

Political connections in boards of directors

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Politically connected directors dominate board of directors of state-owned enterprises as the public owner's representatives. Their political influence affects board organization and performance. We propose a framework to analyze the topic with reference to firms in network industries, which are still dominated by state shareholders.

Introduction

Despite the extensive privatization process that took place over the last two decades, state ownership remains a significant form of ownership especially in middle and lower income countries. State-owned enterprises (SOEs) remain the predominant form of ownership in many network industries such as telecommunications, rail transport, airlines, electricity, gas and water supply, broadcasting, in banking and insurance. In many countries the State still controls the majority of the capital and in others it keeps golden shares. Globally, in 2006, SOEs accounted for 20% of investment and 5% of employment (World Bank, 2006). OECD (2014) confirms that the numbers had not significantly changed from 2006 to 2013 for OECD countries as a whole.

In SOEs, state ownership and government control present inherent governance challenges that might contribute to poor performance. SOEs face the same core problem of separation of ownership and control as privately held firms, the owners in this case being the citizens. Unlike a widely held corporation in the private sector, a SOE generally cannot have its board changed via a takeover and most of them cannot go bankrupt. The absence of potential takeovers and proxy contests reduces the incentives for board members and managers to maximize the company's value and the lack of bankruptcy can lessen the pressure to contain costs. In addition, although SOEs have a very diffused ownership structure, they are generally overseen by a higher body or a combination of government entities (Ministries, Municipalities, the Parliament). These various authorities could pursue different and potentially conflicting goals thus increasing the level of complexity in the SOEs' management. Actually, SOEs' overall results have been disappointing over the world. SOEs have tended to create patronage and reward their supporters. In the process, state firms have diverted resources from both the private sector and other state priorities. OECD (2014)

admits that «Even though regulatory barriers to product market competition have been lifted to a substantial extent since the mid-1990s, room for further reform remains. The policy domains with largest scope for improvement both in OECD and non-OECD countries include public ownership and the governance of state-owned enterprises, as well as regulatory barriers to entry in network industries and professional services».

Board of directors in SOEs: role and value of politically connected directors

In the analysis of the corporate governance challenges of state-owned (or state-controlled) enterprises, some important questions concern the role of board of directors. The World Bank (2006), in reference to emerging economies, says that «the boards of state-owned enterprises should have the necessary authority, competencies and objectivity to carry out their function of strategic guidance and monitoring of management», thus recognizing to board composition a role. When defining board composition in state-owned enterprises, the categories into which directors are classified by the prominent literature on the private firms' governance (insiders vs. outsiders and independent vs. not independent directors) are conveniently integrated by the 'politically connected directors' class. In SOEs, indeed, the presence of politicians on the board is guaranteed by those firms' public (direct and indirect) control.

A large literature on privatization neglects any social welfare goal to bureaucrats in control of state firms (Shapiro and Willig, 1990; Shleifer and Vishny, 1994). In this literature, bureaucrats are moved by political interests. At best, they only have an indirect concern about profits and have goals that are very different from the social interest, so that they can force the firms they control toward harmful objectives.

As warned by OECD (2006), «a major challenge is to

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find a balance between the state's responsibility for actively exercising its ownership functions, such as the nomination and election of the board, while at the same time refraining from imposing undue political interference in the management of the company» (p. 3). OECD (2006) adds: «In order to minimize possible conflict of interest, the ownership entity should avoid electing an excessive number of board members from the state administration. This is particularly relevant for partly owned SOEs and for SOEs in competitive industries» (p. 25).

In corporations providing a public service and where the sensitivity to social or economic developments is necessary, such as utilities and manufacturing firms with high environmental impact, some (outside) directors could be considered as 'politically useful' (Faccio, 2006). Recent contributions (Fan et al., 2007, among others) find that political connection at top levels harms newly privatized firms' performance. Menozzi et al. (2012) find that board size and the presence of politically connected directors have an inflationary effect on the level of employment of Italian public utilities during the period 1994-2004 and that the overall board size and the number and proportion of politicians have a negative effect on the accounting performance. Apparently, when privatization does not remove politicians from boards of directors, these directors can seriously undermine the goals of privatization. These results support the interventions introduced by the Italian legislator in recent years. The Italian law decree no. 95/2012 (the so-called spending review) and the law decree no. 39/2013 imposed a limit to the total number of directors sitting on the board of public utilities and in general, of firms fully owned by local municipalities (directors must be three to five, depending on the firm size). Two (or three, in boards with five components) directors must be chosen among the local municipality's employees but they cannot cover the position of President or CEO. The declared purpose was to avoid that executive positions in those sectors were covered by politicians.

Carretta et al. (2012) disentangle the effect of tout court politically connected boards from that of politically connected executive directors within Italian cooperative banks: they find that banks with politically connected boards have a significantly higher overhead costs (relative to total assets) and higher net interest revenues than non-connected banks if the bank also has, at least, a politician in an influential position. On the contrary, Infante and Piazza (2010) find that Italian firms, politically connected at a local level, benefit from lower interest rates and that this effect is stronger when politically connected firms borrow from banks with politicians in their boards.

