Politically Connected Directors and Corporate Governance

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Research has shown that firms can benefit when they are politically connected. The extant literature has shown that politically connected firms benefit from procurement contracts, reduced regulatory issues and lower costs of capital. However, with more politicians joining corporate boards, the effect of political connectedness on corporate governance remains unclear. This paper examines the association between politically connected directors and corporate governance. A sample of high ranking politicians that have joined firm boards of directors is examined. I find that firms with politician directors have higher corporate governance scores. Additional tests also indicate that an addition of a politician to a board of directors increases the governance quality.

Keywords: politically connected firms, corporate governance, board of directors, director nominations, politician directors

INTRODUCTION

Politicians often have the power and influence to benefit corporations. In 2007, Tenet Healthcare was suffering through regulatory and reputational problems, when it decided to appoint former Governor Jeb Bush and former Senator Bob Kerrey to its board of directors. By 2009, the corporation was the second best performing stock on the S&P 500 for the year and has since become one of the largest healthcare companies in the United States (Krantz, 2010). In contrast, in the midst of the Chesapeake Energy scandal—where the company failed to disclose the CEO's questionable financial practices—were two powerful ex-politicians. Senator Don Nickles and Governor Frank Keating enjoyed several perks, such as access to the firm's private planes for travel, while failing to maintain their fiduciary duty (McIntyre & Zajac, 2012). However, while more attention is paid to scandals regarding governance failures, these directors were likely an anomaly compared to the many politicians sitting on boards that bring value to firms. Thus, this paper empirically examines the association between politicians on corporate boards and corporate governance.

Academics, the business media and governance experts have started to take a closer look at ex-politicians sitting on corporate boards. While there has been an increasing amount of literature recently regarding politically connected firms, the extant literature has tended to focus on countries with underdeveloped financial markets or in highly corrupt political environments. However, political figures, albeit often retired from public office, being nominated to board positions in the United States is becoming more common. Politicians identified in this paper are those that have sat on high level public positions, such as former presidential candidates, senators, congressmen, big city mayors, governors, secretaries, and ambassadors. These politicians are independent directors and are less likely to have direct business connections than other outside directors.

To date, the extant literature on director nominations often takes a resource dependence view (Pfeffer & Salancik, 1978). The board of directors can be viewed as a linking instrument between the organization and the external environment. Political leaders (who can be classified as community influence type directors) often have different background than other types of board members (business experts/insiders, support specialists). However, these politicians share many of the same traits, skills, and previous job experiences as other corporate directors. These directors are often high profile and have been shown to help business procure government contracts, reduce borrowing costs, and allow firms to benefit from becoming more tax aggressive (Chaney et al., 2011; Goldman et al., 2013; Kim & Zhang, 2016).

Data was collected comes from management information circulars (proxy statements), Compustat, CRSP and ISS/RiskMetrics, for the years 2007 to 2012. 6372 firm-years are examined and show that 29% of listed firms in the sample have or had at least one politician on its board of directors. Furthermore, these politically connected firms tend to have different firm and governance characteristics than their counterparts. However, there is little difference in their performance characteristics.

Utilizing the Entrenchment Index (Bebchuk et al., 2009), this paper hypothesizes and finds that firms with politician directors are associated with higher corporate governance scores. This relationship persists after controlling for firm-level, performance, and other governance based variables. The paper also documents that firms which add former politicians to their board of directors improve their corporate governance quality. Dropping politicians from boards has minimal or a negative effect on governance quality. Additional testing, including a propensity scoring matching model and difference-in-differences, provide support for these hypotheses.

This paper contributes to the corporate governance literature and to the diverse research field of politically connected firms. To the best of the author's knowledge, this is the first paper to examine the connection between politicians as directors and corporate governance quality, using a relatively large sample size. While previous literature has focused on the performance effects of being politically connected, this paper finds that adding politicians to corporate boards can also be an effective governance mechanism.

The rest of the paper is organized as follows: The next section presents background information regarding boards of directors and political connections. Hypotheses development is described in the third section. Section four outlines the research methodology. Results are reported in the fifth section. Section six provides additional testing. The final section of the paper concludes the study.

BACKGROUND

Prior Literature on Politically Connected Firms

Watts and Zimmerman's (1978) influential paper on Positive Accounting Theory put forward the political cost hypothesis. Their model demonstrated that firms may use accounting methods to lower profits so as not to attract the attention of politicians. Shleifer and Vishny (1994) put forward an alternative model where politicians will extract rents from politically connected firms. Firms are able to enhance their value when the benefits of these connections outweigh their rents (costs). However, when there is the potential for political exploitation, firms often can take steps towards mitigate these risks, such as hiring high quality auditors (Gul, 2006).

Much of the extant literature has examined firms with political connections in emerging or corrupt markets, often in both. These studies have mainly focused on politician ownership of firms or politicians in high management positions, with only a few focusing primarily on the board of directors. Furthermore, these papers tend to focus on countries with underdeveloped financial markets or in highly corruption political environments (Carretta et al., 2012). For instance, in emerging markets and highly corrupt countries, Faccio et al. (2006) find that firm value increases when an entrepreneur is elected to a top political position. Asian studies have shown that politically connected firms are often given special privileges by the government (Effiezal Aswadi et al., 2011). In recent years, a number of studies have examined the political connectivity of Chinese firms since the country's move towards privatization. Fan et. al. (2007) find that politically connected CEOs have poorer post-IPO stock performance and that these firms are more likely

to appoint other bureaucrats, rather than directors with relevant professional backgrounds, to the board of directors. Private Chinese firms with politically connected managers are more likely to obtain government subsidies (Wu et al., 2012), are more likely to expropriate from minority shareholders (Cheung et al., 2010; Qian et al., 2011) and are less likely to be forced to resign than poorer performing state owned firms (Chang & Wong, 2009).

