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Too close for comfort? Geographic propinquity to political power and stock returns

Christos Pantzalis [a,1], Jung Chul Park [b,*]

[a] Department of Finance, College of Business Administration, BSN 3403, University of South Florida, Tampa, FL 33620, United States
[b] Department of Finance, Raymond J. Harbert College of Business, 303 Lowder Hall, Auburn University, Auburn, AL 36849, United States

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ABSTRACT

We show that firm headquarters' geographic proximity to political power centers (state capitals) is associated with higher abnormal returns. Consistent with the notion that this effect is rooted in social network links, we find it is more pronounced in communities with high levels of sociability and political values' homophily, and that it dissipates when firms move their headquarters to another state. Finally, in line with the view that investors perceive such networks to be associated with political risk, we find that this effect is particularly strong when there are substantial levels of corruption, dependency on government spending, and politicians' turnover.

1. Introduction

Social networks entail relationships between individuals from all facets of society. One important characteristic of social networks is that individuals are not linked in a random fashion, but rather, in accordance with the homophily principle.[2] Specifically, people are more likely to interact with others when they share a common background and, especially, when they live and work in close geographic proximity. In this paper we provide a financial economics perspective to social networks linking U.S. firms and politicians at the state level. We use geographic propinquity, which is the principal source of homophily, to devise a proxy for the likelihood of social ties between businesses and political establishments concentrated in state capitals, referred to here as "political power centers" (hereafter, PPCs), and examine the relationship of these likely social links to firm stock return performance. In doing so we are extending a long stream of recent papers that emphasize the importance of *explicit* political ties for firms' financing (Claessens et al., 2008; Francis et al., 2009, among others), governance (Goldman et al., 2009, 2013) and performance (Cooper et al., 2010; Kim et al., 2012). In contrast to the explicit connections' measures used in the literature, such as political action campaign (PAC) contributions, lobbying expenditures or appointments of politicians on corporate boards, our geographic proximity measure serves as an indicator that firms located near PPCs have social networks that are distinctly different from those of distant firms.[3] We argue that from the perspective of an outside investor such links can render the scope and effectiveness of a firm's corporate political strategies as more uncertain. Our contribution to the literature is that we

* Corresponding author. Tel.: +1 (334) 844 3003; fax: +1 (334) 844 4960.
E-mail addresses: cpantzal@usf.edu (C. Pantzalis), jzp0023@auburn.edu (J.C. Park).
[1] Tel.: +1 (813) 974 3262; fax: +1 (813) 974 3084.

[2] The homophily principle simply states that familiarity breeds connection, and is a well-established fact in the social networks' literature. Propinquity has been shown to be instrumental in close relationships, such as friendship and marriage (Bossard, 1932), in the frequency of communications within firms (Allen, 1984), in the forming of interlocked corporate boards (Kono et al., 1998), in dealings among floor traders (Baker, 1984), and in investment patterns of venture capital firms (Sorenson and Stuart, 2001). In addition to propinquity, studies have shown that relationships are more likely when individuals share similar backgrounds, demographic characteristics as well as values (Marsden, 1988; McPherson et al., 2001, among others). We address the importance of homophily based on shared values in Section 3.5 below.

[3] In this study, we use the terms "social links" and "geographic proximity to political power centers" interchangeably and acknowledge that our geographic distance based variable is only a noisy measure of the extent of firm's social networks linking them with the political establishment in state capitals.

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provide evidence consistent with the notion that social networks linking firms and politicians matter in a very fundamental sense, because they shape investors' perceptions about firms' risk which, in turn, is reflected in firms' stock returns.[4]

Social network links spanning the corporate and political worlds can be established directly through social contacts between firm executives and politicians, or indirectly through lobbyists and/or interest groups. Typically, across the different states within the U.S., political actors including, lobbyists, interest groups and politicians tend to be geographically clustered in the capital city (PPC) of each state they operate in. Social links to PPCs can have both beneficial and detrimental effects on firm performance. The benefits firms can derive from networking with the political establishment can be either direct or indirect. Direct benefits have been documented in a number of prior studies (Fisman, 2001; Faccio, 2006; Faccio et al., 2006; Claessens et al., 2008; Bunkanwanicha and Wiwattanakantang, 2009; Cingano and Pinotti, 2013; Amore and Bennedsen, 2013) and come in the form of explicit favors politically connected firms can extract from politicians.

In spite of the fairly obvious benefits that firms can derive from social networks that support their political strategies, there are also reasons to believe that maintaining social links to PPCs can sometimes prove to be detrimental to the firm (Vedder, 1996; Cho et al., 2006; Bertrand et al., 2007; Repetto, 2007; Chen et al., 2010; Chaney et al., 2011; Correia, 2012). In particular, from an investor's perspective, this would imply that poorly designed political strategies can render firms riskier investments. For example, Cho et al. (2006) provide evidence that firms engaging in more political spending are associated with poorer environmental performance in the community in terms of corporate governance, diversity, human rights, employee relations, etc. Chaney et al. (2011) find that the quality of accounting information in politically connected firms is significantly poorer than that of similar non-connected companies.

