POLITICAL CONNECTIONS OF NEWLY PRIVATIZED FIRMS *

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ABSTRACT

We investigate the extent of political connections in newly privatized firms. Using a sample of 245 privatized firms headquartered in 27 developing and 14 developed countries over the period 1980 to 2002, we find that 87 firms have a politician or an ex-politician on their board of directors. Politically-connected firms are generally incorporated in major cities, are highly leveraged, and operate in regulated sectors. The likelihood of observing political connections in these firms is positively related to government residual ownership, and negatively related to foreign ownership. Political fractionalization and tenure, as well as judicial independence are also key explanatory variables. Finally, politically-connected firms exhibit a poor accounting performance compared to their non-connected counterparts.

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* We appreciate the helpful comments and suggestions offered by Neil Brisley, Mara Faccio, Aleksandra Gregoriç, and Omrane Guedhami. We also received valuable comments from the participants at the 2006 Northern Finance Association Meeting in Montréal and at the Workshop on the Politics of Corporate Governance in Copenhagen (September 29-30, 2006). We are indebted to Mouafek Abada and Sébastien Trottier for excellent research assistance. All errors remain our responsibility. We gratefully acknowledge the financial support of the Social Sciences and Humanities Research Council of Canada, le Fonds Québécois de la Recherche sur la Société et la Culture, and le Centre de Recherche en e-Finance (HEC Montréal).

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1. Introduction

Privatization programs launched in developed and developing countries over the last two decades have transformed the structure of corporate ownership around the world, transferring a large bulk of assets, previously under government control and ownership, to the private sector. However, anecdotal evidence suggests that control is often not relinquished even though ownership is. In fact, governments often maintain their control over the newly privatized firms through political connections, namely through appointed politicians or bureaucrats in key positions within the firms. French privatization programs provide an interesting example of this phenomenon. Most privatizations were implemented via initial public offerings to favour popular capitalism and avoid the possibility that a controlling owner (shareholder) would emerge. Loyal bureaucrats, linked to the government, were simultaneously appointed chief executive officers of the newly privatized firms, allowing them to be involved in the decision making of these firms. Furthermore, a network of cross shareholdings and cross directorships (the "noyaux durs" or hard cores) were set up between privatized manufacturing firms, banks, and insurance companies to protect these firms from possible takeover threats (Bertrand et al., 2006).

In this paper, we provide a worldwide description of political connections in newly privatized firms, a crucial aspect of postprivatization corporate governance. We focus on the particular case of newly privatized firms because, in the spirit of privatization, we would expect governments to reduce their interference in the firms' policies. Indeed, the switch from government to private ownership is intended to eliminate the political objectives of state-owned firms (considered in the literature as the main reason for state-owned enterprises' inefficiency), and to induce a change towards profit maximization by new private owners. If newly privatized firms are not completely independent from

government influence (i.e., state ownership and control are not completely relinquished), then firms will face conflicting objectives: political benefits of control by bureaucrats and politicians on the one hand, and private benefits of control by new private owners on the other. Hence, we expect that politically-connected privatized firms will reduce the expected benefits of the reform (i.e., change in incentives, increased monitoring of management, improved performance, etc.). Nothing other than immediate ownership would then change, and privatizations could be viewed as purely *cosmetic*. Such behaviour is at odds with the primary objectives of privatization.

These observations raise the following questions: how pervasive are political ties in the privatization context? In which countries and in which firms are we more likely to observe political connections? How do political ties affect performance? Where do politically-connected firms stand performance-wise in comparison to their non-connected newly privatized counterparts?

To determine the presence of political connections in newly privatized firms, we examine the composition of their respective board of directors and supervisory board (when they exist), and we trace the political background of these directors. Our results are as follows: we find that 87newly privatized firms out of 245 have a politician or an ex-politician on their boards. In other words, 35.51% of our sample firms (are) remain politically-connected after privatization. We show that residual government ownership and the presence of foreign investors are key determinants of the likelihood of observing politically-connected boards in newly privatized firms. We also bring to light some common characteristics of politically-connected firms. For instance, they are located in major cities, are highly-leveraged firms, and operate in regulated sectors. Political and judicial variables also determine political ties. For example, a government that faces higher political fractionalization and that has been in office for only few years is more likely to have (maintain) politicians on the boards of privatized firms. Political connections seem also to be more prevalent in countries with lower judicial independence. When we assess the impact of political ties on performance, we find that

politically-connected firms exhibit a poor accounting performance compared to their non-connected counterparts. Our results are robust to the use of an alternative measure for political connections that is, the percentage of members of the board of directors that are politically-connected.

Our paper contributes to the recent empirical literature on the politics of privatization. Dinç and Gupta (2006), for example, focus on the impact of political competition and patronage on privatization decisions in India. They find that the government, concerned with political goals, is reluctant to privatize firms located in regions where the ruling party faces political competition. They also show that politicians in charge of government-owned enterprises do not privatize those firms that are located in their home state. Our study complements this evidence by providing additional support for the hypothesis that privatization is indeed related to political variables.

We also complement a recent study by Bortolotti and Faccio (2006) who document a "reluctant privatization" in OECD countries. That is, governments do not relinquish complete control after privatization and either remain the largest shareholders of the firm, or use special powers (specifically, golden shares). Our study adds to this literature by focusing on political appointments as an alternative mechanism that allows governments to maintain control and interfere in the management of previously state-owned firms. In fact, we are able to show that reluctant privatization is not only prevalent in OECD countries, but in other parts of the world as well, where it involves a different mechanism of retained control. Indeed, while golden shares constitute a frequent device by which governments in OECD countries retain control of newly privatized firms (Bortolotti and Faccio, 2006), keeping the firms politically tied appears to be an equally important mechanism that allows governments around the world to control former state-owned firms.

Our paper also adds to the literature on corporate governance, and more specifically on postprivatization corporate governance. For example, using a multinational sample of 209 privatized

firms, Boubakri et al. (2005) show that the average government stake decreases substantially after privatization, and that most governments generally relinquish control over time (after a few years). By investigating whether newly privatized firms remain politically-connected through their boards despite ownership divestiture by the state, we can determine whether privatization was able to eliminate political interference and government control. This issue has an important implication with respect to the incentive structure and objectives of the newly privatized firms.

A recent study by Fan et al. (2006) finds indeed that Chinese newly privatized firms whose CEOs are ex- or current government bureaucrats are associated with poorer accounting and stock price performance. However, as the authors themselves acknowledge, their evidence is specific to a single country and could depend on the country's particular conditions. Our study seeks to provide some additional, more general insights on the determinants and impact of political ties in newly privatized firms around the world by using a multinational sample of 245 firms privatized in 27 developing countries and 14 industrialized countries. The use of a multinational sample offers several advantages: first, it allows us to control for cross-country variations in legal systems and extent of law enforcement (La Porta et al., 1998), which are likely to influence the presence of political connections at the corporate level. Second, a multinational sample allows us to account for the cross-country variation in the level of corruption, which is closely related to political connections (Faccio, 2006a). Finally, while a single-country study is also informative, it only allows researchers to control for firm level determinants of political ties. The use of a multinational sample adds to this evidence by incorporating additional variables that are related to the country environment, specifically political, institutional, and economic potential determinants of the likelihood of observing political ties in newly privatized firms.

The remainder of the paper is organized as follows: section 2 reviews the literature and develops our hypotheses. Section 3 defines and describes the phenomenon of political connection. Section 4

presents the respective samples of newly privatized and politically-connected firms. Section 5 investigates the determinants of political connection while section 6 links political connection to performance. The last section summarizes our findings and discusses some policy implications.

2. Literature and hypotheses

According to Boycko et al. (1996), state-owned enterprises (SOEs) are inefficient because they address the objectives of politicians rather than profit maximization. For instance, one key objective of politicians is to maintain political support through employment policies; they care about the votes of those whose jobs are in danger, and seek to satisfy labor unions which are often considered as having a significant influence on political parties. Similarly, SOEs are also frequently asked to locate their production in politically desirable rather than economically attractive regions.[1] Other illustrations of political influence are provided by Dinç (2005) who shows that government-owned banks increase their lending in election years relative to private banks in emerging markets and Bertrand et al. (2006) who find that firms managed by connected CEOs in France create more jobs in politically more contested areas.

Shleifer and Vishny (1998) state that the "grabbing hand" of governments on the former SOEs must be minimized for privatization to succeed. Specifically, they argue that the design of privatization should restrict the future influence that the state exerts on privatized firms through subsidies, regulations, and minority ownership.[2] Privatization is thus effective if it controls political

[1] Shleifer and Vishny (1994) provide examples of Italian firms that are told to build production facilities in the South where the ruling Christian Democrats have the most support. They also provide examples from France where Renault and Airbus chose locations that pleased politicians rather than locations that minimized costs.

[2] Along the same line of thought, Boycko et al. (1996) argue that managerial discretion problems are generally small compared to political discretion problems.

discretion, or put differently, if it draws a line between politicians and firms, and drives a wedge between politicians and managers. As a result, privatization should depoliticize firms and lead to their restructuring. For this to happen, privatization must involve two changes: (1) the turnover of control from spending politicians to managers (whereby the power of bureaucracy to protect its control rights diminishes), and (2) a reduction of the government cash flow ownership that is compensated by an increase of control ownership in the hands of outside shareholders.

