POLITICAL CONNECTIONS AND FIRM VALUE
Evidence from the Regression Discontinuity Design of Close Gubernatorial Elections

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This study received the prize for the “Best corporate finance paper” at SFS Finance Cavalcade 2013.

Using the network of university classmates among corporate directors and politicians and the regression discontinuity design of close gubernatorial elections from 1999 to 2010, we identify the positive and significant impact of social-network based political connections on firm value. Firms connected to elected governors increase value by 1.36% on average surrounding the election date. Political connections are more valuable in a state with a higher level of regulation and corruption, in smaller firms, and in firms dependent on external finance. Firms connected to election winners invest more, earn better operating performance, hold more cash, and enjoy better long-term stock performance.

Research question
Do individual politicians channel favor to their socially connected firms? This is an important question for the design of institutions that govern politics and business. A firm’s social connections to politicians may benefit its shareholders, while potentially damage other firms and harm society’s overall welfare. Friendships between politicians and firms can inhibit conflicts of interests that need to be more closely watched.

How can we correctly evaluate this phenomenon? Existing empirical designs face several challenges. First, to provide systematic statistical evidence, one needs to clearly define connections between politicians and firms, and to collect enough data with sufficient variations of connections. Second, one can never observe enough factors that may affect connections and outcomes at the same time (the endogeneity problem), and failure to control for unobservables will produce spurious results. Third, one needs to choose appropriate outcome variables to evaluate the impact of connections on firm.

Methodology
This study focus on the social links between US governors and their friends in listed firms’ boards of directors, using BoardEx dataset from 2000 to 2010. A firm is considered linked to a politician if a director went to the same university program within one year of the politician (social networks of classmate).

We then focus on close elections of governors from 2000 to 2010. In close races, winners and losers are statistically similar along all dimensions, even unobservable ones. By comparing firms connected to winners to firms connected to losers, we can correctly estimate the effect of having a social link to an elected governor in the US.

We consider stock value of publicly traded firms as measure of firm value, under the hypothesis that the market correctly prices in available information about the firm. We compute cumulative abnormal returns (CARs) of stocks around the election day as a measure of changes to the Firm’s value.

We then use the Regression Discontinuity Design (RDD) technique to appropriately compare between winner-connected firms and loser-connected firms around the win/lose threshold of 50% vote share. In further robustness checks, we also control for other variables and specifications.

Results
The analysis in the above table reveals a strongly robust pattern in the data: Being socially connected to a governor increases a firm’s value on average by 1.36%. For an average firm in the sample, it is equivalent to USD 41 Million. The results remain robust when we control for observed factors related to elections, to firms, and fixed effects for years, schools and industries.

Further analysis shows that the effect is strongest in states with more corruption, measured by number of corruption convictions per head. It is also higher in more regulated states, in states where the government employs a higher fraction of the population in the public sector, and in states with a lower index of economic freedom. These results are consistent with the interpretation that politicians favour their socially connected firms in environments of low transparency, where red tapes increase their discretionary power.

We also find that over the course of three years following the election, firms connected to elected governors invest much more, hold more cash, and have better stock performance.

Concluding remarks
This study shows that American governors and government officials can bring large value to connected firms, even when the informal connections are only based on former classmate networks. It is likely that such value comes from the politicians’ discretionary power in opaque environments. This result calls for more checks and scrutiny on social connections of politicians and businessmen, especially in contexts where existing institutions are weak.