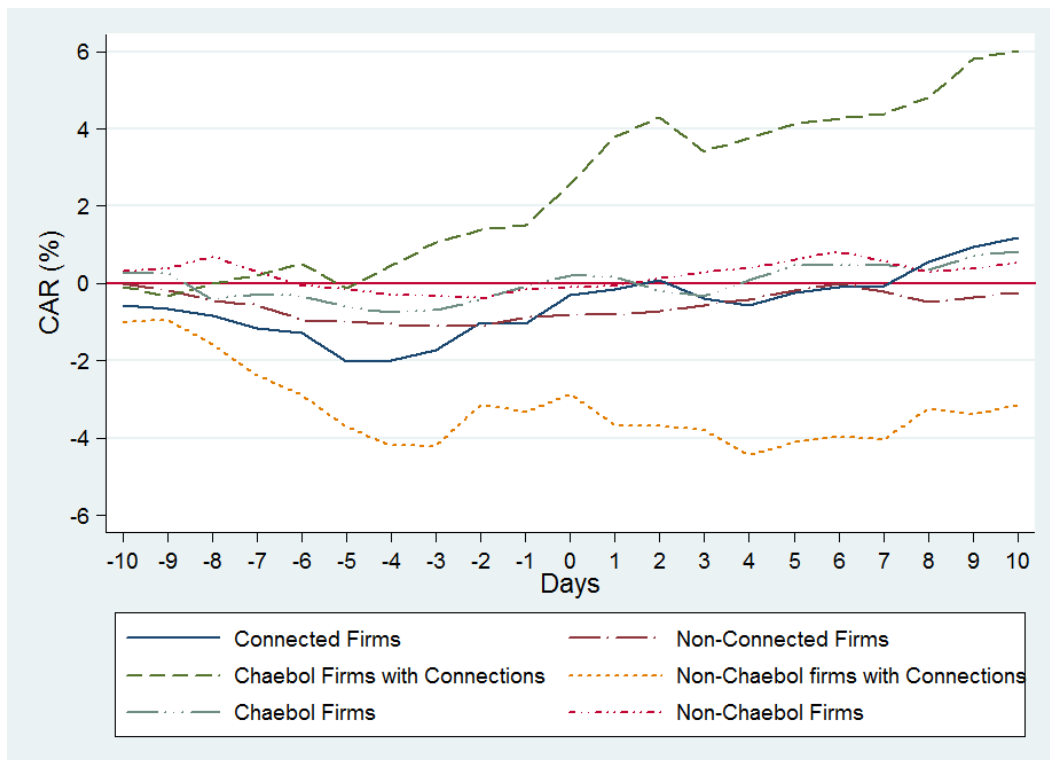
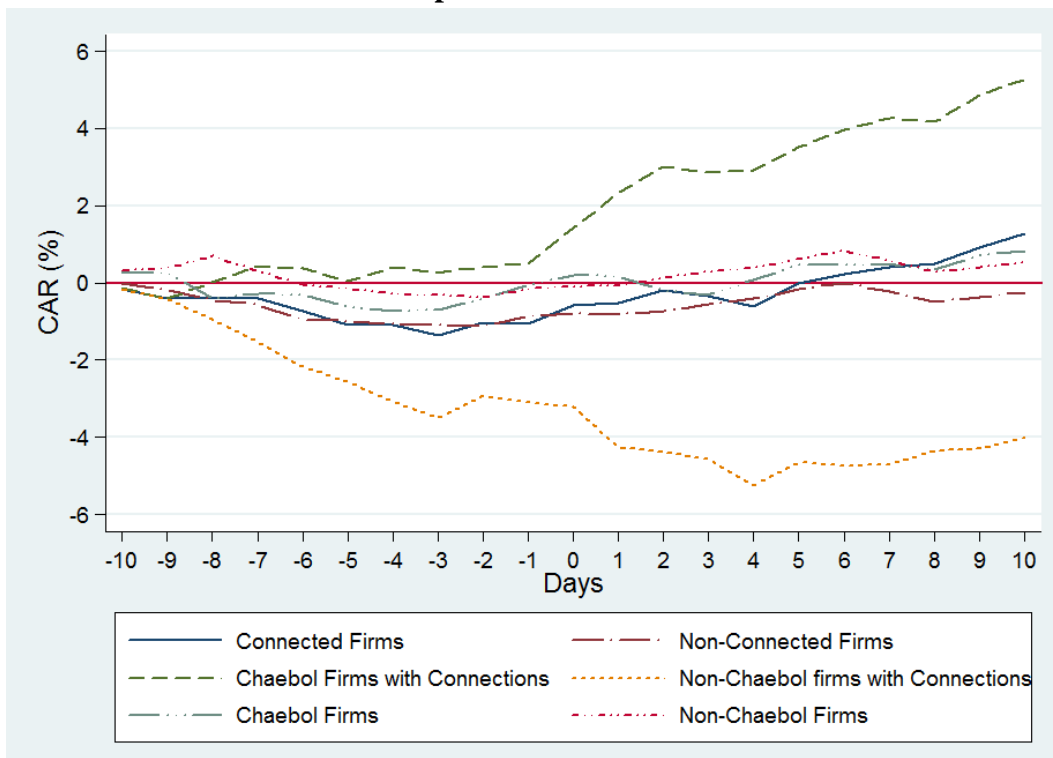


Figure 6.2 Mean Cumulative Abnormal Returns (CARs) around the Establishment of Business Group-Level Political Connections



Similar patterns are observed in Figure 6.2 when we define political connection at the business group level. As before, the group of chaebol firms with connections experience the most positive wealth effects, while non-chaebol firms with connections have the most negative share price reaction to the establishment of political ties. By the end of the 21-day event window, the mean CAR is almost 6% for connected chaebol firms but -4% for connected non-chaebol firms.

Tables 6.1 and 6.2 report the mean and median CARs for the five political events, where the connection is defined at the firm and business group level respectively. For robustness, we report the results based on various event windows: (-1, +1), (-2, +2), (-5, +5), and (-10, +10), where time 0 marks the first day when a new connection with the politician is made. We report parametric t-statistics for the mean CAR calculated from the cross-section standard errors of the CARs. We also report the median CAR and significance levels using the Wilcoxon-Mann-Whitney test.

Table 6.1 shows that the new connections, measured at the firm level, generate an economically moderate increase in the price of politically connected firms, which is statistically significant only for the (-2, +2) window. The difference in the mean (median) CAR between connected and non-connected firms in the (-2, +2) window is 1.47% (1.05%) and significant at the 5% significance level. This result is close to the 1.43% reported by Faccio (2006) for the same event window (p -value=0.09) and roughly similar to the absolute value of the CAR (-1.01%, p -value=0.01) over the (-1, +5) window for the termination of political ties in Faccio and Parsley (2009). Thus, there is some evidence supporting the first hypothesis that political connections add firm value in Korea.

TABLE 6.1
Cumulative Abnormal Returns (CARs) around the Establishment of Firm-level Political Connections

	<i>No. of Obs.</i>	Event Windows							
		(-1, +1)		(-2, +2)		(-5, +5)		(-10, +10)	
		Mean	Median	Mean	Median	Mean	Median	Mean	Median
Politically Connected Firms (A)	87	0.86%	0.63%	1.80%***	0.98%**	1.05%	0.87%	1.17%	1.55%
		(0.13)	(0.24)	(0.01)	(0.04)	(0.22)	(0.25)	(0.36)	(0.47)
Non-Politically Connected Firms (B)	6,012	0.27%***	-0.08%	0.33%***	-0.06%	0.70%***	0.32%***	-0.37%**	-0.99%***
		(0.00)	(0.69)	(0.00)	(0.48)	(0.00)	(0.00)	(0.02)	(0.00)
Differences (A –B)		0.59%	0.71%	1.47%**	1.05%**	0.34%	0.55%	1.54%	2.54%
		(0.31)	(0.25)	(0.04)	(0.05)	(0.73)	(0.50)	(0.23)	(0.19)
Chaebol Firms (C)	685	0.58%***	0.17%	0.49%**	0.10%	0.79%**	0.42%*	0.83%*	0.18%
		(0.00)	(0.20)	(0.03)	(0.24)	(0.02)	(0.09)	(0.06)	(0.26)
Non-Chaebol Firms (D)	5,414	0.26%***	-0.10%	0.38%***	-0.05%	0.78%***	0.32%***	-0.34%**	-1.03%***
		(0.00)	(0.81)	(0.00)	(0.39)	(0.00)	(0.00)	(0.04)	(0.00)
Differences (C-D)		0.32%	0.27%	0.11%	0.15%	0.01%	0.10%	1.18%**	1.21%***
		(0.14)	(0.24)	(0.68)	(0.40)	(0.97)	(0.75)	(0.02)	(0.00)
Politically Connected Firms if Chaebol=1 (E)	41	2.42%***	2.31%***	3.24%***	1.94%***	3.61%***	3.49%***	6.00%***	5.02%***
		(0.00)	(0.00)	(0.00)	(0.00)	(0.00)	(0.00)	(0.00)	(0.00)
Politically Connected Firms if Chaebol=0 (F)	46	-0.53%	-1.11%	-0.52%	-0.31%	-1.23%	-1.40%	-3.14%*	-4.18%**
		(0.53)	(0.18)	(0.60)	(0.99)	(0.32)	(0.31)	(0.08)	(0.02)
Differences (E-B)		2.13***	2.39%***	2.87%***	1.98%***	2.83%**	3.16%***	6.25%***	6.00%***
		(0.01)	(0.00)	(0.00)	(0.00)	(0.02)	(0.00)	(0.00)	(0.00)
Differences (F-B)		-0.82%	-1.03%*	-0.89%	-0.27%	-2.01%	-1.73%	-2.89%	-3.20%**
		(0.30)	(0.11)	(0.88)	(0.88)	(0.15)	(0.12)	(0.11)	(0.05)

Note: *, **, and *** indicate significance at the 10%, 5%, and 1% levels respectively.

In partitioning the sample, we find the establishment of political connections results in a statistically and economically significant increase in the price of chaebol firms. The difference in the mean (median) CAR between chaebol firms with connections and non-connected firms is 2.13% (2.31%) for the (-1, +1) window (1% significance level), and 6% (5.02%) for the (-10, +10) window (1% significance level). This finding suggests that the market takes some time to reflect the full value of the political connection, consistent with the evidence in Faccio and Parsley (2009) for a sample of 8,191 firms from 35 countries. The observed positive market reaction is consistent with the value-adding hypothesis of connections. As shown earlier in the plots of CARs, the value of political connections is highest for connected chaebol firms, which have an average CAR of 2.42% for the (-1, +1) window, significantly higher than the -0.53% for connected non-chaebol firms. The average CAR of 3.24% for the (-2, +2) window is slightly less than that (4.32%, p -value=0.08) reported by Faccio (2006) for a sample of firms with new connections in countries with high corruption levels. .