In the United States, it is rare for an active or former politician to obtain control of a corporation or the CEO position in a firm. However, politicians being nominated to board positions is becoming more prevalent. Politically connected firms are most likely to occur in regulated industries (Agrawal & Knoeber, 2001). At the same time, these companies often need to improve their accounting transparency and are more likely to hire a Big Four auditor (Guedhami et al., 2014). Additional studies on politically connected firms have shown that these firms are more likely to receive corporate bailouts and more preferential treatment in procurement contacts (Faccio et al., 2006; Lenway & Rehbein, 1991).

However, few papers have examined how politician directorships affect the corporate governance of firms in developed markets. A seminal study in this literature by Goldman et al. (2009) did find that politically connected director nominations are associated with significant cumulative abnormal returns (CARs) in the United States, although the study focused mainly on CARs around the time of presidential elections. Nonetheless, both Republican and Democratic affiliated board nominations were found to have significant effects. Other papers on politically connected firms have shown that political connections, and especially politically connected directors, can be extremely beneficial to firms. Hillman (2005) finds that firms with ex-politicians on the board of directors are associated with better market-based performance, especially in heavily regulated industries. Similarly, the cost of bank loans is significantly lower for companies that have board members with political ties (Houston et al., 2014).

Director Nominations

Since Fama and Jensen (1983) a great deal of research and regulation has focused on the board of directors, as they play a vital role in monitoring management, setting policies and reducing agency conflicts. Rather than just playing an advisory role, directors are often needed to facilitate better access to important resources in the firm's external environment (Pfeffer, 1972). This includes providing direct connections to important stakeholders (Mizruchi, 1996) such as creditors, customers and the government. Furthermore, board members are often nominated as a means for a firm to gain legitimacy. Thus, firms tend to hire high profile directors as a credible signalling mechanism to the market (Deutsch & Ross, 2003).

Directors are often nominated by the nominating committee of a board, although CEOs often have a considerable amount of influence over the process (Zajac & Westphal, 1996). To ensure the quality of the board, directorships are recommended to be staffed with independent, experienced and knowledgeable members (Vafeas, 1999). Once a nomination is made, shareholders then ratify director candidates selected by the board itself. Director nomination candidates are rarely voted down by shareholders, unless there is an ongoing proxy battle - often caused by institutional investors (MacGregor & Campbell, 2008). Furthermore, it has been noted that directors can be categorized into four types: insiders (e.g. current or former firm executives), business experts (e.g. CEOs or directors of other firms), support specialists (e.g. lawyers and bankers) and community influencers (e.g. political leaders and university faculty) (Hillman et al., 2000). Thus, unlike the first three categories where the directors often have significant business experience, politicians are nominated for alternative reasons.

HYPOTHESES DEVELOPMENT

Resource Dependence and Other Theories

The board of directors can be seen as a linking instrument between the organization and the external environment. Resource dependence theory is often employed in political connectedness research to explain why firms become politically connected and nominate former politicians to their boards. Resource dependence theory, as posited by Pfeffer and Salancik (1978), argues that interdependent relationships are needed by organizations in order to both reduce uncertainty and enhance power. To minimize conflicts, an

organization will often nominate a representative of the source of the constraint onto its governing board. Although the organization might forgo some of its autonomy, an individual appointed to a board is expected to support and aid the organization in its problems (Pfeffer & Salancik, 1978).

Based on resource dependence theory, Kim and Zhang (2016) show that politically connected firms, including those with politicians as board members, are associated with (and benefit from) tax aggressiveness. Likewise, Chaney et al. (2011) find that while the cost of debt is higher for firms with lower quality reported earnings, politically connected firms are able to report poorer quality earnings without a negative effect to their cost of debt. Thus, the academic literature has begun to demonstrate that nominating politicians to the board of directors can be an efficient strategy for enhancing corporate outcomes.

Other theories have also been proposed to explain the emergence of politically connected firms. Agency theory deals with potential conflicts between political directors and management (e.g. Ellstrand, et al., 2002; Lee. et al., 2014). Embeddedness theory takes an economic-sociological perspective in studying inter-organization costs and constraints when politicians are involved (Siegel, 2007; Okhmatovskiy, 2010). Exchange theory in this literature describes the interdependence of suppliers and demanders of public policy (Schuler et al., 2002). Finally, some studies have taken more of a philosophical approach, such as a Confucian perspective for political appointments (Li & Liang, 2015) or ethical perspectives, such as how political connections relate to corporate social responsibility (Li & Zhang, 2010).

Former Politicians as Corporate Directors

Successful high level politicians share many of the same traits as corporate directors. Namely, their job requires them to be accountable (both professionally and legally) and be performance orientated along with having strong leadership, decision making, and communication skills (Romzek, 2000). Moreover, previous government experience allows them to provide valuable advice and counsel regarding the public policy environment of a firm. This includes, "channels of communication to existing government officials, bureaucrats, and other political decision makers; influence over political decisions; and legitimacy" (Lester et al., 2008). Moreover, politicians are independent directors and are less likely to have direct business connections than other outside directors. These directors also have a high reputation to keep and, with their public profiles, are more likely to be scrutinized than other directors—incentives to avoid poor governance practices.

