Lobby or Contribute? The Impact of Corporate Governance on Firms’ Political Strategies

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Universitat Autònoma de Barcelona
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Motivation

- Political strategies
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- Political strategies
  - Outside directors with political background;
  - Informational lobbying;
  - Political pressure
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  - Informational lobbying;
  - Political pressure
- Corporate governance $\Rightarrow$ firm’s business strategy
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  - Outside directors with political background;
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- Corporate governance ⇒ firm’s business strategy
- Question:
  - How will CG level influence firm’s political strategies?
DEFINITION

CORPORATE GOVERNANCE LEVEL

Shareholders’ rights compared with managers’ rights at firm.
**Definition**

**Corporate Governance Level**

*Shareholders’ rights compared with managers’ rights at firm.*

**Informational Lobbying**

*The practice of persuading legislators/regulators to influence policy decisions by providing related information.*
<table>
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</tr>
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<tbody>
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<td>Financial supports provided by firms through political committees to policy makers. An instrument of “buying political favors”.</td>
</tr>
</tbody>
</table>
LITERATURE

Lobbying reduces firm's tax rates (Richter, Samphantharak & Timmons, 2008); increases firm's financial performance (Chen, Parsley & Yang, 2008).

Contribution has no effect on legislators' votes (Ansolabehere, de Figueiredo & Snyder, 2003); causes the appearance of corruption (Joo, 2006); incurs agency costs in a firm (Aggarwal, Meschke & Wang, 2008); should be regulated and restricted (Drazen, Lima˜ o & Stratmann, 2007), (Dahm & Porteiro, 2008).
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**Main Results**

Will corporate governance level influence firms’ choice in political strategies? Yes!
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- Good corporate governance firms contribute less frequently. However, once they contribute, they contribute more than bad corporate governance firms;
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- Lobbying is a preferred instrument by good corporate governance firms;
- Political pressure is favored by bad corporate governance firms;
- Good corporate governance firms contribute less frequently. However, once they contribute, they contribute more than bad corporate governance firms;
- Better corporate governance level leads to lower probability of making wrong policy.
1. Introduction
2. Theoretical Model
3. Empirical Study
4. Conclusion and Extension
Basic Setup

- Two period game
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- The prior belief of state $a$ is $q_0 \in (\frac{1}{2}, 1)$
- The policy maker is interested in matching $d$ with $\omega$, but also responsive to the political influence from $F$
- $F$ prefers $B$ independent of $\omega$ ($V_B - V_A = V > 0$)
  - Owned by a shareholder ($SH$), who cares more about firm’s long-term success
  - Operated by a manager ($M$), who cares more about his personal interests (short-term return)
**Time Line**

0  
Nature

1-1  
Firm

1-2  
P

1-3  
Firm

1-4  
P

2-1  
Firm

2-2  
P

Choose the state of the world \( \omega \in \{a, b\} \)

Makes decision on the informational lobby, by choosing \( x \)

Updates the prior belief \( q_0 \) to \( q_f \)

Chooses the contribution amount \( c_1 \)

Chooses policy \( d_1 \in \{A, B\} \)

Chooses the contribution amount \( c_2 \)

Chooses policy \( d_2 \in \{A, B\} \)
**The Firm**

- **Informational Lobbying:**
  - investment \((x \in [0, 1])\) in test \((t)\) at a cost \(C(x) = \frac{kx^2}{2}\);
  - \(Pr.(t = \omega) = x\) and \(Pr.(t = \phi) = 1 - x\);
  - sending a report \((r)\) to \(P\), valid for two periods;
  - perfectly correlated lobbying strategies.
The Firm

- **Informational Lobbying:**
  - Investment ($x \in [0, 1]$) in test ($t$) at a cost $C(x) = \frac{k_x x^2}{2}$;
  - $Pr(t = \omega) = x$ and $Pr(t = \phi) = 1 - x$;
  - Sending a report ($r$) to $P$, valid for two periods;
  - Perfectly correlated lobbying strategies.

- **Political Pressure:**
  - Exert political pressure ($c \geq 0$) to $P$ at a cost $C(c) = k_c c$;
  - Additively separable and linear on $P$’s utility;
  - Valid for one period.

**Assumption 1**

\[ k_x >> k_c \]
**THE FIRM**

- Discount rates:

**Assumption 2**

\[ \delta^{SH} > \delta^M, \quad \text{where} \quad \delta^{SH}, \delta^M \in (0, 1) \]
The Firm

- Discount rates:

**Assumption 2**

\[ \delta^{SH} > \delta^{M}, \quad \text{where} \quad \delta^{SH}, \delta^{M} \in (0, 1) \]

- \( F \) is characterized by its corporate governance level \((g \in [0, 1])\).