Under the reasonable assumption that it is difficult for incumbent managers/politicians to abandon the policies that they previously employed in SOEs, appointing new skilled managers and directors that are more suitable to the postprivatization environment is the easiest and the most effective way to break the old corporate governance (Barberis et al. 1996). These changes, argue the authors, take less time than equity incentives to improve the performance of firms and may matter more than incentives.[3] In the same vein, Cuervo and Villalonga (2000), who investigate the cross-firm variance in the performance effects of privatization, state that newly privatized firms (NPFs) exhibit a greater increase in their performance when boards are effective in exercising control.

In light of this discussion, we can draw up the following main testable hypothesis:

H1*: P**rivatization is accompanied by a removal of political connections in NPFs.*

If H1 is rejected, we can conclude that privatization fails to draw a line between politicians and firms, and as a consequence, NPFs remain politically-connected and subject to government interference and political discretion problems.

[3] Cragg and Dyck (1999) report empirical evidence from the UK that turnover of top managers, both immediately and after privatization, was significantly high. They conclude that human capital replacement is an important process in privatization because it brings new resources and new ideas. In contrast, such turnover is not observed in SOEs because, according to the authors, either monitoring is less important in SOEs compared to private firms, or SOEs pursue many objectives at the same time, such as maximizing social welfare and political support.

Several existing studies suggest that political connections are advantageous to private firms. For instance, Dinç (2005), Cull and Xu (2005), and Khwaja and Mian (2005) show that politically-connected private firms benefit from a preferential access to credit, while Faccio et al. (2006) show that, whenever needed, they can also count on the government to bail them out. In the same vein, Faccio (2006a) reports that firm value is enhanced when managers assume top political positions, and Faccio (2006b) documents higher leverage, larger market shares, and lower tax rates for politically-connected versus non-connected firms. Single-country studies also find that political connections are related to firm value (Fisman, 2001; Ramalho, 2003; Ferguson and Voth, 2006).

However, in the specific context of "reluctant privatization," we consider political connections to mitigate postprivatization performance improvements since the postprivatization incentive structure remains oriented towards political goals, which conflicts with the new shareholders' objective of profit maximization. Therefore, we expect political connections in the context of privatization to be detrimental, rather than beneficial, to firm performance, as in the case of privately-held firms. In this latter case, political connections allow private shareholders to extract *private benefits* and maximize value, whereas in NPFs, political connections help the government and affiliated politicians to extract *political benefits* at the expense of wealth maximization for the benefit of other stakeholders in the firm. Our conjecture is echoed by arguments in Cuervo and Villalonga (2000) that the replacement of preprivatization managers is called for in order to allow internal changes in the governance of NPFs. To the extent that these managers might have the wrong entrepreneurial skills, namely being better at dealing with politicians rather than effectively facing competitive market conditions, postprivatization performance improvements may not be achieved. Barberis et al. (1996) make a case for this conjecture. They specifically state (page 765):

> "Privatization works in so far as it selects owners and managers who are better at running firms efficiently. Managers of state firms are selected for their ability to get

along with politicians, address political concerns, and lobby for assistance. In contrast, managers of privatized firms are selected for their ability to run them efficiently."

Hence, management skills rather than political acceptability become the main requirements for privatization to work. We can thus draw an additional hypothesis about the impact of political connections on firm performance: if the government retains control rights, or if boards are politically-connected, privatization will not create the necessary incentives to maximize the shareholders' wealth and improve overall firm performance. Consequently, we formulate H2 as follows:

H2: I*f NPFs are politically-connected, we expect them to perform more poorly than non-connected firms.*

3. Political connections of privatized firms

3.1. Definition of political connections

We consider that a company is politically-connected if at least one member of its board of directors[4] (BOD) or its supervisory board is or was a politician, that is, a member of parliament, a minister or any other top appointed-bureaucrat. We track politicians on the board of NPFs over a period of three years after the privatization date.

The definition of political connection in this paper takes into account the standard definitions used in the literature. For example, according to Faccio (2006a), a firm is politically-connected if at least one of the firm's largest shareholders or one of its top officers is a member of parliament, a minister, a head of state or closely related to a top official. Fan et al. (2006) define a Chinese firm as

[4] In general, the chairman of the board is also the CEO. Thus, we also include the CEO to identify the political connections.

being politically-connected if the CEO is a current or former officer of the central government, local government, or the military. Bertrand et al. (2006) consider a firm as politically-connected in France if its CEO attended elite schools ("Grandes Écoles": École Nationale d'Administration and École Polytechnique) and was employed as a civil servant or had a government position. Ferguson and Voth (2006) consider firms to be politically-connected if the executives and supervisory board members were close to the ruling party in the early 1930s in Germany. Our definition of political connection covers *current* and *former* politicians based on the argument that politicians are able to extract rents even when they are not directly in power. Recent single-country studies suggest that this is indeed the case. For example, Khwaja and Mian (2005) bring to light the role of ex-politicians in providing government bank loans to politically-connected Pakistani firms. Likewise, Agrawal and Knoeber (2001) show that politically-experienced directors (i.e., with prior employment in government or a political party) are more prevalent in U.S. manufacturing firms for which politics (through, for example, government purchases, trade policy, and environmental regulation) might affect their performance. Generally, the largest shareholders of privatized firms also sit on the BOD. Hence, our definition also takes into account the largest shareholders to identify cases of political connection as in Faccio (2006a).

Based on this definition, we are able to identify 87 politically-connected firms out of our sample of 245 NPFs. They therefore account for 35.51% of our sample. This evidence complements the several cases of political connection in OECD privatized firms, highlighted in Bortolotti and Faccio (2006).

3.2. Examples of political connections in NPFs

This section describes the involvement of politicians in some of the NPFs from our sample. Note that these cases come from developing and industrialized countries from around the globe.

In Europe and Central Asia, specifically in France, we note that Jean-Dominque Comelli, Chairman of the BOD and CEO of "*Seita,*" a tobacco manufacturer that was privatized in 1995 by the Balladur government, was previously the chief of staff of Pierre Bérégovoy, the Prime Minister of the socialist government under François Mitterand from 1992 to 1993. Likewise, "*Renault,*" a leading car manufacturer in France and privatized in 1994 by the same government, was headed by Louis Schweitzer, chairman of the BOD and CEO, who was an "Ecole Nationale d'Administration'' graduate, and an ex-chief of staff of the socialist Prime Minister Laurent Fabius from 1984 to 1986. In Finland, in 2001, eleven of the sixteen members of the supervisory board of the company "*Fortum,*" which was privatized in late 1998, are members of the parliament. In Turkey, the Republican People's Party (CHP) owns 28% of the shares of Isbank, which was privatized in 1998. The BOD of "*Isbank*" includes four politicians from the CHP.[5]

In Latin America, we find evidence of many political appointments in NPFs. In Chile, for example, high military officers dominate the BOD of the telecommunication company "*Entel,*" privatized in 1986. Jorge Cauas Lama, an ex-minister, also appears as a director. "*CTC,*" a telecommunication company, privatized in 1986, appoints Sergio Badiola Broberg, a brigadier general and a minister during Pinochet's presidency, as chairman of the BOD. In Brazil, we find that Djalma Bastos de Morais, the chairman of the BOD and CEO of "*CEMIG*", an energy company privatized in 1997, was a state minister of communications a few years before. Still in Brazil, we note that ex-ministers and top bureaucrats served as directors during the three years following the share issue privatization (SIP) of "*Petrobras,*" a large petroleum company privatized in 1997.[6]

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[5] For a description of the Isbank experience, see: http://www.turkpulse.com/economy3.htm.

[6] Ramalho (2003) studies the effects of the 1992 presidential impeachment in Brazil on politically-connected firms. These firms gained value from their connection, obtaining preferential loans and government contracts.

In Africa, we note that, in the case of Nigeria, higher bureaucrats from the Ministry of Justice are appointed directors of "*The United Nigeria Life Insurance Company PLC,"* which was privatized in 1989. Likewise, influent politicians from the All Nigeria People Party are appointed members of the BOD of "*Unipetrol,"* a leading petroleum company which was privatized in 1991.

In East Asia, "*Thai Airways,"* privatized in 1992, appoints as Vice-Chairman of the BOD, Siripong Thongyai, a commander in chief of the Royal Thai Air Force in 1993-1994. Other directors are top bureaucrats in different Thai ministries.[7] This appointment stems from the influence of the army in government decision-making over this period.[8] In the Philippines, we note that in 1991 President Corazon C. Aquino, appointed her ex-Presidential Legal Counsel, Press Secretary and Presidential Spokesman, Adolfo S. Azcuna, as a chairman of the BOD of one of the largest banks in the country, "*Philippine National Bank,"* which was privatized in 1989.

In the Arab world, we find that Saleh Rusheidat and Suleiman Hafez, the two successive Chairmen of the BOD (for the three years following the privatization) of "*Arab Potash Company"* (privatized in 1997) are ex-ministers in several Jordanian governments. The same BOD also includes a current Jordanian minister, an ex-minister, and top bureaucrats from different ministries.

These examples show that political connections of NPFs are not geographically clustered. They also bring to light the fact that, although the literature has widely documented that privatization in developing countries (DCs) has a dynamic of its own compared to the experience of industrialized

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[7] Several studies focus on political connections in Thailand. Bunkanwanicha and Wiwattanakantang (2006) examine the market valuation of political connections, following the appointment of the Thai Prime Minister Thaksin Shinawatra in 2001. Charumilind et al. (2006) study connected lending in Thailand before the financial crisis.

