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Corporate governance and lobbying strategies

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ABSTRACT

The paper extends the recent research on corporate non-market actions (Fernández & Usero, 2010, and Usero & Fernández, 2009). Specifically, we study whether corporate governance, in terms of managerial entrenchment, determines the choice and degree of lobbying engagements as a non-market strategy and with what impact on firm value. The results indicate that firms with more entrenched management have a greater tendency to engage in lobbying activities. Within the group of firms that lobby, there is a negative relation between the degree to which management is entrenched and lobbying intensity. In addition, there is a positive relation between lobbying intensity and value added by lobbying firms. Overall, the evidence suggests that corporate lobbying is not agency driven and may, in fact, create value.

1. Introduction

In an article published in *Fortune* magazine in 2006, Matt Miller writes, "A company's return on lobbying and campaign contributions – let's call it return on political investment, or ROPI – is astronomically higher than any real investment it can make."

In a corporate world with no agency conflict between managers and shareholders, shareholders may rejoice at this report. However, given the lack of transparency, weak corporate democracy, and divergence between management and shareholder objectives, it may be a cause for concern for investors. Two main reasons for this concern come to mind. First, in the real world, characterized as it is by performance-linked compensation plans and information asymmetries, management may be motivated to undertake lobbying investments that may boost short run performance – and hence their payoff – at the cost of long term value creation for shareholders. The second reason for the concern is that in the pursuit of personal interests – political connections and positions, promoting political ideologies/preferences, etc. – management may use lobbying expenses in a wasteful manner, yielding neither short term nor long term value gains.

Recent evidence (Fernández and Usero, 2010; Ozer, 2010; Usero and Fernández, 2009) suggests that the composition and orientation of top management influences corporate political activities. Agency theory argues that more powerful and entrenched management teams pursuing their personal interests may distort the expected positive link between corporate lobbying and value creation. By studying the link between corporate lobbying and balance of power between shareholders and management, this paper seeks to enhance our understanding of the motivations behind corporate lobbying and its shareholder value relevance.

Brasher and Lowery (2006) suggest that most of the research on political engagements of businesses focuses on corporate campaign contributions through political action committees (PACs) rather than lobbying. They opine, "Unfortunately, the literature does not provide very clear and consistent answers about why some organizations lobby and other do not··· [and] ···the literature on lobbying impact has generated an equally confusing and inconsistent set of empirical results."

This paper addresses the above gaps in our understanding by studying management entrenchment as one possible explanation for corporate lobbying and how entrenchment and lobbying strategies interactively impact corporate performance. Analyzing the corporate political strategies in terms of lobbying behavior is valuable as not only the lobbying outlays are significantly larger (Milyo et al. (2000)), the number of lobbying entities is also bigger compared to the number of active PACs (Brasher and Lowery (2006)).

The purpose of this paper is to seek answers to the following questions:

1. What, if any, is the relation between proclivity and intensity of corporate lobbying and management entrenchment?
2. Does lobbying relate to corporate value creation?
3. Is the value relevance of lobbying conditioned by management entrenchment?

Our results suggest that firms with more entrenched management (weaker shareholder rights) have a greater tendency to engage in

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lobbying activities. Within the group of firms that lobby, there is a negative relation between the degree to which management is entrenched and the lobbying intensity. In addition, the evidence suggests that after controlling for variations in shareholder rights and industry effects, there is a positive relation between lobbying intensity and value added by lobbying firms.

The paper proceeds as follows: in the next section we discuss the theoretical and empirical framework and develop our hypotheses. Section 3 describes data sources and sample selection as well as explains the variables used in the analysis; Section 4 presents the discussion of our results and Section 5 concludes the paper.

2. Literature review

2.1. Corporate lobbying leads to higher shareholder value

Why do firms lobby? One stream of thought holds the view that corporations value political connections. Studying over twenty thousand firms in forty-seven countries, Faccio (2006) concludes that firms, on average, experience about a two percent increase in shareholder wealth at the time of announcement of their executive or large shareholder joining politics. Similar evidence provided by Faccio and Parsley (2009) suggests a value loss of about two percent at the time of an event that disrupts a political connection. Therefore, we expect that management at value-maximizing corporate entities – with effective governance mechanisms in place – would pursue lobbying as a nonmarket strategy to create value.

