Full Length Research Paper

Firm performance effects of nurturing political connections through campaign contributions

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In a research context suggesting that there are positive effects of political connections on firm performance, this paper addressed one mechanism generating performance superiority: cash giving to political candidates in exchange for favors. A dataset from the major 2006 election for president, governor, senator, federal and state deputies was used to estimate a multilevel model of listed firms operating in Brazil, an interesting setting because political institutions favor a close one-to-one relationship between managers and politicians. The main results indicated that campaign contributions related positively to firm capital structure performance (Return on Equity) and to investors' expectations of profit and value (Tobin's q), but not operational profitability (Operational Return on Assets). Such a political strategy seemed to be a non-market source of advantage since connectedness apparently related to the reduction of transaction costs leading to financial advantage, but not significantly to opportunities associated with the generation of market failures. The results reinforced theoretical arguments that political connections directly improve firm performance by means of providing superior and lower-cost access to financial debt and foster market expectation and valuation due to close relations between businesses and politicians.

Key words: Political strategy, firm performance, political connections, campaign contributions.

INTRODUCTION

The corporate political strategy (CPS) literature usually address how firms can access policy makers, and influence the political process in a quest for economic benefits (Hillman et al., 2004; Keim and Hillman, 2008). Usual strategies are lobbying, campaign contribution, advocacy advertizing, constituency building, coalition building, and personal services from public appointment. Pursuing competitive advantage through political means is an important non-market strategy since direct or indirect individual benefits may accrue to firms. For instance, firms may indirectly benefit from asymmetric effects over firm regulations, deterrence of foreign competition, or through the increasing of rivals' costs (Mcwilliams et al., 2002). Direct benefits may include financial advantages or personal services from board members appointed to public positions (Hillman et al., 1999).

While existing CPS research has considerably advanced in investigating indirect benefits from corporate political activities, the mechanisms through which political connections directly increase firm performance are rarely investigated. A growing body of literature has reported direct benefits and costs accruing to politically connected firms as well as how the economic and institutional environments affect the net benefits and the differences concerning non-connected firms (Faccio, 2006). However, the measures used for political connection,

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such as political ties, may proxy for several mechanisms, ranging from corruption to politically-driven choices of national champions. This paper aims to fill this theoretical gap by empirically addressing the mechanism of exchanging direct contributions to political campaigns in order to improve firm performance. Instead of using a vague definition of political ties, firm donating to political candidates engage in direct exchange with politicians.

Political forces can particularly influence the relation between strategy and performance in emerging nations (Parnell, 2011) because of the dynamics (and sometimes instability) of the institutional backgrounds of these nations (Liou et al., 2011). The context of Brazil is suitable for three reasons: first, the government practically controls long-term resource allocation. Since Brazil has consistently shown the highest interest rates in the world, firms who succeed in accessing long-term debt through government connections at a cost considerably lower than the interest rates offered by private banks are most likely to benefit from superior debt financing and lower costs of capital (Claessens et al., 2008). Secondly, the Brazilian electoral system, such as large district size, opaque disclosure of contributions, and open-list of candidates, also play their role in favoring low accountability and particularistic relationships between business and politicians (Samuels, 2001b, 2002). Thirdly, the lack of encompassing peak associations, capable of controlling free-riding and their use for personal favors, motivates close individual relationships between firms and politicians (Maxfield and Schneider, 1997).

It is theoretically relevant to address such question because deciding to invest shareholders' resources in cash giving to politicians is an important strategic decision that has implications to corporate governance and future market expectations. In the context of most Latin America emerging economies, this decision is particularly salient, because, paradoxically, capital markets and market institutions are developing at the same time that political institutions provide strong incentives to nurture particularistic relationships with the government (Maxfield and Schneider, 1997; Keim and Hillman, 2008). The present research also provides a methodological improvement to the field of corporate political strategies. Past research relied basically on cross-sectional or event study research designs. This paper models firm performance effects using multilevel, or hierarchical, modeling. It is possible to take into account unique contextual contributions of firms and industries to firm performance effects. This research design provides unbiased estimates for performance effects of political connections considering the fact that a given firm in a given industry has donated money to a politician in a given election.

Finally, this Brazilian case offers an opportunity to extend the corporate political strategy literature to political contexts in which nurturing particularistic relationships with the government gives competitive advantage to firms. The results of this paper indicate that firms who succeeded in supporting the campaign of powerful politicians are better off than non-connected firms. Despite the fact that cash giving to politician may be costly to firms, the net benefits appear to be positive.

