Wharton-SMU Research Center

Corporate Transparency and Political Connections

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Corporate Transparency and Political Connections

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Abstract

In this paper, we study the corporate transparency choices of firms operating in a weak institutional environment. We argue that in relationship-based systems, high levels of corporate transparency and strong political connections are alternative means to create firm value. Firms can try to commit to more transparency by issuing securities abroad. However, the expanded disclosures and additional scrutiny that come with having foreign securities are often at odds with close political ties at home because these ties can best be exploited when little is disclosed about the firm. Using data from Indonesia, we provide strong support for the hypothesis that corporate transparency and political connections are substitutes: Firms with close political ties to former President Suharto are significantly less likely than non-connected firms to issue foreign securities. To study the performance effects of firms’ transparency choices, we examine how returns during the Asian financial crisis differ between transparent and non-transparent firms. Consistent with prior work, we find that transparent firms exhibit higher returns during the crisis. However, our data indicate that politically well-connected firms also received considerable support during this period. As a result, previous estimates of the value of corporate transparency appear to be considerably biased.

JEL classification: P16, G32, G38, K22, K42, M41, G18

Key Words: Disclosure; Cross listing; Financing choices; Emerging market economies; Asian financial crisis; Indonesia; Cost of capital

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1. Introduction

Recent research suggests that weak corporate governance and investor protection make it more difficult for firms to raise external capital (La Porta, Lopez-de-Silanes, Shleifer and Vishny, 1997 and 2000). To alleviate this problem, firms in countries with weak legal institutions can try to commit to more transparency by issuing securities in capital markets with stringent legal standards (Coffee, 1999; Stulz, 1999). For firms in relationship-based economies, however, the greater disclosure that comes with issuing foreign securities may be costly in that high levels of transparency are often difficult to reconcile with the benefits that good political connections can confer. For instance, in many weakly regulated markets, firms are free to engage in undisclosed related-party transactions with which they can benefit close associates and political backers. Transactions of this type need to be reported once the firm’s shares are listed on a major exchange. This reasoning suggests that improved transparency and closer political ties represent two alternative means to create firm value. The tradeoff between greater disclosure and stronger political relations may be particularly steep in economies characterized by crony capitalism, an extreme form of a relationship-based system. In these economies, the favors extended to politically well-connected firms are often of dubious legality, making it all the more risky to provide detailed accounts of a firm’s finances.

While there are reasons to see political connections and corporate transparency as substitutes, other arguments suggest they could be complements. Close political ties typically increase firm value (Fisman, 2001; Faccio, 2002). As a result, firms with good connections make attractive investment opportunities, suggesting that foreign investors might be particularly interested in these listings. If it is correct that, in practice, greater disclosure poses little legal and political risk for well-connected firms and their backers (Siegel, 2002), close political ties could
actually increase the likelihood that a firm issues foreign securities. As these arguments make clear, the relationship between firms’ transparency choices and their investments in political connections is ultimately an empirical question. In this paper, we examine this relationship using data from Indonesia.

Indonesia’s crony capitalism under former President Suharto provides a particularly suitable setting to examine firms’ transparency choices. First, Indonesia has low levels of mandatory disclosure, providing more discretion to firms and increasing cross-sectional variation in transparency. Second, there is ample evidence that the Suharto regime provided substantial economic benefits to politically well-connected firms (Fisman, 2001). Third, Indonesia’s relatively centralized power structure facilitates the measurement of political connections. And finally, the Asian financial crisis towards the end of the Suharto era provides an economic shock that we can exploit to assess the performance consequences of transparency and political connections (Mitton, 2002).

In our analysis, we find strong support for the view that issues of foreign securities and close political connections are substitutes, two alternative means to create firm value. Firms that are close to the Suharto regime are significantly less likely to have publicly traded securities abroad. They are also less likely to have debt or equity securities traded on US exchanges. These findings hold after controlling for firm size, financial leverage, firm profitability, and industry characteristics.

There are at least three explanations for our results. First, it is well-known that Indonesian firms with close ties to the regime had preferential access to financing, typically from state-owned banks. Once such funds become available, the benefits of issuing foreign securities are simply smaller. Second, foreign securities require greater transparency, which is likely to
impede politically arranged financing via covert operations with state-owned banks. And third, low transparency facilitates the extraction of private benefits of control, giving another reason why firms from countries with weak institutional structures do not cross list in the US despite evidence of substantial cross listing benefits (Doidge, Karolyi and Stulz, 2001; Reese and Weisbach, 2002).

These three explanations are not mutually exclusive, and it appears likely that all of them influence firms’ transparency choices. While our data do not allow us to distinguish between these various mechanisms, our main finding that firms trade off political connections and corporate transparency alone has important empirical implications. A key question in the recent literature on cross listing is whether or not foreign securities are effective bonding devices which commit firms operating in weak institutional environments to better corporate governance (Fan and Wong, 2001; Doidge et al., 2001; Reese and Weisbach, 2002; Siegel, 2002). In support of this view, Mitton (2002) reports that Asian firms with higher-quality disclosures have significantly higher returns during the Asian financial crisis. However, if domestic sources of firm value – for instance President Suharto’s attempts to save firms close to the regime – are omitted from these analyses, the resulting estimates are likely to be biased.