Directors are directly linked with the setting, monitoring, and reviewing of all top level corporate policies and decisions. The argument can be made that firm performance is positively associated with good corporate governance quality (Gao, et al., 2016; Gompers et al., 2003; Ueng, 2016, among others). Nonetheless, the aforementioned literature generally suggests that politicians on boards of directors do benefit corporations in multiple ways. For example, studies of the university faculty, the other community influencer type of director, have shown that professors in the boardroom have positive effects on the corporate governance of firms (Francis et al., 2015; Huang et al., 2016).

As resource dependence theory suggests, firms will bring in resources, such as directors, to manage uncertainty, especially when dealing with governments or regulators (Pfeffer, 1987). The aforementioned extant literature demonstrates that politicians are an effective human resource, especially when dealing with government intervention or regulatory issues- which high level politicians often have a comprehensive understanding on the policy and regulatory processes. Ex-politicians as directors are an important source of human and social capital (Lester et al., 2008) and are known to provide firms with important expertise on legislative and bureaucratic procedures (Goldman et al., 2009). Furthermore, these politicians have the knowledge and experience on how to appease constituents (a.k.a. shareholders). Thus, the hypotheses are provided in alternative form:

H1: *Firms with former politicians on their board of directors are associated with higher quality corporate governance.*

H2: *Firms that add former politicians to their board of directors improve their corporate governance quality.*

METHOD

The data collected in this paper derives from management information circulars (proxy statements), Institutional Shareholder Services (ISS)/RiskMetrics, Compustat and the Center for Research in Security Prices (CRSP) databases. Prior studies have utilized various measures and model specifications to measure political connectedness. For instance, campaign contributions, lobbying expenditures, or authors have created their own political alignment indexes. Here, only board members with prior political experience are examined, as directors are directly linked with the setting, monitoring, and reviewing of all top level corporate policies and decisions.[1]

The sample begins with all firms that contain data from 2007 to 2012 in ISS. Firms that do not have the necessary information in ISS/Riskmetrics, proxy statements from EDGAR (the Electronic Data Gathering, Analysis, and Retrieval system) or Compustat are removed due of insufficient data. Similarly, trusts, which have different governance structures, and government sponsored entities (such as Fannie Mae), which are politically connected by design, were taken out of the sample. This left a total of 6372 firm-year observations. The detailed sample description is presented in Table 1.

TABLE 1
SAMPLE DESCRIPTION

Number of firm-year observations from ISS/RiskMetrics	8815
Less: Firms with missing data	(1555)
Less: Trusts and government sponsored entities	(192)
Less: Firms with missing EDGAR or Compustat data	(696)
Final Sample	6372

Politicians are identified by the Goldman et al. (2009) method via a textual analysis. The proxy statements for all of the firms in the sample are downloaded from EDGAR and entered into a java-based program co-developed by the author. Next, all of the proxy statements are analyzed and a company is classified as politically connected if it has at least one board member with one of the following former positions: president, presidential (vice-presidential) candidate, senator, member of the House of Representatives, (assistant) secretary[2], deputy secretary, deputy assistant secretary, undersecretary, associate director, governor, director (CIA, FEMA), deputy director (CIA, Office of Management and Budget), commissioner (IRS, NRC, SSA, FDA, SEC), ambassador, mayor, White House staff, chairman of the presidential election campaign, and chairman or member of the president's council. During this process, each result was manually checked (by reading through the proxy statement) to determine whether or not the result was referring to a director's past position.

To test whether these firms also have provisions that enable them to be entrenched, Bebchuk et al.'s (2009) Entrenchment Index[3] (E Index) was utilized.[4] The E index is a subset of Gompers et al.'s (2003) Governance Index (G Index), based on what Bebchuk et al. (2009) identified as the six most important corporate governance items. These six corporate governance provisions that determine whether a board is entrenched are: a staggered board, limits to amend bylaws, limits to amend charter, supermajority voting rules, golden parachutes and poison pills. All of the governance provisions are provided in the ISS/RiskMetrics data and the E Index is calculated from there. Prior studies that have used the Entrenchment Index as a proxy for corporate governance have shown that firms which score higher on the E Index are associated with lower creditor ratings, excessive CEO compensation, tax aggressiveness and lower firm valuations (see Alali et al., 2012; Brown & Caylor, 2006; Francis et al., 2013; Hoppe & Moers, 2011; Skantz, 2012; Veld & Wu, 2013).

The following regression was then performed:

$$E\ Index_{it} = \alpha 0_{it} + \alpha 1 PoliticianOnBoard_{it} + \sum Controls_{it} + \mu_{it} \quad (1)$$

where Entrenchment Index is the dependent variable and lower scores suggest higher corporate governance quality.

Characteristics of the Board

Various studies have examined the corporate governance effects of age and other board composition variables. Hunt and Jennings (1997) show that younger aged managers tend to make the most unethical decisions. Similarly, older, more educated and female managers are found to be more ethical than their counterparts and may reduce firm level risk (Deshpande, 1997). CEO age is also positively associated with financial reporting quality (Huang et al., 2016), although CEOs acquire more power over time by participating in the appointment of board members and once they pass their first five years in office, their dismissal likelihood declines (Shen & Cannella, 2002). Kim and Zhang (2016) note that firms with politicians as board members often pay less taxes. Older directors on the audit committee are negatively related to the cost of equity capital (Dao et al., 2013). However, Ali et al. (2014) find mixed results when testing between board age diversity and performance. When prior firm performance is better, the former CEO is more likely to be retained on the board (Evans et al., 2010). Finally, busy and long tenured directors may be associated with governance problems (Niu & Berberich, 2015).