LITERATURE REVIEW

The political strategy literature in developed countries usually admits indirect individual benefits for firms (Hillman et al., 2004; Keim and Hillman, 2011), such as asymmetric effects over firm regulations (Shaffer, 1995; Mcwilliams et al., 2002), and deterrence of foreign competition (Schuler, 1996). With some exceptions (Lester et al., 2008), the mainstream literature of corporate political action in management research has given little attention to particularistic relationships between business and government and how this connection affects firm performance.

However, there is a growing body of literature that reports empirical findings relating political connections, exchange of favors, and the relative advantages and costs of establishing such connections. Empirical evidence suggests that the value of political connections may come from favorable regulatory conditions (Agrawal and Knoeber, 2001), preferential access to credit (Sapienza, 2004; Dinç, 2005; Charumilind et al., 2006), capital controls (Johnson and Milton, 2003), licenses (Khwaja and Mian, 2005), as well as protection and preferential information from the powerful (Pearce, 2001). Another source of positive effects comes from personal service. Research has suggested that firms benefit from superior market valuation once their owners or firm representatives are elected or nominated to government offices (Bunkanwanicha and Wiwattanakantang, 2009; Hillmam et al., 1999; Faccio, 2006; McGuire et al., 1998). Connected Board members are found to increase firm value after having their seats on the board (Goldman et al., 2009; Agrawal and Knober, 2001). Ferguson and Voth (2008) investigated the value of connections between German industrialists and the Nazi movement in 1933. They find that firms with substantial links with Nazi party experienced unusually high stock returns between January and March 1933, when Hitler was appointed Chancellor. Institutional changes and the intervention of non-facilitative governments in transition economies and China made managing personal contacts with the powerful a central feature of firm strategizing and organizing (Pearce, 2001). Institutional-based explanations are supported by findings that suggest that political ties have helped firms overcome market failures, weak legal systems and corruption (Li et al., 2008; Faccio, 2006).

Contrasting to benefits accruing to connected firms, rent-seeking activities may also be relevant sources of

costs to firms (Shleifer and Vishny, 1994). Fisman (2001) found that politically connected firms in Indonesia were more likely to suffer from rumors about the dictator Suharto. In Peru, De Soto (1989) indicates that the amount paid in bribes is equivalent to taxes that companies should pay. In a multiple country study, Faccio (2010) found that despite the fact that politically connected firms have higher leverage and higher market shares than their non-connected counterparts, they show lower accounting performances. However, she suggests that although connections on average may add value, politically connected firms shows, on average, lower performances than non-connected firms.

Although, being politically connected may be sources of costs and revenues, existing research indicates that political ties are found to affect firm financial variables. Politicians may readily manipulate local bankers into offering financing arrangements they would not offer otherwise (La Porta et al., 2002); thus, political influence enables firms to receive preferential access to credit (Faccio, 2010; Khwaja and Mian, 2005; Chiu and Joh, 2004; Cull and Xu, 2005; Dinç, 2005; Li et al., 2008; Classens et al., 2008; Leuz and Oberholzer-Gee, 2006). Claessens et al. (2008) found that firms connected to elected federal deputies through campaign financing in Brazil have shown superior access to debt financing for the four-year term after the election. Instead of promoting the reduction of transaction costs, the government intervention in the financial markets in emerging countries is viewed as an instrument for politicians to bargain for political support and personal interests (Sapienza, 2002; Dinç, 2005).

In this paper, it is argued that net effect of politically connected firms operating in Brazil is positively associated to firm performance. The prevalence of advantages over costs comes from two reasons. First, the Brazilian setting favors one-to-one relationships between firms and politicians in which firms and politicians are dependent to one another. Since political campaigns are expensive and competitive because the usage of open-list of candidates competing in geographically large districts, incumbents need money to market their ideas and claim credit for what they have done in office (Samuels, 2001b, 2002). Despite the fact that money plays a large role in political campaigns almost everywhere, in Brazil, campaign financing comes mostly from firms donating directly to related candidates (Samuels, 2001a). For instance, construction firms donate more to governors and the financial sector to presidential candidates. Secondly, since interest rates in Brazil are the highest rates in the world, debt financing plays a large role in overall firm performance. The Brazilian government practically controls long-term debt allocation and use this power to bargain for financial support. Because politically connected firms have superior access to finance in Brazil (Claessens et al., 2008), we expect that these firms will show superior

performance.

The Brazilian case is an interesting natural experiment that uncovers the generative mechanism of political ties affecting firm performance. In previous researches, firm political connections serve as a proxy for several mechanisms generating firm effects, varying from corruption to asymmetric effects of legislation. In this paper, we use firm donations to politicians as the proxy for political ties. As firms donate in exchange of favors (Samuels, 2002), this exchange mechanism can be assessed. The research hypothesis considers the role of the context favoring particularistic relationships to predict the direct effects of the campaign contribution strategy on firm performance during the term of supported politicians in office (the electoral cycle). From the ongoing discussion, it is proposed that:

H_1: Connected firms in a given election will show on average greater firm performance than non-connected firms for the respective electoral cycle.

