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Political patronage and analysts' forecast precision

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ABSTRACT

We test whether the channel by which the government plays the role of political patron to selected firms influences analysts' forecast precision in Malaysia. Correcting for analysts' self-selection bias, we find a negative relation between analysts' forecast errors and the social dimension of political patronage, as proxied by government-controlled institutional ownership. The reverse is found for the economic dimension of political patronage, as proxied by the percentage shareholding of government-linked corporations. We find no evidence that the personal dimension of political patronage influences analysts' forecast precision.

1. Introduction

Intimate ties between business and politics in Malaysia have been well-documented (Gomez and Jomo, 1999; Fraser et al., 2006), with almost one-third of listed Malaysian firms known to be politically connected (Faccio et al., 2006). Malaysia thus provides an interesting and important case study of relationship-based capitalism, where firms with political patronage have emerged as the principal rent seeking group in the corporate sector. For example, in documenting the practice of cronyism during the Asian financial crisis, Johnson and Mitton (2003) report that capital control restrictions imposed by the Malaysian government in September 1998 assisted firms which were politically connected to the then prime minister (Tun Mahathir Mohammad) to outperform firms connected to his ex-deputy (Dato' Seri Anwar Ibrahim). Of the estimated $5 billion gain in market value for Mahathir-connected firms during September 1998, approximately one-third of the gain was attributed to political connections. Gul (2006) provides complementary evidence which supports Johnson and Mitton (2003), based on the observation of changes in audit fees paid by Malaysian firms during the Asian financial crisis and the subsequent implementation of capital controls. Fraser et al. (2006) document a positive relation between three dimensions of political patronage (social, economic, and personal) and leverage. Bliss and Gul (2012a,b) extend Fraser et al.'s (2006) work by including firms with negative equity and find lenders perceive politically connected firms as being more risky.

Our paper contributes to this field of research by examining how the various dimensions of political patronage relate to the information processing ability of financial analysts. Previous studies show the value of analysts' intermediary role in the capital market stems from their skill at interpreting public information and their ability to collect and process private information (Ivković and Jegadeesh, 2004; Chen et al., 2010; Livnat and Zhang, 2012). We argue that the channel by which the government plays the role of political patron to selected firms affects corporate transparency and thus analysts' forecast precision.

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We predict analysts' forecast precision is lower for firms with personal and economic political patronage. The personal dimension of political patronage is captured by whether the firm has established intimate informal ties with powerful politicians. To capture the economic dimension of political patronage, we use direct government ownership because the government has little justification to assume an equity position in a firm which is not compatible with its economic objectives (Fraser et al., 2006). Previous studies on the reported earnings of politically connected firms (Ball et al., 2003; Gul, 2006; Chaney et al., 2011) show that firms with higher government ownership (Bushman et al., 2004) capture underlying economic events less accurately.

In Malaysia, anecdotal evidence and widespread press reports show that, in addition to displaying characteristics of a relationship-based system such as cronyism, politically connected firms have lower levels of transparency than non-connected firms (Jomo and Gomez, 2000), which makes forecasting earnings more difficult. The uncertainty in the timing and magnitude of the payback from these forms of political patronage also makes the income stream more erratic, reducing earnings predictability further. This argument is in line with the fact that firms with economic and personal political patronage typically derive gains from the government over and above the payments they make. The nature of these payments and gains may create additional incentives to suppress firm-specific information in order to hide expropriation activities by politicians and their cronies (Bushman et al., 2004; Chaney et al., 2011). In Malaysia, for instance, businessmen with informal personal ties with politicians are often rewarded with lucrative state rents in the form of licences, contracts, and business deals with state corporations and privatised state shareholdings (Chan, 2012). These connected firms may also care less about the quality of financial information disclosed because of the protection they receive from politicians,[1] and because they have less need to raise external capital due to their privileged access to loans from government controlled banks (Faccio et al., 2006; Claessens et al., 2008).