There is some evidence that Suharto tried to protect well-connected firms. The Texmaco group for example received loans in excess of US$ 1 billion from Bank Negara Indonesia, one of Indonesia’s largest state banks. The loans far exceeded the bank’s legal lending limit, but were approved by Suharto “as a means to prop up the conglomerate after the Asian financial crisis” (Solomon, 1999). Texmaco’s founder, Marimutu Sinivasan, is said to be a long-time friend of President Suharto. Consistent with such examples, we find that the performance effects associated with foreign securities increase considerably once we control for a firm’s closeness to
the Suharto regime, indicating that both greater disclosure and political connections continued to contribute to firm value during the crisis. This result is consistent with and complements recent evidence by Johnson and Mitton (2003) who show that politically well-connected firms in Malaysia benefited from the imposition of capital controls during the Asian crisis.

The paper is organized as follows. Section 2 describes the institutional setting and explains our research design. Section 3 describes the sample and the data. Section 4 presents the results for firms’ transparency choices and Section 5 reports the performance tests. Section 6 concludes the paper.

2. Institutional Setting and Research Design

A key premise of our approach is the idea that political connections constitute a source of firm value. There is empirical evidence supporting this view, both for Indonesia (Fisman, 2001) and for a larger set of economies. For instance, connected firms pay fewer taxes and have larger market shares (Faccio, 2002). In Indonesia, the Suharto regime often arranged preferential financing for well-connected firms (so-called “memo-lending”). An example of the early 1990s is Golden Key, a little-known chemical and manufacturing group, which received an unsecured loan of $430 million from the state-owned Bank Pembangunan Indonesia. Court proceedings subsequently revealed that Hutomo Mandala Putra, the youngest son of President Suharto, was an early investor in Golden Key and had introduced the firm to bank officials who approved the loan at “neck-breaking speed” (McBeth, 1994). Similarly, the Barito Pacific group received huge loans from state banks prior to the crisis. Political connections are widely cited as the reason behind the state banks’ generosity (Borsuk, 1993).
The benefits of political connections are not confined to debt financing. Barito Pacific’s 1993 public stock offering, for instance, was greatly helped by the state civil-service pension fund acquiring a 20% stake. Barito denied allegations that it needed the pension fund’s entry to “shore up the company before it could go public,” but analysts noted that the fund’s investment substantially boosted the company’s capital (Borsuk, 1993). A further source of value for politically well-connected firms is the granting of important licenses. The Salim Group, one of the largest Indonesian conglomerates, had very close ties with President Suharto and was awarded lucrative franchises in banking, flour milling and telecoms (Shari, 1998).

These anecdotes illustrate that political connections are one way to obtain low-cost financing and other economic advantages. Instead of relying on political connections, firms can increase their value by reinsuring shareholders about their quality and their willingness to respect shareholder rights (Morck, Yeung and Yu, 2000). To this end, they can increase financial disclosure, switch to internationally-accepted accounting standards, hire reputable international auditors, and issue securities in foreign capital markets with tougher legal standards. Whether or not cross listings effectively protect minority shareholders is the subject of an ongoing debate. Cheung and Lee (1995), Coffee (2002), Mitton (2002) and Reese and Weisbach (2002) argue that foreign securities tend to improve investor protection. Fanto (1996), La Porta, Lopez-de-Silanes and Shleifer (1999), Licht (2001) and McNeil (2001) are more skeptical. Legal protection aside, better growth prospects (Blass and Yafeh, 2001), a greater analyst following (Lang, Lins and Miller, 2002) and improved incentives to protect the firm’s reputation (Siegel, 2002) could also account for the higher returns of cross listed firms.

To better understand the performance effects of improved corporate transparency, it is key to know why firms choose to issue foreign securities. The incentives to do so depend in part on
the relationship between higher levels of transparency and domestic business opportunities. If cross-listed firms are best able to exploit political connections, we would expect firms to simultaneously invest in domestic relationships and access foreign capital markets. However, if the issue of publicly traded foreign securities forces firms to give up domestic business opportunities, those with good opportunities might be reluctant to access foreign markets. The nature of the relationship between transparency and political ties is not a priori obvious. The pursuit of domestic sources of firm value could be a substitute or a complement to an international orientation which entails greater disclosure. On the one hand, it seems plausible that domestic transactions of dubious legality discourage corporate transparency. On the other hand, close political connections might contribute to firm growth and increase the firm’s demand for capital, thereby making it more likely that well-connected firms issue foreign securities.

To examine the relationship between political ties and corporate transparency, we analyze the likelihood of Indonesian firms having publicly traded foreign securities. We also try to explain which firms have debt or equity securities traded on major US exchanges. In this case, firms have to file Form 20-F with the SEC, which requires extensive disclosures (e.g., on related-party transactions) as well as reconciliations of net income and shareholders’ equity under foreign GAAP to U.S. GAAP. In addition, the filing exposes firms to SEC enforcement and civil liability under Section 18 of the 1934 Securities Exchange Act, and makes them subject to the record keeping and accounting provisions of the Foreign Corrupt Practices Act. We report our main results in Section 4. Before we turn to our findings, we describe our sample and data in the following section.
3. Sample and Data

Our tests require financial statement and share price data. We obtain financial data from the Worldscope database. In 1997, the database comprises 151 Indonesian firms. We lose 13 firms because we are unable to find share price data on Datastream. In addition, we drop 8 firms that are not traded over our sample period. Thus, the final sample consists of 130 firms, representing over 80% of the Indonesian market capitalization in December 1996.

