# Board Composition, Political Connections and Performance in State-Owned Enterprises

Anna Menozzi

Università del Piemonte Orientale, Universidad Carlos III de Madrid and HERMES

María Gutiérrez Urtiaga

Universidad Carlos III de Madrid

Davide Vannoni

Università di Torino, Ceris CNR and HERMES

Ceris CNR, Moncalieri, 14 giugno 2010

## Board of directors in state-owned enterprises (SOEs)

- Board of directors is a corporate governance instrument in charge of monitoring and advising the management, in both private and state-owned enterprises. Board composition (outsiders vs. insiders, independent vs. non independent) influences the shareholders value

- Actually, board of directors in SOEs may act as a kind of parliament representing the interests of various stakeholders, at worst having coordination problems, pursuing different objectives and short term political goals

- In SOEs, the absence of potential takeovers and the impossibility to go bankrupt might contribute to poor performance

- However, efforts to improve the corporate governance of SOEs have been weaker than in the private sector in the last two decades and board composition has received little attention in the context of SOEs

# Italian public utilities in 1994-2004

- During the period 1994-2004, a deep transformation of the institutional and industrial environment took place in the traditionally state-dominated sectors, in Italy as well as in many OECD countries

- The legislative changes implied the progressive separation of public welfare and policy functions from the commercial ones, the introduction of competition in the retail segment and the regulation of the access to the market segments requiring significant investments by means of auctions

- Italian public utilities have been undertaking a transformation of their juridical form from "Azienda Municipalizzata", to (sometimes) "Azienda Speciale", to the limited company form with a proper board of directors, in which both public and private entities can invest (*corporatization*). This transformation is expected to improve the productive efficiency of public utilities

- Even if in the limited company form, most Italian public utilities are still state-owned and politicians dominate the board of directors

## Research questions

- Do board size and composition matter in firms with concentrated ownership in the hands of the State?
- For such firms, what is the impact of board characteristics and particularly of politicians directors, on profitability and labour demand?
- What is the role of independent directors?

Research questions
**Literature review**
Empirical evidence
Conclusions

**Board size and composition**
Politically connected directors

# Determinants and consequences of board size and composition

- Board size and profits are endogenously determined (Harris and Raviv, 2008).
  Too many outsiders could harm firm value (Raheja, 2005; Harris and Raviv, 2008)

- Board structure depends on the costs and benefits of the board's monitoring and advising roles (Link et al., 2008).
  After IPOs, board structure is tailored on the firm's specific competitive environment (Boone et al., 2007)

- Board size negatively affects performance (Yermack, 1996)

- U-shaped relationship between board size and performance: complex firms require a larger number of directors and of outsiders than simple firms, R&D intensive firms should prefer inside directors (Coles et al., 2008)

- The presence of inside directors in committees positively affects performance (Klein, 1998)

Research questions
**Literature review**
Empirical evidence
Conclusions

Board size and composition
**Politically connected directors**

## Politicians and performance

- If boards expand for political reasons, too many outsiders may enter the board and harm firm value (Agrawal and Knoeber, 2001)

- Firm value increases after a top officer enters politics (Faccio, 2006). Politically connected firms show better market performance (Goldman et al., 2009; Niessen and Ruenzi, 2009)

- Politically connected CEOs distort the firm labor demand for political reasons and finally damage the firm economic performance (Bertrand et al., 2004).
  Newly privatized firms still politically connected under-perform unconnected peers (Boubakri et al., 2008; Fan et al., 2007)

Research questions
Literature review
**Empirical evidence**
Conclusions

Data set
Board of directors and labor demand
Board of directors and profitability

## Definition of board composition

- Independent vs. not independent directors
    - Codice di Autodisciplina (Italian Stock Exchange, 2006): "A suitable number of directors are independent, that is directors who do not have at the moment or have recently had with the firm or with any subject related to the firm any direct or indirect relationship potentially influential on their autonomy"

- Outsiders vs. insiders
    - Outside directors are board members who are not current employees of the firms

- Politically-connected directors: directors with a political charge in the Municipal, Provincial or Regional governments, directors affiliated to a political party or whose connection is well-documented