It is worth noting that the magnitude of the stock reaction for chaebol firms with connections is almost twice of that for non-chaebol firms with connections, indicating that the effect of political connection is more pronounced in connected chaebol firms. This supports our second hypothesis that politically connected chaebols experience significantly more positive abnormal returns than other connected firms around the establishment of political connections.

Table 6.2 presents similar tests for the wealth effect of political connections at the business group level. The results are qualitatively similar to those reported above. Specifically, chaebol firms with connections have a significantly more positive average CAR than non-connected firms for all the windows examined. Although the magnitude of the stock reaction for connected chaebol firms is smaller than that reported for the firm level connections, the results confirm the value-adding hypothesis and suggest that the effect of political

TABLE 6.2
Cumulative Abnormal Returns (CARs) around the Establishment of Business Group-Level Political Connections

	<i>No. of Obs.</i>	Event Windows							
		(-1, +1)		(-2, +2)		(-5, +5)		(-10, +10)	
		Mean	Median	Mean	Median	Mean	Median	Mean	Median
Politically Connected Firms (A)	139	0.51% (0.27)	0.47% (0.33)	1.18%** (0.04)	0.87%* (0.10)	0.71% (0.30)	0.09% (0.41)	1.27% (0.20)	0.97% (0.35)
Non-Politically Connected Firms (B)	5,960	0.29%*** (0.00)	-0.08% (0.62)	0.37%*** (0.00)	-0.04% (0.34)	0.78%*** (0.00)	0.33%*** (0.00)	-0.25% (0.12)	-0.98%*** (0.00)
Differences (A-B)		0.22% (0.64)	0.55% (0.35)	0.81% (0.15)	0.91% (0.12)	-0.07% (0.93)	-0.24% (0.51)	1.51% (0.83)	1.95% (0.11)
Chaebol Firms (C)	685	0.58%*** (0.00)	0.17% (0.20)	0.49%** (0.03)	0.10% (0.24)	0.79%** (0.02)	0.42%* (0.09)	0.83%* (0.06)	0.18% (0.26)
Non-Chaebol Firms (D)	5,414	0.26%*** (0.00)	-0.10% (0.81)	0.38%*** (0.00)	-0.05% (0.39)	0.78%*** (0.00)	0.32%*** (0.00)	-0.34%** (0.04)	-1.03%*** (0.00)
Differences (C-D)		0.32% (0.14)	0.27% (0.24)	0.11% (0.68)	0.15% (0.40)	0.01% (0.97)	0.10% (0.75)	1.18%** (0.02)	1.21%*** (0.00)
Politically Connected Firms if Chaebol=1 (E)	79	1.91%*** (0.00)	1.36%*** (0.00)	2.75%*** (0.00)	1.73%*** (0.00)	3.13%*** (0.00)	2.98%*** (0.00)	5.28%*** (0.00)	3.55%*** (0.00)
Politically Connected Firms if Chaebol=0 (F)	60	-1.33%* (0.09)	-1.06%** (0.03)	-0.89% (0.32)	-1.54% (0.16)	-2.48%** (0.02)	-1.48%** (0.02)	-4.02%*** (0.01)	-4.67%*** (0.00)
Differences (E-B)		1.62%*** (0.01)	1.45%*** (0.00)	2.38%*** (0.00)	1.77%*** (0.00)	2.35%** (0.03)	2.64%*** (0.00)	5.52%*** (0.00)	4.52%*** (0.00)
Differences (F-B)		-1.63%** (0.02)	-0.98%** (0.02)	-1.26% (0.14)	-1.50% (0.11)	-3.26%*** (0.01)	-1.82%*** (0.00)	-3.77%** (0.02)	-3.70%*** (0.01)

Note: *, **, and *** indicate significance at the 10%, 5%, and 1% levels respectively.

connections extends to other member firms within a chaebol.

The above results are based on pooled political events. Insofar as the value of political connections may differ across the five political events, we rerun the above tests separately for each of the events. Table 6.3 shows the difference in returns between the subgroups examined is mostly insignificant, suggesting that our results are not specific to a certain event. We also rerun the above tests separately for each of the industries. The results, reported in Appendix 3, show that the difference in returns between the subgroups is mostly insignificant, suggesting that our results are not specific to a certain industry.

Overall, the univariate results show that firm membership to chaebols plays a key role in determining whether political connections are valuable or not. From the investors' viewpoint, chaebols are more able to capitalize on the political connections so that the net benefit for establishing political ties is a positive one for chaebol firms. The opposite is however documented for non-chaebol firms, where the market views the establishment of political ties as wealth decreasing. These findings remain intact when connections are measured at the business group level, indicating that new political connections by an affiliate firm has a "spill over" effect on the share price of other members within the same business group. The positive stock reaction for all connected firms is significantly smaller than that for connected chaebol firms, suggesting that the cost of the connection to non-chaebol firms offsets the benefit of the connection to chaebol firms at the national level.

TABLE 6.3
Cumulative Abnormal Returns (CARs) around the Establishment of Firm-Level Political Connections for Each Political Event

Event 1 refers to the presidential election. Event 2 is the appointment of first cabinet ministers. Event 3 is the general election for members of parliaments. Event 4 indicates the second appointment of ministers. Event 5 is the election for the head of a local government.

	<i>No. of Obs.</i>	Event Windows							
		(-1, +1)		(-2, +2)		(-5, +5)		(-10, +10)	
		Mean	Median	Mean	Median	Mean	Median	Mean	Median
Politically Connected Firms in Event 1	22	0.60% (0.63)	-0.45% (0.91)	0.50% (0.74)	0.51% (0.91)	0.96% (0.63)	1.97% (0.47)	6.00%* (0.06)	7.03%* (0.08)
Non-Politically Connected Firms in Event 1	1,138	-0.09% (0.61)	-1.20%*** (0.00)	-0.31% (0.13)	-1.34%*** (0.00)	0.15% (0.61)	-1.04%** (0.05)	0.72%* (0.08)	-0.51% (0.87)
Differences		0.69% (0.59)	0.75% (0.49)	0.81% (0.59)	1.85% (0.48)	0.81% (0.70)	3.02% (0.34)	5.28%* (0.08)	7.54%* (0.06)
Politically Connected Firms in Event 2	21	2.85%*** (0.01)	2.32%*** (0.01)	3.75%*** (0.01)	1.95%*** (0.01)	4.52%*** (0.01)	5.07%*** (0.01)	5.48%** (0.03)	2.85%** (0.04)
Non-Politically Connected Firms in Event 2	1,131	1.85%*** (0.00)	1.38%*** (0.00)	2.13%*** (0.00)	1.58%*** (0.00)	2.23%*** (0.00)	1.84%*** (0.00)	3.35%*** (0.00)	3.47%*** (0.00)
Differences		1.00% (0.41)	0.93% (0.26)	1.62% (0.26)	0.37% (0.30)	2.29% (0.28)	3.23% (0.17)	2.13% (0.45)	-0.62% (0.54)
Politically Connected Firms in Event 3	40	0.25% (0.77)	-0.20% (0.88)	1.87%* (0.07)	1.85% (0.14)	-0.73% (0.52)	-1.32% (0.44)	-2.88% (0.06)	-1.80%* (0.10)
Non-Politically Connected Firms in Event 3	1,117	-0.09% (0.54)	-0.35%* (0.10)	0.50%*** (0.00)	0.45%*** (0.00)	-0.20% (0.43)	-0.63%*** (0.01)	-1.82%*** (0.00)	-2.79%*** (0.00)
Differences		0.34% (0.66)	0.15% (0.71)	1.37% (0.15)	1.40% (0.33)	-0.54% (0.69)	-0.70% (0.65)	-1.07% (0.54)	0.98% (0.96)
Politically Connected Firms in Event 4	2	0.99% (0.69)	0.99% (0.65)	0.32% (0.92)	0.32% (0.65)	-5.77% (0.40)	-5.77% (0.18)	-10.80% (0.37)	-10.80% (0.18)
Non-Politically Connected Firms in Event 4	1,269	-0.41%*** (0.01)	-0.39%*** (0.00)	-0.33%* (0.09)	-0.01% (0.14)	1.17%*** (0.00)	1.29%*** (0.00)	-0.62%* (0.07)	-1.10%*** (0.00)
Differences		1.40% (0.72)	1.38% (0.54)	0.65% (0.89)	0.33% (0.88)	-6.94% (0.34)	-7.06% (0.18)	-10.18% (0.25)	-9.70% (0.16)
Politically Connected Firms in Event 5	2	-5.05%* (0.06)	-5.05% (0.18)	-4.34% (0.19)	-4.34% (0.18)	7.92% (0.31)	7.92% (0.18)	-3.92% (0.20)	-3.92% (0.18)
Non-Politically Connected Firms in Event 5	1,357	0.26%** (0.05)	-0.06% (0.65)	0.02% (0.91)	-0.85%*** (0.00)	0.52%** (0.04)	-0.03% (0.72)	-2.34%*** (0.00)	-2.45%*** (0.00)
Differences		-5.32% (0.13)	-5.00%** (0.04)	-4.35% (0.34)	-3.49% (0.12)	7.41% (0.26)	7.95% (0.12)	-1.58% (0.84)	-1.46% (0.76)

Note: *, **, and *** indicate significance at the 10%, 5%, and 1% levels respectively.

6.3 Multivariate Results

To better understand the cross-sectional variation in abnormal returns from political connections, we present the estimates from multivariate regressions. We report coefficient estimates from OLS regressions of stock returns on dummy variables for political connections (*Politically Connected*); whether the firm belongs to a large business group (*Chaebol*); control variables (*Firm Size*, *Book-to-Market*, and *Leverage*); and fixed effects for *Industry*, *Event Time*, and *Exchange*. For the political connection variable, we also create dummies to denote *Connected Chaebol* and *Connected Non-Chaebol* firms. The dependent variable is the CAR over the (-10, +10) window in regressions (1)-(8). For robustness, results for CARs over three alternative windows (-1, +1), (-2, +2), and (-5, +5) are also reported in regressions (9)-(11) respectively. We report *p*-value in parentheses, based on clustering by company, bootstrapped by re-sampling observations 1,000 times, and heteroskedasticity-consistent standard errors.

Table 6.4 presents a number of OLS regressions on the wealth effect of political connections measured at the individual firm level. Regressions 1 to 6 differ in the date used to denote the establishment of connection through the presidential election. Specifically, regressions (1) and (2) use “President Event 1” as the event date; regressions 3 and 4 use “President Event 2” as the event date; and regressions 5 and 6 use “President Event 3” as the event date.¹⁵ Regressions 7 and 8 allow the spill over effects of connections from earlier events to later events, i.e., if a firm was connected through the first event, it is assumed to be also connected in subsequent events.