DATA AND METHODS

The availability of reliable data for strategy research in emerging economies is always problematic and challenging for researchers (Hoskinsson et al., 2000). To attenuate these limitations, we constrained our population to publicly-traded companies in Brazil because they provide audited information instead of self-reported figures of non-listed firms. The Economatica database provided the list of sample firms and firm financial and market figures. Firm political connections were measured by official donation to political campaigns which is mandatory disclosed by political parties. Despite the fact that disclosure problems make this self-reported data somewhat problematic, Samuels (2001a) found strong correlations between the office for which the candidate was trying election and its power to influence the sector of the donating. Hence, in order to capture this association, but without relying in the disclosed donated amount, we decided to measure donations by a dummy variable.

We intended to test whether politically connected firms show superior performance than non-connected firms during the term period of the financially-supported politicians. We chose President Lula's first term (2003 to 2006), which is the last complete four-year electoral cycle with available data. During this period, state governors, senators, federal and state deputies were also elected. Firm performance was measured by operational, financial and market performances indicators. Political connections were measured by a categorical variable representing contribution to elected candidates that were part of government coalition. Control variables were firm size, year fixed effects, and the nested effect of firms into industries over time. Table 1 shows the operational definition of all modeled variables.

Hierarchical models are usually applied to identify contextual effects in a regression (Raudenbush and Bryk, 2002). In this work, the regression intercept p_{0jk} varies according to each firm as a function of a particular performance context.

Existing research relies basically on cross-sectional or event study research designs. By using multilevel modeling, it is possible to estimate unique contextual contributions of firms and industries to firm performance, with unbiased estimates for performance effects of political connections considering that a given firm in a given industry has donated money to a politician in a given election. The

Table 1. Operational definitions of variables in the model.

Variable	Operational definition
Operational profit (OPROA)	It is the ratio of operational income to total assets. It captures variation in firm revenue and usage of operational resources.
Return on equity (ROE)	It is the ratio of net income to equity. It is influenced by firm financial decision on capital structure.
Tobin's Q	It is the ratio of the firm market value to its book value. It captures investors' expectation of future profits and the value of intangibles.
Political connectedness (GOV)	A dummy variable which captures different levels of firm political connectedness. Connected firms are companies who supported elected candidates that were part of Government coalition. It was considered firm donation to candidates for President, state governors, senators, federal and state deputies.
Total assets (Size)	Control variable. It is log transformation of the industry-mean centered yearly values of firm total assets considering the years 2003 to 2006.

model has three levels according the description given thus:

Level 1 (time):

$$Performance_{ijk} = \pi_{0jk} + \pi_1 Year\_2004 + \pi_2 Year\_2005 + \pi_3\_Year\_2006 + e_{ijk} \qquad e_{ijk} \sim N(0, \sigma_e^2)$$

Where Year_2003 to Year_2006 are year dummies, used to control macroeconomic effects

Level 2 (firm):

$$\pi_{0jkl} = \beta_{00k} + \beta_{010}Size + \beta_{012}Gov + r_{0jk}$$
$$r_{0jk} \sim N(0, \sigma_{r0}^2)$$

Where Size is the logarithm of the firm average assets (2003 to 2006) centered on the industry mean; Gov represents the *proxy* for political connection

Level 3 (industry):

$$\beta_{00k} = \gamma_{000} + s_{00k}$$
$$s_{00k} \sim N(0, \sigma^2)$$

The model also includes heteroscedastic residuals, which means that variance may differ at each year (2003 to 2006). This treatment for heteroscedasticity isolate the effects of the variables in the model, leading to an unbiased estimate of the parameter related to the variable of interest (Gov) and other parameters.

After matching Economatica and Às Claras (website with information of electoral donation in Brazil), 199 firms were found to have information on both databases. The exclusion of 23 firms that had less than 3 yearly observations and one outlier firm with operational return on assets (OPROA) below -200% left 693 observations from 175 firms and 15 industry sectors for analysis. For analysis with return on equity (ROE) as the dependent variable, additional deletions were necessary. Other 12 firms were removed as they presented negative equity values and 3 were considered outliers (ROE outside the -200 to 200% range), leaving 622

observations in 160 firms. There were no outliers for the Tobin's q measure in the sample.