Next, we search for foreign securities of Indonesian firms using the SDC database, Datastream, the Global Access database, SEC filings on Edgar, and the Bank of New York’s ADR list. We identify 22 firms with publicly traded debt and equity securities on 6/30/1997, shortly before the beginning of the Asian crisis. We do not include private debt agreements or private equity placements because these arrangements allow investors to be informed via private channels rather than public disclosure. Our hypothesis, however, relies on the notion that foreign securities imply greater transparency and public disclosure. The most stringent requirements apply to firms with debt or equity securities that are traded on major US exchanges. We identify 8 sample firms filing Form 20-F.

Our measure of political connections is based on Fisman (2001). His study shows that stock returns around news events indicating health problems of President Suharto are negatively related to the Suharto Dependency Index developed by the Castle group, an economic consulting firm in Jakarta. That is, firms that are close to Suharto suffer negative returns when bad news about the President’s health hit the market. We compute stock returns around the 6 health-
related events identified by Fisman (2001). The average cumulative return for a firm in our sample is -4.6%. The variable exhibits considerable cross-sectional variation. Some firms lose more than 20% of their value during these 6 events. We multiply the cumulative returns by -1 so that larger realizations indicate greater closeness to Suharto. This variable is our proxy for political connections.

Table 1 reports descriptive statistics for all firms and for two subsamples. All financial statement data is measured as of the fiscal year end in 1996.

4. The Choice of Foreign Securities

We begin to analyze the link between political connections and corporate transparency by studying firms’ decisions to have publicly traded foreign securities. In our empirical model, the net benefit of foreign securities \( y_i^* \) depends on a vector of firm characteristics \( X_i \), a firm’s closeness to the Suharto regime \( C_i \), and industry fixed effects \( \mu_s \):

\[
y_i^* = X_i \beta + \gamma C_i + \mu_s + \epsilon_i
\]

If firms with closer connections to the Suharto regime are less likely to have foreign securities, we will observe \( \gamma < 0 \). Prior studies identify firm size and industry as important factors influencing the decision to cross list shares abroad (Saudagaran, 1988; Saudagaran and

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1 The event days are January 30 – February 1, 1995; April 27, 1995; April 29, 1996; July 4 – 9, 1996; July 26, 1996; April 1-3, 1997. For further details on the events see Fisman (2001). There are 7 firms, for which we do not have return data for all 6 events. Dropping these firms does not materially alter our results or inferences. The results are also similar using the average event return.

2 The Suharto Dependency Index used by Fisman (2001) is only available for 42 sample firms, which is why we use event returns. The Dependency Index and our proxy exhibit a significant correlation (\( \rho = 0.407 \)).
Biddle, 1995; Karolyi, 1998). We control for firm size by including total assets in our models. Financing needs, profitability and financial leverage have also been shown to be important for firms’ transparency choices (Healy and Palepu, 2001). We use capital intensity as a proxy for financing needs and the return on assets as our measure for profitability. The former is computed as the ratio of fixed assets to total assets. The latter is measured as the ratio of operating income to total assets. Finally, we take into account that, in emerging market economies, business groups often provide financing to other members of the group (Khanna and Palepu, 2000). If financing strategies within a business group are correlated, estimates ignoring group affiliation overstate the number of independent observations. To avoid this problem, we cluster standard errors on group affiliation using data from Claessens et al. (2000) and Fisman (2001).

The net benefit of foreign securities \( y_i^* \) is unobserved, but we know which firms have foreign securities:

\[
y_i = \begin{cases} 
1 & \text{if } y_i^* > 0 \\
0 & \text{if } y_i^* \leq 0
\end{cases}
\]

Given the binary nature of our dependent variable, we report probit estimates in Tables 2 and 3. The models for foreign securities (Table 2) as well as the models for the 20-F filings (Table 3) explain a substantial fraction of the cross-sectional variation. The key result in these tables is that politically well-connected firms are less likely to have foreign securities and securities requiring a 20-F filing. The estimated coefficient in the first specification of Table 2

\[\text{______________________________}\]

\[^{3}\text{It would be desirable to include foreign sales, but we cannot do so because the Worldscope database does not provide this data for most sample firms.}\]

\[^{4}\text{Using the market value of equity as a proxy for size yields even stronger results. We nevertheless rely on total assets because market capitalization could also be affected by the choice of foreign securities.}\]
implies that a one-standard-deviation increase in closeness reduces the likelihood of a firm having foreign securities by 5.8 percentage points. The main result is largely unchanged if we control for firm profitability (ROA), financing needs (capital intensity) and financial leverage.

The trade-off between a domestic orientation and access to international capital markets is likely to be different for the subsidiaries and affiliates of foreign firms. Not surprisingly, none of the foreign firms in our sample has publicly traded foreign securities. To check the robustness of our results, we drop the 11 foreign firms from our sample (model 4). As before, we find that firms which are close to the regime are less likely to have foreign securities. In a second check of our results, we use an alternative measure of the closeness to the regime: the stock returns during the days leading up to Suharto’s resignation in 1998. The idea is again that firms close to Suharto are likely to experience negative returns when he resigns. As it is not clear at which point the market expected Suharto to step down, we compute log returns over the period from May 12th through May 21st 1998. We use these returns instead of the health-based Suharto variable in model 5. We find again that firms experiencing more negative returns are less likely to have foreign securities.