[8] The link, http://www.asiaweek.com/asiaweek/96/0830/biz1.html, gives more details of the privatization of Thai Airways, describes the Thai environment during the mid-1990s, and shows the involvement of the military in the governance of the airline company.

countries (ICs), political connections in the context of privatization are a common feature in most countries, regardless of their level of development. The extent to which this is true and the conditions in which political ties occur in NPFs are questions that we intend to address further in the paper. We shall first, however, provide a detailed description of our sample.

4. Data and descriptive statistics

4.1. The sample

We obtain the list of privatized firms from several sources such as the *World Bank* privatization database for DCs, the *Privatization Barometer* for OECD countries, and Megginson's (2003) list of privatized firms in developed and developing countries. For every privatized firm, we collect ownership structure from several data sources including annual reports, Asian, Brazilian, and Mexican Company Handbooks, the Guide to Asian Companies, and Kompass Egypt Financial Year Book. We draw financial information from the firms' financial statements, their web sites, and from databases such as *Moody's International*, *Mergent Online*, *Worldscope Disclosure*, and *Bankscope*. Using these sources, we gather financial data and ownership structure of 273 privatized firms.[9] For every privatized firm, we collect data on BOD members, using the sources mentioned above. For some firms, especially Scandinavian and Germanic firms, we also have the composition of the supervisory board which manages the firm with the BOD.[10] We lose 28 firms for which we cannot trace information about BOD composition. Many companies in our sample describe the experience profile of their directors in their annual reports or in their prospectus. For some companies, we

[9] We generally lose observations because of unavailable data on firm ownership structure in developing countries, or because companies privatized in the 1980s no longer have these data.

[10] Members of the supervisory board are elected during the annual shareholders' general meeting. The supervisory board elects the chairman/chairwoman and the members of the BOD.

compile the name of the members of the BOD and we search for their background data from other sources like *Lexis-Nexis, Who's Who*, *Forbes*, *Fortune*, company, government, and parliament websites, and the Internet. In addition, we crosschecked our sample of privatized firms with Faccio's (2006a) list of politically-connected firms around the world.

We are finally able to collect data on boards and board members for 245 firms privatized in 14 ICs and 27 DCs, over the period 1980 to 2002. Our sample does not include privatized companies in the ex-communist countries for at least three reasons. First, the process of privatization in these countries takes place in a context of major institutional and political changes. Thus, the traditional law system in these countries is based on the Soviet law which has undergone many changes during the transition period (La Porta et al., 2000). Second, these countries have generally conducted mass privatizations which involve the distribution of vouchers to the population for free or a nominal fee. Third and foremost, the postprivatization ownership structure in these countries is mainly in the hands of insiders (managers and employees). Consequently, privatization programs generally do not shift control from incumbent managers, and privatized firms remain politically-connected (Boycko et al., 1994).

Table 1 provides some descriptive statistics on the 245 firms used in the study. The 245 firms are located in different geographical regions as categorized by the *World Bank*. For example, 28.57% come from Africa and the Middle East, 20.41% from East and South Asia and the Pacific, 22.04% from Latin America and the Caribbean, and 28.98% from Europe and Central Asia. This geographical diversification is important because it involves countries with different development levels and legal, political, and institutional environments. As reported in Table 1, our sample is also diversified across industries with 21.22% in the financial sector, 12.24% in the energy sector, and 10.20% in telecommunications. Furthermore, 85.71% of the privatization transactions occurred between 1990 and 2002, as compared to 14.29% in the 1980s. These figures are largely driven by

recent large-scale privatizations, especially in DCs.[11] A total of 70.20% of our privatized firms are headquartered in major cities (the two biggest cities in the country), and 29.80% are located in other cities.[12] Our sample includes 74.30% of firms privatized through SIPs, while 25.70% were privatized through private sales, including privatization through auctions. We also find that 27 out of 157 firms have outstanding golden shares. Golden shares are typically used in developed countries, although a few governments from the developing world also make use of this device, notably Malaysia. In unreported statistics, we find that 20 out of the 27 firms that use golden shares in our sample belong to NPFs in ICs. Finally, we find that golden shares are more likely in SIPs (73% of the cases).

Insert Table 1 about here

4.2. The phenomenon of political connections

Table 2 provides descriptive statistics on the subsample of 87 NPFs that are politically-connected.[13] Of the 61 firms operating in ICs, 26 are politically-connected (i.e., 42.62%), while 61 of the 184 firms operating in DCs, (i.e., 33.15%) are politically-connected. Most of the sample of

[11] In terms of percentages, the figures discussed in this text about our sample are close to those of the *World Bank* list of privatized firms. For example, the *World Bank* reports that 30.48% of the firms are from Africa and the Middle East, 17.08% from East and South Asia and the Pacific, 42.35% from Latin America, and 10.09% from Europe and Central Asia. 20.52% of the firms are from the financial sector, and 15.97% are utilities. We also note that 80% of the privatization transactions occurred in the nineties. Additionally, our sample of privatized firms from industrialized countries is largely drawn from Megginson's (2003) appendix and the *Privatization Barometer* database, which, to our knowledge, offer the most comprehensive record of privatization in these countries.

[12] We consider the firm's headquarter as its location.

[13] 42 NPFs are connected through the CEO/chairman or chairman, and the 45 remaining ones are connected through directors. 25 NPFs are connected through a minister, and 62 NPFs are connected through members of parliament or bureaucrats.

politically-connected firms is located in East and South Asia and Europe. Only 12.64% of our sample of politically-connected firms is in Africa and Middle East countries. A likely explanation for this lack of political connections in NPFs from this region is that firms privatized in these countries were mostly small in size. Of the 30 firms operating in the energy sector, 18 are politically-connected (i.e., 60%). The presence of politicians on the BOD of such firms is most likely explained by the importance of strategic sectors and their relative impact on the country's whole economy: for instance, the presence of politicians on the boards of petroleum companies ensures a relative stabilization of the market, and a quick reaction in times of crisis. Furthermore, strategic sectors are traditionally state monopolies (especially utilities) and the transfer to private ownership requires new regulations and extensive supervision. Hence, keeping the firm politically close by appointing politicians as directors may serve as a supervisory (monitoring) mechanism. Connected boards rule 44% (11/25) of the telecommunication firms in our sample. This strategic sector is also vital for the whole economy, and the government tries to maintain its influence in this sector that hires thousands of employees. We also find that 14 out of the 27 firms (i.e., 51%) that have outstanding golden shares are politically-connected. These numbers seem to suggest that some governments use both golden shares and political appointments to keep control of NPFs and serve political objectives.

In our sample, 81.61% of politically-connected firms are located in major cities where politicians are more likely to extract political support (votes), and almost one third of NPFs that went through SIPs (or private sales) are still run by politicians.

Insert Table 2 about here

Overall, these descriptive statistics confirm that NPFs remain politically-connected, in developed and developing countries alike, whatever the privatization method and time period. This evidence

suggests that governments are "reluctant" to privatize, and that privatization does not remove the political ties of former SOEs. Thus, we do not find support for H1.

5. The determinants of the political connections of NPFs

5.1. Ownership structure and characteristics of politically-connected NPFs

To examine the postprivatization ownership structure of firms run by connected boards, we calculate the average ownership fraction for the three years following the privatization date for five groups of investors: the government, local institutions, foreign investors, employees, and individuals.

Table 3 reports the postprivatization ownership structure of the entire sample, the politically-connected firms, and their non-connected counterparts. The average government-retained-ownership stake (over the three years following privatization) for politically-connected firms is 45.27% compared to 24.86% for their non-connected counterparts.[14] This difference is statistically significant (at the 1% level). Thus, on average, governments retain control through significant ownership shares and political ties. In other words, government ownership divestiture is not accompanied by the elimination of political connections. In contrast, the average foreign investors' ownership stake for politically-connected firms is 9.05%, while it amounts to 19.37% for the non-

[14] These numbers reflect direct state ownership. For a subsample of 81 NPFs for which we are able to collect ultimate state ownership as defined by La Porta et al. (1999), Claessens et al. (2000), and Faccio and Lang (2002), we find that the ultimate state ownership for politically-connected NPFs is 53.51% compared to 31.35% for their non-connected counterpart. This difference is statistically significant at the 1% level. The direct state ownership for the same subsample of firms is 46.04% for politically-connected NPFs and 23.73% for their non-connected counterparts. Although direct ownership understates ultimate ownership, it shows that the government-held stake in politically-connected firms is significantly larger than that held in non-connected ones, whatever the measure of ownership. Since the direct ownership sample is larger, we use direct ownership in the rest of this paper, but also assess the robustness of our findings using the ultimate ownership subsample as well.

connected firms.[15] This difference is also significant at the 1% level. This suggests that foreign investors are reluctant to hold large stakes in politically-connected NPFs. The firm employees are involved in the ownership structure of politically-connected NPFs at 5.14%, compared to 6.60% in non-connected NPFs. The difference in medians is statistically significant at the 5% level. As for the other two groups of investors (local institutions and individuals), the average stakes are almost identical between sub-samples, and the difference is not statistically significant. Overall, these results show that governments keep an important stake in politically-connected firms, while foreign investors are more reluctant to invest in such companies, compared to the non-connected counterparts.