Controls in this study include: Size, which is measured using the natural log of the total assets of a corporation. ROA measures the return on assets for the firm in the current year. Book-to-market is calculated as the book value of equity, excluding preferred shares, divided by the market value of the firm on the balance sheet date. Leverage is measured as a firm's total debt divided by its total assets. Firm Age is measured as the number of data years (as a public company) available on CRSP.[5] Cash Effective Tax Rate is calculated as the amount of tax paid in cash divided by the firm's net income. GAAP Effective Tax Rate is also run as a tax avoidance substitute for Cash ETR. Other governance variables related to the structure of the board are also controlled for: Board Size measures the size of the board of directors, divided by the natural log of the total assets. Independent Chair is also a dummy variable, with a value of one if the chairman of the board was independent from the CEO and zero otherwise. Female Directors measures the percentage of directors on the board that are female. CEO Age is the age of the chief executive officer on the proxy statement date—including Young CEO if the CEO is younger than fifty years of age and Old CEO if the CEO is sixty years of age or older—while CEO Tenure is the number of years as chief executive officer on the same date. Directors' Average Age measures the average age of all the directors (endogeneity testing is done to measure the average age without the politicians and/or CEOs). Finally, Busyness or busy directors measures the average number of other public directorships per board member.

A similar regression to Eqn (1) is then performed to determine whether there are any incremental effects from adding or dropping politicians from the board of directors:

$$E\ Index_{it} = \alpha 0 + \alpha 1 PoliticianOnBoard_{it} + \alpha 2 Add\_politician_{it} + \alpha 3 Drop\_politician_{it} + \sum Controls_{it} + M_{it} \quad (2)$$

where Add_politician is an indicator value of one if a politician has been added to the board of directors, zero otherwise and Drop_politician is an indicator value of one if a politician has been dropped from the board of directors, zero otherwise. All non-indicator variables are winsorized at the 1% and 99% levels for the two equations. Finally, to address the issue of independence in time-series data, robust standard errors are required. Thus, the regressions are run with standard errors clustered by firm.

RESULTS

Table 2 shows the distribution of politicians over the 2007-2012 sample periods. Approximately 24% of the firms had at least one politician on its board of directors. The number of politically connected firms, and total number of politicians on boards, increased by about five percent over the sample period. Table 3 presents the descriptive statistics for the sample. Panel A provides the descriptive statistics for all the firms in the sample. Additional analysis shows that approximately 29% (304/1062) of the firms in the sample had

a politician on its board of directors for at least one of the sample years. Descriptive statistics in Panel B show firms with political directors have higher corporate governance (lower Entrenchment Index scores). Consistent with the extant literature (e.g. Kim & Zhang, 2016), these firms are also significantly larger than firms without a former politician on its board of directors. The "political firms" are significantly older, have larger boards as well as retain a higher percentage of female directors. Politician on Board firms are more likely to be audited by the Big 4 versus the control group (consistent with Guedhami et al., 2014). Furthermore, the "political boards" are older, but with directors having shorter average tenures on those boards, and with outside directors hold significantly more other directorships. Finally, consistent with Faccio (2010) and other studies, it was found that politically connected firms are more leveraged than non-politically connected firms.

TABLE 2
POLITICIANS BY YEAR

Year	# of Firms with Politician on Board	% of Firms with Politician on Board	Total # of Politicians on Boards
2007	241	22.7%	320
2008	246	23.2%	323
2009	254	23.9%	337
2010	262	24.7%	350
2011	255	24.0%	339
2012	253	23.8%	335

TABLE 3
DESCRIPTIVE STATISTICS

Panel A: Entire Sample

Variable	Mean	Min	25%	Median	75%	Max
Politician on Board	0.237	0	0	0	0	1
GIndex	7.329	0	6	7	9	16
EIndex	2.643	0	2	3	4	6
Size	8.204	5.079	6.989	8.037	9.285	12.710
Firm Age	29.684	1	15	24	40	87
Leverage	0.556	0	0.405	0.558	0.704	0.998
Big4	0.985	0	1	1	1	1
ROA	0.040	-0.345	0.014	0.047	0.085	0.560
BKMK	0.628	-0.011	0.325	0.513	0.777	2.129
Cash ETR	0.227	0	0.067	0.217	0.327	1
Board Size	9.561	4	8	9	11	18
IND Chair	0.479	0	0	0	1	1
Female Directors	0.127	0	0	0.110	0.200	0.570
CEO Age	57.039	35	52	57	61	91
CEO Tenure	9.840	1	4	7	13	39
Directors' Age	62.279	46	59.9	62.4	64.6	77.9
Directors' Tenure	9.118	1	6.5	8.5	11	20.7
Busy Director	1.065	0	0.5	0.8	1.2	2.6

Panel B: Differences between Politician on Board and No Politician Firms

Variable	Politician on Board Mean (n=1511)	No Politician Mean (n=4861)	T-test between Groups
Gindex	7.279	7.488	-2.49***
EIndex	2.493	2.689	-4.74***
Size	9.094	7.927	24.34***
Firm Age	36.267	27.637	14.91***
Leverage	0.614	0.537	11.27***
Big4	0.985	0.938	7.36***
ROA	0.048	0.037	1.35
BKMK	0.583	0.643	-2.19**
Cash ETR	0.228	0.226	0.40
Board Size	10.525	9.261	18.44***
IND Chair	0.393	0.506	-7.70***
Female Directors	0.145	0.121	8.35***
CEO Age	57.367	56.938	2.10**
CEO Tenure	9.604	9.914	-0.34
Directors' Age	63.166	62.003	10.72***
Directors' Tenure	8.704	9.247	-3.82***
Busy Director	1.065	0.784	19.74***

*** Significant at the 1% level; ** Significant at the 5% level; * Significant at the 10% level
See Appendix I for variable descriptions