Robustness Checks

We perform a number of robustness checks to validate our findings. First, we use alternative proxies for firms’ financing needs, namely average sales and asset growth. We also use a different measure of profitability, EBITDA over total assets. The resulting estimates are very similar to those reported in Tables 2 and 3. Second, we control for a firm’s average trading

5 On May 12th, student protests calling for Suharto’s resignation gained momentum and widespread support. On May 15th, a wing of the leading Golkar party called for his resignation. The upper house of the Parliament joined these calls on May 18th (Cohen, 1998; DJ Newswire, 5/18/1998). Suharto finally resigned on May 21st.
volume over the event days that we use to compute the closeness proxy. We are concerned that infrequent trading of some stocks could affect our results and, in particular, bias the Suharto measure towards zero. Including trading volume leaves our results virtually unchanged.

Third, we re-estimate our models using a different dependent variable. We code a binary indicator for the six firms with private foreign securities. These securities – examples include private placements in the US under Rule 144a and private foreign debt – allow firms to access foreign capital markets, but they do not require extensive public disclosure of information. If issues of transparency are critical for the decision to have publicly traded foreign securities, closely connected firms might be as likely or even more likely to have private foreign securities. While the results of the private securities model are driven by a small number of observations and should thus be interpreted with care, it is interesting to note that more closely connected firms are significantly more likely to have private securities.\(^6\) As in Tables 2 and 3, this model controls for firm size, ROA, capital intensity and financial leverage of the firms in our sample.

Finally, we address the concern that our closeness measure might be endogenously determined. The models in Table 2 and 3 as well as our robustness tests assume that a firm’s political connections are predetermined. This need not be an unreasonable view. While President Suharto came to power in 1966, the first Indonesian ADR was not issued until 1991 (Bekaert, Harvey and Lundblad, 2002). Thus, it might well be that the important political alliances in Indonesia were largely forged prior to financial market liberalization and the issuance of foreign securities. In addition, many important political connections appear to be

\(^6\) The estimated coefficient on closeness is 6.208 with a robust standard error of 2.842.
family related, another exogenous factor (Backman, 2001). While it is possible that political connections are exogenous to listing decisions, the endogeneity concern appears equally valid.

Smith and Blundell (1986) devise a simple exogeneity test for models with limited dependent variables. The test involves the estimation of a first stage with closeness as the dependent variable. The residuals from the first stage are then included as an additional covariate in the models in Table 2 and 3. The standard order condition for identification applies here, indicating that we need an instrument for a firm’s closeness to the regime. We use the ethnicity of the president director of a firm as an instrument in the first stage. Given the delicate state of race relations in Indonesia, we think it likely that Chinese managers view close political connections with President Suharto in a different light than indigenous Indonesians. A priori, it is difficult to say if good political relations are more or less important for Chinese managers. Given anti-Chinese sentiments, one could argue that political protection is more valuable for the Chinese than for Pribumis. However, there are also arguments to the contrary. Political favors of often dubious legality typically need to be repaid by kickbacks and side payments of equally dubious nature. This is risky for any manager, but particularly risky for Chinese executives. If found out, both their criminal wrongdoing and SARA – an Indonesian acronym for the hot-button issues of suku (tribe), agama (religion), ras (race), and antar golongan (ethnicity) – tend to stir emotions. The trial of Golden Key owner Tan Tjoe Hong provides an illustrative example. Accused of having fraudulently secured a $430 million letter of credit,

7 Indonesian firms have a two-tiered board structure. The role of the president director corresponds to the role of the CEO.
8 Information on the ethnicity of the president director and the dominant owner, which we use as an alternative instrument, comes from a large number of publicly available sources such as press reports and company websites. We cross checked information with an Indonesian accounting firm, an Indonesian stock broker, and with Indonesian students at the Wharton School. Michael Backman was kind enough to also share his expertise in these matters. A complete list of all sources is available upon request.
Hong was subject to a vocal anti-Chinese campaign throughout his trial. The *Far Eastern Economic Review* reports that Indonesians holding anti-Chinese views were paid to attend the court hearings (McBeth, 1994). While it is difficult to know the extent to which judges are impressed by such public pressure, it is possible that Chinese managers are more reluctant to engage in corrupt behavior in a country where their ethnicity can be used against them. Ultimately, the relationship between Chinese ethnicity and political closeness to the regime is an empirical matter.

A valid instrument is a variable that is correlated with political closeness and uncorrelated with the presence of foreign securities. Other than through the channel of political connections, we could find no evidence that the ethnicity of the president director influences listing decisions. When included in the models in Table 2 and 3, the ethnicity variable remains economically small and statistically insignificant, while the closeness variable remains largely unchanged. In our first-stage regressions, we find that president directors of Chinese ethnicity are significantly less close to the Suharto regime.\(^9\) We report \(p\)-values for the Smith-Blundell exogeneity test for all models in Tables 2 and 3. Under the null hypothesis of exogeneity, the first-stage residuals have no explanatory power. We cannot reject the null for any of our specifications.

Taken together, the results presented in this section lend reasonable support to our hypothesis that domestic political considerations influence listing decisions. In particular, we find that investments in political connections and investments in access to foreign capital markets appear to be substitutes.