¹⁵ We use the date when Lee Myung-bak officially declared to run for the nomination of the presidential candidate of Grand National Party (GNP) (May 10, 2007) as the date of the presidential election (Presidential event 1). As it is not clear when the market first impounds the value of the connection, we rerun the event study using the other dates as described in Table 5.6 for robustness.

TABLE 6.4
Regressions of CARs around the Establishment of Firm Level Political Connections

The dependent variable is the cumulative market-adjusted returns (CAR) over the (-10, +10) window in regressions (1)-(8) and over the (-1, +1), (-2, +2), and (-5, +5) windows in regressions (9)-(11) respectively. *Politically Connected* takes a value of 1 if a firm is politically connected, and zero otherwise. *Chaebol* takes a value of 1 if the firm belongs to a chaebol, and zero otherwise. *Connected Chaebol* takes a value of 1 if the firm belongs to a chaebol and is also politically connected, and zero otherwise. *Connected Non-Chaebol* takes a value of 1 if the firm is non-chaebol and politically connected. *Firm Size* is the logarithm of the firm's market capitalization. *Book-to-Market* is the ratio of the book value of equity to the market value of equity. *Leverage* is the ratio of total liabilities to total assets. All control variables are measured at the end of fiscal year immediately before the political event. Fixed effects consist of *Industry*, *Event Time*, and *Exchange* effects. Regressions (1) to (6) differ in the establishment date of connection through the presidential election: regressions (1) and (2) use "President Event 1"; regressions 3 and 4 use "President Event 2"; and regressions 5 and 6 use "President Event 3". Regressions 7 and 8 allow the spill over effects of connections from earlier events to later events. The remaining regressions (9-10) use alternative (shorter) event windows. The *p*-values are in parentheses, based on clustering by company, bootstrapped by re-sampling observations 1,000 times, and heteroskedasticity-consistent standard errors. *, **, and *** indicate significance at the 10%, 5%, and 1% levels respectively.

Independent Variables	CAR (-10, +10)								CAR	CAR	CAR
	President Event 1		President Event 2		President Event 3		Spill Over Connection		(-1, +1)	(-2, +2)	(-5, +5)
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)
<i>Politically Connected</i>	0.0062 (0.6241)		-0.0067 (0.4887)		-0.0112 (0.2939)			0.0058 (0.5847)			
Of which											
<i>Connected Chaebol</i>		0.0498*** (0.0009)		0.0268** (0.0374)		0.0137 (0.3663)		0.0390*** (0.0030)	0.0180** (0.0137)	0.0256*** (0.0086)	0.0336*** (0.0010)
<i>Connected Non-Chaebol</i>		-0.0314* (0.0852)		-0.0495** (0.0451)		-0.0116 (0.7116)		-0.0252* (0.0674)	-0.0072 (0.3692)	0.0001 (0.9890)	-0.0194 (0.1153)
<i>Chaebol</i>	0.0097* (0.0876)	0.0064 (0.2466)	0.0054 (0.2375)	0.0035 (0.4550)	0.0061 (0.1878)	0.0050 (0.2814)	0.0095 (0.1081)	0.0053 (0.3629)	0.0041 (0.1277)	0.0029 (0.3483)	0.0008 (0.8620)
<i>Firm Size</i>	0.0017 (0.2107)	0.0016 (0.2179)	0.0028** (0.0162)	0.0028** (0.0204)	0.0035*** (0.0020)	0.0034*** (0.0051)	0.0016 (0.2446)	0.0017 (0.2001)	-0.0006 (0.2845)	-0.0011 (0.1202)	-0.0021** (0.0374)
<i>Book-to-Market</i>	0.0003 (0.7451)	0.0003 (0.7501)	0.0002 (0.8024)	0.0002 (0.8001)	0.0003 (0.7631)	0.0003 (0.7566)	0.0003 (0.7459)	0.0003 (0.7460)	0.0002 (0.4680)	-0.0001 (0.7773)	-0.0002 (0.5276)
<i>Leverage</i>	0.0045 (0.5594)	0.0050 (0.5184)	0.0002 (0.9779)	0.0001 (0.9865)	-0.0057 (0.3951)	-0.0059 (0.3729)	0.0045 (0.5646)	0.0049 (0.5219)	-0.0020 (0.5868)	-0.0094** (0.0305)	0.0025 (0.7022)
Intercept	-0.0470* (0.0659)	-0.0468* (0.0707)	-0.0601*** (0.0087)	-0.0585** (0.0104)	-0.0641*** (0.0039)	-0.0615*** (0.0080)	-0.0463* (0.0903)	-0.0473* (0.0660)	0.0143 (0.1914)	0.0322** (0.0155)	0.0428** (0.0237)
Adjusted R-square	0.0276	0.0289	0.0276	0.0281	0.0345	0.0343	0.0276	0.0289	0.0232	0.0229	0.0083
Industry dummies	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Event Time dummies	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Exchange dummy	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
No. of Obs.	5906	5906	5906	5906	5906	5906	5906	5906	5906	5906	5906

Regressions (1), (3), (5), and (7) support the univariate findings of economically insignificant consequences of the establishment of political connections for the average Korean firm. Regressions (2), (4), and (8)-(11) corroborate the univariate findings that chaebols play a central role in determining whether political connections are valuable or not.

In regression (1), *Politically Connected* captures the average wealth impact of the establishment of political connections. It has a coefficient of 0.0062, which is not statistically significant, corroborating the univariate results. The coefficient estimate on *Chaebol* is positive and statistically significant at the 10% level (0.0097), indicating that chaebol firms, on average, earn a higher stock return (by nearly 1%) than non-chaebol firms. The political events that we examine represent a change in the Korean political landscape where the major political positions swing from the Liberal Party to the Conservative Party. Our finding therefore suggests that the market responds positively to the shift in the political landscape for chaebol firms. As discussed in Section 3.2, chaebols and the Conservatives have traditionally maintained a close relationship.

Regression (2) shows the impact of political ties by firms' membership to chaebols. To recap, *Connected Chaebol* and *Connected Non-Chaebol* respectively take a value of 1 if a chaebol firm and a non-chaebol firm is politically connected, and zero otherwise. Results show the coefficient on *Connected Chaebol* is 0.0498, suggesting that chaebol firms with connections have a stock return that is 4.98% higher than the return of other firms around the political events. This finding is consistent with the value-adding hypothesis and our second hypothesis.

In contrast, the coefficient on *Connected Non-Chaebol* is -0.0314, which is significant at the 10%. This finding is consistent with the univariate results and supports the value-destroying hypothesis. That is, non-chaebol firms with connections are on average associated with a greater stock price decrease than other firms around the establishment of political connections.

One possible explanation for why the market discriminates the value of political connections between chaebol and non-chaebol firms lies in the shift of the Korean political landscape where the Conservative Party reinstated its ruling position from the Liberal Party. As the Conservative Party tends to implement policies that favour chaebols, connected chaebol firms are more likely to receive benefits under the Conservative regime than that under the prior Liberal government. Non-chaebol firms with political connections would barely gain government resource and support as most of these political benefits would be earmarked for the connected chaebols. Thus, from the view of investors, the marginal cost of connections exceeds the marginal benefits for non-chaebol firms, resulting in the negative value of connections for these firms.

In regressions (3) and (4), the event date is represented by the date when candidate Lee defeated Park Geun-hye in the GNP's primary to become the party's nominee (August 20, 2007). The date when candidate Lee won the presidential election (December 19, 2007) is the event date in regressions (5) and (6).

Contrary to regression (1), the results in regressions (3) and (5) show that the coefficient on *Politically Connected* is negative and statistically insignificant. The coefficient on *Chaebol* is still positive, but not statistically significant. Regressions (4) and (6) show that the coefficient on *Connected Chaebol* and *Connected Non-Chaebol* are only statistically significant in regression (4) and the price reaction continues to decrease as time gets closer to the actual election date. Therefore, it appears that the stock market already incorporates information about candidate Lee's potential winning even prior to the election. Of the control variables, only *Firm Size* has some explanatory power while *Book-to-Market* and *Leverage* are not significant. Contrary to the small firm size effect (Banz, 1981; Fama and French, 1992; Pontiff and Schall, 1998), large firms have, on average, higher returns than the stock of small firms around the political events. However, the evidence is weak.

In regression (7) and (8), we find that the coefficient estimates on *Connected Chaebol* and *Connected Non-Chaebol* are still statistically significant but the price reactions are smaller than in regression (1). This result suggests that the spill over effects of connections to subsequent events is not as strong as that when the five events for the establishment of connections are assumed to be independent.

For robustness, we also report the results for event windows (-1, +1), (-2, +2), and (-5, +5) in regressions (9), (10), and (11) respectively. In all these regressions, the coefficient estimates on *Connected Chaebol* are statistically significant, supporting the value-adding hypothesis and our second hypothesis. The longer the event window, the larger the stock reaction for chaebol firms with connections, corroborating the univariate results. On the other hand, the coefficient estimates on *Connected Non-Chaebol* are not statistically significant when we use different event windows.

Table 6.5 presents the regression results when political connection is measured at the business group level. Overall, the results are mostly similar to those for firm-level connections (Table 6.4) but statistically more stable. Regressions (1), (3), (5) and (7) of Table 6.5 support the univariate findings of insignificant economic consequences of the establishment of political connections on average. Regressions (2), (4), (6) and (8)-(11) corroborate the univariate findings that chaebols play a central role in determining whether political connections are valuable or not. Our results confirm that the establishment of political connections by an affiliate firm has a “spill over” effect on the share price of other members within the same business group. This finding is consistent with the recent study by Bae, Cheon, and Kang (2008) who show another example of the “spill over” effect in business groups. They find that the announcement of increased earnings by a chaebol firm has a positive “spill over” effect on the stock price of other member firms in the same group.