Table 4 presents the correlations matrix. The maximum correlation is between Size and Board Size at 0.625, while the minimum correlation is between ROA and book-to-market valuation at -0.58. Consistent with expectations, Politician on Board and the E Index are negatively correlated ($p < 0.01$). The E Index is positively correlated with a larger Board Size and a higher book-to-market valuation. It is negatively correlated with Size, older firms, return on assets, Female Directors, and Director Tenure. Meanwhile, Politician on Board is positively correlated with both firm Size and Board Size, along with Firm Age, higher Leverage, Female Directors, older CEOs, longer tenured directors and Busy Directors. Politician on Board has a negative correlation with a higher Book-to-market valuation, independent chair, younger CEOs and Director Age.[6]

TABLE 4
CORRELATIONS MATRIX

	gindex	eindex	politi~d	nlsize	firmage	leverage	roa	bookto~j	cashetr	boards~e	indchair	female~s	youngceo	oldceo	direct~g	avgyea~e	busyness
gindex	1																
eindex	0.7444*	1															
politician~d	-0.0385*	-0.0616*	1														
nlsize	0.1204*	-0.0969*	0.2803*	1													
firmage	0.0208	-0.0329*	0.1303*	0.3428*	1												
leverage	0.1369*	0.0149	0.1514*	0.5338*	0.1992*	1											
roa	-0.0565*	-0.0668*	-0.0069	-0.1349*	-0.0167	-0.3800*	1										
booktomark~j	0.0051	0.0457*	-0.0474*	0.0905*	0.0309	0.0554*	-0.5826*	1									
cashetr	0.0178	0.0267	-0.0024	-0.0752*	-0.0411*	-0.1432*	0.3420*	-0.1637*	1								
boardsize	0.1646*	0.0472*	0.2277*	0.6251*	0.3531*	0.4062*	-0.0974*	0.0535*	-0.0239	1							
indchair	-0.0275	-0.013	-0.0960*	-0.1288*	-0.1191*	-0.0710*	-0.0296	-0.0018	-0.016	-0.0422*	1						
femaledire~s	0.0540*	-0.0486*	0.1186*	0.2807*	0.1833*	0.2474*	-0.0166	-0.0556*	0.0015	0.2835*	-0.0516*	1					
youngceo	-0.0067	0.0203	-0.0403*	-0.0957*	-0.1551*	-0.0718*	0.0347*	-0.0632*	0.0408*	-0.0805*	0.1710*	-0.0327*	1				
oldceo	-0.0166	-0.0112	0.0325*	0.0275	0.0894*	-0.0226	-0.006	0.0563*	-0.0026	0.0366*	-0.2216*	-0.0733*	-0.2803*	1			
directorsa~g	-0.0451*	-0.0423*	0.137*	0.0788*	0.19*	0.0123	-0.028	0.0903*	-0.0042	0.1004*	-0.0615*	-0.1642*	-0.2420*	0.3137*	1		
avgyearsof~e	-0.0792*	-0.0315	-0.0786*	-0.1067*	0.1378*	-0.1040*	0.0285	0.0315	0.015	-0.0377*	-0.0376*	-0.1708*	-0.1105*	0.1741*	0.4256*	1	
busyness	0.1324*	-0.0219	0.2393*	0.3485*	0.2013*	0.1332*	0.0821*	-0.1563*	0.0153	0.2361*	-0.0507*	0.1782*	-0.0199	-0.0316	-0.0142	-0.2753*	1

* Significant at the 1% level
See Appendix I for variable descriptions

Table 5 presents the results of the regressions. The base model is shown in the first column, followed by Eqn (1) in the second column and Eqn (2) in the third column. The base model shows that there is a significant negative relationship ($p < 0.01$) between the E Index and Politician on Board (once again a lower index score shows higher governance quality). The full model shows that this significant relationship persists ($p < 0.05$) after controls are added. This is consistent with H1 (firms with a politician on the board of directors have superior corporate governance quality). The final column shows the incremental effect of adding or dropping politicians from the board of directors. There is a significantly negative ($p < 0.05$) relationship between the E Index and Add_politician, while there is no significant relationship between the E Index and Drop_politician. This provides some evidence to support H2 (adding a politician to the board improves governance quality).

The firm level variables show that larger firms have significantly lower governance scores (higher E Index), while higher leveraged and larger firms have significantly higher corporate governance scores (lower E Index). This is consistent with the notion that larger firms are under more scrutiny and more leveraged firms are riskier. Similarly, higher Book-to-Market firms (lower market valuation) are positively associated with the E Index. As can be expected when it comes to governance quality, the governance variables show that larger boards have significantly more entrenchment provisions, while boards with an independent chairperson have less provisions/higher governance scores. Finally, boards with older (on average) directors have significantly lower corporate governance quality.