Insert Table 3 about here

Table 4 compares the following characteristics of politically-connected firms and their non-connected counterparts:

Firm size: We measure firm size by the natural logarithm of total sales upon privatization and find that firms run by connected boards are larger than non-connected firms (13.07 for politically-connected firms compared to 12.39 for non-connected firms). This difference is statistically significant (at the 5% level). Our results for a cross-country sample of privatized firms confirm the findings of Agrawal and Knoeber (2001) who show that politically-experienced directors are more prevalent in large U.S. firms. For a multinational sample of publicly-traded firms, Faccio (2006a) also finds that political connections are more common among larger firms.

[15] The average stake of foreign ownership when the NPFs are connected through a minister is 12.46% compared to 7.71% for NPFs connected through members of parliament or bureaucrats. This difference is statistically significant at the 10% level. This seems to suggest that although foreign investors are generally reluctant to invest in politically-connected firms, they would rather choose those where the strength of the connection is strong when they do invest in such firms.

Board size: Politically-connected firms have also larger boards than non-connected firms. The median number of directors on the BOD for politically-connected firms is 11 compared to 9 for the unconnected ones. This difference is statistically significant at the 1% level.

Leverage: The preprivatization mean (median) leverage of politically-connected firms measured by the ratio of total debt to total assets (DTA) is 52.9% (48.1%) compared to 38.4% (37.8%) for non-connected firms. The difference is statistically significant (at the 1% level).[16] These results are consistent with the evidence provided in single-country studies. Khwaja and Mian (2005) find that politically-connected firms in Pakistan exercise their political influence to obtain preferential access to credit from government banks. Faccio et al. (2006) also find that politically-connected firms make greater use of debt than non-connected ones and interpret their evidence as suggesting that lenders factor into their lending decisions the likelihood that borrowers will be bailed out when they face financial distress.

Employment: Politically-connected firms hire more employees than non-connected ones. The mean (median) number of employees for politically-connected firms is 35,976 (9,193) compared to 9,623 (3,692) for unconnected firms. We also find that the mean (median) percentage change in employment for politically-connected firms is 11.54 (4.04) compared to 1.06 (-4.66) for their non-connected counterparts. These results are consistent with Shleifer and Vishny's (1994) arguments

[16] Privatization programs in most of our countries are secondary share offerings. Given that the proceeds of these offerings go to the government and the equity and asset bases of NPFs do not change, we could use either the preprivatization or the postprivatization mean (median) of the DTA ratio. Table 4 reports preprivatization leverage ratio, also used in our regression analysis. However, we also consider the leverage of privatized firms for the three years following privatization. The results, unreported here but available from the authors, show that politically-connected firms are more leveraged than their non-connected counterparts.

that politicians generally want the firms to overemploy since they derive political benefits from excess employment.

Insert Table 4 about here

5.2. Methodology and variables

We perform logit regressions to identify the determinants of political connections. The dependent variable is a dummy that is equal to one if the BOD or the supervisory board is politically-connected and zero otherwise. The independent variables, discussed below, are political and judicial independence variables, environment variables, firm-specific variables, and privatization variables.

5.2.1. Definition of variables

a. Judicial independence and political variables

As a proxy for judicial independence, we use the index of tenure of administrative court judges built by La Porta et al. (2004).[17] Judicial independence becomes relevant in private disputes and when the litigants (e.g., BOD members) are politically-connected. In addition, judges are both less susceptible to political pressure and less likely to have been selected by the government currently in office when they have life-long tenure (La Porta et al., 2004). Thus, we expect governments to appoint allies as BOD members because they are less likely to be pursued in case of fraud in lower judicial independence countries.

As a proxy for political competition, we use government fractionalization which represents the probability that two deputies picked at random from among the government parties will be of

[17] This variable measures the tenure of the highest ranked judges ruling on administrative cases. The variable takes three possible values: 2 - if tenure is lifelong, 1 - if tenure is more than six years but not lifelong, 0 - if tenure is less than six years.

different parties. Measures of this variable come from the "Database of Political Institutions," (the *World Bank)*. Dinç and Gupta (2006) find that governments in India are reluctant to privatize firms located in regions where the ruling party faces more political competition from parties in opposition. We expect that even if the government privatizes firms, when it faces higher fractionalization, it will appoint friends and politically-connected directors to interfere in the firms' decisions and to prevent drastic decisions that can lead to falls in government popularity.

As a proxy for government tenure, we use the number of years the chief executive has been in office. Measures of this variable come from the "Database of Political Institutions," (the *World Bank)*. The appointment of politicians to the board of privatized firms can be used by the government in the initial years to limit the potential actions of the divested firm, such as layoffs and setting higher prices. This interference consolidates the government's position. However, we can also expect the opposite relation: a government that has been in office for many years can resort to political appointments to reward friends and politicians close to the party.

b. Environment variables

We use the following environment variables that are likely to affect the political connection decision: economic development, bureaucracy, and corruption. As a proxy for economic development, we use the natural log of per capita GDP. We expect to have less political connections in developed countries. These countries have press freedom and transparent systems that can detect the political appointments on the board of privatized firms.

As a proxy for bureaucracy, we use the number of procedures that a start-up has to comply with in order to obtain a legal status (Djankov et al., 2002). The number of procedures in the sample ranges from 2 in Australia to 17 in Colombia. A large number of start-up procedures will constitute a barrier to entry and will protect existing firms against competition. Many privatized firms are either

monopolistic or quasi-monopolistic firms, and appreciate these barriers to entry. Political connections can help to protect a firm against competition. Thus, we expect political connections to be more prevalent in countries with higher barriers to entry.

As a proxy for corruption, we use the International Country Risk Guide (ICRG) assessment of the corruption in government. Faccio (2006a) finds that connections in publicly-traded firms are particularly common in countries that are perceived as being highly corrupt. We assess this relation for our sample of privatized firms.

c. Firm-specific variables

We use the following firm-specific variables: size, sector, location, and leverage. The size is the natural logarithm of total sales at the time of privatization, and the sector is an indicator variable that takes the value of 1 if the firm is from a regulated sector (utilities, telecommunication and petroleum), and 0 otherwise. Shleifer and Vishny (1994) argue that politicians want to control large and influent firms to get political benefits, like excess employment and lower prices. Thus, we expect that large, regulated firms, and those located in major cities are more likely to have politicians on their boards.

Specific-country studies like Johnson and Mitton (2003) in Malaysia, Cull and Xu (2005) in China and Khwaja and Mian (2005) in Pakistan, and cross-country studies like Faccio et al. (2006), and Faccio (2006b) show that politically-connected firms have higher leverage ratios than their non-connected counterparts. We control for this variable to assess this relation in the context of a multinational sample of privatized firms.

d. Privatization variables

We use the following four privatization variables: residual government ownership, fraction held by foreigners, outstanding golden share, and privatization method. The larger the residual stake of

the government, the more likely the privatized firm is expected to be politically-connected. If the government keeps a significant stake after privatization, it will have the power to appoint friends as directors. We expect that NPFs are less likely to be politically-connected when foreign investors are involved in the ownership structure. To the extent that foreign investors closely monitor managers' actions and are more concerned with profitability than with political goals, they are less likely to accept the political discretion of bureaucrats, which they perceive to be value destroying rather than value enhancing (i.e., in the context of privatization, the costs of political connections are higher than their benefits).

Bortolotti and Faccio (2006) find that in 62.4% of privatized firms in OECD countries, the government is either the largest shareholder, or holds outstanding golden shares. They conclude that governments are reluctant to privatize. We expect that firms having outstanding golden shares are more likely to be politically-connected. In other words, both devices are complementary.

We also expect firms privatized through private sales to be less likely to be politically-connected since, as shown by Boubakri et al. (2005), this type of privatization engenders a concentrated ownership by private investors who are more concerned with profitability than with political goals.

5.2.2. Regression results

The dependent variable is a dummy variable that is equal to one if the BOD or the supervisory board has a politically-experienced director, and zero otherwise. We regress this variable on four groups of independent variables as defined earlier, namely (1) judicial and political variables, (2) environment variables, (3) firm-specific variables, and (4) privatization variables. Table 5 defines the variables used in these regressions and their sources. We present four different specifications which allow us to separately include variables that are highly correlated (e.g. economic development and corruption, years in office and government fractionalization). We assess multicollinearity in the retained regression models using Belsley et al.'s (1980) condition index as a criterion. We retain

specifications for which the condition index is below the threshold level of thirty. Finally, the standard errors are corrected for heteroskedasticity and clustering of observations at the country level.

Insert Table 5 about here

Table 6 reports the results of the multivariate regression analysis. A striking general inference that can be made is that variables related to the macro economic and legal environments do not have a significant explanatory power when it comes to predicting the presence of politicians on the boards of NPFs. Contrary to the findings of Faccio (2006a) for publicly-traded firms, we do not find that corruption is a determinant of political connections for privatized firms.[18] Bureaucracy is negatively but insignificantly (at the conventional levels) associated with political connection in specifications (i), (ii), and (iv). In contrast, political and judicial variables contribute significantly to explain such phenomenon. For instance, in all four specifications, we observe a negative and significant association between the likelihood of political connections and the index of judicial independence. This result suggests that political appointments in NPFs are more prevalent in countries with weaker judicial independence.