**Firm’s Discount Rate**

\[ \delta^{F}(g) = g \cdot \delta^{SH} + (1 - g) \cdot \delta^{M} \quad \text{where} \quad \frac{\partial \delta^{F}(g)}{\partial g} > 0 \]
**Corollary 1**

Lobbying firm contributes to the policy maker less frequently than firm without lobbying. However, if the lobbying firm contributes, it will contribute more than non-lobbying firm because informational lobbying may increase policy maker’s belief of state a.
RESULTS

COROLLARY 1
Lobbying firm contributes to the policy maker less frequently than firm without lobbying. However, if the lobbying firm contributes, it will contribute more than non-lobbying firm because informational lobbying may increase policy maker’s belief of state a.

PROPOSITION 1
When the contribution cost is low, the firm will not do informational lobbying. The firm will exert political pressure on the P for both periods, and policy B will be chosen for both periods.
Proposition 2

For intermediate contribution cost, the firm will invest in the informational lobbying. A report will be sent to P and the policy maker will update his belief with the report. Political pressure will also be exerted for the two periods, but only when the test fails. For both periods, policy A will be chosen when \( r = a \) and B will be selected otherwise.
**Proposition 3**

*If the contribution cost is very high, only informational lobbying will be used by the firm. The policy maker will update his belief with the message. Since the contribution cost is very high, the firm will not exert political pressure. Policy B will be chosen when \( r = b \) and A will be selected otherwise.*
RESULTS

Corollary 2

Better corporate governance level (or higher shareholder rights) incurs more investment in lobbying.
Results

Expected contribution amount $EC$ and corporate governance level $g$ (Dahm and Porteiro 2008).

$$EC = Pr(\omega = a)[Pr(t = a|\omega = a)(c_1^* + c_2^*) + Pr(t = \phi|\omega = a)(c_1^* + c_2^*)]$$

$$+ Pr(\omega = b)Pr(t = \phi|\omega = b)(c_1^* + c_2^*)$$

$$= (1 + \delta(g))(2q_r - 1) - (1 - q_0)(1 + \delta(g))(2q_r - 1)x^*(g)$$

(1)

**Corollary 3**

For lower contribution cost, better corporate governance $g$ induces more political contribution from $F$. For intermediate contribution cost, better corporate governance induces less political contribution from $F$, if $F$'s corporate governance level is above a threshold $g \geq g^*$.
Better corporate governance level leads to lower probability of making wrong policies?

\[
Pr(\text{err}) = Pr(\omega = a)[Pr(t = a | \omega = a)(Pr(d_1 = d_2 = B | t = a))
+ Pr(t = \phi | \omega = a)(Pr(d_1 = d_2 = B | t = \phi))
+ Pr(\omega = b)Pr(t = \phi | \omega = b)(Pr(d_1 = d_2 = A | t = \phi))
\] (2)

**Corollary 4**

For lower contribution cost, where there is no informational lobbying, the probability of making a wrong decision is equal to the prior probability of state a, \(q_0\). For higher level of contribution cost, when there is informational lobbying, better corporate governance level leads to lower probability of making wrong decision.
Empirical Questions Studied

- Difference in corporate governance level between lobbying firms and contribution firms;
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- Difference in corporate governance level between lobbying firms and contribution firms;
- Effect of corporate governance level on lobbying investment;
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- Difference in corporate governance level between lobbying firms and contribution firms;
- Effect of corporate governance level on lobbying investment;
- Effect of corporate governance level on political contribution.
## Data Description

- Unbalanced Panel data from US market, including 910 firms with 5048 observations from 1998 to 2006.
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  - Corporate governance index (Gompers, Ishii and Metrick 2003): RiskMetrics
  - Entrenchment-index (Bebchuk, Cohen and Ferrell 2009)
  - Other financial accounting data: COMPUSTAT
Hypothesis testing I:

$H_0 :$ The lobbying-only group has the same corporate governance level as the contribution-only group.