TABLE 5
REGRESSION RESULTS

Variable	OLS Coefficient (t-stat) EIndex	OLS Coefficient (t-stat) EIndex	OLS Coefficient (t-stat) EIndex
Politician on Board	-0.196***	-0.170**	-0.154**
	(-2.72)	(-2.31)	(-2.04)
Add_politician			-0.202**
			(-1.97)
Drop_politician			-0.100
			(-0.83)
Firm Level Variables			
Size		-0.198***	-0.198***
		(-7.50)	(-7.47)
Firm Age		-0.001	-0.001
		(-0.40)	(-0.37)
Leverage		0.651***	0.649***
		(4.12)	(4.11)
Performance Based Variables			
ROA		0.207	0.203
		(0.73)	(0.71)
BKMK		0.180***	0.179***
		(2.62)	(2.62)
Cash ETR		-0.072	-0.074
		(-0.70)	(-0.70)
Other Governance Variables			
Board Size		0.095***	0.096***
		(6.20)	(6.24)
IND Chair		-0.101**	-0.102**
		(-1.96)	(-1.97)
Female Directors		0.313	0.306

		(1.12)	(1.09)
Young CEO		-0.003	-0.002
		(-0.04)	(-0.03)
Old CEO		-0.050	-0.049
		(-0.93)	(-0.91)
Directors Average Age		0.025***	0.024***
		(2.66)	(2.64)
Directors' Tenure		-0.005	-0.005
		(-0.51)	(-0.53)
Busy Director		-0.006	-0.006
		(-0.09)	(-0.10)
Industry Effects		Yes	Yes
Year Effects		Yes	Yes
Observations	6372	6372	6372
Adjusted R^2	0.001	0.4135	0.4139

*** Significant at the 1% level; ** Significant at the 5% level; * Significant at the 10% level, two-tailed tests. See Appendix I for variable descriptions

ADDITIONAL TESTING

Propensity Score Matching

Following Armstrong, Jagolinzer, and Larcker (2010), an ordered logistic-propensity score model was run, which models the probability that the EIndex will be affected by whether a firm has Politicians on Board. Matched pairs are formed by selecting an observation politically connected firm and matching it with a non-politically connected firm with the closest propensity score, based on size, industry and year, from the control group. This is performed with no replacement. Results are presented in Table 6. Similar to the ttest and the other linear models, the average treatment effect (ATT) of adding a politician to the board of directors shows a negative relationship between Politician on Board and the E Index. A regression run with the matched pairs also documents this relationship ($p < 0.05$). This provides additional support for H1.

TABLE 6
PROPENSITY SCORE MATCHING

Variable	Sample	Treated	Controls	Difference	t-stat
EIndex	Unmatched	2.495	2.689	-0.194	-4.69***
	ATT	2.507	2.558	-0.122	-2.57**

Variable	OLS Coefficient (t-stat)
Politician on Board	-0.119**
	(-2.20)
Firm Age	-0.004***
	(-2.95)
Leverage	-0.198
	(-1.36)
Performance Based Variables	
ROA	-2.522***
	(-5.48)

BKMK	-0.115
	(-1.54)
Cash ETR	0.404***
	(2.95)
Other Governance Variables	
Board Size	0.026**
	(1.99)
IND Chair	-0.121**
	(-2.18)
Female Directors	0.471**
	(2.23)
Young CEO	0.099
	(1.63)
Old CEO	-0.069
	(-1.64)
Directors Average Age	0.080***
	(12.00)
Directors' Tenure	-0.039***
	(-6.11)
Busy Director	0.367***
	(8.60)
Observations	3010
Adjusted R^2	0.0204

*** Significant at the 1% level; ** Significant at the 5% level; * Significant at the 10% level, two-tailed tests. See Appendix I for variable descriptions

Difference-in-Differences

A difference-in-differences design is also used to analyze the comparisons of the EIndex around the year of an additional or withdrawal of a politician to a company's board of directors. Here the control firms are those that have not added (or dropped) a politician to its board of directors from 2008-2012. Table 7 reports mean values of across the baseline (2007-2011) and follow-up periods (2008-2012). During the sample period, 117 firms added a politician to its board, while 92 politicians were dropped from boards of directors. Panel A shows that there is a significant governance quality increase (lower score) in the EIndex after a politician joins a board. Meanwhile, Panel B shows that there is a significantly governance quality decrease (higher score) in the EIndex after a politician is dropped from a board. This provides additional support for H2.

TABLE 7
DIFFERENCE-IN-DIFFERENCES

Panel A: E-Index, Politician Added to Board			
	Baseline	Follow-up	Diff-in-Diff (t-stat)
Control Group N=6249 (No Politicians Added)	2.522	3.298	
Treatment Group N=117 (Politician Added to Board)	2.177	2.333	
Difference (T-C)	-0.345**	-0.965***	-0.619*
(t-stat)	(-2.44)	(-3.18)	(-1.85)
R^2	0.04		

Panel B: E-Index, Politician Dropped from Board			
	Baseline	Follow-up	Diff-in-Diff (t-stat)
Control Group N=6274 (No Politicians Added)	2.524	3.277	
Treatment Group N=92 (Politician Dropped from Board)	1.987	3.400	
Difference (T-C)	-0.537***	0.123	0.092*
(t-stat)	(-3.40)	(0.34)	(1.69)
R^2	0.04		

*** Significant at the 1% level; ** Significant at the 5% level; * Significant at the 10% level
See Appendix I for variable descriptions

Governance Index as a Lagged Indicator

To address the possibility that politicians on board effect future governance quality, the following regressions were also run:

$$E\ Index_{it+1} = \alpha 0_{it} + \alpha 1 politicianonboard_{it} + \sum Controls_{it} + \mu_{it} \quad (3)$$

where the Entrenchment Index is now one year forward. Table 8 presents the results. The results are consistent with the main regression. The negative relationship between the EIndex and PoliticianOnBoard is still significant ($p < 0.05$), once again, implying higher governance quality. This provides support for both of the hypotheses.

