

Discussion of

“The Geography of Financial Misconduct”

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Overview of Paper

- Data:** Annual measure of financial misconduct (**FM**) for firms headquartered in 20 large cities, 1970-2009
- Hand-collected by KKLM (2013)
 - Indicates all firm-years when FM occurs (assuming no false positives)
- Pattern:** City-level average FM ranges from **0.48%** of firm-years (Indianapolis) to **1.66%** (Miami)
- City-level standard deviation ranges from **0.73%** (LA) to **2.12%** (Orlando)
- Question:** How can we better explain cross-sectional and time-series variation in city-level financial misconduct (FM)?
- Answer:** Social Factors \leftrightarrow Peer Effects!
- “For just as proximity facilitates the spread of disease, the spillover of ideas and social norms can permit the diffusion of both prosocial and antisocial behavior.”*

Overview of My Discussion

1. **Difficult to rule out alternatives to peer effects...**

... especially without a clean experiment and detailed data on social networks...

... although the authors certainly make an honest effort

2. **Unclear whether the peer effects are economically significant...**

... unless you read the companion paper linking FM waves to future economic slowdown (or the earlier combined paper)

Evidence of Peer Effects

- Find that FM of firm **j** in industry **i** in area **a** in year **t** can be predicted by:
 - **FM of firms in other industries in same area (T4)**
 - FM of firms in same industry in other areas **(T4)**
 - FM of firms in same industry and same area **(T4)**
 - even when controlling for changes in local economic conditions and demographics **(T9)**
- **Network?** Large (small) firm FM predicts large (small) firm FM **(T5)**
- **Enforcement?** Across-city FM rates detected in former clients of Arthur Andersen are positively correlated with main ranking **(T6)**
- **Enforcement?** City-level FM is “highly correlated” with city-level political corruption and questionable medical practices, neither of which are enforced locally **(T8)**
- **Bartik?** FM in dominate industry (instrumented for by FM in same industry outside the area) predicts FM in other industries **(T10)**

Economic Significance?

- **Throwdown regarding theory of rational crime:** *“perhaps the theory’s largest embarrassment is its failure to account for the enormous variation in crime rates across both time and space.”*
- In Table 3, Authors begin with linear probability model (LPM) where unit of obs. is firm j in year t and they include different sets of FEs
 - R^2 of Year FEs $>$ R^2 of Industry FEs $>$ R^2 of Area FEs
 - **$R^2 < 1.0\%$ even when they include all three sets of FEs**
 - *How about R^2 when including area-by-year FEs?*
- In Table 4, they switch to logits, include contemporaneous FM averages and firm-level controls, but drop all FEs
 - **Pseudo R^2 is 5-6%, but it is unclear how much of increase is due to peer’s FM versus firm controls**
- *Is the glass half full (huge percentage increase over R^2 of 1%) or half empty (R^2 still “embarrassingly” close to 1%)?*

City-Level Rankings

- **Correlations between city-level FM and other measures led me to wonder about roles of politics and population in explaining cross-sectional differences in FM**

• City-level FM and political corruption	0.30	0.34	(T8)
(Liu and Mikesell (2014) : Only IL (4), PA (5), FL (10) appear in top 10)			
• City-level FM and medical practices	0.33	0.28	(T8)
• FM non-AA clients and FM AA clients	0.43	0.59	(T6)
• City-level FM and pension underfunding	-0.24	-0.26	(State)
• and property crime rate	-0.15	-0.16	(City)
• and violent crime rate	0.08	0.13	(City)
• and millionaires per capita	0.14	0.12	(State)
• and happiness quintile	0.20	0.20	(State)
• and # Republican victories	0.30	0.30	(State)
• and average high temp	0.42	0.44	(City)
• and population	0.46	0.57	(City)

Econometrics

- **Central challenge in testing for peer effects is distinguishing whether CEO A is influenced by CEO B or whether both CEOs independently respond to same area-time specific incentives**
- One approach is to include **area-by-year FEs** and then test for multiplier effects within subsamples (e.g., Bertrand et al. (2000))
 - *While low average FM rates push authors towards Logits, I would prefer to see everything estimated as LPMs with fixed effects (e.g., when testing for differential peer effects based on firm size)*
 - *Will minimize Gormley & Matsa (2014) style critique re: averages*
- At a minimum, baseline model should include additional controls for variation in firm-level costs and benefits of FM
 - **Nature of CEO compensation? Extent of local labor market?**
 - **Level of institutional monitoring? Distance to rating threshold?**
 - **Political party of governor in year t ?**
 - **Whether state pension fund invests directly in the firm**

Econometrics (cont.)

- **Additional challenge in this paper is possibility that cross-sectional and time-series variation in FM reflects variation in detection rather than in underlying behavior**
 - Authors take several steps to address this concern... including T7
 - Why not simply compare specification where $FM = 1$ in year fraud begins to another where $FM = 1$ in the year fraud is detected?
 - If peer effects matter, estimated peer effect should be stronger with respect to initiation than detection
- **If FM arises from social interactions, spillovers should be weaker for CEOs with fewer interactions**
 - **Quick:** Focus on variation in CEO tenure rather than CEO age
 - **Better:** Compare CEOs who are new to the city (external hires) to those with a long tenure (internal hires)
 - **Stalker:** Identify zip codes of CEO homes and test for stronger peer effects among CEOs in same zip code

Conclusion

- I have long thought of LA, MS, and IL as being corrupt states...
... but I had not thought about spillovers to firms in these states...
... or spillovers across firms within cities
- This paper highlights interesting cross-sectional and time-series variation in the level of financial misconduct by public firms
 - *Interestingly, cities from LA and MS don't make their list*
 - *Is it harder or more expensive to go public in a corrupt state?*
- The evidence for peer effects is stronger than I expected it to be before reading the paper but not bullet proof
 - Most convincing test is limited to four cities
- *I encourage the authors to include more firm-level controls and explore additional LPM specifications*
- *I also encourage them to focus more on the link between political corruption and financial misconduct, which is fascinating*