Research questions
Literature review
**Empirical evidence**
Conclusions

**Data set**
Board of directors and labor demand
Board of directors and profitability

## Data set

- Unique, hand-collected data set including economic, technical and governance variables of 114 Italian public utilities in the gas, water, electricity production, distribution and sale, surveyed annually in 1994-2004 $\Rightarrow$ unbalanced panel of 838 firm-year observations and 1630 board directors

- Accounting data at the end of fiscal year. Original database Ceris-CNR and Hermes (Moncalieri, Italy). Primary sources: paper balance sheets, AIDA and Osiris

- The newly collected data on governance include the juridical form, the biggest three shareholders' identity, the percentage of equity they own, the directors' name, charge, profile: insider, independent and politician. Sources for the data on governance: balance sheets, interviews, firm and Parliament's websites, Internet

Research questions
Literature review
**Empirical evidence**
Conclusions

Data set
Board of directors and labor demand
Board of directors and profitability

# Descriptive statistics: performance and board composition

| Variable | Obs. | 25% | 50% | 75% | Mean | St. Dev |
|----------|------|-----|-----|-----|------|---------|
| *ROA* | 838 | 0.013 | 0.033 | 0.056 | 0.037 | 0.037 |
| *ROE* | 838 | 0.007 | 0.037 | 0.091 | 0.067 | 0.120 |
| *ROI* | 838 | 0.021 | 0.050 | 0.090 | 0.069 | 0.098 |
| *Assets* ($'000$ *euro*) | 838 | 23,024 | 63,228 | 179,306 | 212,623 | 476,818 |
| *Sales* ($'000$ *euro*) | 838 | 11,625 | 27,571 | 85,907 | 96,910 | 221,688 |
| *n* | 838 | 54 | 168 | 413 | 505.7 | 1,294.3 |
| *Board* | 821 | 5 | 7 | 7 | 6.14 | 2.48 |
| *Polit* | 821 | 4 | 5 | 7 | 5.58 | 2.49 |
| *Indep* | 821 | 0 | 0 | 2 | 1.42 | 2.10 |
| *Out* | 821 | 4 | 6 | 6 | 5.13 | 2.64 |

Research questions
Literature review
**Empirical evidence**
Conclusions

Data set
Board of directors and labor demand
Board of directors and profitability

# Descriptive statistics: shareholders, juridical form and sectors

| Variable | Obs. | Mean |
|:---:|:---:|:---:|
| *Publock* | 19 | 0.023 |
| *Lblock* | 662 | 0.790 |
| *Prblock* | 157 | 0.187 |
| *Azmun* | 178 | 0.212 |
| *Azspec* | 221 | 0.264 |
| *Corp* | 439 | 0.524 |
| *Gas* | 139 | 0.166 |
| *Water* | 183 | 0.218 |
| *Electricity* | 58 | 0.069 |
| *Multiutilities* | 458 | 0.547 |

Research questions
Literature review
**Empirical evidence**
Conclusions

Data set
Board of directors and labor demand
Board of directors and profitability

## Correlation matrix for board composition

|  | Board | Polit | Indep | Out | %Polit | %Indep | %Out |
|---|---|---|---|---|---|---|---|
| Board | 1 |  |  |  |  |  |  |
| Polit | 0.915*** | 1 |  |  |  |  |  |
| Indep | 0.396*** | 0.270*** | 1 |  |  |  |  |
| Out | 0.970*** | 0.913*** | 0.364*** | 1 |  |  |  |
| %Polit | -0.048 | 0.338*** | -0.203*** | -0.002 | 1 |  |  |
| %Indep | 0.198*** | 0.088** | 0.917*** | 0.189*** | -0.215*** | 1 |  |
| %Out | 0.623*** | 0.591*** | 0.208*** | 0.716*** | -0.048 | 0.213*** | 1 |

Pearson correlations: *** Significant at 1%; ** Significant at 5%; * Significant at 10%

Research questions
Literature review
**Empirical evidence**
Conclusions

Data set
Board of directors and labor demand
Board of directors and profitability

# Correlation matrix for board composition and firm performance

|        | ROA        | ROE        | ROI         | Assets      | n           |
|--------|------------|------------|-------------|-------------|-------------|
| Board  | 0.008      | -0.026     | -0.079**    | 0.134***    | 0.115***    |
| Polit  | -0.065*    | -0.057     | -0.155***   | 0.068*      | 0.051       |
| Indep  | 0.039      | -0.062*    | -0.022      | 0.305***    | 0.259***    |
| Out    | -0.042     | -0.035     | -0.116***   | 0.154***    | 0.134***    |
| %Polit | -0.214***  | -0.149***  | -0.292***   | -0.115***   | -0.126***   |
| %Indep | 0.018      | -0.055     | -0.035      | 0.275***    | 0.241***    |
| %Out   | -0.025     | 0.027      | -0.078**    | 0.113***    | 0.104***    |