2.2. Lobbying results in favorable influence on policy outcomes

Lord (2000) reports that the congressional staff perceived professional lobbying as the most effective way to influence congressional legislative policy provisions. With respect to influence of public policy on firm performance, while Banker et al. (1997) study airline carriers, Bowman et al. (2000) look at pharmaceutical firms. Given that both of the studies report that expected policy changes impact market value, it is plausible to argue that lobbying activities aimed at swaying policy outcomes influences the value of the firm. Lo's (2003) analysis of the 1992 revision of executive compensation disclosure rules suggests that firms who lobbied against the proposed regulation experienced positive abnormal stock returns of about six percent.

Thus, at value maximizing firms corporate management is expected to lobby to favorably influence public policy.

2.3. Managerial entrenchment influences lobbying strategy

There are several theoretical arguments as to why management entrenchment is expected to influence decision to lobby and lobbying intensity. With respect to the propensity to lobby, the first argument is in terms of managerial risk aversion. This line of reasoning suggests that managerial power intensifies managerial risk aversion (Grinstein and Hribar (2004)) and that a more powerful management is more likely to engage in lobbying as a risk-reducing strategy. Repetto (2006, pp 4) argues that, “Executives see much of their lobbying activity as essentially defensive efforts to ward off potential threats.”

The second argument is in terms of agency-conflict-driven managerial self-interest. Extending the political-contributions-as-managerial-consumption (Ansolabehere et al. (2003)) perspective to lobbying, agency theorists (Jensen (1986)) argue that management may engage in lobbying for furthering their entrenchment. There exists evidence that management team heterogeneity – that in turn determines management power relative to board of directors – is an important influence on corporate strategic decisions in general (Auh & Menguc, 2006; Cho, 2006) and political strategies in particular (Ozer, 2010). Thus, one can argue that entrenched managers engage in lobbying to further their own interests.

The third possible explanation is in terms of the rational myopia hypothesis (Daines & Klausner, 2001). The argument suggests that more powerful management teams can pursue longer-term nonmarket strategic options, such as lobbying, more effectively. Thus, in the value-maximizing framework, firms with more entrenched managements have greater likelihood to engage in lobbying and with a greater expected positive value impact.

The above discussion also suggests that the impact of lobbying on corporate value may be positive or negative. One possibility is that lobbying is value destroying as it misallocates resources away from potentially productive usage. Additionally, agency driven managers may lobby for promoting public policies that create a power balance favorable to management relative to shareholders. The second possibility is that lobbying may be value enhancing, as well as promoting personal interests of management. That is, lobbying may well be consistent with management-shareholders interest alignment.

There exists significant evidence suggesting a negative relation between management entrenchment and corporate value. Gompers et al. (2003) provide evidence that the greater is the managerial power relative to shareholders, the poorer is the corporate value performance. Bebchuk et al. (2004) and Bebchuk and Cohen (2005) provide complementary evidence. Several studies extend this line of research by studying corporate strategies and their value impact as conditioned by managerial entrenchment. For instance, Jiraporn et al. (2006) report that firms with more powerful management have a greater propensity to engage in corporate diversification and that these firms face a greater diversification discount.

In sum, evidence on agency conflict suggests that managements may pursue their own objectives to the detriment of shareholders' interests, and that the likelihood of their doing so is greater when they have more power. However, in case lobbying serves their interest and is shareholder value adding too, then the managers have greater incentive to engage in lobbying. In either case, it is plausible to argue that management at firms with greater managerial power would have greater propensity to engage in lobbying. This argument forms the basis of hypothesis H1A below:

Hypothesis H1A. Firms with greater degree of management entrenchment are more likely to engage in lobbying activities.

Despite the above discussion suggesting a positive relation between propensity to lobby and managerial entrenchment, we need to recognize at least two possibilities that may result in a negative relation between the intensity of lobbying and entrenchment. The first possibility concerns the corporate reputation. For instance, citing the Boeing example, Repetto (2006, p. 8) suggests, “Business lobbying can lead to adverse publicity and reputational and other losses…”. The second possibility resulting in a negative relation between lobbying intensity and managerial entrenchment emanates from the need to contain corporate risks arising from judgment errors (Repetto, 2006) in management decisions. Given our previous discussion that stronger managements become more risk averse, we argue that more powerful managements will deliberately limit their exposure to lobbying related risks. Thus, we expect a negative relation between the degree of management entrenchment and lobbying intensity. This discussion forms the basis of the next hypothesis.

Hypothesis H1B. Firms with a greater degree of management entrenchment lobby less intensely in terms of lower lobbying outlays and lesser number of lobbyists hired.

2.4. Managerial entrenchment may moderate the lobbying–corporate value link

There exists material evidence of a positive relation between political engagements and corporate performance (see for example, Shaffer et al. (2000), Claessens et al. (2008), Richter et al. (2009),