

**Punish One, Teach A Hundred:
The Sobering Effect of Punishment on the Unpunished ***

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Abstract

Direct experience of a peer's punishment might make salient the probability and negative consequences of facing punishment, and hence induce a change in the behavior of non-punished peers. We test for this mechanism in a unique setting. After observing peer firms punished for wrongdoing, Chinese listed State Owned Enterprises (SOEs) – which are less disciplined by traditional governance mechanisms than non-SOEs – cut the resources they tunnel to related private parties via loan guarantees, move to more independent boards, cut inefficient investment, and increase total factor productivity. SOEs experience positive cumulative abnormal returns around the announcements of peers' punishment, which suggests a positive association between peers' punishment and shareholder value. SOEs do not shift to more opaque forms of tunneling – the bank credit and investment of related parties drop and do not revert after peers' punishment.

JEL classification: D91, D72, G32, G41, K42.

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*All errors are our own.

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