A government that faces a higher fractionalization, and that has been in office for only a few years is also more likely to keep/appoint politicians on the boards of NPFs. These actions minimize frictions among veto players, and favor voting support. The findings of specifications (i), (ii), and (iii)

[18] We assess the robustness of this result by using other proxies of corruption such as the Kaufmann et al. (2006) series, or *Transparency International*. Our inferences remain unchanged with respect to corruption. We choose to report the results with the ICRG indicator of the risk of corruption since it has the longest time series, and enables us to use observations that date back to the eighties.

confirm these conjectures with regard to government fractionalization, and to the number of years in office.

As for firm-specific variables, the results suggest that privatized firms located in major cities and operating in regulated sectors are more likely to be politically-connected. Indeed, these firms generally hire thousands of employees. As argued in Shleifer and Vishny (1994), politicians are reluctant to relinquish control of these firms and thus appoint "friends" on their boards to get political benefits, with rent-seeking from these firms being higher. We also find that firms with a higher leverage before privatization are more likely to be politically-connected. This multinational finding for privatized firms confirms the literature results for specific-country studies (Johnson and Mitton (2003) in Malaysia, Cull and Xu (2005) in China, and Khwaja and Mian (2005) in Pakistan) and multi-country studies (Faccio et al., 2006).

With respect to privatization variables, specifications (i), (ii) and (iv) show that the residual stake of the government increases the likelihood of political connections. As can be seen from Table 6, the coefficient associated with the residual stake of the government in NPFs is positive and highly significant. In contrast, the percentage held by foreign investors in specifications (i), (ii), and (iii) exhibits a negative and significant coefficient. This finding suggests that the involvement of foreigners in firm governance reduces the likelihood of rent-seeking by politicians and political interference in firm management.

For a subsample of firms for which we have information on golden shares, we find in specification (iv) that the coefficient of golden shares is positive, and marginally significant (at the 10% level). This result supports the view that, in addition to political connections, outstanding golden shares can enhance the possibilities of government intervention.

Insert Table 6 about here

5.3. Robustness tests

We perform a number of robustness tests for the different models of the determinants of political connections. The results, unreported here for the sake of space, are available from the authors upon request.

5.3.1. An alternative definition of political connections

The results reported above could be specific to the choice of our political connection measure. Indeed, the strength of the government influence could vary with the number of politically-connected members on the BOD. We could expect/argue that the influence of a single politically-connected member could be less decisive than that of several connected directors. Thus, we consider an alternative measure of political connection that could capture this effect: the percentage of politically-connected directors. For each board, we identify politically-experienced directors, and we compute their percentage with respect to all board members. Table 7 displays the results of a tobit analysis using the percentage of politicians on the BOD of NPFs. Overall, the results do not change. Most importantly, the coefficients associated with the government residual ownership are positive and highly significant in all three specifications (i.e., (i), (ii), and (iv)). Foreign ownership also yields negative and significant coefficients.

Insert Table 7 about here

5.3.2. Alternative proxies for political and environment variables

To ensure that our results are not specific to the choice of our proxies, we employ alternative measures of government competition. We specifically use the Herfindahl index of legislature,[19] and

[19] The sum of the squared seat shares of all parties in the legislature.

total fractionalization[20] rather than government fractionalization (the *World Bank*'s Database of Political Institutions). The results are qualitatively similar and confirm that governments that face higher fractionalization are more likely to keep/appoint politicians on the boards of NPFs.

We also use the ICRG bureaucracy assessment as a proxy of bureaucracy rather than the number of procedures for a business start-up (Djankov et al., 2002). We find in specifications (i), (ii), and (iv) that the coefficient is consistently negative and insignificant as previously documented.

Finally, we control for other measures of institutional and macro-economic environments (environment variables). For instance, introducing the level of unemployment in the country (the World Development Indicators) yields an insignificant coefficient. Other environment variables such as the ICRG assessment of a country's law and order, and the ICRG assessment of a country's level of democracy are not significant determinants of political connections either.

5.3.3. Financial companies and ultimate ownership

Since leverage ratios of financial firms are not comparable to those of non-financial firms, we re-run our models without considering financial companies. The results are not affected significantly.

In addition, we consider a subsample of NPFs for which ultimate government ownership data is available, and we re-run the logit model for specifications (i), (ii), and (iv). The results, displayed in Table 8, show that the ultimate government residual stake is positively and significantly related to the likelihood of political connections, thus confirming our previous results.

Overall, our results show that the political and judicial variables, as well as firm-specific and privatization characteristics, are key determinants of political connections. The institutional and

[20] The probability that two deputies picked at random from the legislature will be of different parties.

macro-economic variables, however, have no explanatory power. Our results are robust to the choice of political and environment proxies, and to an alternative measure of political connection.

Insert Table 8 about here

6. Political connections and performance

In this section, we examine the impact of the presence of politically-experienced directors on the performance of NPFs.

6.1. Performance measurement

In the context of China, Fan et al. (2006) use changes in return on sales (ROS), sales growth, and earnings growth as proxies for accounting performance. They find that newly partially privatized firms with political ties underperform non politically-connected firms. For the sake of comparison, we use the same variables as Fan et al. (2006), although we also consider two additional profitability measures in our summary statistics namely, return on assets (ROA) and return on equity (ROE). Focusing on ROS in the main analysis is more appropriate because it is based on two flow measures (net income and sales) that are less sensitive to inflation and accounting conventions, in contrast to the two other profitability ratios (ROA, ROE) that involve flow and stock measures (net income, total assets, common equity) (Megginson et al., 1994). We compute the profitability measures for a period of 7 years (3 years prior to privatization and 3 years postprivatization) or at least for a period of 5 years (2 years prior to privatization and 2 years postprivatization). We then compute the means before and after privatization for each profitability ratio.

The sales (earnings) growth variable is the growth rate of sales (earnings) from the average annual sales (earnings) of the three years prior to privatization to that of the three years that follow

privatization. The privatization date is the date on which the government divests, for the first time, a certain amount of shares or capital.

We expect political connections to hinder (to be negatively related to) postprivatization performance improvements since there is no switch towards profitability maximization, or change in the incentive structure of the firms that accompany ownership divestiture by the state. Consequently, compared to non-connected counterparts who seek to maximize profits, connected firms are more likely to continue to pursue political goals which often conflict with value maximization. Thus they should exhibit a lower performance (Hypothesis H2).

6.2. Univariate results

Table 9 reports the mean and median performance changes for the entire sample of NPFs which we split into two groups of firms: firms whose BOD or supervisory board is politically-connected, and those where BODs are politically-independent. Profitability changes for politically-connected firms are significantly lower than for non-connected firms (at the 1% level for ROS, and at the 5% level for ROE and ROA). The mean (median) ROS, ROA, and ROE changes for firms run by connected BODs are respectively 1.82% (0.85%), 0.85% (0.26%), and -1.56% (1.38%) compared to 6.36% (3.57%), 2.43% (1.27%), and 4.86% (5.36%) for their non-connected counterparts. For growth measures, we find that the means and medians of sales growth and earnings growth are also higher for non-connected firms than for their connected counterparts.[21] The difference is statistically significant at conventional levels only for sales growth. Overall, the results support the findings of Fan et al. (2006) for Chinese newly partially privatized firms and Faccio (2006b) for a multinational

[21] We do not find a significant performance difference between firms that are connected through (1) a minister rather than a member of parliament or bureaucrat or (2) through a CEO/chairman or chairman of the BOD rather than a member of the BOD.

sample of publicly-traded companies: politically-connected firms exhibit a lower accounting performance than do non-connected ones.[22]

Insert Table 9 about here

6.3. Multivariate regression analysis

We next perform a multivariate regression analysis to identify the effect of political connection on firm performance. We regress changes in ROS, sales growth, and earnings growth on three groups of independent variables, namely (1) macro-economic variables, (2) corporate governance variables, and (3) control variables. Table 10 defines these variables.

We use the following independent variables related to the macro-economic environment: the real GDP growth and the change in the size of the trade sector (the sum of imports and exports over GDP) during the privatization window (-3,-1 and +1,+3). The use of real GDP growth allows us to control for the impact of economic growth on the post-privatization performance of NPFs. The size of the trade sector is a proxy for an economy's openness to trade.

We consider the following corporate governance variables: (i) PC which measures political connections is a dummy variable that takes the value of 1 if politically-connected directors are involved in the management of the privatized firm, and 0 otherwise. As discussed earlier, the involvement of politically-connected directors in NPFs can distract these firms from profitability objectives to pursue political goals which might in turn affect their operating performance. (ii)

[22] For the same reasons as discussed above, we do not expect politically-connected NPFs to exhibit significant performance changes after privatization, since they are more likely to pursue political objectives than profit maximization objectives. Unreported results show indeed that changes in ROS, in sales growth, and earnings growth are not significant for these firms after privatization. Thus, previous evidence that privatization improves performance is not generalizable to firms that remain politically-connected, even after divestiture.

Control is a dummy variable that is equal to one if the government relinquishes control (i.e., sells a majority stake that is equal or higher than 51%), and 0 otherwise.

We also consider the natural logarithm of total sales upon privatization as a measure of firm size. Aussenegg and Jelic (2003) and Villalonga (2000) argue that larger firms may show more resistance to changes which can lead to less substantial post-privatization performance improvements. We include an indicator variable which has the value of 1 if the privatized firm is regulated (telecommunication, petroleum or utilities) and 0 otherwise. Regulated firms frequently operate as a monopoly and retain significant market power that can be exploited to increase profitability following privatization.