TABLE 6.5
Regressions of CARs around the Establishment of Business Group Level Political Connections

The dependent variable is the cumulative market-adjusted returns (CAR) over the (-10, +10) window in regressions (1)-(8) and over the (-1, +1), (-2, +2), and (-5, +5) windows in regressions (9)-(11) respectively. *Politically Connected* takes a value of 1 if a firm is politically connected, and zero otherwise. *Chaebol* takes a value of 1 if the firm belongs to a chaebol, and zero otherwise. *Connected Chaebol* takes a value of 1 if the firm belongs to a chaebol and is also politically connected, and zero otherwise. *Connected Non-Chaebol* takes a value of 1 if the firm is non-chaebol and politically connected. *Firm Size* is the logarithm of the firm's market capitalization. *Book-to-Market* is the ratio of the book value of equity to the market value of equity. *Leverage* is the ratio of total liabilities to total assets. All control variables are measured at the end of fiscal year immediately before the political event. Fixed effects consist of *Industry*, *Event Time*, and *Exchange* effects. Regressions (1) to (6) differ in the establishment date of connection through the presidential election: regressions (1) and (2) use "President Event 1"; regressions 3 and 4 use "President Event 2"; and regressions 5 and 6 use "President Event 3". Regressions 7 and 8 allow the spill over effects of connections from earlier events to later events. The remaining regressions (9-10) use alternative (shorter) event windows. The *p*-values are in parentheses, based on clustering by company, bootstrapped by re-sampling observations 1,000 times, and heteroskedasticity-consistent standard errors. *, **, and *** indicate significance at the 10%, 5%, and 1% levels respectively.

Independent Variables	CAR (-10, +10)								CAR	CAR	CAR
	President Event 1		President Event 2		President Event 3		Spill Over Connection		(-1, +1)	(-2, +2)	(-5, +5)
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)
<i>Politically Connected</i>	0.0048 (0.6413)		-0.0042 (0.5980)		-0.0039 (0.6362)		-0.0045 (0.5777)				
Of which											
<i>Connected Chaebol</i>		0.0428*** (0.0005)		0.0236** (0.0109)		0.0177* (0.0883)		0.0158 (0.1375)	0.0120** (0.0370)	0.0215*** (0.0066)	0.0285*** (0.0021)
<i>Connected Non-Chaebol</i>		-0.0393*** (0.0051)		-0.0365*** (0.0025)		-0.0289*** (0.0140)		-0.0302** (0.0112)	-0.0172** (0.0219)	-0.0135 (0.1129)	-0.0317*** (0.0012)
<i>Chaebol</i>	0.0094* (0.0954)	0.0039 (0.5129)	0.0055 (0.2298)	0.0015 (0.7535)	0.0061 (0.1877)	0.0030 (0.5290)	0.0105* (0.0057)	0.0050 (0.4424)	0.0033 (0.2053)	0.0015 (0.6581)	-0.0011 (0.8182)
<i>Firm Size</i>	0.0017 (0.2014)	0.0017 (0.2142)	0.0028** (0.0156)	0.0029** (0.0169)	0.0035*** (0.0033)	0.0035*** (0.0037)	0.0017 (0.1887)	0.0017 (0.1936)	-0.0005 (0.3484)	-0.0010 (0.1702)	-0.0020* (0.0518)
<i>Book-to-Market</i>	0.0003 (0.7456)	0.0003 (0.7434)	0.0002 (0.7994)	0.0002 (0.8045)	0.0003 (0.7604)	0.0003 (0.7657)	0.0003 (0.7349)	0.0003 (0.7405)	0.0002 (0.4591)	-0.0001 (0.7967)	-0.0002 (0.5401)
<i>Leverage</i>	0.0045 (0.5584)	0.0052 (0.4959)	0.0002 (0.9779)	0.0007 (0.9212)	-0.0058 (0.3912)	-0.0054 (0.4577)	0.0044 (0.5667)	0.0051 (0.5199)	-0.0017 (0.6206)	-0.0092** (0.0299)	0.0028 (0.6508)
Intercept	-0.0472* (0.0633)	-0.0482* (0.0750)	-0.0597*** (0.0080)	-0.0604*** (0.0096)	-0.0629*** (0.0063)	-0.0634*** (0.0074)	-0.0493* (0.0574)	-0.0519** (0.0464)	0.0129 (0.2447)	0.0306** (0.0282)	0.0413** (0.0351)
Adjusted R-square	0.0276	0.0298	0.0276	0.0290	0.0343	0.0351	0.0276	0.0286	0.0239	0.0235	0.0093
Industry dummies	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Event Time dummies	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Exchange Dummy	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
No. of Obs.	5906	5906	5906	5906	5906	5906	5906	5906	5906	5906	5906

In comparison, we find that the effect of political connections is much more pronounced at the business group level than at the individual firm level. Specifically, the coefficient estimates on *Connected Chaebol* and *Connected Non-Chaebol* are both statistically significant in regression (6) and the coefficient estimates on *Connected Non-Chaebol* are statistically significant in regressions (9) and (11). We also find that the “spill over” effect of political connections to subsequent events does not apply to chaebols. Contrary to firm-level outcomes, the coefficient estimate on *Connected Chaebol* is not statistically significant in regression (8).

To address the concern of calendar time clustering, as discussed in section 5.3, we re-estimate regressions (1) and (2) in Tables 6.4 and 6.5 using a generalized least squares (GLS) method. The results are reported in Table 6.6. Regressions (1) and (2) show the results for connections measured at the individual firm level, and regressions (3) and (4) report the same at the business group level. Overall, the GLS results are quantitatively and statistically similar to those estimated by OLS, suggesting that our findings are robust to corrections for calendar time clustering.

The results so far suggest that the establishment of political ties create value for chaebol firms but destroy value for non-chaebol firms. In Table 6.7, we extend the tests of the effect of the establishment of political connections by examining whether some connections are more valuable than others. We conduct these tests only at the firm-level since our results are not sensitive to how we measure the connection. To do this, we sort the sample of politically

TABLE 6.6
GLS Regressions of CARs around the Establishment of Political Connections

The dependent variable is the cumulative market-adjusted returns (CAR) over the (-10, +10). *Politically Connected* takes a value of 1 if a firm is politically connected, and zero otherwise. *Chaebol* takes a value of 1 if the firm belongs to a chaebol, and zero otherwise. *Connected Chaebol* takes a value of 1 if the firm belongs to a chaebol and is also politically connected, and zero otherwise. *Connected Non-Chaebol* takes a value of 1 if the firm is non-chaebol and politically connected. *Firm Size* is the logarithm of the firm's market capitalization. *Book-to-Market* is the ratio of the book value of equity to the market value of equity. *Leverage* is the ratio of total liabilities to total assets. All control variables are measured at the end of fiscal year immediately before the political event. Fixed effects consist of *Industry*, *Event Time*, and *Exchange* effects. Regressions (1) and (2) show the results for connections measured at the firm level, and regressions (3) and (4) report the same at the business group level. The *p*-values are reported in parentheses, based on heteroskedasticity-consistent standard errors. *, **, and *** indicate significance at the 10%, 5%, and 1% levels respectively. The *p*-values^b are based on an F-test of model specification.

Independent Variables	CAR (-10, +10)			
	Firm Level		Business Group Level	
	(1)	(2)	(3)	(4)
<i>Politically Connected</i>	0.0045 (0.5636)		-0.0009 (0.8614)	
Of which				
<i>Connected Chaebol</i>		0.0461*** (0.0000)		0.0395*** (0.0000)
<i>Connected Non-Chaebol</i>		-0.0296*** (0.0058)		-0.0389*** (0.0000)
<i>Chaebol</i>	0.0086** (0.0145)	0.0048 (0.1789)	0.0085** (0.0171)	0.0018 (0.6321)
<i>Firm Size</i>	0.0031*** (0.0000)	0.0031*** (0.0000)	0.0033*** (0.0000)	0.0033*** (0.0000)
<i>Book-to-Market</i>	0.0002 (0.5495)	0.0002 (0.5880)	0.0002 (0.5342)	0.0002 (0.5684)
<i>Leverage</i>	0.0068* (0.0821)	0.0080** (0.0391)	0.0076* (0.0588)	0.0094** (0.0147)
Intercept	-0.0748*** (0.0000)	-0.0735*** (0.0000)	-0.0777*** (0.0000)	-0.0764*** (0.0000)
Industry dummies	Yes	Yes	Yes	Yes
Event Time dummies	Yes	Yes	Yes	Yes
Exchange dummy	Yes	Yes	Yes	Yes
No. of Obs.	5906	5906	5906	5906
<i>p</i> -values ^b	0.0000	0.0000	0.0000	0.0000

connected firms by: i) the nature of the connections, i.e., whether the connections are through *Blood Relative, Marital Relation, Cases of Friendship, Former Directorship, or Direct Ownership*; ii) the type of politicians, i.e., whether the politician is *President, Minister, Member of Parliament, or Head of Local Government*; and iii) owner or director (*Owner and Director* respectively).

In particular, we probe further into the relationship between chaebols and politicians to ascertain which type of connections adds the most value to chaebol firms. Therefore, we further partition firms with *Connected Chaebol* into i) the nature of connections, i.e., *Blood Relative_Chaebols, Marital Relation_Chaebols, Former Directorship_Chaebols, and Direct Ownership_Chaebols*; ii) the type of politicians, i.e., *President_Chaebols, Ministers_Chaebols, and Member of Parliament_Chaebols*; and iii) owner and director (*Owner_Chaebols and Director_Chaebols* respectively).

Panel A of Table 6.7 shows all the coefficient estimates on the specific connections are insignificant, suggesting that firm abnormal returns are not specific to a certain type of connections for connected firms. Regression (1) in Panel B of Table 6.7 considers the relationship in greater depth by analysing whether the relationship is driven by certain types of connections for chaebol firms. The coefficient on *Marital Relation_Chaebols* is 0.0577, which is significantly significant at 1% level, indicating that the stock return to chaebol firms connected to politicians via marital networks is higher than the return of other firms by 5.77%. This result is consistent with the recent finding that marriage of a member of the controlling family adds values to the chaebol firm, especially when the partner is from a prominent political or business family (Bunkanwanicha, Fan and Wiwattanakantng, 2013).¹⁶

¹⁶ Using a total of 131 events of marriages during 1991-2006 in Thailand, marriages that connect family firms to other prominent families are associated with an 11 day (around the wedding) CAR that is 2.3% higher than marriages to ordinary families. Especially, political networking-creating marriages are, on average, associated with a 3.3% stock return premium (Bunkanwanicha, Fan and Wiwattanakantng, 2013).