RESULTS AND DISCUSSION

Table 2 shows the results of the models with OPROA, ROE and Tobin's Q as dependent variables. The effect of political connection (Gov) was positively significant on performance measured by means of ROE and Tobin's q, but not on the OPROA measure. The connection effect on Tobin's q was notably smaller than on ROE, but this difference is attributable to the nature of both measures. Size, as literature states, related positively, although not significantly in all models, to performance, and together with the significant variance components in all levels and heteroscedastic residuals of different years assured an unbiased estimate of the effect of political connection.

The fact that connection significance only appeared in the models with ROE and Tobin's q as dependent varia-bles favored the theoretic arguments that in the Brazilian context the political strategy of firms generates results by means of direct benefits like financial advantage or personal services from powerful members to donating firms. Since the firm financial decision on capital structure influenced ROE, it is reasonable to assume that connected firms may have had advantage on their cost of capital as a result of their exchange with members of government coalitions. Their investment decisions may have been driven by superior debt financing conditions and even by informational advantage on long-term debt allocation, which reduced transaction costs in financial markets to these firms.

The Tobin's q measure, on its turn, reflected investors' expectation of future profits and the value of intangibles, and its significant relation with political connection was consistent with the literature proposition that connected

Table 2. Estimates of multilevel models.

Dependent variable	Model 1	Model 2	Model 3
	OPROA (operational return on assets)	ROE (return on equity)	Tobin´s q
Level 1 – time			
YEAR_2003 (π1)	1.68 (0.54)**	2.61 (2.01)	0.10 (0.02)**
YEAR_2004 (π2)	0.31 (0.77)	1.51(2.23)	0.15 (0.03)**
YEAR_2005 (π3)	-0.27 (0.90)	-0.23(2.20)	0.29 (0.04)**
Level 2 – firm			
SIZE (total assets)	2.9 (0.89)**	7.56 (2.51)	0.14 (0.05)**
GOV (political connectednes)	2.11 (1.61)	7.61 (4.53)*	0.14 (0.08)*
Level 3 – Industry			
Intercept	5.39 (1.47)**	11.59 (3.23)**	1.09 (0.06)**
Variance components			
Level 3	18.79**	43.45**	0.017**
Level 2	44.62**	328.05**	0.13**
Level 1			
2003	26.31**	324.14**	0.045**
2004	23.77**	305.33**	0.052**
2005	77.23**	458.00**	0.161**
2006	109.72**	402.09**	0.329**

*p-value < 0.10, ** p-value <0.05.

firms experiment market valuation as a consequence of investors' perceptions of these firms' close individual relationships with people in public positions.

On the other hand, the absence of significance of a political connectedness effect on OPROA defeated the arguments which suggest that political strategy leads to differences on firm efficiency due to indirect benefits related to interventions on competition or increasing rivals' costs. By capturing variation in firm revenue and usage of operational resources, OPROA should have been able to cater for these effects if they existed. As results revealed no relation between connections and variation on OPROA, the political strategy seemed to be a non-market strategy indeed. It is interesting that competitive advantage of connectedness related to the reduction of transaction costs leading to financial advantage but not significantly to opportunities related to the generation of market failures.

The results could be strongly contextualized due to the characteristics of the Brazilian electoral system. The mutual dependence of firms and Government, driven by the fact that conditions of access to debt is crucial in Brazil for firm performance and that the role of campaign contributions is crucial in Brazilian elections may explain the results of this study. But one may find similar conditions in other contexts, such as large district size, opaque disclosure of contributions, open-list of candidates, low accountability, and particularistic relationships between business and politicians in emerging economies.

Therefore, firms facing some of these conditions can benefit from the results here in order to support their investment decisions regarding political connectedness. Also, the Brazilian public sector may use this study as an inspiration to reflect about imperfections resulting from its electoral system, and so can do public agents which face electoral systems within comparable contexts.

Finally, the findings here may have revealed particular conditions in which political strategy should permeate corporate governance strategy; since corporate governance relates strongly to the capital structure of firms and their interaction with stakeholders and board compositions, the fact that political connectedness positively affected performance as a consequence of financial decisions (ROE) and investor's expectations (Tobin's q) puts the subject definitely on the research agenda about corporate governance.

Conclusion

This study was a step to confirm the association between political connectedness and business performance in a context where firms donate to political candidates to engage in direct exchange with politicians in Government coalitions. This research should be reapplied in different contexts in order to increase its reliability and support its findings.

For managers, implications are not obvious, because

they cannot foresee if they are contributing to candidates who will really win an election or take part in a government coalition. Although the results do not allow for further conclusions, they reinforce theoretical arguments that political connections directly improve firm performance by means of providing superior and lower-cost access to financial debt and foster market expectation and valuation due to close relations between businesses and powerful politicians. These conclusions are theoretically and intuitively consistent and provide a background for future research.

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