$H_1 :$ The lobbying-only group has better corporate governance level than the contribution-only group.
### Corporate Governance and Political Strategy

#### Table 4: Corporate Governance Difference

<table>
<thead>
<tr>
<th>Year</th>
<th>Lobbying Gr.</th>
<th>Contribution Gr.</th>
<th>Dif.</th>
<th>t-stat.</th>
</tr>
</thead>
<tbody>
<tr>
<td>1998</td>
<td>8.85</td>
<td>9.98</td>
<td>−1.13</td>
<td>−3.17***</td>
</tr>
<tr>
<td>2000</td>
<td>8.85</td>
<td>10.45</td>
<td>−1.60</td>
<td>−4.98***</td>
</tr>
<tr>
<td>2002</td>
<td>8.79</td>
<td>10.59</td>
<td>−1.80</td>
<td>−5.43***</td>
</tr>
<tr>
<td>2004</td>
<td>8.96</td>
<td>10.47</td>
<td>−1.51</td>
<td>−4.68***</td>
</tr>
<tr>
<td>2006</td>
<td>9.18</td>
<td>10.15</td>
<td>−0.97</td>
<td>−2.79***</td>
</tr>
</tbody>
</table>

*, ** and *** denote statistical significance at 10%, 5% and 1% level.
Hypothesis testing II:

\[ H_0 : \text{Firm’s corporate governance level has no effect on its lobbying activities.} \]

\[ H_1 : \text{Firm’s corporate governance level has a positive effect on its lobbying activities.} \]
Hypothesis testing II:

\[ H_0 : \text{Firm’s corporate governance level has no effect on its lobbying activities.} \]
\[ H_1 : \text{Firm’s corporate governance level has a positive effect on its lobbying activities.} \]

Model:

\[
\ln \text{LOBBY}_{i,t} = \alpha_0 + \alpha_1 \text{GIMIND}_{i,t} + \sum_{k=1}^{10} \alpha_k Z_k + \sum_{t=1999}^{2006} \alpha_t \text{Year}_t + \sum_{j=2}^{55} \alpha_j \text{Industry}_j + \epsilon_{i,t}.
\]
## Corporate Governance and Lobbying Activities

### Table 5: Corporate Governance Level and Lobbying Activities: Fixed Effect

<table>
<thead>
<tr>
<th>Dependent Variable: Lobbying Expenditures</th>
<th>Coefficient</th>
<th>(t-statistic)</th>
</tr>
</thead>
<tbody>
<tr>
<td>GIMIND</td>
<td>−0.082**</td>
<td>(−2.33)</td>
</tr>
<tr>
<td>Sales</td>
<td>0.024</td>
<td></td>
</tr>
<tr>
<td>R&amp;D</td>
<td>0.166**</td>
<td>(2.44)</td>
</tr>
<tr>
<td>Sales Impact</td>
<td>0.313***</td>
<td>(2.71)</td>
</tr>
<tr>
<td>ROA</td>
<td>0.45</td>
<td>(0.94)</td>
</tr>
<tr>
<td>Tobin’s Q</td>
<td>−0.268***</td>
<td>(−3.2)</td>
</tr>
<tr>
<td>Book/Market</td>
<td>0.02</td>
<td>(0.72)</td>
</tr>
</tbody>
</table>
**CORPORATE GOVERNANCE AND LOBBYING ACTIVITIES (CONTINUED)**

Sales Growth \( -0.12 \)  
\[ (-1.35) \]
Free CF \( -0.16 \)  
\[ (-0.08) \]
Investment 0.25  
\[ (1.19) \]
Leverage \( -0.052** \)  
\[ (-2.3) \]
Const. 13.37***  
\[ (9.66) \]

<table>
<thead>
<tr>
<th>Adj. ( R^2 )</th>
<th>Within: 0.1688</th>
<th>Between: 0.2039</th>
<th>Overall: 0.2430</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of Obs.</td>
<td>1539</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Number of Groups</td>
<td>309</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Time Dummies</td>
<td>Yes</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

The t-statistic is in the parentheses.  
*, ** and *** denote statistical significance at 10%, 5% and 1% level.
Hypothesis testing III:

\( H_0 : \) Firm’s corporate governance level has no effect on its contribution strategy.

\( H_1 : \) Firm’s corporate governance level has a negative effect on its contribution strategy.
Hypothesis testing III:

\( H_0 : \) Firm’s corporate governance level has no effect on its contribution strategy.
\( H_1 : \) Firm’s corporate governance level has a negative effect on its contribution strategy.