Sometimes, politically connected directors are explicitly recognized as 'useful' in virtue of their political status that gives them a comparative advantage in the struggle for a board seat even in absence of a remarkable curriculum or a significant experience in the sector. For example, politicians might help the firm in achieving a higher economic result by predicting the government's actions or, in a straight line, when the firm's revenues depend on the political process, like in the case of contracts with public institutions. In 2009, the United Kingdom's Financial Services Authority (FSA) approved the appointment of Mr Paul Flowers as a non-executive directors of the Co-op Bank and his promotion to chairman a year later despite his lack of experience in the banking sector, believing that his experience as a local Labour politician and his close relationship with the Co-op movement could help bring order to the bank's board. The FSA ordered the mutual to offset Mr Flowers's lack of banking knowledge by appointing two deputy chairmen who had greater expertise. Nevertheless, the Co-op Bank's 1.5bn pounds capital hole in 2013 revealed the shortfall in governance and the Co-op's new chief executive, Euan Sutherland, arranged the appointment of a new bank chief executive and chairman.

Cronyism in the appointment of state-owned enterprises' directors is an actual and widespread fear. On June 28, 2012, the Thailand's newspaper *The Nation* wrote: «Several state enterprises, including Thai Airways International [...] are inviting candidates for the position of chief executive officer. [...] But they aren't going to get any professionally qualified managers to apply». The reasons were found in the CEO appointment process, supposedly subject to a «heavy political manipulation» that would produce «only mediocre leaders at best and political cronies or lackeys at worst». CEO of state enterprises are chosen by board of directors that are, in turn, «usually picked by Cabinet members whose only yardsticks are whether the directors can serve the politicians' interests or not». In Britain, at the end of 2013, despite a succession of controversies in the previous years, a series of people with link to senior politicians received honours in the 2014 Honours list, which rewards services to public life, thus sparking accusations of cronyism in the system. At the beginning of July 2014, the Irish Cabinet was put under fire for three former Labour councillors being appointed to cover state board positions under the Department of Transport, Tourism and Sport.

The ability to attract, motivate and retain suitable candidate to the firm's top positions crucially depends on the remuneration offered. European SOEs, and in particular public utilities, interested by the liberalization movement

of the '90s, have gone through a corporatization process that has transformed them into limited companies in which both private and public entities could invest. As a consequence, both private citizens and public servants could sit on the board of directors as shareholders representative. To that respect, in order to attract well-qualified and experienced executives and board members, rewards should reasonably be included in the compensation schemes. However, for reasons of fairness and in order to avoid public controversy over unequal and excessive pay in the public sector, there are serious concerns about the extensive use of incentive remuneration schemes for companies owned by central or local government.

In fact, the empirical evidence confirms this intuition: Barontini and Bozzi (2011) find that between 1995 and 2002, board members of Italian listed state-owned companies received a significantly lower compensation than directors of family or widely held firms; Feng et al. (2007) show that in regulated US REITs, the regulator tries to influence the CEOs' and directors' pay in order to avoid excessive payouts that would challenge the prevailing public sentiment; Joskow et al. (1996) find that, for a sample of 87 US state-regulated private utilities observed during 1978–1990, CEOs of regulated firms earn less than their counterparts in unregulated firms and that their compensation scheme is less tied to firm profitability; Menozzi et al. (2014) find that the proportion of politicians sitting in the board negatively influences the level of per capita compensation in Italian local public utilities between 1994 and 2004. Also, boards are better remunerated in big firms and in the energy sector with respect to the water sector, and no relationship is found between firm performance and board per capita compensation.

In Italy, the appointment and financial treatment of directors and executives of non-listed firms directly or indirectly controlled by the Ministry of Economy and Finance are regulated by a recently updated set of norms. In a note from June 24th, 2013, the Italian Ministry of Economy and Finance stressed its intention to guarantee the «maximum transparency and quality in the corporate charges' appointment process, with a special attention to the integrity and level of professionalism of board directors», to achieve with the adoption of «specific procedures aimed at pursuing the public interest and assuring a correct resource management and the safeguard of the public ownership's image». The Ministry of Economy and Finance's decree 166/2013 has imposed a cap to the yearly compensation received by executive directors sitting on the board of firms it directly or indirectly controls, effective April 1st, 2014. The norm comes as an integration and completion of previous interventions that, starting from the Italian budgetary law 296/2006, were intended to rationalize the governance of public firms by reducing, at the same time,

the public expenditure.

Conclusions

It is common wisdom that SOEs are affected by the presence of multiple and potentially conflicting objectives. In SOEs, board directors are called to pursue a social mission and are subject to social control. If politically connected, they might go after goals other than profit maximization, like increasing the level of employment at a local level or offering low prices to consumers. These practices have commonly been used in many network industries, such as local public utilities, so that clear and good corporate governance practices are strongly required. Reforms have been introduced in order to improve the performance of SOEs but their effects could be neutralized by the activity of self-interested CEOs and by the presence of weak board of directors.

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