TABLE 6.7
Regressions of CARs around the Establishment of Firm Level Political Connections:
Types of Connections

The dependent variable is the cumulative market-adjusted returns (CAR) over the (-10, +10) window. *Politically Connected* takes a value of 1 if a firm is politically connected, and zero otherwise. *Chaebol* takes a value of 1 if the firm belongs to a chaebol, and zero otherwise. *Connected Chaebol* takes a value of 1 if the firm belongs to a chaebol and is also politically connected, and zero otherwise. *Connected Non-Chaebol* takes a value of 1 if the firm is non-chaebol and politically connected. Regression (1) shows the effect of political connections by the nature of connections. *Blood Relative* takes a value of 1 if a firm is politically connected through blood relatives, and zero otherwise. *Marital Relation* takes a value of 1 if a firm is politically connected through in-law relatives, and zero otherwise. *Cases of Friendship* takes a value of 1 if a firm is politically connected through close friendship, and zero otherwise. *Former Directorship* takes a value of 1 if a firm is politically connected through former directors, and zero otherwise. *Direct Ownership* takes a value of 1 if a firm is politically connected through direct ownership, and zero otherwise. *Blood Relative_Chaebol* takes a value of 1 if a chaebol firm is politically connected through blood relatives, and zero otherwise. *Marital Relation_Chaebol* takes a value of 1 if a chaebol firm is politically connected through in-law relatives, and zero otherwise. *Former Directorship_Chaebol* takes a value of 1 if a chaebol firm is politically connected through former directors, and zero otherwise. *Direct Ownership_Chaebol* takes a value of 1 if a chaebol firm is politically connected through direct ownership, and zero otherwise. Regression (2) shows the effect of political connections by the type of politicians. *President* takes a value of 1 if a firm is politically connected with president, and zero otherwise. *Ministers* takes a value of 1 if a firm is politically connected with ministers, and zero otherwise. *Member of Parliament* takes a value of 1 if a firm is politically connected with member of parliament, and zero otherwise. *Head of Local Government* takes a value of 1 if a firm is politically connected with head of local government, and zero otherwise. *President_Chaebol* takes a value of 1 if a chaebol firm is politically connected with president, and zero otherwise. *Ministers_Chaebol* takes a value of 1 if a chaebol firm is politically connected with ministers, and zero otherwise. *Member of Parliament_Chaebol* takes a value of 1 if a chaebol firm is politically connected with member of parliament, and zero otherwise. Regression (3) shows the effect of political connections by owner and director. *Owner* takes a value of 1 if a firm is politically connected through owners, and zero otherwise. *Director* takes a value of 1 if a firm is politically connected through directors, and zero otherwise. *Owner_Chaebol* takes a value of 1 if a chaebol firm is politically connected through owners, and zero otherwise. *Director_Chaebol* takes a value of 1 if a chaebol firm is politically connected through directors, and zero otherwise. *Firm Size* is the logarithm of the firm's market capitalization. *Book-to-Market* is the ratio of the book value of equity to the market value of equity. *Leverage* is the ratio of total liabilities to total assets. All control variables are measured at the end of fiscal year immediately before the political event. Fixed effects consist of *Industry*, *Event Time*, and *Exchange* effects. The *p*-values are reported in parentheses, based on clustering by company, bootstrapped by re-sampling observations 1,000 times, and heteroskedasticity-consistent standard errors. *, **, and *** indicate significance at 10%, 5%, and 1% level, respectively.

Panel A. Types of Connections

Independent Variables	CAR (-10, +10)		
	(1)	(2)	(3)
<i>Politically Connected</i>			
Of which			
<i>Blood Relative</i>	0.0126 (0.6645)		
<i>Marital Relation</i>	0.0063 (0.6814)		
Cases of Friendship	0.0223 (0.5750)		
<i>Former Directorship</i>	0.0156 (0.7242)		
<i>Direct Ownership</i>	-0.0603 (0.4618)		
Of which			
<i>President</i>		0.0459 (0.1466)	
<i>Ministers</i>		0.0089 (0.6869)	
<i>Member of Parliament</i>		-0.0172 (0.2768)	
<i>Head of Local Government</i>		-0.0126 (0.1965)	
Of which			
<i>Owner</i>			0.0169 (0.4215)

TABLE 6.7 (Continued)

<i>Director</i>			-0.0108 (0.6065)
<i>Chaebol</i>	0.0096* (0.0959)	0.0096* (0.0838)	0.0096 (0.1016)
<i>Firm Size</i>	0.0016 (0.2565)	0.0016 (0.2105)	0.0017 (0.2245)
<i>Book-to-Market</i>	0.0003 (0.7455)	0.0003 (0.7410)	0.0003 (0.7500)
<i>Leverage</i>	0.0045 (0.5537)	0.0044 (0.5532)	0.0046 (0.5551)
Intercept	-0.0459* (0.0918)	-0.0464* (0.0672)	-0.0475* (0.0797)
Adjusted R-square	0.0273	0.0277	0.0275
Industry dummies	Yes	Yes	Yes
Event Time dummies	Yes	Yes	Yes
Exchange dummy	Yes	Yes	Yes
No. of Obs.	5906	5906	5906
Panel B. Types of Connections with Chaebols			
		CAR (-10, +10)	
Independent Variables	(1)	(2)	(3)
<i>Connected Chaebol</i>			
Of which			
<i>Blood Relative_Chaebol</i>	0.0326 (0.3127)		
<i>Marital Relation_Chaebol</i>	0.0577*** (0.0030)		
<i>Former Directorship_Chaebol</i>	0.0433 (0.3685)		
<i>Direct Ownership_Chaebol</i>	-0.0450 (0.3259)		
Of which			
<i>President_Chaebol</i>		0.0782** (0.0157)	
<i>Ministers_Chaebol</i>		0.0580* (0.0820)	
<i>Member of Parliament_Chaebol</i>		0.0284* (0.0994)	
Of which			
<i>Owner_Chaebol</i>			0.0219 (0.5471)
<i>Director_Chaebol</i>			0.0251 (0.5071)
<i>Connected Non-Chaebol</i>	-0.0315* (0.0849)	-0.0315* (0.0858)	-0.0314* (0.0800)
<i>Chaebol</i>	0.0063 (0.2900)	0.0064 (0.2645)	0.0069 (0.2307)
<i>Firm Size</i>	0.0017 (0.2181)	0.0017 (0.2010)	0.0017 (0.2058)
<i>Book-to-Market</i>	0.0003 (0.7423)	0.0003 (0.7410)	0.0003 (0.7459)
<i>Leverage</i>	0.0051 (0.5001)	0.0049 (0.5137)	0.0050 (0.5239)
Intercept	-0.0476* (0.0699)	-0.0474* (0.0645)	-0.0468* (0.0651)
Adjusted R-square	0.0286	0.0288	0.0285
Industry dummies	Yes	Yes	Yes
Event Time dummies	Yes	Yes	Yes
Exchange dummy	Yes	Yes	Yes
No. of Obs.	5906	5906	5906

This finding also supports previous studies that family networks can be especially valuable to firms in developing economies where legal institutions are weak (La Porta, Lopez-de-Silanes, and Shleifer, 1999; Burkart, Panunzi, and Shleifer, 2003).¹⁷

Regression (2) in Panel B of Table 6.7 shows that not all politicians are equally effective in generating benefits for the chaebol firm they are connected to. The coefficient estimate on *President_Chaebols* is 0.0782 (significant at the 5% level) while the coefficient estimates on *Ministers_Chaebols* and *Member of Parliament_Chaebols* are 0.0580 and 0.0284 respectively (both statistically significant at the 10% level). These results suggest that connections with more powerful politicians result in larger price increases (Amore and Bennedsen, 2012; Faccio, 2006).¹⁸

Regression (3) in Panel B of Table 6.7 shows that investors do not discriminate between connections through owner and director for chaebol firms. The coefficient estimates on *Owner_Chaebols* and *Director_Chaebols* have a similar price effect and both are statistically insignificant. These results are contrary to Faccio's (2006) finding that connections with more vested interests in the company results in larger announcement return.¹⁹ Our results may be due to the fact that many chaebol firms are managed and owned by controlling family members.

¹⁷ La Porta, Lopez-de-Silanes, Shleifer, and Vishny (2000) argue that the legal protection of investors is an important dimension of corporate governance. La Porta, Lopez-de-Silanes, Shleifer, and Vishny (1998) examine a sample of 49 countries and find that ownership concentration in the largest public companies is negatively related to investor protection. This finding suggests that in countries with poor investor protections, minority shareholders are less likely to be important. Korean laws protect incumbent controlling shareholders by prohibiting both hostile and foreign M&As. In addition, anyone acquiring 25% of a firm's shares must tender an offer for at least 50% of the share. This mandatory tender offer virtually prevents plurality ownership takeovers (Joh, 2003). Since ownership in chaebol firms is heavily concentrated, in as much as one individual has almost complete control over all firms within a group, the controlling owner can easily expropriate other investors in the firm by investing the firm's resources to maximize her welfare given the weak legal environment in Korea (Bae, Cheon, and Kang, 2008).

¹⁸ Faccio (2006) shows the market value of firms with political connections is affected by unexpected electoral outcomes in a broad cross-section of 35 countries. Connections through a minister result in an average value increase of 12.31% while connections through a member of the parliament result in a value increase of only 1.28%. Amore and Bennedsen (2012) find that doubling the political power (as measured by population per elected politician), on average, doubles the performance of politically connected firms in Denmark, suggesting that firms connected to stronger politicians benefits more.

¹⁹ Connections through a larger shareholder result in a five-day CAR of 4.47%, while connections via an officer result in a CAR of only 1.94%.

In fact, four out of five of the connections involve both the owner and the manager in chaebol firms, as previously shown in Table 5.4. Therefore, the market does not react differently to connections through the owner or the director.

6.4 Summary and Conclusion

This chapter presents the results of the value of political connections in Korea. Results show that on average, the establishment of political ties is only marginally positive. However, when we partition the sample into chaebol and non-chaebol firms, results show that firm membership to chaebols plays a key role in determining whether political connections are valuable or not. Around the establishment of political connections, chaebol firms with connections experience a significantly positive stock returns, consistent with the value-adding hypothesis. In contrast, non-chaebol firms with connections suffer a significant price drop, consistent with the value-destroying hypothesis. The results are robust when we define connections at the business group level, indicating that new political connections by an affiliate firm have a “spill over” effect on the share price of other members within the same business group.

Additionally, we find that some types of connections create more value than others for chaebol firms. First, connections through marital networks between a member of the controlling family and a member of the politician’s family add more value to chaebol firms. Second, connections with more powerful politicians result in larger price increases for chaebol firms.

Chapter 7

Conclusion

Political connections are ubiquitous around the world, e.g., Faccio (2006) reports that politically connected firms exist in 35 of the 45 countries she examines. The proportion of connected firms is very small, less than 3% (541 companies) of her total sample (20,202 companies). Using a measure of political connections based on hand-collected data of all non-financial firms listed on the Korea Stock Exchange (KSE), we find the same in Korea. We identify 87 connected firms belonging to 49 business groups with a total of 139 affiliates from 2007 to 2011. In 2008, for instance, there were 22 firms connected with the president, 23 firms connected with a minister, and 40 firms connected with a member of parliament in our sample. In total, politically connected firms represent 7.35% of 1,157 non-financial firms listed on the KSE. However, connected firms are large in size, accounting for about 40% of the total market capitalization on the KSE, much higher than that documented globally – in Faccio (2006), connected firms account for only 8% of the world's stock market capitalisation.