Model:

\[
\ln PAC_{i,t} = \beta_0 + \beta_1 \text{GIMIND}_{i,t} + \sum_{k=1}^{9} \beta_k Z_k + \sum_{t=2000}^{2006} \beta_t \text{Year}_t \\
+ \sum_{j=2}^{48} \beta_j \text{Industry}_j + \epsilon_{i,t}.
\]
**Corporate Governance and Campaign Contribution**

Table 6: Corporate Governance Level and Contribution: Fixed Effect

<table>
<thead>
<tr>
<th>Dependent Variable: PAC Contributions</th>
<th>Coefficient</th>
<th>(t-statistic)</th>
</tr>
</thead>
<tbody>
<tr>
<td>GIMIND</td>
<td>0.039</td>
<td>(1.34)</td>
</tr>
<tr>
<td>Sales</td>
<td>0.601***</td>
<td>(5.34)</td>
</tr>
<tr>
<td>Sales Impact</td>
<td>0.028</td>
<td>(0.28)</td>
</tr>
<tr>
<td>ROA</td>
<td>0.006</td>
<td>(0.01)</td>
</tr>
<tr>
<td>Tobin’s Q</td>
<td>0.277**</td>
<td>(2.07)</td>
</tr>
<tr>
<td>Book/Market</td>
<td>0.026</td>
<td>(0.36)</td>
</tr>
</tbody>
</table>
**Corporate Governance and Campaign Contribution (Continued)**

<table>
<thead>
<tr>
<th></th>
<th>Coefficient</th>
<th>t-statistic</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales Growth</td>
<td>-0.194</td>
<td>(-1.33)</td>
</tr>
<tr>
<td>Free CF</td>
<td>-0.4</td>
<td></td>
</tr>
<tr>
<td>Investment</td>
<td>0.54</td>
<td>(1.42)</td>
</tr>
<tr>
<td>Leverage</td>
<td>-0.036</td>
<td>(-0.84)</td>
</tr>
<tr>
<td>Const.</td>
<td>4.915***</td>
<td>(3.93)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Adj. $R^2$</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Within</td>
<td>0.1657</td>
<td></td>
</tr>
<tr>
<td>Between</td>
<td>0.3260</td>
<td></td>
</tr>
<tr>
<td>Overall</td>
<td>0.3549</td>
<td></td>
</tr>
</tbody>
</table>

Number of Obs.: 1262  
Number of Groups: 388  
Time Dummies: Yes

The t-statistic is in the parentheses.  
*, ** and *** denote statistical significance at 10%, 5% and 1% level.
Table 7: Lobbying Firms’ Contribution Behavior

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>GIMIND ≤ 6</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>% of firms contribute</td>
<td>53.5%</td>
<td>51.4%</td>
<td>43.8%</td>
<td>44.3%</td>
<td>55.6%</td>
</tr>
<tr>
<td>Ave. PAC/NS</td>
<td>12.96</td>
<td>14.81</td>
<td>12.54</td>
<td>10.02</td>
<td>9.92</td>
</tr>
<tr>
<td><strong>GIMIND ≥ 13</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>% of firms contribute</td>
<td>76.8%</td>
<td>77.8%</td>
<td>75%</td>
<td>73.3%</td>
<td>74.6%</td>
</tr>
<tr>
<td>Ave. PAC/NS</td>
<td>11.69</td>
<td>8.73</td>
<td>9.23</td>
<td>10.56</td>
<td>9.82</td>
</tr>
</tbody>
</table>

**GIMIND ≤ 6**: Firms with GIM index smaller than 6.

**GIMIND ≥ 13**: Firms with GIM index larger than 13.
## Extensions

- Robustness test for theoretical model:
  - Partly correlated lobbying strategies;
EXTENSIONS

- Robustness test for theoretical model:
  - Partly correlated lobbying strategies;
  - Independent lobbying strategies;
EXTENSIONS

- Robustness test for theoretical model:
  - Partly correlated lobbying strategies;
  - Independent lobbying strategies;
  - Strategic information sending: hidden information.
EXTENSIONS

- Robustness test for theoretical model:
  - Partly correlated lobbying strategies;
  - Independent lobbying strategies;
  - Strategic information sending: hidden information.

- Robustness test for empirical model:
  - Entrenchment-index is used for independent variable.
Better corporate governance level induces more lobbying expenditure and less contribution.
Conclusions

- Better corporate governance level induces more lobbying expenditure and less contribution.
- Improving corporate governance level helps to restrict contribution behavior.
Better corporate governance level induces more lobbying expenditure and less contribution.

Improving corporate governance level helps to restrict contribution behavior.

Future studies:
- model corporate governance level in a moral hazard surrounding;
- endogeneity? Other measurements?