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\(^9\) For instance, using the covariates in model 3 of Table 2a, the estimated coefficient of the ethnicity indicator on closeness is -0.0558 with a robust standard error of 0.023. The ethnicity of the dominant owner turns out to be the weaker instrument.
5. Returns to Foreign Securities Before and During the Asian Financial Crisis

The availability of alternative strategies to create firm value, one based on political connections and another relying on foreign securities, has strong implications for the identification and measurement of the performance effects of corporate transparency and good governance. We analyze the value of these two strategies by analyzing stock returns for the Indonesian firms in our sample one year prior to and during the financial crisis of 1997 and 1998. In financial market equilibrium, it would be surprising to see that firms with foreign securities consistently outperform firms that have invested in political relationships. In contrast, unexpected shocks such as the financial crisis in Asia are more likely to result in significant differences in performance. In particular, the Asian crisis, which many believe was in part due to weak corporate governance and low levels of transparency (Stiglitz, 1998; Harvey and Roper, 1999), may well have put a premium on transparent firms. Mitton (2002) provides evidence that this was in fact the case. In a sample of firms from five Asian countries, he reports that firms adhering to more stringent standards of corporate transparency significantly outperformed low-transparency enterprises during the crisis.

However, as the results in the previous section suggest, corporate transparency is only half the story. In measuring the performance effects of high-transparency firms, it is important to take into account how the regime responded to the economic turmoil. Suppose President Suharto lost some of his ability to support politically well-connected firms during the crisis. As political closeness and corporate transparency are substitutes, we would then overestimate the value of high levels of transparency. In contrast, if Suharto generously supported “his” firms during the
crisis – Texmaco provides a good example – the benefits of cross listing might well be larger than previously estimated.

To investigate these issues, we estimate a series of models explaining the stock price performance of our sample firms prior to and during the Asian financial crisis. In particular, we compare models which treat the presence of foreign securities as exogenous with models that explicitly take into account that cross listing decisions depend on previous political investments. We investigate three different time periods. The year prior to the crisis (7/1/96-6/30/97), the crisis period up to President Suharto’s resignation (6/30/97-5/21/98), and a somewhat longer window of time which corresponds to the analysis in Mitton (2001) (6/30/97-8/31/98). The dependent variable in these analyses is the annualized log of stock returns $r_i$ for the 130 Indonesian firms in our sample. We control for firm size (measured as the log of total assets), financial leverage (the ratio of long-term debt to total assets), and the riskiness of the stock (the standard deviation of the weekly returns in 1996).

$$(3) \quad r_i = X_i \beta + \phi y_i^* + \mu + \epsilon_i.$$  

The bonding hypothesis predicts that cross listed firms outperform other corporations, $\phi > 0$. The estimates of the performance effects of issuing foreign securities are reported in Table 4. In simple OLS regressions, we find positive and significant effects throughout the crisis (columns 4 and 7). In contrast, firms that had issued foreign securities did not outperform other firms in the year prior to the crisis (column 1). To the extent that these estimates are biased, the bias is not the result of an omitted variable problem. Adding our measure of closeness to these OLS regressions, we find that the coefficient on having foreign securities changes little and our closeness measure bears no significant relationship to stock returns.
In columns 2, 5 and 8 of Table 4, we report the results of treatment effects models which explicitly account for the substitutive relationship between political connections and corporate transparency. The listing equations reported in Tables 2 and 3 form the first stage of these models. At the second stage, we estimate equation (4).

The two-stage estimates of the performance effects of issuing foreign securities are considerably larger than the simple OLS results. Controlling for investment in political relationships, we now also find a smaller positive performance effect for the year prior to the Asian crisis. To address the concern that these results could simply reflect longer-run differences in performance across firms, a second set of models controls for firm profitability prior to the crisis (ROA) and the demand for capital. While this reduces the size of the estimated performance effects of foreign securities, we continue to find positive and statistically significant effects in all three time periods.

In Table 5, we repeat this exercise looking at the effects of 20F filings. The pattern of results is similar. Taking a firm’s closeness to the regime into account, we find much larger cross listing effects. When we control for past profitability, there is no performance effect of 20-F listings prior to the crisis.

The estimates presented in Tables 4 and 5 are consistent with anecdotal evidence that President Suharto lent considerable financial support to politically well-connected firms during the financial crisis (similar support was available to firms in Malaysia, see Johnson and Mitton 2003). As a result, conventionally measured cross listing effects are downward biased because political considerations are ignored. Our results indicate that both strategies pursued by Indonesian firms, the one based on political connections and the one relying on foreign securities, increase firm value prior to and during the Asian financial crisis. While the two
strategies are similarly profitable before the crisis, the economic turmoil post July 1997 put a premium on firms with foreign securities.

6. Conclusions

Crony capitalism is seen as a major structural weakness of many emerging economies. The suggested policy reforms to address this issue include the privatization of state-owned financial institutions and the adoption of rules that lead to improved transparency. While governments can do much to improve corporate transparency and governance, firms operating in countries with weak institutions can attempt to commit to more disclosure and better investor protection by issuing foreign securities. Consistent with prior work, our results indicate that these actions do result in better performance. This is particularly true during the Asian financial crisis.

However, committing to more transparency is not the only way to create firm value. In relation-based systems, investments in political connections can also provide access to important economic benefits such as preferential financing and licenses. Our results indicate that firms in Indonesia view these two strategies as substitutes. Firms with good political connections do not issue foreign securities, while cross listed firms do not have close ties to the regime. There are several explanations for this finding. It might be that close political ties and high levels of transparency are simply inconsistent. Another possibility, emphasized by Doidge et al. 2001, is that the dominant shareholders of politically well-connected firms are unwilling to share the benefits of political patronage with minority shareholders.