Insert Table 10 about here

Table 11 displays the results for performance changes and politically-connected boards. In accordance with our expectations, we generally find that performance is negatively related to political connections. Specifically, the changes in profitability (ROS) and sales growth are lower for politically-connected firms. These relations are statistically significant at the 5% level and 10% level, respectively, and are consistent with Shleifer and Vishny (1998) who argue that privatization is successful if it draws a line between politicians and firms.

Control relinquishment by the government does not significantly affect our performance indicators. This result contrasts with previous studies that document improved performance after control relinquishment (Megginson and Netter, 2001), but suggests that once we account for political connections, government ownership becomes less relevant in conditioning the degree of performance changes.

Further, the changes in profitability and sales growth are significantly (at the 1% level and 10% level, respectively) and positively related to real GDP growth. Trade openness also plays a significant

role in explaining sales growth and earnings growth, suggesting that the higher competition that characterizes more open economies provides NPFs with more growth opportunities.

Insert Table 11 about here

6.4. Robustness checks

We perform a number of diagnostic checks for our accounting performance regressions. The results, unreported here for the sake of space, are available from the authors upon request.

6.4.1. An alternative definition of political connections

To ensure that our results are not specific to the political-connection measure chosen here, we rerun our regressions using the percentage of politically-connected members on the BOD instead of the dummy variable of political connection. Table 12 displays the results and shows that the percentage of politically-connected members of the BOD is negatively-associated with performance measures and suggests that the existence and strength of political connections are value destroying. As previously documented in Panels A and B of Table 11, this relation is statistically significant for ROS changes and sales growth.

Insert Table 12 about here

6.4.2. Endogeneity of political connections

Political connections could be affected by factors that also determine firm performance. This raises the issue of endogeneity between political connections and postprivatization reform. To tackle this possibility, we re-estimate the performance regressions using the predicted probability that the BOD is politically-connected. To generate these values, we consider the different political connection specifications described above (Section 5.2.2). For all the specifications, we verify that the error terms of the second stage regression are uncorrelated with the instruments we use. The

results of the two-stage approach remain qualitatively similar to those obtained with the one-stage approach for the sales growth and earnings growth models. Political connection remains negatively associated with ROS changes but becomes insignificant. We perform this analysis using both definitions of political connection, and obtain the same results, namely the impact of political connection is significantly robust for sales growth, but becomes insignificant for ROS changes and remains insignificant for earnings' growth, although consistently negative.

6.4.3. Other robustness tests

Using ultimate or direct ownership of the government instead of the indicator of government control relinquishment in the performance models yields an insignificant coefficient (but consistently negative through all specifications) for PC.

In an attempt to show whether the negative impact of PC on performance is worse when the government retains a larger stake, we interact PC with the direct ownership stake of the government (and alternatively with the ultimate stake held by the government), and find support for our conjecture in the sales growth model. The coefficient of the interaction variable is negative for both ROS changes and earnings growth, but is not significant.

In addition to changes in ROS, we also regress changes in ROA and in ROE on our independent variables. The results show that the regression coefficient of the measure of political connection in the ROA change model is negative and significant at the 10% level. It enters negatively and is marginally significant (at the 10% level) for the ROE change model as well.

We also re-estimate the three regressions without considering financial companies. Unreported results show that the exclusion of financial companies does not affect our results significantly.

In summary, the regression results confirm our predictions (H2) and the univariate results, and suggest that continued political interference inhibit firms from achieving the expected performance

improvements after divestiture. Reluctant privatization is thus damaging to the firms and is value destroying.

7. Conclusion and policy implications

In this paper, we investigate the extent of political connections in newly privatized firms around the world. Using a sample of 245 privatized firms headquartered in 27 developing countries and 14 industrialized countries over the period 1980 to 2002, we find that 87 firms have a politician or an ex-politician on their board of directors or supervisory board. We also show that political connection of newly privatized firms is a worldwide phenomenon, common to different sectors and privatization methods.

Next, we examine the ownership structure and the characteristics of politically-connected newly privatized firms. We find that the larger the residual government ownership, the more likely it is that the board is politically tied. In contrast, we note that foreign investors are reluctant to invest in politically-connected privatized firms. Our multivariate analysis of the determinants of political connections shows that political and judicial conditions influence political appointments in newly privatized firms. For example, a government that faces higher political fractionalization and has held office for only a few years is more likely to appoint politicians on the boards of privatized firms. Furthermore, we find that political connection is more prevalent in countries with lower judicial independence. Other firm-specific variables affect the likelihood of political connection. For instance, leveraged firms, operating in regulated sectors and located in major cities are more likely to be politically-connected. Privatization characteristics such as the residual government stake and foreign ownership respectively have a positive and negative effect on the likelihood that newly privatized firms are politically-connected. Macro-economic or institutional environments do not seem to determine the likelihood of political connections. Our results are robust to the use of an

alternative measure of political connections, namely the percentage of politically-connected members on the board of directors.

Finally, we examine the impact of the political connection of board directors on the accounting performance of newly privatized firms. To do so, we consider three accounting performance measures: change in return on sales, sales growth, and earnings growth. Our results suggest that politically-connected privatized firms underperform their non-connected counterparts.

Our evidence complements a recent study by Bortolotti and Faccio (2006) who show that governments maintain control over privatized firms by direct (no relinquishment of control) or indirect (control through the ownership of golden shares) means. We suggest that an additional indirect means of government control is the appointment of politicians, closely related to the government, on the boards of directors of newly privatized firms. Our results thus provide further evidence that governments are reluctant to privatize. A major implication of these results is that if governments retain control over privatized firms, through means of ownership, golden shares or political appointments, privatization is more likely to fail in delivering its promises.

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Table 1

Description of the sample of newly privatized firms

This table provides descriptive statistics for the sample of 245 privatized firms used in this study. We report the distribution of privatizations in the countries included in the sample by year, golden share, industry, location, region, development level, and type of offering.

Distribution of privatizations

By year

Year	Number	Percentage
1980	1	0.41
1983	1	0.41
1984	1	0.41
1985	4	1.63
1986	3	1.22
1987	2	0.82
1988	1	0.41
1989	22	8.98
1990	11	4.49
1991	19	7.76
1992	20	8.16
1993	11	4.49
1994	16	6.53
1995	19	7.76
1996	29	11.84
1997	32	13.06
1998	17	6.94
1999	19	7.76
2000	10	4.08
2001	4	1.63
2002	3	1.22
Total	245	100

By Golden Share (GS)

Category	Number	Percentage
With GS	27	17.20
Without GS	130	82.80
Total	157	100

By industry

Industry	Number	Percentage
Financial	52	21.22
Utilities	24	9.80
Telecommunication	25	10.20
Energy	30	12.24
Other industries	114	46.53
Total	245	100

By location

Category	Number	Percentage
Major cities	172	70.20
Other cities	73	29.80
Total	245	100

By region *

Region (countries)	Number	Percentage
Africa and the Middle East (5)	70	28.57
East and South Asia and the Pacific (12)	50	20.41
Latin America and the Caribbean (9)	54	22.04
Europe and Central Asia (15)	71	28.98
Total (41)	245	100

By development level

Category (countries)	Number	Percentage
Industrialized countries (14)	61	24.90
Developing countries (27)	184	75.10
Total (41)	245	100

By privatization method

Method	Number	Percentage
Share issue privatization (SIP)	159	74.30
Private sale (PS)	55	25.70
Total	214	100

* World Bank country group classification.

Table 2

Description of the sample of politically-connected firms

This table provides descriptive statistics for the subsample of 87 politically-connected firms. We report the distribution of politically-connected firms in the sample by year, golden share, industry, location, region, development level, and type of offering.

Distribution of political connections

By year

Year	Number	Percentage
1980	0	0.00
1983	1	1.15
1984	0	0.00
1985	2	2.30
1986	2	2.30
1987	0	0.00
1988	1	1.15
1989	6	6.90
1990	5	5.75
1991	7	8.05
1992	8	9.20
1993	6	6.90
1994	6	6.90
1995	6	6.90
1996	6	6.90
1997	10	11.49
1998	5	5.75
1999	8	9.20
2000	3	3.45
2001	2	2.30
2002	3	3.45
Total	87	100

By industry

Industry	Number	Percentage
Financial	17	19.54
Utilities	8	9.20
Telecommunication	11	12.64
Energy	18	20.69
Other industries	33	37.93
Total	87	100

By location

Category	Number	Percentage
Major cities	71	81.61
Other cities	16	18.39
Total	87	100

By region *

Region (countries)	Number	Percentage
Africa and the Middle East (5)	11	12.64
East and South Asia and the Pacific (12)	28	32.18
Latin America and the Caribbean (9)	16	18.39
Europe and Central Asia (15)	32	36.78
Total (41)	87	100

By development level

Category (countries)	Number	Percentage
Industrialized countries (14)	26	29.89
Developing countries (27)	61	70.11
Total (41)	87	100

By Golden Share (GS)

Category	Number	Percentage
With GS	14	24.14
Without GS	44	75.86
Total	58	100

By privatization method

Method	Number	Percentage
Share issue privatization (SIP)	54	73.97
Private sale (PS)	19	26.03
Total	73	100

* World Bank country group classification.

Table 3

Summary of the ownership structure for the sample of privatized firms: 1980-2002

This table presents the univariate results for the complete sample of privatized firms, for both the politically-connected (PC) boards and non-connected (NC) boards over the period 1980-2002. The measures of ownership structure are the average percentage of ownership during the three years after privatization for the government, the local institutions, the foreign investors, the employees, and the individuals. For each type of investor, it provides the average mean and median ownership percentage for the three years after privatization. Columns 6 and 7 provide the *T*-statistic for the difference in means and the Wilcoxon *Z*-statistic for the difference in medians, respectively.