Pearson correlations: *** Significant at 1%; ** Significant at 5%; * Significant at 10%

Research questions
Literature review
**Empirical evidence**
Conclusions

Data set
Board of directors and labor demand
Board of directors and profitability

## Firm-level employment and board of directors

- In firms controlled by a political body holding effective control, as in Italian public utilities, employment might expand for political reasons (Shleifer and Vishny, 1994).
  In profit-maximizing firm, independent directors would be expected to contrast those expansions of employment that are pursued at the expense of profitability

- Question 1: how does board size affect labour demand?

- Question 2: how do politicians affect labour demand, given that they have a word in deciding a public utility's employment?

Research questions
Literature review
**Empirical evidence**
Conclusions

Data set
**Board of directors and labor demand**
Board of directors and profitability

## Firm-level employment, board size and composition

- We estimate the dynamic panel model (with the GMM-sys estimators):

$$n_{it} = \alpha_1 n_{it-1} + \beta_1 w_{it} + \beta_2 w_{it-1} + \beta_3 k_{it} + \beta_4 k_{it-1} + \beta_5 X_{it} + \lambda_t + \eta_i + \upsilon_{it}$$

  - $n_{i.}$ is the logarithm of employment of firm $i$ at the end of the corresponding year; $w_{it}$ is the logarithm of average wage; $k_{it}$ is the logarithm of firm gross capital; $X_{it}$ is a set of governance variable such as $board_{it}$, $polit_{it}$, $indep_{it}$, $out_{it}$, $\%polit_{it}$, $\%indep_{it}$, $\%out_{it}$; $\lambda_t$ is a time effect common to all firms; $\eta_i$ is a permanent but non-observable firm specific effect; $\upsilon_{it}$ is the error term

Research questions
Literature review
**Empirical evidence**
Conclusions

Data set
Board of directors and labor demand
Board of directors and profitability

# Firm-level employment, board size and composition

| | Dependent variable: $n_{it}$ | | | |
|---|---|---|---|---|
| $board_{it}$ | 0.030**<br>(0.014) | | | 0.030**<br>(0.014) |
| $polit_{it}$ | | 0.027**<br>(0.011) | | |
| $\%polit_{it}$ | | | 0.211<br>(0.241) | 0.146<br>(0.253) |
| $\%indep_{it}$ | | | -0.133<br>(0.171) | -0.162<br>(0.154) |
| $\%out_{it}$ | | | -0.019<br>(0.221) | -0.260<br>(0.252) |

*** Significant at 1%; ** Significant at 5%; * Significant at 10%. Standard errors in parentheses.

Sample period: 1994-2004. Number of firms: 111. Time dummies included. Observations: 699

Research questions
Literature review
**Empirical evidence**
Conclusions

Data set
Board of directors and labor demand
**Board of directors and profitability**

## Governance e profitability

- The progressive corporatization of public utilities has put the bases for their strategic independence and their autonomy in the expenses plans and financing capacity.
  Expected profitability of state-controlled firms is crucial in order to stimulate private investors to be part of the ownership structure

- Question: do board dimension and composition affect firm value in the Italian local public utilities?

- We estimate the following static panel (with the GMM-sys estimators):

$$y_{it} = \beta_G \, G_{it} + \beta_X X_{it} + \lambda_t + \eta_i + \upsilon_{it}$$

- $y_{it}$ is *ROE* or *ROI*; $G_{it}$ is a vector of governance variables, like the juridical form, board dimension or composition; $X_{it}$ is a vector of control variables, like sector or firm dimension (*small$_{it}$*, *medium$_{it}$*); $\lambda_t$ is a time invariant variable; $\eta_i$ is a permanent but non-observable firm specific effect; $\upsilon_{it}$ is the error term

Research questions
Literature review
**Empirical evidence**
Conclusions

Data set
Board of directors and labor demand
**Board of directors and profitability**