One of the most distinguishable notion in this thesis is that we identify whether a firm belongs to a chaebol or not. Through regulatory disclosure mandated by the Korean Fair Trade Commission, we are able to construct a unique database to identify the family network between politicians and chaebols' founding families. Of the 85 connected firms in our sample, there are 41 chaebols firms. We also find that the huge economic size of connected firms is mostly derived from chaebols as they account for 35.16% of total market capitalization. Therefore, for a very large part of the Korean economy, political connections apparently matter a lot, specifically amongst connected chaebols.

Based on our unique and new dataset, we analyse the value of these connections around the establishment of political ties during the Lee government, as represented by the following five events: (i) the presidential election; (ii) two cases on the appointment of ministers; (iii) the

election for members of parliaments; and (iv) the election for the head of a local government. Especially, we capitalize on the dominance and economic power of chaebols in our tests of the value impact of political connections in Korea.

Our research shows that political connections have a discriminative impact on the value of public firms in Korea, which depends on the firms' membership to chaebols. Specifically, there is on average a positive and significant stock price response for chaebol firms with connections but the reverse is found for connected non-chaebol firms. The results are robust when we measure connections at the business group level, suggesting that new political connections by an affiliate firm have a "spill over" effect on the share price of other members in the same business group. Our results also show that connections through marital networks between a member of the controlling family and a member of the politician's family result in a larger price increase for chaebol firms than other forms of connections. So do connections with more powerful politicians.

In conclusion, the evidence we present in this paper regarding the value of political connections opens up a number of interesting avenues for future research. In particular, we show that there is a "spill over" effect of political connections within a business group. Given the importance of business groups in the context of corporate political connections, more research is clearly needed in countries where business groups are prevalent.

Our results also suggest an additional implication. Recent studies show that chaebol firms suffer a value loss relative to non-chaebol firms due to the fact that chaebol firms tend to pursue profit stability rather than profit maximization and over-invest in low performing industries (Ferris, Kim, and Kitsabunnarat, 2003). Our results only show market's belief that the connected chaebols would especially gain future benefits from the connections. However, if it is true, politicians favour inefficient firms (chaebol firms) by allocating resources to them. Combined with chaebol's inefficiency and their huge economic size, the ties between chaebols

and politicians are likely to bring a negative aggregate economic effect on a country's investment and long-term economic growth. It is reasonably assume that connected chaebols firms would obtain benefits from connections in line with empirical evidence from other countries. Further studies should be taken whether connected chaebol firms indeed gain benefits such as preferential access to finance or awarding government contacts.

References

- Acemoglu, D., Johnson, S., Kermani, A., Kwak, J., Mitton, T., 2010. The Value of political connections in the United States. Unpublished working Paper. Harvard Business School.
- Agrawal, A., Knoeber, C., 2001. Do some outside directors play a political role?. *Journal of Law and Economics* 44, 179–198.
- Aggarwal, R. K., Meschke, F., Wang, T., 2009. Corporate political contributions: Investment or agency?. Unpublished working paper. University of Minnesota and University of Kansas.
- Albrecht, C., Turnbull, C., Zhang, Y., Skousen, C., 2010. The relationship between South Korean chaebols and fraud. *Management Research Review* 33, 257–268.
- Almeida, H., Park, S. Y., Subrahmanyam, M. G., Wolfenzon, D., 2011. The Structure of formation of business groups: Evidence from Korean chaebols. *Journal of Financial Economics* 99, 447–475.
- Amore, M. D., Bennedsen, M., 2013. The value of local political connections in a low-corruption environment. *Journal of Financial Economics*, <http://dx.doi.org/10.1016/j.jfineco.2013.06.002> .
- Ansolabehere, S., de Figueiredo, J. M., Snyder, J. M., 2003. Why is there so little money in U.S. Politics?. *Journal of Economics Perspectives* 17, 105–130.
- Ansolabehere, S., Snyder, J., Ueda, M., 2004. Campaign finance regulations and the return on investment from campaign contributions. Mimeo. Massachusetts Institute of Technology, Cambridge, MA.
- Arditti, F., 1967. Risk and the required return on equity. *Journal of Finance* 22, 19–36.
- Bae, K. H., Cha, B. K., 1997. Price changes, trading volume and price limits. *Advances in the Pacific-Basin Financial Markets* 3, 21–37.
- Bae, K., Kang, J., Kim, J., 2002. Tunneling or value added? Evidence from mergers by Korean business groups. *Journal of Finance* 57, 2695–2740.
- Baek, J., Kang, J., Park, K., 2004. Corporate governance and firm value: Evidence from the Korean financial crisis. *Journal of Financial Economics* 71, 265–313.
- Baek, J., Kang, J., Lee, I., 2006. Business groups and tunneling: Evidence from private securities offerings by Korean chaebols. *Journal of Finance* 61, 2415–2449.
- Bae, G. S., Cheon, Y. S., Kang, J. K., 2008. Intragroup propping: Evidence from the stock-effects of earnings announcements by Korean business group. *Review of Financial Studies* 21, 2015–2060.
- Banz, R. W., 1981. The Relationship between return and market value of common stocks. *Journal of Financial Economics* 9, 3–18.
- Bennedsen, M., 2000. Political ownership. *Journal of Public Economics* 76 ,559–581.
- Bernard, V. L., 1987. Cross-sectional dependence and problems in inference in market based accounting research. *Journal of Accounting Research* 25, 1–48.
- Berry, M. A., Gallinger, G. W., Henderson, G. V., 1990. Using daily stock returns in event studies and the choice of parametric versus nonparametric test statistics. *Quarterly Journal of Business and Economics* 29, 70–85

- Bertrand, M., Mehta, P., Mullainathan, S., 2002. Ferreting out tunneling: an application to Indian business groups. *Quarterly Journal of Economics* 117, 121–148.
- Bertrand, M., Kramaraz, F., Schoar, A., Thesmar, D., 2007. Politicians, firms and the political business cycle: evidence from France. Unpublished working paper. University of Chicago.
- Bhandari, L. C., 1988. Debt/Equity ratio and expected common stock returns: Empirical evidence. *Journal of Finance* 43, 507-528.
- Bloomberg., 2013. Hyundai home advantage vanishes as Koreans say camry best. Available at <http://www.bloomberg.com/news/2013-02-20/hyundai-home-advantage-vanishes-as-koreans-say-camry-best-cars.html>
- Boubakri, N., Guedhami, O., Mishra, D., Saffar, W., 2012. Political connection and the cost of equity capital. *Journal of Corporate Finance* 18, 541–559.
- Brown, S., Warner, J., 1980. Measuring security price performance. *Journal of Financial Economics* 8, 205–250.
- Brown, S., Warner, J., 1985. Using daily stock returns: the case of event studies. *Journal of Financial Economics* 14, 3–31.
- Bunkanwanicha, P., Fan, J. P. H., Wiwattanakantng, Y., 2013. The value of marriage to family firms. *Journal of Financial and Quantitative Analysis* 48, 611–636.
- Burkart, M., Panunzi, F., Shleifer, A., 2003. Family firms. *Journal of Finance* 58, 2167–2202.
- Chaney, P., Faccio, M., Parsley, D., 2011. The quality of accounting information in politically connected firms, *Journal of Accounting and Economics*, 51, 58–76.
- Chang, S., Choi, U., 1988. Strategy, structure and performance of Korean business groups: a transactions cost approach. *Journal of Industrial Economics* 37, 141–158.
- Chang, S. J., 2003. Financial crisis and transformation of Korean business groups, the rise and fall of chaebol. Cambridge University Press.
- Charumilind, C., Kali, R., Wiwattanakantang, Y., 2006. Connected lending: Thailand before the financial crisis. *Journal of Business* 79, 181–218.
- Chen, N. F., Zhang, F., 1998. Risk and return of value stocks, *Journal of Business* 71, 501–535.
- Claessens, S., Feijen, E., Laeven, L., 2008. Political connections and preferential access to finance: The role of campaign contributions. *Journal of Financial Economics* 88, 554–580.
- Collins, D. W., Dent, W. T., 1984. A comparison of alternative testing methodologies use in capital market research. *Journal of Accounting Research* 22, 48–84.
- Cooper, M. J., Gulen, H., Ovtchinkov, A. V., 2010. Corporate political contributions and stock returns. *Journal of Finance* 65, 687–723.
- Corrado, C.J., 1989. A nonparametric test for abnormal security-price performance in event studies. *Journal of Financial Economics* 23, 385–395.
- Cotton, J., 1995. Politics and policy in the new Korean state: From Roh tae-woo to Kim Youngsam. St Martin's Press, New York.
- De Soto, H., 1990. *The Other Path*. Harper and Row, New York.

- Dhaliwal, D. S., Heitzman, S., Zhen, O. L., 2006. Taxes, leverage, and the cost of equity capital. *Journal of Accounting Research* 44, 691–723.
- Dinc, S., 2005. Politicians and banks: political influences on government-owned banks in emerging countries. *Journal of Financial Economics* 77, 453–479.
- Evans, P., 1995. *Embedded autonomy: States and industrial transformation*. Princeton University Press, Princeton, NJ.
- Faccio, M., 2004. Politically-connected firms: Can they squeeze the state?. Unpublished working Paper, University of Notre Dame.
- Faccio, M., 2006. Politically connected firms. *American Economic Review* 96, 369–386.
- Faccio, M., Masulis, R., and McConnell, J., 2006. Political connections and corporate bailouts. *Journal of Finance*, 61, 2597–2635.
- Faccio, M., Parsley, D. C., 2009. Sudden deaths: Taking stock of geographic ties. *Journal of Financial and Quantitative Analysis* 44, 683–718.
- Faccio, M., 2010. Differences between politically connected and nonconnected firms: A cross-country analysis, *Financial Management*, 39, 905–927.
- Fama, E.F., French, K.R., 1992. The cross-section of expected stock returns. *Journal of Finance* 47, 427–465.
- Fan, J. P.H., Wong, T. J., Zhang, T., 2007. Politically connected CEOs, corporate governance, and Post-IPO performance of China's newly partially privatized firms. *Journal Financial Economics* 84, 330–357.
- Ferris, S., Kim, K., Kitsabunnarart, P., 2003. The costs (and benefits?) of diversified business groups: the case of Korean chaebols. *Journal of Banking and Finance* 27, 251–273.
- Fisman, R., 2001. Estimating the value of political connections. *American Economic Review* 91, 1095–1102.
- Fisman, D., Fisman, R., Galef, J., Khurana, R., 2006. Estimating the value of connections to vice-president Cheney. Unpublished working Paper. Columbia University.
- Friedman, E., Johnson, S., Mitton, T., 2003. Propping and tunneling. *Journal of Comparative Economics* 31, 732–750.
- George, T. J., Hwang, C. Y., 2009. A resolution of the distress risk and leverage puzzles in the cross section of stock returns. *Journal of Financial Economics* 96, 56–79.
- Ghemawat, P., Khanna, T., 1998. The nature of diversified business groups: a research design and two case studies. *The Journal of Industrial Economics* 46, 35–61.
- Goldman, E., Rocholl, J., So, J., 2008. Do politically connected boards affect firm value?. *The Review of Financial Studies* 22, 2331–2360.
- Goldman, E., Rocholl, J., So, J., 2013. Politically connected boards of directors and the allocation of procurement contracts. *Review of Finance* 17, 1617–1648.
- Granovetter, M., 1994. *Business Groups*. *Handbook of Economic Sociology*. Princeton University Press, Princeton, NJ.
- Guedhami, O., Pittman, J. A., 2006. Ownership concentration in privatized firms: The role of disclosure standards, auditor choice, and auditing infrastructure. *Journal of Accounting Research* 44, 889–929.