In this study we empirically investigate whether the likelihood (or strength) of social networks that can exist between firms and PPCs matters in terms of stock performance. Based on the above discussion, we argue that it is very hard for outside investors to clearly predict whether social links to politicians will have a definitive positive or negative effect for firm performance. In fact, we posit that, from their perspective, social links to PPCs will broaden the range of firms' possible future cash flows, and therefore will be associated with greater uncertainty. As mentioned before, we devise a measure of likelihood (or strength) of firms' social ties to political power centers based on the fact that the most basic source of homophilous ties is geographic propinquity. Accordingly, the starting point for the development of our social link measure is the geographic distance of a firm's headquarters from the capital city of the state wherein the headquarters is located. We extract the part of the distance that cannot be accounted for by geographic and firm-specific variables as the residual from the spatial distance model we estimate and refer to it as "distance from state capital," *DSC*. Note that since *DSC* is measured as the residual geographic distance, low (high) values of *DSC* indicate a greater (smaller) likelihood of social ties. In light of the difficulty in measuring strength of social ties that exist in networks spanning firms and PPCs, we acknowledge that measuring ties along a single (geographic) dimension is not going to provide a comprehensive measure of social network ties. Therefore our *DSC* measure should be viewed merely as an indicator, i.e. a measure of *likelihood* of social ties, and the results that it generates should be interpreted from that point of view. Nevertheless, in spite of the simple nature of our social link measure, it is both encouraging and noteworthy that *DSC* produces strong results with very intuitive implications. To alleviate concerns about the uni-dimensionality of our *DSC* measure, in our empirical analysis, we account for other state-level socio-demographic factors (such as political values' homophily and community sociability) that can also contribute to the development of social network ties and find that *DSC*'s explanatory power improves further, consistent with the notion that *DSC* captures the extent of the social network spanning firms and PPCs.

Our tests' main results indicate that the proximity of firms to political power centers is strongly associated with return performance. Firms with low *DSC*, i.e. those more likely to maintain or develop social networks with PPCs, outperform those with high *DSC* on a risk adjusted basis by about 24 basis points per month. This statistically and economically sizeable effect, which we refer to as the *DSC* effect, is quite robust to different estimation methods and sorting procedures. When we explore the *DSC* effect further we uncover that it is stronger when the state capital's community is characterized by high levels of sociability and when there is substantial ideological beliefs-based homophily between the political elite and citizens residing in the state. This evidence corroborates the social link interpretation of our residual geographic propinquity measure. Furthermore, the *DSC* effect is more pronounced for firms whose headquarters are located in states with greater levels of corruption, when there is more politician turnover and greater dependence on government spending. Unsurprisingly, the *DSC* effect is also found to be weakening with the degree of a firm's geographic dispersion. Overall, the aforementioned results are consistent with the view that investors perceive firms as riskier when their geographic location is closer to that of political power brokers.[5] Finally, we also explore whether the nature of social ties between firms and nearby political centers is permanent or transitory by investigating the impact of a change in firms' headquarters' location on the *DSC* effect. We find evidence of a weaker *DSC* effect after the firm has moved its headquarters to a different state. This evidence implies that the *DSC* effect is less likely to be driven by other possible proximity-to-PPCs effects, such as access to managerial labor market, better human capital, information spillovers etc., but rather by social ties between firms and the political establishment that are not permanent and need time to develop.

This study contributes to the literature in several ways. First, unlike the previous papers that suggest either the benefits or costs of political connections, we expect a positive relation between geographic proximity to PPCs and stock returns in the fundamental sense that firms' proximity to political power results to greater exposure to political risk, which in turn is compensated by higher stock returns. Investors perceive firms as riskier investments when they are more likely to have social links to PPCs because the personal nature of these ties can affect the scope and effectiveness of corporate political strategies in an unpredictable manner. Essentially, from outside investors' perspective, low *DSC* firms can reap more benefits or more disadvantages relative to high *DSC* firms depending on how they manage political connections, which leads to greater uncertainty. Second, most studies on the financial implications of political connections deal with relatively small datasets that typically expand within a decade. Moreover, some other papers such as Goldman et al. (2009) and Faccio and Parsley

[4] It should be noted here that proximity to state capitals may often also entail proximity to managerial labor market, top universities (i.e., better quality human capital), sources of financing, and information spillovers among other things. Although our empirical design of the proximity variable has explicitly accounted for many of these effects, it is almost impossible to account for all non-political effects. We therefore view our proximity measure as a broad indicator of the extent of a firm's social network when it is located near a PPC rather than a measure of political connections.

[5] Nevertheless, when we regress proxies of market valuation on *DSC* we find a strong positive relationship, which implies that the market seems to expect that proximity to political power centers can boost future cash flows. These results are not shown for the sake of brevity, but are available upon request.