Type of investors	N	Mean (Median) Total Sample	Mean (Median) PC board	Mean (Median) NC board	*T*-statistics for difference in means	*Z*-statistics for difference in medians
Government	213	31.95 (30.00)	45.27 (52.94)	24.86 (17.60)	-5.29***	-4.91***
Local institutions	172	24.65 (18.24)	23.01 (14.25)	25.46 (18.70)	0.59	0.06
Foreign investors	195	15.82 (6.63)	9.05 (3.42)	19.37 (10.86)	3.52***	2.89***
Employees	156	6.16 (3.30)	5.14 (0.80)	6.60 (4.32)	0.80	2.36**
Individuals	170	18.35 (13.06)	16.17 (11.26)	19.42 (13.76)	1.12	0.79

Significance at the 1% and 5% level is noted by *** and **, respectively.

Table 4

Summary of the firm size, BOD size, leverage, number of employees, and employment change for the sample of privatized firms: 1980-2002

This table presents the univariate results for the sample of privatized firms, for both politically-connected (PC) boards and non-connected (NC) boards over the period 1980-2002. Firm size is the natural logarithm of total sales at the time of privatization. BOD size is measured by the number of directors on the BOD. Leverage is measured by the average total debt to assets for the three years prior to privatization. Number of employees corresponds to the average number of employees for the three years before privatization. Employment change is measured by the percentage of change in the number of employees after privatization. Columns 6 and 7 provide the *T*-statistic for the difference in means and the Wilcoxon *Z*-statistic for the difference in medians, respectively.

Variable	N	Mean (Median) Total Sample	Mean (Median) PC board	Mean (Median) NC board	*T*-statistics for difference in means	*Z*-statistics for difference in medians
Firm size	245	12.63 (12.72)	13.07 (13.25)	12.39 (12.28)	-2.14**	-2.43**
BOD size	245	10.64 (10)	11.74 (11)	10.03 (9)	-2.94***	-2.99***
Leverage	228	43.8 (39.9)	52.9 (48.1)	38.4 (37.8)	-2.89***	-2.73***
Number of employees	159	18,739 (4,335)	35,976 (9,193)	9,623 (3,692)	-3.85***	-2.65***
Employment change	159	4.69 (-2.14)	11.54 (4.04)	1.06 (-4.66)	-0.97	-2.52**

Significance at the 1% and 5% level is noted by *** and **, respectively.

Table 5

Summary of the variables

This table describes the variables used in the regression analysis to investigate the determinants of political connection.

Variable	Definition	Sources
Judicial and political variables		
JudI	Index of judicial independence	La Porta et al. (2004)
GovF	The government fractionalization	Database of Political Institutions
Yoff	The years that the chief executive has been in office	Database of Political Institutions
Environment variables		
LGDP	The natural log of GDP per capita	World Development Indicators
Burr	The number of bureaucratic procedures for a start-up	Djankov et al. (2002)
Corr	The ICRG assessment of a country's corruption	International Country Risk Guide
Firm variables		
Size	The natural logarithm of total sales upon privatization.	Authors' calculations
Ind	Indicator variable that takes the value of 1 if the firm is from regulated sectors and 0 otherwise	Authors' calculations
Loc	Indicator variable that takes the value of 1 if the firm is located in major cities and 0 otherwise	Authors' calculations
Lev	The ratio of total debt to total assets during the window (-3,-1)	Authors' calculations
Privatization variables		
%Gvt	The average fraction held by the government during the window (+1,+3)	Authors' calculations
%For	The average fraction held by foreign investors during the window (+1,+3)	Authors' calculations
GS	Indicator variable that takes the value of 1 if the firm has an outstanding golden share and 0 otherwise	Authors' calculations
SIP	Indicator variable that takes the value of 1 if the privatization occurs through SIP and 0 otherwise	Authors' calculations

Table 6

Political connections in newly privatized firms: logit regressions

This table presents the logit results of the determinants of politically-connected boards of 245 newly privatized firms over the period 1980-2002. The dependent variable is a dummy variable equal to one if the board is politically-connected. The independent variables are related to judicial, political, environment, firm, and privatization characteristics. They are described as follows: JudI is an index of judicial independence; GovF represent government fractionalization; Yoff is the years that the chief executive has been in office; LGDP is the natural log of GDP per capita; Burr is the number of bureaucratic procedures for a start-up; Corr is the ICRG assessment of a country's corruption; Size is the natural logarithm of total sales upon privatization; Ind is an indicator variable that takes the value of 1 if the firm is from regulated sectors; Loc is an indicator variable that takes the value of 1 if the firm is located in major cities; Lev is the ratio of the total debt to assets during the window (-3,-1); %Gvt is the average fraction held by the government during the window (+1,+3); %For is the average fraction held by foreign investors during the window (+1,+3); GS is an indicator variable that takes the value of 1 if the firm has an outstanding golden share; SIP is an indicator variable that takes the value of 1 if the privatization occurs through a SIP. The *p*-values, adjusted for heteroskedasticity and clustering at the country level, are reported in parentheses.

		Judicial and political variables			Environment variables			Firm variables				Privatization variables					
	Constant	JudI	GovF	Yoff	LGDP	Burr	Corr	Size	Ind	Loc	Lev	%Gvt	%For	GS	SIP	N	Pseudo R^2
(i)	-1.829	-1.074**	1.978**		0.067	-0.042			1.452**	1.412**	1.470**	2.632***	-5.212***			154	0.32
	(0.576)	(0.014)	(0.022)		(0.754)	(0.668)			(0.028)	(0.019)	(0.014)	(0.003)	(0.000)				
(ii)	0.819	-0.860*		-0.092**	-0.139	-0.082			1.494**	1.520***	1.602**	2.867***	-3.469***			178	0.30
	(0.737)	(0.077)		(0.026)	(0.408)	(0.329)			(0.020)	(0.003)	(0.012)	(0.000)	(0.007)				
(iii)	-2.241	-0.840**	2.308**				0.054	0 .046	1.406**	1.619***	1.075**		-6.274***		0.395	142	0.28
	(0.184)	(0.012)	(0.019)				(0.790)	(0.729)	(0.020)	(0.007)	(0.020)		(0.000)		(0.567)		
(iv)	-0.681	-1.078***				-0.060			1.202		1.003***	3.752***		1.011		132	0.23
	(0.659)	(0.008)				(0.552)			(0.107)		(0.009)	(0.000)		(0.102)			

Significance at the 1%, 5%, and 10% level is noted by ***, **, and *, respectively.

Table 7

Political connections in newly privatized firms: tobit regressions

This table presents the tobit results of the determinants of politically-connected boards of 245 newly privatized firms over the period 1980-2002. The dependent variable is the percentage of directors that are politically-connected. The independent variables are related to judicial, political, environment, firm, and privatization characteristics. They are described as follows: JudI is an index of judicial independence; GovF represent government fractionalization; Yoff is the years that the chief executive has been in office; LGDP is the natural log of GDP per capita; Burr is the number of bureaucratic procedures for a start-up; Corr is the ICRG assessment of a country's corruption; Size is the natural logarithm of total sales upon privatization; Ind is an indicator variable that takes the value of 1 if the firm is from regulated sectors; Loc is an indicator variable that takes the value of 1 if the firm is located in major cities; Lev is the ratio of the total debt to assets during the window (-3,-1); %Gvt is the average fraction held by the government during the window (+1,+3); %For is the average fraction held by foreign investors during the window (+1,+3); GS is an indicator variable that takes the value of 1 if the firm has an outstanding golden share; SIP is an indicator variable that takes the value of 1 if the privatization occurs through a SIP. The *p*-values, adjusted for heteroskedasticity and clustering at the country level, are reported in parentheses.

		Judicial and political variables			Environment variables			Firm variables				Privatization variables					
	Constant	JudI	GovF	Yoff	LGDP	Burr	Corr	Size	Ind	Loc	Lev	%Gvt	%For	GS	SIP	N	Adj-R^2
(i)	-0.181	-0.094**	0.300***		0.002	-0.006			0.148**	0.171***	0.094***	0.272***	-0.591***			154	0.52
	(0.525)	(0.033)	(0.002)		(0.879)	(0.460)			(0.016)	(0.001)	(0.008)	(0.007)	(0.003)				
(ii)	0.049	-0.057		-0.012**	-0.010	-0.011			0.150**	0.188***	0.075*	0.301***	-0.365**			178	0.46
	(0.832)	(0.275)		(0.017)	(0.473)	(0.261)			(0.018)	(0.000)	(0.080)	(0.000)	(0.031)				
(iii)	-0.391***	-0.069**	0.353***		0.007		0.014	0.007	0.180***	0.226***	0.089***		-0.835***		0.024	142	0.43
	(0.009)	(0.029)	(0.003)		(0.488)		(0.638)	(0.488)	(0.002)	(0.000)	(0.001)		(0.002)		(0.749)		
(iv)	-0.047	-0.101*				-0.012			0.129		0.090**	0.429***		0.075		132	0.37
	(0.841)	(0.091)				(0.463)			(0.127)		(0.021)	(0.000)		(0.113)			

Significance at the 1%, 5%, and 10% level is noted by ***, **, and *, respectively.