- Hoshi, T., Kashyap, A., Scharfstein, D., 1991. Corporate structure liquidity, and investment: evidence from Japanese industrial groups. *Quarterly Journal of Economics* 106, 33–59.
- Jayachandran, S., 2006. The Jeffords Effects, *Journal of Law and Economics* 49, 397–426.
- Jensen, M.C., Meckling, W. H., 1976. Theory of the firm: Managerial behaviour, agency costs and ownership structure. *Journal of Financial Economics* 3, 305–360.
- Joh, S. W., 2003. Corporate governance and firm profitability: evidence from Korea before the economic crisis. *Journal of Financial Economics* 68, 287–322.
- Johnson, S., Mitton, T., 2003. Cronyism and capital controls: evidence from Malaysia. *Journal of Financial Economics* 67, 351–382.
- Julio, B., Yook, Y., 2012. Political uncertainty and corporate investment cycles. *Journal of Finance* 46, 45–83.
- Jwa, S. H., Lee, I. K., 2004. Competition and corporate governance in Korea: Reforming and restructuring the chaebol. Edward Elgar Publishing Limited, Cheltenham, UK.
- Kang, J. K., Stulz, R. M., 2000. Do banking shocks affect borrowing firm performance? An analysis of the Japanese experience. *Journal of Business* 73, 1–23.
- Kang, D. C., 2002. Crony Capitalism: Corruption and development in South Korea and the Philippines. Cambridge University Press, Cambridge, UK.
- Keister, L. A., 1998. Engineering growth: Business group structure and firm performance in China's transition economy. *American Journal of Sociology* 104, 404–440.
- Khanna, T., Palepu, K., 2000. Is group affiliation profitable in emerging markets? An analysis of diversified Indian business groups. *Journal of Finance* 55, 867–891.
- Khwaja, A., Mian, A., 2005. Do lenders favor politically connected firms? Rent provision in an emerging financial market. *Quarterly Journal of Economics* 120, 1371–1411.
- Kim, Y. T., 2007. Korean Elites: Social networks and power. *Journal of Contemporary Asia* 37, 19–37.
- Kim, I. J., Kim, J. E., Kim, W. S., Byun, S. J., 2010. Foreign investors and corporate governance in Korea. *Pacific-Basin Finance Journal* 18, 390–402.
- Kim, C., Pantzalis, C., Park, J. C., 2012. Political geography and stock returns: The value and risk implications of proximity to political power. *Journal of Financial Economics* 106, 196–228.
- Korean Times., 2013. President's brother gets two years. Available at http://www.koreatimes.co.kr/www/news/nation/2013/07/113_129406.html
- Kothari, S. P., Shanken, J., 1997. Book-to-market, dividend yield, and expected market returns: a time series analysis. *Journal of Financial Economics* 44, 169–203.
- Kroszner, R., Stratmann, T., 1998. Interest-group competition and the organization of Congress: theory and evidence from financial services' political action committees. *American Economic Review* 88, 1163–1187.
- Krueger, A., 1974. The political economy of the rent-seeking society. *American Economic Review* 64, 291–303.

- La Porta, R., Lopez-de-Silanes, F., Shleifer, A., Vishny, R.W., 1998. Law and finance. *Journal of Political Economy* 106, 1113–1155.
- La Porta, R., Lopez-de-Silanes, F., Shleifer, A., 1999. Corporate ownership around the world. *Journal of Finance* 54, 471–517.
- La Porta, R., Lopez-de-Silanes, F., Shleifer, A., Vishny, R.W., 2000. Investor protection and corporate governance. *Journal of Financial Economics* 58, 3–27.
- Langbein, L. I., Lotwis, M., 1990. The political efficacy of lobbying and money: Gun control in the U.S. House. *Legislative Studies Quarterly* 15, 413–440.
- Lemmon, L., Lins, K. V., 2003. Ownership structure, corporate governance, and firm value: Evidence from the east Asian financial crisis. *Journal of Finance* 58, 1445–1468.
- Leuz, C., Oberholzer-Gee, F., 2006. Political relationship, global financing and corporate transparency: Evidence from Indonesia. *Journal of Financial Economics* 81, 411–439.
- Loughran, T., Schultz, P., 2005. Liquidity: Urban versus rural firms. *Journal of Financial Economics* 78, 341–374.
- Lyon, J. D., Barber, B. M., Tsai, S., 1999. Improved methods for tests of long-run abnormal stock returns. *Journal of Finance* 54, 165–201.
- Mobarak, A. M., Purbasari, D. P., 2006. Corrupt protection for sale to firms: Evidence from Indonesia. Unpublished working paper, University of Colorado at Boulder.
- Modigliani, F., Miller, M. H., 1958. The cost of capital, corporation finance and the theory of investment. *American Economic Review* 48, 261–297.
- Morck, R., Stangeland, D., Yeung, B., 2000. Inherited wealth, corporate control and economic growth: The Canadian disease? In: Morck, R. (Ed.), *Concentrated Corporate Ownership* University of Chicago Press, Chicago, IL.
- Morck, R., Yeung, B., 2004. Family control and the rent-seeking society. *Entrepreneurship: Theory and Practice* 28, 391–409.
- Noland, M., Pack, H., 2003. *Industrial policy in an era of globalization: Lessons from Asia*. Institute for international economics, Washington.
- Petersen, M., 2009. Estimating standard errors in finance panel data sets: Comparing approaches. *Review of Financial Studies* 22, 435–480.
- Pontiff, J., Schall, L., 1997. Book-to-market ratios as predictors of market returns. *Journal of Financial Economics* 49, 141–160.
- Qian, M., Pan, H., Yeung, B., 2011. Expropriation of minority shareholders in politically connected firms. Unpublished working paper, National University of Singapore.
- Rajan, R., Zingales, L., 1998. Which capitalism? Lesson from the East Asian crisis. *Journal of Applied Corporate Finance* 11, 40–48.
- Roberts, B. E., 1990. A dead senator tells no lies: seniority and the distribution of federal benefits. *American Journal of Political Science* 34, 31–58.
- Shin, H. H., Park, Y., 1999. Financing constraints and internal capital markets: Evidence from Korean chaebols. *Journal of Corporate Finance* 5, 169–91.
- Shleifer, A., Vishny, R. W., 1994. Politicians and firms. *Quarterly Journal of Economics* 109, 995–1025.
- Shleifer, A., Vishny, R.W., 1998. *The grabbing hand: government pathologies and their cures*. Harvard University Press, Cambridge, Massachusetts.

- Stigler, G. J., 1971. The theory of economic regulation. *Bell Journal of Economics and Management Science* 2, 3–21.
- Stultz, R. M., 1990. Managerial discretion and optimal financing policies. *Journal of Financial Economics* 26, 3–27.
- Treisman, D., 2000. The causes of corruption: A cross national study. *Journal of Public Economics* 76, 399–457.
- You, J. S., 2005. Embedded autonomy or crony capitalism? explaining corruption in South Korea, relative to Taiwan and the Philippines, Focusing on the Role of Land Reform and Industrial Policy, Washington, DC, September 1–4. Available at <http://irps.ucsd.edu/assets/003/5292.pdf>
- Wahab, E., How, J., Verhoeven, P., 2007. The impact of the Malaysian code on corporate governance: compliance, institutional investors and stock performance. *Journal of Contemporary Accounting and Economics* 3, 1–36.
- Wedeman, A., 1997. Looters, rent-Scrapers, and dividend collectors: Corruption and growth in Zaire, South Korea, and the Philippines. *The Journal of Developing Areas* 31, 457–478.
- Wu, W., Wu, C., Rui, O. M., 2012. Ownership and the value of political connections: Evidence from China. *European Financial Management* 18, 695–729.

Appendices

Appendix 1

Data Source for the Identification of Political Connections

Panel A. Data Source for Politicians

President	http://english.president.go.kr/main.php
Ministers	
of which	
Prime Minister	http://eng.pmo.go.kr/pmo_eng/main
Ministry of Strategy and Finance	http://english.mosf.go.kr
Ministry of Science, ICT and Future Planning	http://www.msip.go.kr/english
Ministry of Education	http://english.moe.go.kr/enMain.do
Ministry of Foreign Affairs	http://www.mofa.go.kr/ENG/main/index.jsp
Ministry of Unification	http://eng.unikorea.go.kr
Ministry of Justice	http://www.moj.go.kr/HP/ENG/index.do
Ministry of National Defense	http://www.mnd.go.kr/mndEng_2009/main/index.jsp
Ministry of Security and Public Administration	http://www.mospa.go.kr
Ministry of Culture, Sports and Tourism	http://mcst.go.kr/english/index.jsp
Ministry of Agriculture, Food and Rural Affairs	http://english.mafra.go.kr/main.jsp
Ministry of Trade, Industry and Energy	http://www.motie.go.kr/language/eng/index.jsp
Ministry of Health and Welfare	http://english.mw.go.kr/front_eng/index.jsp
Ministry of Environment	http://eng.me.go.kr/main.do
Ministry of Employment and Labor	http://www.moel.go.kr/english/main.jsp
Ministry of Gender Equality and Family	http://english.mogef.go.kr/index.jsp
Ministry of Land, Infrastructure and Transport	http://english.molit.go.kr/intro.do
Ministry of Oceans and Fisheries	http://www.mof.go.kr
Member of Parliament (National Assembly)	http://korea.assembly.go.kr
Head of Local Government	
of which	
Seoul	http://english.seoul.go.kr
Busan	http://english.busan.go.kr
Daegu	http://english.daegu.go.kr
Incheon	http://english.incheon.go.kr
Gwangju	http://eng.gjcity.net/index.jsp
Daejeon	http://www.daejeon.go.kr/english/index.jsp
Ulsan	http://english.ulsan.go.kr/