TABLE 8
ADDITIONAL REGRESSION RESULTS

DV =E Indexit+1

Variable	OLS Coefficient (t-stat)
	EIndex
Politician on Board	-0.182**
	(-2.34)
Firm Level Variables	
Size	-0.207***
	(-15.14)
Firm Age	-0.001
	(-1.52)
Leverage	0.628***
	(7.35)
Performance Based Variables	
ROA	-0.066
	(-0.31)
BKMK	0.202***
	(4.68)
Cash ETR	0.020
	(0.26)
Governance Variables	
Board Size	0.090***
	(6.31)

IND Chair	-0.114**
	(-2.07)
Female Directors	0.410
	(1.37)
Young CEO	-0.016
	(-0.19)
Old CEO	-0.053
	(-0.89)
Directors Average Age	0.026***
	(2.62)
Directors' Tenure	-0.005
	(-0.48)
Busy Director	0.005
	(0.08)
Industry Effects	Yes
Year Effects	Yes
Observations	5305
Adjusted R^2	0.3831

*** Significant at the 1% level; ** Significant at the 5% level; * Significant at the 10% level, two-tailed tests. See Appendix I for variable descriptions

Endogeneity Testing

Distance to Washington, D.C. is often used as an instrumental variable in the political connections literature (for example Houston et al., 2014; Kim & Zhang, 2016). DistanceDC is measured as the natural logarithm of one plus the distance from a firm's headquarter to Washington, D.C. There is no reason that this excluded variable would have a direct impact on the E Index. A Heckman two-stage regression and a two-stage least squares regression are run and the second stage results are presented in Table 9. The Heckman two-stage regression shows that the IV for PoliticianOnBoard is still significant ($p < 0.05$), however none of the variables are significant in the two-stage least squares model.

TABLE 9
ENDOGENEITY TESTING

Variable	Heckman (z-stat) EIndex	2SLS (z-stat) EIndex
Politician on Board	-0.036**	6.498
	(-2.49)	(0.41)
Firm Level Variables		
Size	-0.255***	-0.512
	(-9.78)	(-0.67)
Firm Age	-0.002	-0.044
	(-1.62)	(-0.40)
Leverage	0.144	0.769
	(0.79)	(1.47)
Performance Based Variables		
ROA	-1.390***	0.629
	(-2.74)	(0.51)
BKMK	0.100	0.563
	(1.11)	(0.60)
Cash ETR	0.091	-0.197

	(0.61)	(-0.50)
Other Governance Variables		
Board Size	0.081***	0.021
	(4.84)	(0.12)
IND Chair	-0.186**	0.169
	(-2.95)	(0.25)
Female Directors	0.053	-0.286
	(0.15)	(-0.18)
Young CEO	0.151	-0.174
	(1.49)	(-0.38)
Old CEO	-0.115*	0.002
	(-1.77)	(0.01)
Directors Average Age	0.026**	-0.105
	(2.39)	(-0.34)
Directors' Tenure	0.017**	0.063
	(1.74)	(0.38)
Busy Director	0.065	-0.690
	(0.93)	(-0.42)
Industry Effects	Yes	Yes
Year Effects	Yes	Yes
Observations	6372	6372
Wald chi²	1109.08	2268.20

*** Significant at the 1% level; ** Significant at the 5% level; * Significant at the 10% level, two-tailed tests. See Appendix I for variable descriptions

Alternative Governance Index Measures

In Bebchuk et al. (2009), the authors measure the entrenchment index both as a raw score and as an indicator variable. Consistent with their approach, Eqn. (1) is rerun with a logistic regression. In this model a firm has a value of 1 if the E Index is equal or greater than two. The results are presented in Table 10. The results show that PoliticianOnBoard has a significant negative relationship with the E Index ($p < 0.01$), providing additional support for H1. The rest of the results are essential the same as the main regression, except for three variables (Book-to-market, IndChair and Director's Age) which show lower significance.

TABLE 10
LOGISTIC REGRESSION RESULTS

Variable	OLS Coefficient (t-stat) EIndex
Politician on Board	-0.368*** (-2.66)
Add_politician	
Drop_politician	
Firm Level Variables	
Size	-0.342*** (-6.27)
Firm Age	-0.001 (-1.46)
Leverage	1.011*** (3.03)

Performance Based Variables	
ROA	0.093
	(0.11)
BKMK	0.289*
	(1.69)
Cash ETR	-0.100
	(-0.40)
Other Governance Variables	
Board Size	0.135***
	(4.28)
IND Chair	-0.147
	(-1.32)
Female Directors	0.488
	(0.78)
Young CEO	0.018
	(0.11)
Old CEO	-0.071
	(-0.62)
Directors Average Age	0.044**
	(2.21)
Directors' Tenure	-0.018
	(-0.91)
Busy Director	-0.018
	(-0.14)
Industry Effects	Yes
Year Effects	Yes
Observations	6372
Pseudo R^2	0.2340

*** Significant at the 1% level; ** Significant at the 5% level; * Significant at the 10% level, two-tailed tests. See Appendix I for variable descriptions

As an alternative to the E Index, Gompers et al.'s (2003) (G Index) is utilized. The G Index identifies 24 governance provisions that proxy for shareholder rights. These are sorted into five categories: 1) Delay (provisions intended to delay hostile takeover bidders); 2) Voting (provisions dealing with shareholder voting rights); 3) Protection (provisions protecting directors and officers); 4) State (state takeover laws); and 5) Other (provisions related to takeover defenses). Prior studies that have used the Governance Index as a proxy for corporate governance have shown that firms that score higher on the G Index are associated with earnings management, higher underwriting fees, less investment in R&D and reduced capital expenditures, and an increased risk of default (see Cao et al., 2015; Chakraborty & Sheikh, 2010; Jiraporn et al., 2008; Lin & Ulupinar, 2013). The score is calculated from the ISS/RiskMetrics data and the regression is clustered for standard errors. The G Index is substituted for the E Index as follows:

$$\text{G Index}_{it} = \alpha 0_{it} + \alpha 1 \text{politicianonboard}_{it} + \sum \text{Controls}_{it} + \mu_{it} \quad (4)$$

Table 11 presents the results of this regression. Although the two indices are significantly correlated with each other, the negative relationship documented by Politician on Board and the G Index is not significant here. One possible explanation is provided by Bebchuk et al. (2009), which states that the G Index has several unnecessary provisions. Similar to the main models, there is a positive association between both Leverage and Board Size with the index. Unlike the previous models, Female and Busy Directors are positively associated with the G Index.

