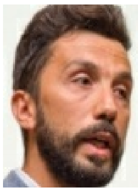
Conflicts of interest may bias research in finance and economics

Economists have explicitly recognised the possibility that regulatory agencies may be captured by those whom they are supposed to regulate. However, the economics profession has been much more hesitant about recognising similar conflicts of interests that may exist in economics and finance research (i.e., academic capture). **Thorsten Beck** *and* **Orkun Saka** *report on the related discussions and research recently presented at the second London Political Finance (POLFIN) workshop.*

Since Stigler's (1971) seminal work, economists have explicitly recognised the possibility that regulatory agencies may be captured by those whom they are supposed to regulate. That is, those public sector employees who are ideally expected to do gatekeeping against the private companies in order to uphold the public interest may have legitimate economic incentives to act against such expectations, leading to pervasive conflicts of interest in regulation. Despite the now widely-held consensus view among economists that public gatekeeping activity may end up serving private interests, our profession has been much more hesitant about recognising similar conflicts of interests that may exist in economics research and bias the scientific process towards powerful institutions with monopolistic access to confidential datasets and high-end job market prospects (Zingales, 2013; Fabo, Jančoková, Kempf and Pástor, 2021).

Building on these issues during the 2nd London Political Finance (POLFIN) Workshop, Renee Adams (2021) delivered an insightful keynote speech based on her past experiences as a young economist at the Federal Reserve Bank of New York. Through an auto-ethnographical lens, she reflected on her correspondence with one of the top journals in finance while she was trying to publish a paper on the potential governance failures in the way that Fed regulated its member banks. Despite her serious attempts to target the concerns of the referees, it seemed that the gatekeepers—some of whom were seemingly well-connected to the Fed—were less than willing to accept the implications that her research could have had on the bank and its top management. Disheartened by the potential conflicts of interest on the part of the "gatekeepers", she left the project behind as a working paper. Unfortunately, this early experience went a long way to answer the question she posed in the beginning of her speech: "why haven't I written more papers about political finance?".

Apart from its memorable keynote speech and the following fruitful discussion (which you can see in the video below), this year's POLFIN workshop brought together a set of high-quality research projects on this rather niche theme. Below we present a short summary for a few of these papers and comment on the avenues that would benefit most from further research in the future.

Politics & finance

In *Power, Scrutiny, and Congressmen's Favoritism for Friends' Firms*, Kieu-Trang Nguyen and co-authors question the standard wisdom that "power tends to corrupt and absolute power corrupts absolutely". Rather, using a regression discontinuity design of close congressional elections in the US, they find evidence that a politician's win reduces the stock value of his or her former classmates' firms by 2.8% (Do et al., 2020). This adverse effect is most prominent among younger candidates, when career concerns are arguably the strongest. They explain this result with politicians reducing quid-pro-quo favours towards connected firms to preserve their career prospects when attaining higher-powered positions. While certainly a surprising result, this clearly underlines the need for further research on the role of scrutiny in restraining favouritism in politics.

In *Does Political Partisanship Cross Borders? Evidence from International Capital Flows*, Larissa Schäfer and co-authors gauge whether partisan perception shapes the flow of international capital. Using data on syndicated loans and equity market funds, they show that the ideological alignment or distance of individual investors/lenders in the US (based on political contributions by banks and voter registration for fund managers) to foreign governments affects their capital allocation around the world (Kempf et al., 2021).

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Considering investment in the same country around the same foreign elections, the authors show that US banks reduce lending after an increase in the ideological gap between their own (Republican or Democratic) political stance and the political stance of the new foreign government and charge higher interests (while they do not face higher default). In a similar fashion, US mutual funds decrease portfolio allocation, again with no difference in performance. The authors also confirm the results for non-US investors (Canada and UK), even though this is done with less granular data. These quite striking results negate the old notion that partisan politics would stop at the water's edge, and invite further research on how political connections (and/or shared affiliations) across countries may end up influencing and potentially distorting private actors' investment behaviour.

In *Political Polarization in Financial News*, Ryan Israelsen and co-authors find strong evidence of political polarisation in corporate financial news (Goldman et al., 2020). Comparing the coverage in the *Wall Street Journal* to that in the *New York Times* over 30 years on the largest 100 companies, they document that newspapers are more likely to cover and write positively about politically aligned firms (as measured by campaign contributions by employees and corporate political action committees to Democratic and Republican Party candidates). For example, an article in the WSJ about a firm that donated only to Republican Party candidates in the previous election cycle uses 20% more positive words than an article in the NYT, while an article in the WSJ about a firm that donated only to Democratic Party candidates uses 10% fewer positive words compared to the NYT.

This different reporting also has implications for investment and trading. Specifically, there is more trading on days where there is more politics-induced disagreement in the reporting on a specific firm. Finally, matching granular data on individual investor trades from a retail brokerage database to newspaper circulation data based on the zip code location of the investors, the authors find that when news about a stock appears in the newspaper an individual investor is more likely to read, the investor trades more and in the same direction as other investors who read the same paper. This study, alongside other recent work showing how individuals may create their own reality bubbles based on the very same facts (Alesina, Miano & Stantcheva, 2020), brings a new perspective to the micro-foundations of information asymmetries in financial markets and invites further thinking on what makes such subjective perceptions of the same financial reality survive in the long-term.

Last, but not least, in *The Political Polarization of U.S. Firms*, Elisabeth Kempf and co-authors illustrate that executive teams in U.S. firms are becoming increasingly politically homogenous, based on voter registration records for top executives of S&P 1500 firms between 2008 and 2018 (Fos et al., 2021). This trend seems to be driven by politically misaligned executives being more likely to leave, especially between 2015 and 2017 while the effect is stronger in states where there is no legal prohibition of political discrimination, in firms with lower institutional ownership and those led by CEOs with longer tenure. The authors also show that differences in executives' political views manifest in differences in beliefs about the company's future stock price performance after political events, such as the surprise win by Donald Trump in 2016, with Democratic executives having a significantly higher likelihood of selling the firm's share than Republican executives of the same firm after this specific event.

Conclusion

The diversity of the research topics presented at the POLFIN workshop was more than representative of that of the field; however, none of the papers put the mirror back to the face of our own profession (with a key exception of a recently published paper by Fabo et al., 2021). Going back to Renee's keynote speech, there is certainly a bias in our academic community to 'not rock the boat' and a risk of getting too close to authorities such as central banks that provide us with data and consultancies. The good news is that unlike ten years ago, this is now being openly discussed; the bad news is that we have only taken the first (baby) step in addressing this problem. We need a much broader discussion on the biases that current institutional setting in economics/finance may inflict upon the scientific output including the lack of diversity in journal editorial boards and concentration of the gatekeeping power in a few hands (Angus et al., 2021).

- *This blog post first appeared at LSE Business Review.*
- *Featured image by Matthew Henry from Burst*

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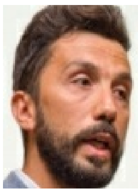

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