If the political patronage is for social considerations, however, we predict greater analysts' forecast precision for patron firms. The five largest domestic institutional investors in Malaysia, all established by the government and are members of the Minority Shareholder Watchdog Group (MSWG),[2] have been instrumental in increasing Bumiputra shareholding in the capital market, thereby reducing equity ownership imbalances between the various ethnic groups (Gomez and Jomo, 1999). Evidence shows these government-controlled/sponsored domestic financial institutions play an effective corporate governance role (Abdul Wahab et al., 2007), with their investee firms displaying better disclosure practices (Lim et al., 2014). The increased transparency of the investee firms should make it easier for analysts to forecast earnings.

In a cross-country analysis, Chen et al. (2010) find analysts have greater difficulty in predicting the earnings of connected firms, and that anti-corruption measures can curb the adverse effect of political connections on firms' information environment. Their investigation is based on a sample of 114 politically connected firms in 17 jurisdictions between 1997 and 2001. For a sample of 73 firms in Malaysia, they identify 23 firms as being politically connected. By focusing on just one country, i.e., Malaysia, we are able to provide a more in-depth analysis of political patronage (of which political connection is a subset) using a larger sample of firms. We sample 440 firms listed on Bursa Malaysia from 1999 to 2003 and find 17.5 percent have established personal connections with ruling politicians. Importantly, our study is not subject to issues which are commonly encountered in cross-country studies, including mismatching measurement periods for firm- and country-level variables, high correlations between country-level variables, and the dominance of country-level variables in driving the explanatory power of the model (Miller, 2004).

The accounting and finance research on financial analysts in Malaysia is scarce. Abdul Wahab et al. (2015) examine the association between culture (a proxy for ethnicity), corporate governance, and analysts' forecast errors. They find the forecast errors are significantly related to culture but not to corporate governance. How et al. (2014) examine whether institutional ownership and political connections are related to analyst following. They report a significant relation between institutional ownership and analyst following, but no similar evidence is found for political connections. Our research differs from the above papers in that we examine whether the channel of political patronage matters to analysts' forecasting ability. Additionally, our sample period (1999–2003) represents a period of political "tranquility", following the 1997–1998 *Reformasi* movement.[3] Johansson (2015) suggests the post-*Reformasi* period is ideal for testing the impact of political change in Malaysia as it reflects the first "true" challenge to the governing party regarding competitive authoritarianism. By ending our sample period in 2003 also ensures that our findings are not subject to exogenous political shocks brought about by the general election on 21 March 2004. Under the leadership of Tun Abdullah Ahmad Badawi, Malaysia witnessed a huge swing towards the ruling coalition, with *Barisan Nasional* (National Front) winning 50 more seats than in the previous election.

Correcting for self-selection bias arising from non-randomness in analysts' stock coverage selection (Rajan and Servaes, 1997), we find evidence supporting our prediction that analysts' forecasting precision, as measured by the consensus analysts' absolute earnings forecast error, varies with the dimension of political patronage. Results show a negative relation between analysts' forecast errors and the social dimension of political patronage, consistent with the monitoring role of institutional investors (Abdul Wahab et al., 2007; Lim et al., 2014). This finding is also in line with the income smoothing proposition (Chen et al., 2010), where politicians use their

[1] Chaney et al. (2011) report that politically connected firms do not face the same negative consequences of poor information quality as non-connected firms since lower quality reported earnings are associated with a higher cost of debt only for the latter. Yu and Yu (2010) find fraudulent firms spend more on political lobbying and are able to evade fraud detection longer. They report that in the U.S., more than half of former congressmen or senate members work as lobbyists hired by corporations.

[2] These government-controlled domestic institutional investors consist of two pension funds (Employees Provident Fund (EPF) and Lembaga Tabung Angkatan Tentera (LTAT)), an investment fund (Permodalan Nasional Berhad (PNB)), a pilgrim fund (Lembaga Tabung Haji (LTH)), and an insurance company for employees (Pertubuhan Keselamatan Sosial (SOCSO)).

[3] The 1997–1998 *Reformasi* period has been described as a political "tsunami" period by Johansson (2015). The *Reformasi* movement was triggered by the Asian financial crisis and the subsequent sacking of Deputy Prime Minister-cum-Finance Minister, Dato' Seri Anwar Ibrahim.