# Board dimension and economic performance

|  | Dependent variable: ROI | | Dependent variable: ROE | |
|---|---|---|---|---|
| $board_{it}$ | -0.006** | -0.004** | -0.006** | -0.007** |
|  | (0.003) | (0.002) | (0.003) | (0.003) |
| $small_{it}$ |  | 0.035** |  | 0.026 |
|  |  | (0.016) |  | (0.017) |
| $medium_{it}$ |  | -0.002 |  | -0.015 |
|  |  | (0.008) |  | (0.011) |
| $water_{it}$ | -0.028 | -0.024 | -0.044*** | -0.045*** |
|  | (0.017) | (0.016) | (0.012) | (0.014) |
| $gas_{it}$ | 0.054* | 0.049* | 0.038 | -0.029 |
|  | (0.029) | (0.029) | (0.035) | (0.031) |
| $electr_{it}$ | -0.007** | -0.013 | 0.004 | -0.001 |
|  | (0.016) | (0.016) | (0.021) | (0.023) |

*** Significant at 1%; ** Significant at 5%; * Significant at 10%. St. err. in parentheses. Sample

period: 1994-2004. Number of firms: 113. Time dummies and constant included. Observations: 821

Research questions
Literature review
**Empirical evidence**
Conclusions

Data set
Board of directors and labor demand
**Board of directors and profitability**

# Performance, juridical form and blockholders

|  | Dependent variable: *ROI* | | |
|---|---|---|---|
| *board$_{it}$* | -0.006* | -0.003 | -0.003 |
|  | (0.004) | (0.002) | (0.003) |
| *Azmun$_{it}$* | -0.037* |  | -0.014 |
|  | (0.020) |  | (0.012) |
| *Azspec$_{it}$* | -0.045*** |  | -0.021*** |
|  | (0.015) |  | (0.008) |
| *Publock$_{it}$* |  | -0.069* | -0.068* |
|  |  | (0.041) | (0.039) |
| *Lblock$_{it}$* |  | -0.067*** | -0.059*** |
|  |  | (0.017) | (0.017) |

**\*\*\* Significant at 1%; \*\* Significant at 5%; \* Significant at 10%. St. err. in parentheses. Sample**

**period: 1994-2004. Number of firms: 113. Time dummies and constant included. Observations: 821**

Research questions
Literature review
**Empirical evidence**
Conclusions

Data set
Board of directors and labor demand
Board of directors and profitability

# Performance, board size and composition

| | Dependent variable: *ROI* | | | |
|---|---|---|---|---|
| $board_{it}$ | -0.004** | | | 0.000 |
| | (0.0032) | | | (0.002) |
| $polit_{it}$ | | -0.008* | | |
| | | (0.004) | | |
| $\%polit_{it}$ | | | -0.067* | -0.094** |
| | | | (0.038) | (0.046) |
| $\%indep_{it}$ | | | -0.050 | -0.043 |
| | | | (0.031) | (0.028) |
| $\%out_{it}$ | | | -0.006 | -0.074 |
| | | | (0.035) | (0.064) |

*** Significant at 1%; ** Significant at 5%; * Significant at 10%. St. err. in parentheses. Sample

period: 1994-2004. Number of firms: 113. Time dummies and constant included. Observations: 821

# Board of directors in the Italian public utilities

- Despite the evolution of the legal and industrial framework, Italian public utilities are still controlled by state entities and their boards dominated by politicians

- Board size and composition matter even in state-owned firms with concentrated ownership and public blockholders

- In Italian SOEs, board size and the presence of politically connected directors have an inflationary effects on employment

- Board size is more important than composition in increasing the labour demand, while the number and the proportion of politicians is more important than size in reducing the economic performance of Italian SOEs

- Independent directors might hide an indirect affiliation to politicians or share the same objectives

## Policy implications

- Favouring strong political connection in local public utilities can annihilate the positive effects that the reforms of the sector (corporatization processes and the introduction of competitive elements) are expected to bring.
  This is in line with the regulation recently imposed to most Italian local public utilities to ban mayors and members of municipal bodies from the management of regulated firms

- A large number of directors might indicate the presence of several stakeholders with a potential interest in increasing employment or pursuing strategies that could harm the firm profitability.
  The limits recently imposed by the Italian Budget Law (Law 27/12/2006, n. 296) to the total number of directors of state firms or to the number of directors eligible by the local municipality may be consistent with this view