The results presented here shed light on the politically difficult task to improve standards of corporate transparency in relationship-based economic systems. While improving these
standards generates better economic performance, firms can also create competitive advantages by investing in political ties. For Indonesia as well as other emerging markets, it is easy to find examples where political connections provide benefits to both majority and minority shareholders. In the year prior to the crisis, we find no evidence that minority shareholders of politically well-connected firms fare worse than those who invest in corporations with a commitment to high transparency and good corporate governance, suggesting that not even minority shareholders may actively demand reforms.

A second conclusion relates to research on firms operating in relationship-based economic systems in general. A quickly growing literature investigates the performance effects of adopting firm strategies that are more consistent with the Anglo-Saxon model of market-based, arms-length financing. Can emerging market firms outperform domestic competitors by appointing independent boards and by relying on international auditors? In these analyses, it is important to recognize that these decisions are likely to be endogenously determined. In a relationship-based economy, firms with weak political connections have the strongest incentives to improve transparency and corporate governance. Unless this is taken into account, the debate surrounding the performance effects of greater corporate transparency and improved governance is likely to be misinformed.
References


Siegel, Jordan (2002). Can Foreign Firms Bond Themselves Effectively by Renting U.S. Securities Laws?


Table 1 – Summary Statistics

The table reports means and standard deviations in parentheses for the full sample of 130 Indonesian firms. A subsample of 22 firms has publicly traded foreign securities, and 8 firms have securities requiring a 20-F filing, as of June 1997. “Closeness to Suharto” is the sum of log stock returns of five news events indicating that President Suharto is in bad health. “Closeness to Suharto (resignation)” is the log stock returns prior to Suharto’s resignation (5/12/1998-5/21/1998). Firm characteristics are measured at the end of the fiscal year 1996. ROA is the ratio of operating income to total assets. “Capital intensity” is the ratio of fixed assets to total assets. “Financial leverage” is the ratio of long-term debt to total assets. “President Director” indicates whether a firm’s CEO is Chinese (=1). “Log returns” are annualized log stock returns for the periods indicated in the table. “Risk” is the standard deviation of the weekly stock returns during 1996.

<table>
<thead>
<tr>
<th></th>
<th>Full Sample (N=130)</th>
<th>Firms with Foreign Securities (N=22)</th>
<th>Firms with 20F Filings (N=8)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreign Securities</td>
<td>0.169</td>
<td>0.364</td>
<td></td>
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<tr>
<td></td>
<td>(0.376)</td>
<td>(0.492)</td>
<td></td>
</tr>
<tr>
<td>20F Filing</td>
<td>0.062</td>
<td>0.364</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(0.241)</td>
<td>(0.492)</td>
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<tr>
<td>Closeness to Suharto</td>
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<td></td>
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<td>(0.044)</td>
<td>(0.040)</td>
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<tr>
<td>Closeness to Suharto (resignation)</td>
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<td>Total assets (millions of Rupiah)</td>
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<td>7,360</td>
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<td>(5,670)</td>
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<td>(0.237)</td>
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<td>0.341</td>
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<td>(0.168)</td>
<td>(0.149)</td>
<td>(0.170)</td>
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<td>0.636</td>
<td>0.625</td>
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<td></td>
<td>(0.495)</td>
<td>(0.492)</td>
<td>(0.518)</td>
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<td>(0.193)</td>
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<td>(0.294)</td>
<td>(0.354)</td>
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<td>(0.477)</td>
<td>(0)</td>
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<tr>
<td>Log returns Pre-crisis</td>
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<td>-0.238</td>
<td>-0.437</td>
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<tr>
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<td>--------</td>
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<td>--------</td>
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<td>7/1/96-6/30/97</td>
<td>(0.574)</td>
<td>(0.538)</td>
<td>(0.582)</td>
</tr>
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<td>-1.253</td>
<td>-0.972</td>
<td>-0.156</td>
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<td>7/1/97-5/21/98</td>
<td>(1.192)</td>
<td>(0.989)</td>
<td>(0.527)</td>
</tr>
<tr>
<td>Log returns Mitton (2002)</td>
<td>-1.160</td>
<td>-0.928</td>
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<td>7/1/97-8/31/98</td>
<td>(0.988)</td>
<td>(0.872)</td>
<td>(0.608)</td>
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<td>0.062</td>
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<td>(0.026)</td>
<td>(0.036)</td>
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Table 2 – Foreign Securities and Political Connections

The table reports probit estimates of the likelihood that the 130 Indonesian firms in our sample have publicly traded foreign securities. The dependent variable takes on a value of 1 if the firm has foreign securities and 0 otherwise. “Closeness to Suharto” is the sum of log stock returns of five news events indicating that President Suharto is in bad health. “Closeness to Suharto (resignation returns)” is the log stock returns prior to Suharto’s resignation (5/12/1998-5/21/1998). Firm characteristics are measured at the end of the fiscal year 1996. “Firm size” is computed as the log of total assets. ROA is the ratio of operating income to total assets. “Capital intensity” is the ratio of fixed assets to total assets. “Financial leverage” is the ratio of long-term debt to total assets. “Industry” are indicators for agriculture, manufacturing, transport, trade, and finance. Standard errors (in parentheses) are clustered on group affiliation as reported by Fisman (2001) and Claessens et al. (2000). We report p-values for the Smith-Blundell (1986) exogeneity test. The null hypothesis is that our closeness measures are exogenous. We denote levels of statistical significance as follows: † significant at 10% * significant at 5% ** significant at 1%