Appendix 1 (Continued)

Data Source for the Identification of Political Connections

Panel B. Data Source from Top 10 Daily Newspaper in Korea

Chosun Daily	http://www.chosun.com
Joongang Daily	http://joongang.joinsmsn.com
Donga Daily	http://www.donga.com
Seoul Daily	http://www.seoul.co.kr
Kyunghan Daily	http://www.khan.co.kr
Hani Daily	http://www.hani.co.kr
Hankook Daily	http://news.hankooki.com
Kookmin Daily	http://www.kukinews.com
Segye Daily	http://www.segye.com
Munhwa Daily	http://www.munhwa.com

Panel C. Data Source from Searching Sites

Google	http://www.google.com
Naver	http://www.naver.com
Wikipedia	http://en.wikipedia.org/wiki/Main_Page

Appendix 2

Pair-wise Correlations Between the Dependent Variable and Independent Variables

This table reports pair-wise correlation between dependent variable and independent variables. The dependent variable is the mean cumulative abnormal return in the event window (-10, +10). The independent variables include a political connections variable, a chaebol variable and the control variables for firm size, book-to-market ratio and leverage. *Politically Connected* takes a value of 1 if a firm is politically connected, and zero otherwise. *Chaebol* takes a value of 1 if the firm belongs to a chaebol, and zero otherwise. *Connected Chaebol* takes a value of 1 if the firm belongs to a chaebol and is also politically connected, and zero otherwise. *Connected Non-Chaebol* takes a value of 1 if the firm is non-chaebol and politically connected. *Firm Size* is the logarithm of the firm's market capitalization. *Book-to-Market* is the ratio of the book value of equity to the market value of equity. *Leverage* is the ratio of total liabilities to total assets. Numbers in parentheses are *p*-values.

Panel A. Pair-wise Correlations at Firm-Level

Variables	<i>CAR</i> (-10, +10)	<i>Politically</i> <i>Connected</i>	<i>Chaebol</i>	<i>Connected</i> <i>Chaebol</i>	<i>Connected Non-</i> <i>Chaebol</i>	<i>Firm Size</i>	<i>Book-to-</i> <i>Market</i>
<i>Politically Connected</i>	0.0135 (0.2930)						
<i>Chaebol</i>	0.0300* (0.0191)	0.1368* (0.0000)					
<i>Connected Chaebol</i>	0.0414* (0.0012)	0.6839* (0.0000)	0.2313* (0.0000)				
<i>Connected Non-Chaebol</i>	-0.0206 (0.1075)	0.7247* (0.0000)	-0.0310 (0.0154)	-0.0072 (0.5755)			
<i>Firm Size</i>	0.0259 (0.0465)	0.1602* (0.0000)	0.5203* (0.0000)	0.1768* (0.0000)	0.0518* (0.0001)		
<i>Book-to-Market</i>	-0.0017 (0.8952)	-0.0194 (0.1360)	-0.0259 (0.0468)	-0.0159 (0.2219)	-0.0115 (0.3748)	-0.2093* (0.0000)	
<i>Leverage</i>	0.0095 (0.4652)	0.0428* (0.0010)	0.1448* (0.0000)	0.0338* (0.0094)	0.0266 (0.0406)	0.0110 (0.3971)	-0.0620* (0.0000)

Appendix 2 (Continued)

Pair-wise Correlations Between the Dependent Variable and Independent Variables

Panel B. Pair-wise Correlations at Business Group-Level

Variables	<i>CAR</i> (-10, +10)	<i>Politically</i> <i>Connected</i>	<i>Chaebol</i>	<i>Connected</i> <i>Chaebol</i>	<i>Connected Non-</i> <i>Chaebol</i>	<i>Firm Size</i>	<i>Book-to-</i> <i>Market</i>
<i>Politically Connected</i>	0.0182 (0.1549)						
<i>Chaebol</i>	0.0300* (0.0191)	0.2206* (0.0000)					
<i>Connected Chaebol</i>	0.0507* (0.0001)	0.7501* (0.0000)	0.3221* (0.0000)				
<i>Connected Non-Chaebol</i>	-0.0306* (0.0169)	0.6527* (0.0000)	-0.0355* (0.0056)	-0.0114 (0.3726)			
<i>Firm Size</i>	0.0259 (0.0465)	0.1868* (0.0000)	0.5203* (0.0000)	0.2057* (0.0000)	0.0472* (0.0003)		
<i>Book-to-Market</i>	-0.0017 (0.8952)	-0.0254 (0.0508)	-0.0259 (0.0468)	-0.0227 (0.0806)	-0.0124 (0.3404)	-0.2093* (0.0000)	
<i>Leverage</i>	0.0095 (0.4652)	0.0632* (0.0000)	0.1448* (0.0000)	0.0512* (0.0001)	0.0368* (0.0046)	0.0110 (0.3971)	-0.0620* (0.0000)

Appendix 3

Cumulative Abnormal Returns (CARs) around the Establishment of Firm-Level Political Connections for Each Industry

Global Industry Classification Standard (GICS) classifies 8 different industries: 1) Health Care, 2) Industrials, 3) Material, 4) Energy, 5) Utilities, 6) Consumer Discretionary, 7) Information Technology, and 8) Consumer Staples.

	<i>No. of Obs.</i>	Event Window							
		(-1, +1)		(-2, +2)		(-5, +5)		(-10, +10)	
		Mean	Median	Mean	Median	Mean	Median	Mean	Median
Politically Connected Firms in Industry 1	1	-3.51%	-3.51%	-8.29%	-8.29%	-19.32%	-19.32%	-16.37%	-16.37%
Non-Politically Connected Firms in Industry 1	423	0.21%	-0.28%	0.08%	-0.09%	0.23%	-0.14%	-0.40%	-1.19%
Differences		-3.73%	-3.24%	-8.37%	-8.20%	-19.54%	-19.18%	-15.97%	-15.17%
Politically Connected Firms in Industry 2	32	-1.28%*	-1.86%	-0.73%	-0.92%	0.03%	-0.61%	-2.36%	-1.43%
Non-Politically Connected Firms in Industry 2	1,260	0.18%	-0.09%	0.19%	-0.20%	0.43%	0.25%	0.43%	-0.63%
Differences		-1.46%	-1.77%	-0.91%	-0.71%	-0.39%	-0.86%	-2.78%	-0.80%
Politically Connected Firms in Industry 3	19	3.95%***	3.07%**	5.05%***	2.97%**	2.93%	2.59%	5.95%**	5.10%*
Non-Politically Connected Firms in Industry 3	1,120	0.17%	-0.39%	0.01%	-0.42%	0.76%	0.11%	-0.45%	-1.16%***
Differences		3.77%***	3.46%***	5.04%***	3.40%***	2.17%	2.48%	6.40%**	6.25%**
Politically Connected Firms in Industry 4	0	-	-	-	-	-	-	-	-
Non-Politically Connected Firms in Industry 4	43	0.55%	0.51%	0.83%	1.23%	1.53%	-0.34%	-0.11%	-0.17%
Differences		-0.42%	-0.18%	-0.79%	-0.91%	29.03%	22.66%	1.65%	2.07%

Appendix 3 (Continued)

Cumulative Abnormal Returns (CARs) around the Establishment of Firm-Level Political Connections for Each Industry

	<i>No. of Obs.</i>	Event Window							
		(-1, +1)		(-2, +2)		(-5, +5)		(-10, +10)	
		Mean	Median	Mean	Median	Mean	Median	Mean	Median
Politically Connected Firms in Industry 5	2	4.76%	4.76%	7.05%	7.05%	6.34%	6.34%	19.18%	19.18%
		(0.37)	(0.18)	(0.53)	(0.65)	(0.48)	(0.18)	(0.24)	(0.18)
Non-Politically Connected Firms in Industry 5	65	0.47%	0.24%	0.77%*	0.57%	1.11%	0.70%	-0.16%	0.31%
		(0.23)	(0.60)	(0.10)	(0.21)	(0.15)	(0.22)	(0.87)	(0.47)
Differences		4.29%*	4.52%	6.28%**	6.48%	5.22%	5.63%	19.34%***	18.87%**
		(0.06)	(0.11)	(0.03)	(0.42)	(0.24)	(0.29)	(0.00)	(0.03)
Politically Connected Firms in Industry 6	18	2.09%	2.57%	3.13%*	2.26%**	1.37%	2.94%	-0.06%	1.69%
		(0.15)	(0.17)	(0.07)	(0.03)	(0.43)	(0.27)	(0.97)	(0.95)
Non-Politically Connected Firms in Industry 6	1,192	0.63%***	0.27%***	1.12%***	0.49%***	1.00%***	0.50%***	-0.02%	-0.96%*
		(0.00)	(0.01)	(0.00)	(0.00)	(0.00)	(0.01)	(0.95)	(0.07)
Differences		1.46%	2.30%	2.01%	1.77%*	0.37%	2.44%	-0.03%	2.65%
		(0.29)	(0.12)	(0.23)	(0.07)	(0.87)	(0.47)	(0.99)	(0.71)
Politically Connected Firms in Industry 7	8	-2.11%	-1.82%**	-1.74%	-2.10%	1.62%	0.94%	5.29%	-1.00%
		(0.28)	(0.04)	(0.65)	(0.26)	(0.44)	(0.48)	(0.11)	(0.58)
Non-Politically Connected Firms in Industry 7	1,535	0.19%	-0.10%	0.08%	-0.38%**	0.89%	0.29%**	-0.85%***	-1.27%***
		(0.21)	(0.61)	(0.65)	(0.04)	(0.15)	(0.04)	(0.01)	(0.00)
Differences		-2.31%	-1.71%	-1.83%	-1.72%	0.73%	0.65%	6.13%	0.27%
		(0.28)	(0.12)	(0.47)	(0.32)	(0.84)	(0.84)	(0.20)	(0.49)
Politically Connected Firms in Industry 8	7	2.04%	1.52%*	5.10%*	2.23%**	0.48%	-0.85%	0.21%	-0.80%
		(0.11)	(0.06)	(0.07)	(0.02)	(0.85)	(1.00)	(0.96)	(1.00)
Non-Politically Connected Firms in Industry 8	349	0.34%	0.10%	1.11%***	0.43%***	1.34%***	1.19%***	0.32%	-0.18%
		(0.15)	(0.48)	(0.00)	(0.01)	(0.00)	(0.01)	(0.60)	(0.82)
Differences		1.70%	1.42%	3.99%*	1.80%	-0.86%	-2.04%	-0.10%	-0.63%
		(0.30)	(0.17)	(0.10)	(0.04)	(0.80)	(0.67)	(0.98)	(0.83)

Note: *, **, and *** indicate significance at the 10%, 5%, and 1% levels respectively.