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Politically connected firms in Spain

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Abstract The goal of this study is to analyze the incidence of dominant owners in the probability of the presence of political directors and the effect of said presence on firm value. The study uses a sample of non-financial Spanish companies listed on the Spanish Stock Exchange over the period 2003–2012. The results show that around half of the firms have at least one ex-politician on their board of directors. Furthermore, the results indicate that dominant shareholders' voting rights and family nature have a negative effect on the likelihood of having ex-politicians on the board of directors. Moreover, the results show that the presence of political connections positively affects firm value. Further analyses show that this relationship is dependent upon the nature of the dominant owner, the use of pyramidal structures, the tenure of board members and the political directors' ownership stake.

Introduction

Spain, like most countries in Continental Europe, is in the process of changing its corporate governance system. In this context, institutions, academics, politicians and firms highlight the need to improve corporate governance in order to limit potential conflicts between internal agents as dominant owners and managers and minority shareholders. At the same time, the economic, financial and institutional crises affecting Europe since mid-2007, particularly in countries such as Greece, Italy, Ireland, Portugal and Spain, has led to an increased interest in the study of political and business ties and their effect on firm behaviour. The Spanish business environment is characterized by a high level of corruption. According to the *Corruption Perceptions Index 2013* (Transparency International), Spain and Italy are two of the largest European countries with the highest levels of corruption. Moreover, according to the *Global Competitiveness Report 2013–2014* (World Economic Forum), out of the 148 countries surveyed, Spain ranks 101st in terms of citizen trust in politicians, 93rd in terms of board of directors effectiveness and 138th in terms of ease of access to bank loans.

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The low transparency associated with the links between corporate and political elites, as well as the absence of previous empirical evidence on the presence of political connections in the Spanish context, shows that the level of knowledge about this phenomenon does not exceed the level of anecdotal evidence and the number of cases with significant media coverage, such as the appointment of ex-Spanish president Don Felipe González Márquez as director of Gas natural, S.A. in 2010 or the hiring of the ex-Spanish president Don José María Aznar López as an external consultant for Endesa in 2011.

The studies focusing on political connections face two important challenges. First, the links between corporate and political elites are often characterized by their opacity to facilitate political rent-seeking, especially those rents of dubious legality (Leuz and Oberholzer-Gee, 2006). Thus, the connections between politicians and entrepreneurs can be made using private channels that remove the company from the scrutiny faced by politically connected firms (*e.g.*, Riahi-Belkaoui, 2004; Chaney et al., 2011; Boubakri et al., 2012). Second, the analysis of explicit political connections in a firm faces the difficulty arising from the absence of a generally accepted definition of political connection. This makes it difficult to empirically study the relationship between political ties and corporate behaviour (Chen et al., 2011). A firm's political ties can be the result of politicians moving from the political arena to the business environment (revolving door) or *vice versa* (reverse revolving door). In this paper, we focus on revolving door cases. More specifically, following earlier literature (*e.g.*, Faccio, 2006; Goldman et al., 2009; Chaney et al., 2011; Chen et al., 2011; Boubakri et al., 2012; Duchin and Sosyura, 2012), we consider the presence of politicians on a firm's board of directors as a proxy for the existence of political connections.

Previous studies have found several motivations for the existence of politically connected firms. Thus, Khwaja and Mian (2005) argue that politically connected firms enjoy increased access to capital from financial institutions, and Boubakri et al. (2012) show that these firms have less budget constraints and are less sensitive to competitor pressure than firms without political connections. Moreover, Qian et al. (2011) find that dominant shareholders' tunnelling and self-dealing activities are more pronounced in politically connected firms when the goal of the connection is to ensure access to bank financing. Chen et al. (2011) find that politically connected firms increase information asymmetries, and Chaney et al. (2011) and Bona et al. (2014) show a lower quality of accounting information in politically connected firms. Additionally, political directors could be an important source of benefits for the company because they provide knowledge on bureaucratic and regulatory procedures (*e.g.*, Agrawal and Knoeber, 2001; Goldman et al., 2009). Faccio (2006) notes that political connections favour preferential treatment for companies in terms of tax benefits, award of government contracts, less regulatory control over the company or greater control over rivals. Thereby, considering the above arguments and the findings of Agrawal and Knoeber (2001), politicians on the board play a ''political role'', *i.e.*, they primarily serve as an instrument to promote the systematic exchange of favours between political and business elites (Chaney et al., 2011).

In Continental Europe, the presence of dominant shareholders in large public companies is extensive (*e.g.*, La Porta et al., 1999; Faccio and Lang, 2002). These owners shape the business elite and, therefore, may possess high political and economic influence (*e.g.*, Morck and Yeung, 2004; Morck et al., 2004). In this context, dominant owners have the ability and incentive to play an active role in designing the corporate governance system (*e.g.*, Shleifer and Vishny, 1997; La Porta et al., 1999, 2000; Cuervo, 2002; Burkart et al., 2003; Villalonga and Amit, 2006). This is particularly true of boards of directors because dominant owners have the power to influence board composition, defining the different roles that encompass this internal governance device (*e.g.*, Yeh and Woidtke, 2005; Durnev and Kim, 2005; Kim et al., 2007; Dahya et al., 2008).

As such, the aim of this paper is to analyze the relationship between the presence of political directors on the board and dominant owners' effective control, as well as to study the effect of political connections on firm value. For this purpose, we used a sample of non-financial Spanish firms listed on the Spanish Stock Exchange over the period 2003–2012. Moreover, we used the control chain methodology to identify the dominant owner for each firm and determine if said owner exercises effective control through a pyramidal structure (*e.g.*, La Porta et al., 1999; Claessens et al., 2000; Faccio and Lang, 2002; Santana and Aguiar, 2006; Sacristán and Gómez, 2007; Pindado et al., 2012). The study of board composition and ownership structure is conducted for each year and firm in the sample to reduce problems associated with the assumption that the ownership structure remains stable over the entire sample period. Another feature of this study is that the unit of analysis is the company and not the country, thereby reducing the problems related to international studies of corporate governance that address different legal, regulatory and institutional frameworks, which make it complicated to distinguish firm-level effects on the results achieved from country-level effects (King and Santor, 2008). In this line, Faccio (2010) argues that the costs and benefits of political connections depend on the specific characteristics of each country.

The results of this study reveal that around half of listed Spanish companies have at least one ex-politician on its board of directors. Furthermore, the results indicate that both the dominant owner's voting rights and his/her family nature affect the likelihood that an ex-politician might be appointed as director. Moreover, the results show that the presence of a politically connected board positively affects firm value. Further analysis shows that this incidence is dependent upon the nature of the dominant owner, the use of pyramidal structures, the political director's tenure and his/her ownership stake.

Our study contributes to the literature on the effect of political ties and board composition in three ways. First, to the best of our knowledge, this is the first study that focuses on the presence of political directors over a large time period (ten years) in a country in Continental Europe. Second, it is the first work that analyses the relationship between the power of dominant owners and the presence of politicians on the board of directors in a country without a planned economy. In this sense, the study shows the power of the dominant owners in determining the composition of the board of directors and defining the different roles played