<table>
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<th>(3)</th>
<th>(4)</th>
<th>(5)</th>
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<td>-6.566</td>
<td>-6.636</td>
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<tr>
<td></td>
<td>(1.814)**</td>
<td>(1.830)**</td>
<td>(2.002)**</td>
<td>(1.973)**</td>
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<td></td>
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<tr>
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<td>0.886</td>
<td>0.882</td>
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<tr>
<td></td>
<td>(0.176)**</td>
<td>(0.176)**</td>
<td>(0.186)**</td>
<td>(0.180)**</td>
<td>(0.137)**</td>
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<tr>
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<td>0.297</td>
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<td></td>
<td>(3.170)</td>
<td>(3.775)</td>
<td>(4.411)</td>
<td>(3.527)</td>
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<td>0.217</td>
<td>0.681</td>
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</tr>
<tr>
<td></td>
<td>(0.920)</td>
<td>(0.876)</td>
<td>(0.869)</td>
<td>(0.814)</td>
<td></td>
</tr>
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<td>Financial leverage</td>
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<td>2.272</td>
<td>1.692</td>
<td></td>
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<tr>
<td></td>
<td>(1.021)**</td>
<td>(1.000)*</td>
<td>(0.960)†</td>
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<td></td>
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<td>yes</td>
<td>yes</td>
<td>Yes</td>
</tr>
<tr>
<td></td>
<td>(3.711)**</td>
<td>(3.726)**</td>
<td>(4.011)**</td>
<td>(3.844)**</td>
<td>(2.923)**</td>
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<td>130</td>
<td>130</td>
<td>119</td>
<td>119</td>
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<td>Pseudo $R^2$</td>
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<td>0.42</td>
<td>0.45</td>
<td>0.44</td>
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</tr>
<tr>
<td>exogeneity test</td>
<td>0.17</td>
<td>0.23</td>
<td>0.30</td>
<td>0.30</td>
<td>0.18</td>
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</tbody>
</table>
Table 3 – 20-F Filings and Political Connections

The table reports probit estimates of the likelihood that the 130 Indonesian firms in our sample have foreign securities which require a 20-F filing. The dependent variable takes on a value of 1 if the firm has this type of security and 0 otherwise. “Closeness to Suharto” is the sum of log stock returns of five news events indicating that President Suharto is in bad health. “Closeness to Suharto (resignation returns)” is the log stock returns prior to Suharto’s resignation (5/12/1998-5/21/1998). Firm characteristics are measured at the end of the fiscal year 1996. “Firm size” is computed as the log of total assets. ROA is the ratio of operating income to total assets. “Capital intensity” is the ratio of fixed assets to total assets. “Financial leverage” is the ratio of long-term debt to total assets. “Industry” are indicators for manufacturing, transport and trade. Standard errors (in parentheses) are clustered on group affiliation as reported by Fisman (2001) and Claessens et al. (2000). We report p-values for the Smith-Blundell (1986) exogeneity test. The null hypothesis is that our closeness measures are exogenous. We denote levels of statistical significance as follows: † significant at 10% * significant at 5% ** significant at 1%

<table>
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<th>(2)</th>
<th>(3)</th>
<th>(4)</th>
<th>(5)</th>
</tr>
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<td>-3.126</td>
<td>-5.311</td>
<td>-6.791</td>
<td>-6.827</td>
<td>-3.379</td>
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<td></td>
<td>(1.554)*</td>
<td>(2.400)*</td>
<td>(2.734)*</td>
<td>(2.649)**</td>
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<tr>
<td>Closeness to Suharto</td>
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<td></td>
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<td>(resignation returns)</td>
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<td></td>
</tr>
<tr>
<td></td>
<td>-3.379</td>
<td>(1.070)**</td>
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<tr>
<td>Firm size</td>
<td>0.414</td>
<td>0.647</td>
<td>0.590</td>
<td>0.559</td>
<td>0.496</td>
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<tr>
<td></td>
<td>(0.086)**</td>
<td>(0.174)**</td>
<td>(0.168)**</td>
<td>(0.160)**</td>
<td>(0.185)**</td>
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<td>(3.401)</td>
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<td>(4.790)</td>
<td>(3.879)</td>
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<td>4.305</td>
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<td></td>
<td>(1.187)**</td>
<td>(1.036)**</td>
<td>(1.017)**</td>
<td>(1.375)**</td>
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<tr>
<td></td>
<td>(1.393)†</td>
<td>(1.389)</td>
<td>(1.449)</td>
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<td>yes</td>
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<td>-15.484</td>
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<tr>
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<td>(1.883)**</td>
<td>(4.312)**</td>
<td>(4.128)**</td>
<td>(3.905)**</td>
<td>(4.413)**</td>
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<tr>
<td>Pseudo $R^2$</td>
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<td>0.45</td>
<td>0.47</td>
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</table>
Table 4 – Returns to Foreign Securities

The table reports regression results with the annualized log stock returns for 130 Indonesian firms as the dependent variable. “Foreign Securities” is an indicator which is 1 if a firm has publicly traded foreign securities and 0 otherwise. Firm characteristics are measured at the end of the fiscal year 1996. “Firm size” is computed as the log of total assets. “Financial leverage” is the ratio of long-term debt to total assets. “Risk” is the standard deviation of the weekly stock returns during 1996. ROA is the ratio of operating income to total assets. “Capital intensity” is the ratio of fixed assets to total assets. Industry dummies include indicators for agriculture, mining, manufacturing, transport, trade, finance and services. Standard errors (in parentheses) are clustered on group affiliation as reported by Fisman (2001) and Claessens et al. (2000). In the two-stage treatment effects models, the first stage are the probit models reported in Table 2, and $\lambda$ is the parameter estimate on the hazard from the augmented regression. We denote levels of statistical significance as follows: † significant at 10% * significant at 5% ** significant at 1%