TABLE 11
G-INDEX

Variable	OLS Coefficient (t-stat) GIndex
Politician on Board	-0.129
	(-0.92)
Firm Level Variables	
Size	-0.053
	(-0.99)
Firm Age	-0.002
	(-0.65)
Leverage	1.189***
	(3.76)
Performance Based Variables	
ROA	0.015
	(-0.04)
BKMK	0.163
	(1.24)
Cash ETR	-0.138
	(-0.67)
Governance Variables	
Board Size	0.135***
	(4.46)
IND Chair	-0.119
	(-1.17)
Female Directors	1.367**
	(2.45)
Young CEO	-0.093
	(-0.65)
Old CEO	-0.078
	(-0.78)
Directors Average Age	0.029
	(1.57)
Directors' Tenure	-0.002
	(-0.10)
Busy Director	0.394***
	(3.22)
Industry Effects	Yes
Year Effects	Yes
Observations	6372
Adjusted R^2	0.3047

*** Significant at the 1% level; ** Significant at the 5% level; * Significant at the 10% level, two-tailed tests. See Appendix I for variable descriptions

CONCLUSION

Prior research has shown that politically connected firms help business procure government contracts, obtain financing, and allow firms to become more tax aggressive. Former politicians joining corporate boards have been linked to abnormal positive stock returns, reduced borrowing costs and overall increase

market based performance. Nevertheless, the association between politician directors and corporate governance remains unclear.

This paper hypothesizes and finds that firms with politician directors are associated with higher corporate governance scores. This relationship persists after controlling for firm-level, performance, and other governance based variables. A propensity scoring matching model and employing the index as a lagged variable confirms the results. Difference-in-differences regressions show that adding a politician to a board of directors is positively associated with governance quality, while dropping a politician from a board of directors is negatively associated with governance quality. Causality cannot be implied since the antecedents and determinants of why firms hire politicians are not empirically tested in this paper. However, the results, combined with the extant literature, do imply that successful politicians as directors enhance corporate governance.

ENDNOTES

1. This is one of the most popular measures of political connectedness (see. Goldman et al., 2009; Duchin & Sosyura, 2012; Kostovetsky, 2015).
2. All secretary positions refer to federal executive departments of the United States.
3. As posited by Manne (1965) and Shleifer and Vishny (1989), management entrenchment occurs when management and the board are given the power to make firm- level decisions that decreases the likelihood of being forced to vacate their position. This includes protecting against mergers, acquisitions, hostile takeovers or other events that may disrupt their power. Shareholders may be harmed by management shirking, empire-building or extraction of benefits such as higher compensation. Entrenchment is known to cause agency problems with negative valuation consequences (Zerni et al., 2010). However, entrenchment is not necessarily associated with CEO tenure, as many long tenured executives hold on to their positions due to valid reasons, such as superior performance. Rather it is a corporate governance concept that focuses on (poor) alignment between management and shareholder interests.
4. This study utilizes the E Index as a proxy for corporate governance quality and does not attempt to make a direct connection between political directors and management entrenchment.
5. The CRSP database only goes back to 1925. 34 (3.2%) of the firms in the sample have the maximum value of 82-87 years. The results are unchanged when the natural log of firm age is substituted.
6. Also of note, the E Index has a very strong positive correlation with the G Index. This alternative index is explored further in Additional Testing.

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APPENDIX: VARIABLE DEFINITIONS

EIndex	–	Entrenchment Index, corporate governance measure of how many entrenchment provisions a company employs
GIndex	–	Governance Index, corporate governance measure of how provisions limit shareholder rights
Size	–	measured using the natural log of the total assets of a corporation.
ROA	–	measures the return on assets for the firm in the current year
Firm Age	–	number of years as a public company
Leverage	–	measured as a firm's total debt divided by its total assets.
Big 4	–	indicator variable of whether the company has a big four auditor
ROA	–	Return on Assets, measures as net income divided by total assets
Book-to-market	–	calculated as the book value of equity, excluding preferred shares, divided by the market value of the firm on the balance sheet date
Cash ETR	–	Cash Effective Tax Rate, calculated as the amount of tax paid in cash divided by the firm's net income

Board Size	–	measures the size of the board of directors
Independent Chair	–	indicator variable, with a value of one if the chairman of the board was independent from the CEO and zero otherwise
Female Directors	–	measures the percentage of directors on the board that are female
CEO Age	–	age of the chief executive officer on the proxy statement date
CEO Tenure	–	number of years as chief executive officer on the proxy statement date
Directors' (Average) Age	–	measures the average age of the board of directors
Directors' Tenure-	–	average number of years the directors have served on the board
Busyness	–	average number of other public directorships per board member
Politician on Board	–	Indicator variable if the firm had at least one politician on its board of directors
Add_politician	–	indicator value of one if a politician has been added to the board of directors, zero otherwise
Drop_politician	–	indicator value of one if a politician has been dropped from the board of directors, zero otherwise
ATT	–	Average Treatment Effect of adding a politician to the board of directors.
DistanceDC	–	measured as the natural logarithm of one plus the distance from a firm's headquarter to Washington D.C.