Table 8

Political connections in newly privatized firms: logit regressions with ultimate state ownership

This table presents the logit results of the determinants of politically-connected boards of 245 newly privatized firms over the period 1980-2002. The dependent variable is a dummy variable equal to one if the board is politically-connected. The independent variables are related to judicial, political, environment, firm, and privatization characteristics. They are described as follows: JudI is an index of judicial independence; GovF represent government fractionalization; Yoff is the years that the chief executive has been in office; LGDP is the natural log of GDP per capita; Burr is the number of bureaucratic procedures for a start-up; Ind is an indicator variable that takes the value of 1 if the firm is from regulated sectors; Loc is an indicator variable that takes the value of 1 if the firm is located in major cities; Lev is the ratio of the total debt to assets during the window (-3,-1); %Ust is the average ultimate state ownership during the window (+1,+3); %For is the average fraction held by foreign investors during the window (+1,+3); GS is an indicator variable that takes the value of 1 if the firm has an outstanding golden share. The *p*-values, adjusted for heteroskedasticity and clustering at the country level, are reported in parentheses.

		Judicial and political variables			Environment variables		Firm variables			Privatization variables				
	Constant	JudI	GovF	Yoff	LGDP	Burr	Ind	Loc	Lev	%Ust	%For	GS	N	Pseudo R^2
(i)	1.415	-1.876***	0.528		-0.140	-0.024	1.401	1.853*	0.600	4.082***	-5.389**		61	0.34
	(0.665)	(0.002)	(0.518)		(0.479)	(0.815)	(0.185)	(0.095)	(0.525)	(0.007)	(0.016)			
(ii)	2.341	-1.907***		-0.033	-0.212	-0.037	1.361	1.867	0.624	4.552**	-4.793**		61	0.34
	(0.420)	(0.002)		(0.366)	(0.321)	(0.687)	(0.208)	(0.104)	(0.526)	(0.010)	(0.042)			
(iii)	-0.741	-1.522**				0.003	0.189		-0.403	6.972***		0.268	64	0.27
	(0.603)	(0.019)				(0.970)	(0.814)		(0.768)	(0.000)		(0.684)		

Significance at the 1%, 5%, and 10% level is noted by ***, **, and *, respectively.

Table 9

Summary of performance results for the sample of privatized firms: 1980-2002

This table presents the univariate results for the complete sample of privatized firms, for both the politically-connected (PC) boards and non-connected (NC) boards over the period 1980-2002. The measures of operating performance are return on sales (ROS), return on assets (ROA), return on equity (ROE), sales growth, and earnings growth. The mean and the median change in percentage for the three-year period before and after privatization are provided for ROS, ROA, and ROE. The sales (earnings) growth is the growth rate of sales (earnings) from the average annual sales (earnings) of the three years before the privatization year to that of the three years after the privatization year. Columns 6 and 7 provide the *T*-statistic for the difference in means and the Wilcoxon *Z*-statistic for the difference in medians, respectively.

Variable	N	Mean change (Median change) Total sample	Mean change (Median change) PC Board	Mean change (Median change) NC Board	*T*-statistics for difference in mean changes	*Z*-statistics for difference in median changes
Return on sales (ROS)	233	4.76 (2.26)	1.82 (0.85)	6.36 (3.57)	2.51***	2.89***
Return on assets (ROA)	233	1.87 (1.05)	0.85 (0.26)	2.43 (1.27)	1.97**	2.58***
Return on equity (ROE)	233	2.57 (3.60)	-1.56 (1.38)	4.86 (5.36)	1.91**	2.28**
Sales growth	236	109.3 (61.5)	58.8 (55.2)	137.2 (71.8)	2.68***	1.83 *
Earnings growth	233	132.1 (73.3)	128.2 (51.4)	134.1 (92.3)	0.10	0.37

Significance at the 1%, 5%, and 10% level is noted by ***, **, and *, respectively.

Table 10

Summary of the variables

This table describes the variables used in the regression analysis of the link between the post-privatization performance changes and political connections.

Variable	Definition	Sources
Operating performance		
DROS	Change in return on sales during the privatization window (-3,-1 versus +1, +3)	Authors' calculations
Sales growth	Sales growth is the growth rate of sales from the average annual sales of the three years before the privatization year to that of the three years after the privatization year	Authors' calculations
Earnings growth	Earnings growth is the growth rate of earnings from the average annual earnings of the three years before the privatization year to that of the three years after the privatization year	Authors' calculations
Macro-economic environment		
Δ GDP	Percentage growth in real GDP over the privatization window (-3,-1 versus +1, +3)	World Development Indicators
Δ Trade	Change of the sum of exports and imports over GDP during the privatization window (-3,-1 versus +1, +3)	World Development Indicators
Corporate governance		
PC	Indicator variable that takes the value of 1 if the firm is politically-connected and 0 otherwise	Authors' calculations
Control	Indicator variable that takes the value of 1 if the government relinquishes control of the privatized firm and 0 otherwise	Authors' calculations
Control variables		
Size	The natural logarithm of total sales upon privatization	Authors' calculations
Ind	Indicator variable that takes the value of 1 if the firm is from regulated sectors and 0 otherwise	Authors' calculations

Table 11

Performance changes of newly privatized firms and politically-connected boards

This table presents the results from regressions conducted to determine the sources of performance changes of privatized firms over the period 1980-2002. The dependent variables in the three panels are change in return on sales (DROS), sales growth, and earnings growth, respectively. The change in ROS is computed by subtracting the three-year- pre-privatization average from the three-year-post-privatization average. The sales (earnings) growth is the growth rate of sales (earnings) from the average annual sales (earnings) of the three years before the privatization year to that of the three years after the privatization year. The independent variables are related to the macro-economic environment and corporate governance. They are described as follows: ΔGDP is the real GDP growth during the privatization window (-3,-1 and +1,+3); ΔTrade is the change in the sum of exports and imports over GDP during the privatization window (-3,-1 and +1,+3); PC is an indicator variable that takes the value of 1 if the firm is politically-connected; Control takes the value of 1 if the government relinquishes control of the privatized firm; Control variables include Size and industry: Size is the natural logarithm of total sales upon privatization; Ind is an indicator variable that takes the value of 1 if the firms are from regulated sectors. The *p*-values, adjusted for heteroskedasticity and clustering at the country level, are reported in parentheses.

	Macro-economic environment		Corporate governance		Control			
Constant	ΔGDP	ΔTrade	PC	Control	Size	Ind	Adj-R^2	N
			Panel A. DROS					
0.152	0.005***	-0.035	-0.043**	-0.004	-0.005	0.034	0.08	218
(0.126)	(0.000)	(0.524)	(0.019)	(0.870)	(0.356)	(0.313)		
			Panel B. Sales growth					
0.708	0.021*	1.441**	-0.659*	0.469	-0.106	0.312	0.07	221
(0.662)	(0.067)	(0.044)	(0.088)	(0.173)	(0.368)	(0.533)		
			Panel C. Earnings growth					
1.773	-0.040	2.532***	-0.035	-0.795	-0.212	-0.107	0.02	218
(0.354)	(0.734)	(0.008)	(0.948)	(0.130)	(0.111)	(0.846)		

Significance at the 1%, 5%, and 10% level is noted by ***, **, and *, respectively.

Table 12

Performance changes of newly privatized firms and the percentage of politically-connected members on the board

This table presents the results from regressions conducted to determine the sources of performance changes of privatized firms over the period 1980-2002. The dependent variables in the three panels are change in return on sales (DROS), sales growth and earnings growth, respectively. The change in ROS is computed by subtracting the three-year- pre-privatization average from the three-year-post-privatization average. The sales (earnings) growth is the growth rate of sales (earnings) from the average annual sales (earnings) of the three years before the privatization year to that of the three years after the privatization year. The independent variables are related to the macro-economic environment and corporate governance. They are described as follows: ΔGDP is the real GDP growth during the privatization window (-3,-1 and +1,+3); ΔTrade is the change in the sum of exports and imports over GDP during the privatization window (-3,-1 and +1,+3); %PCD is the percentage of directors that are politically-connected; Control takes the value of 1 if the government relinquishes control of the privatized firm; Control variables include Size and industry: Size is the natural logarithm of total sales upon privatization; Ind is an indicator variable that takes the value of 1 if the firms are from regulated sectors. The *p*-values, adjusted for heteroskedasticity and clustering at the country level, are reported in parentheses.

	Macro-economic environment		Corporate governance		Control			
Constant	ΔGDP	ΔTrade	%PCD	Control	Size	Ind	Adj-R^2	N
			Panel A. DROS					
0.161*	0.005***	-0.039	-0.102**	-0.003	-0.006	0.034	0.06	218
(0.084)	(0.000)	(0.455)	(0.033)	(0.895)	(0.243)	(0.329)		
			Panel B. Sales growth					
0.830	0.020*	1.421**	-2.183**	0.451	-0.120	0.351	0.06	221
(0.611)	(0.099)	(0.046)	(0.012)	(0.177)	(0.325)	(0.499)		
			Panel C. Earnings growth					
1.792	-0.037	2.429**	1.321	-0.707	-0.217	-0.179	0.02	218
(0.367)	(0.750)	(0.016)	(0.369)	(0.205)	(0.122)	(0.723)		

Significance at the 1%, 5%, and 10% level is noted by ***, **, and *, respectively.