<table>
<thead>
<tr>
<th></th>
<th>Log returns 7/1/96-6/30/97 (Pre-crisis)</th>
<th>Log returns 7/1/97-5/21/98 (Suharto period)</th>
<th>Log returns 7/1/97-8/31/98 (Mitton (2002))</th>
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<td>OLS</td>
<td>2-stage estimates</td>
<td>2-stage estimates</td>
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<td>Foreign Securities</td>
<td>0.173 (0.161)</td>
<td>0.678 (0.354)*</td>
<td>1.905 (0.721)**</td>
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<td>Firm size</td>
<td>-0.009 (0.044)</td>
<td>-0.075 (0.060)</td>
<td>-0.260 (0.130)*</td>
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<tr>
<td>Financial leverage</td>
<td>-0.136 (0.313)</td>
<td>-0.864 (0.741)</td>
<td>-1.369 (0.671)*</td>
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<td>Risk</td>
<td>1.399 (1.851)</td>
<td>2.453 (3.708)</td>
<td>2.428 (3.632)</td>
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<td>ROA</td>
<td>1.258 (0.789)</td>
<td>1.594 (1.961)</td>
<td>2.268 (1.440)</td>
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<td>Capital Intensity</td>
<td>-0.078 (0.266)</td>
<td>-2.453 (3.708)</td>
<td>0.852 (0.482)**</td>
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<td>yes</td>
<td>yes</td>
</tr>
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<td>129</td>
<td>130</td>
</tr>
<tr>
<td>$\lambda$</td>
<td>-0.448 (0.233)*</td>
<td>-0.354 (0.215)*</td>
<td>-0.759 (0.431)*</td>
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<td>$R$-squared</td>
<td>0.09</td>
<td>0.24</td>
<td>0.23</td>
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Table 5 – Returns to 20-F Filings

The table reports regression results with the annualized log stock returns for 130 Indonesian firms as the dependent variable. “20-F Filings” is an indicator which is 1 if a firm has publicly traded foreign securities which require a 20-F filing and 0 otherwise. Firm characteristics are measured at the end of the fiscal year 1996. “Firm size” is computed as the log of total assets. “Financial leverage” is the ratio of long-term debt to total assets. “Risk” is the standard deviation of the weekly stock returns during 1996. ROA is the ratio of operating income to total assets. “Capital intensity” is the ratio of fixed assets to total assets. Industry dummies include indicators for agriculture, mining, manufacturing, transport, trade, finance and services. Standard errors (in parentheses) are clustered on group affiliation as reported by Fisman (2001) and Claessens et al. (2000). In the two-stage treatment effects models, the first stage are the probit models reported in Table 3, and \( \lambda \) is the parameter estimate on the hazard from the augmented regression. We denote levels of statistical significance as follows: † significant at 10% * significant at 5% ** significant at 1%

<table>
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<tr>
<th></th>
<th>Log returns 7/1/96-6/30/97</th>
<th>Log returns 7/1/97-5/21/98</th>
<th>Log returns 7/1/97-8/31/98</th>
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<td>Mitton (2002)</td>
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<td>OLS</td>
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<td>-0.148 (0.212)</td>
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<td>3.490 (1.480)*</td>
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<td>0.452 (0.451)**</td>
<td>1.306 (0.468)**</td>
<td>1.084 (0.354)**</td>
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<td>Firm size</td>
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<td>0.139 (0.100)</td>
<td>0.038 (0.045)</td>
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<td>0.057 (0.044)</td>
<td>-0.881 (0.077)</td>
<td>-0.124 (0.086)</td>
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<td>-1.224 (0.066)</td>
<td>-1.388 (0.066)</td>
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<td>0.036 (0.736)</td>
<td>0.005 (0.658)</td>
<td>0.015 (0.573)</td>
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<td>Risk</td>
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<td>1.387 (4.050)</td>
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<td>1.138 (0.782)</td>
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<td>1.194 (0.559)†</td>
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<td>(2.535) (0.286)</td>
<td>(3.836) (0.297)</td>
<td>(3.008) (0.439)</td>
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<td>0.184 (0.934)</td>
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<td>0.564 (1.746)</td>
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<td>-0.897 (2.043)</td>
<td>-0.586 (2.043)</td>
<td>-0.754 (1.419)</td>
</tr>
<tr>
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<td>1.896 (0.959)</td>
<td>1.074 (1.631)</td>
<td>-1.131 (0.643)†</td>
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<td>1.244 (1.631)</td>
<td>0.564 (1.746)</td>
<td>-0.476 (0.407)†</td>
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<td>130</td>
<td>130</td>
</tr>
<tr>
<td>( \lambda )</td>
<td>-1.060 (0.446)*</td>
<td>-1.209 (0.752)†</td>
<td>-1.131 (0.643)†</td>
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<tr>
<td></td>
<td>-0.422 (0.258)†</td>
<td>-0.446 (0.267)†</td>
<td>-0.476 (0.407)†</td>
</tr>
<tr>
<td>R-squared</td>
<td>0.09</td>
<td>0.25</td>
<td>0.24</td>
</tr>
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