

1. Motivation

Patronage and Cronyism are major impediments to economic growth imposing high costs of society.

These distortive forces exist both in the government and private sector.

The existing literature treats these distortions in government and private markets as separate sources of inefficiency (e.g., Khwaja & Mian 2005).

2. This paper

We show that the same network that gains control of resource allocation in the government sector also gains control over resource allocation in the private sector.

Specifically, a network that gains control over government (and government banks) also gains control over private banks.

This happens as private banks appoint members of the same network to establish links to the new administration. Consequently, private firms with CEOs from the same network obtain more credit from government and private banks.

3. Research Design

Variation in network links for the same firm across lenders over time sharpens the interpretation of our results.

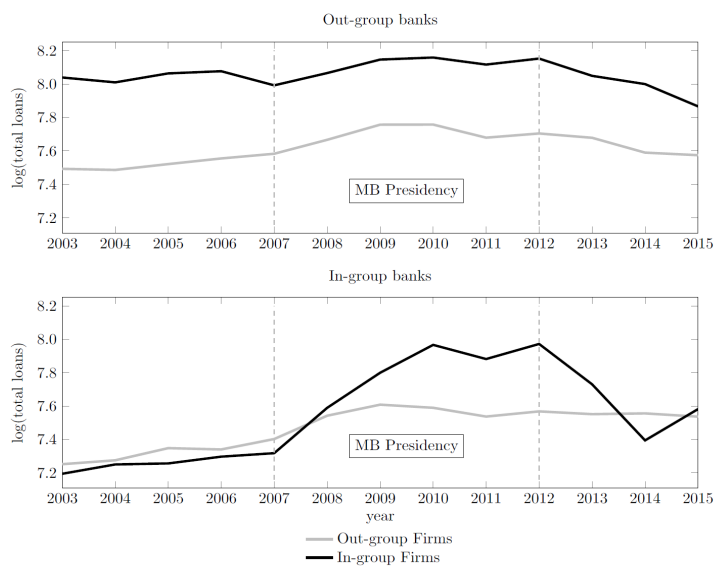
This allows us to control for firm-time and bank-time fixed effects, which rules out alternative explanations based on differences in time-invariant and time-variant firm characteristics.

4. Main Findings

Banks that appoint executives from the new president (MB)'s network allocate more credit to in-group firms.

Higher lending to in-group firms based on cronyism: Banks charge in-group firms lower interest rates despite more defaults.

Return on in-group loans is lower than the risk-free rate generating efficiency losses equivalent to 0.026 percent of GDP.

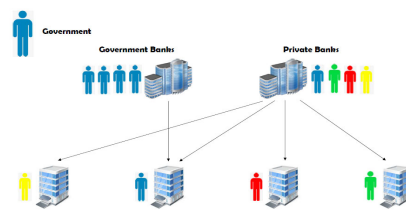


5. Economic Implications

In a parsimonious model of credit allocation and investment, we show that allocative distortions increase drastically when government and private banks are biased in favor of the same group of firms.

Intuition:

When government and private banks have different biases, all firms can finance profitable projects.



When government and private banks share the same bias, out-group firms cannot finance some profitable projects.

