

**ECONOMIC AND POLITICAL TRANSITIONS AND CORPORATE  
POLITICAL STRATEGY IN EMERGING COUNTRIES: EVIDENCE FROM  
CHILE**

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# **ECONOMIC POLITICAL TRANSITIONS AND CORPORATE POLITICAL STRATEGY IN EMERGING COUNTRIES: EVIDENCE FROM CHILE**

## **Abstract**

In this paper we study the appointment of directors with political ties to the incumbent government as a corporate political strategy. By studying both domestic and multinational corporations operating in an emerging economy with recent drastic economic and political transitions and powerful business groups (Chile), we attempt to determine what type of firm is more inclined to follow this kind of political strategy and whether doing this helps the firm to improve its economic performance. We find that the firms more likely to appoint directors linked to the incumbent government are those that did not benefit from the previous regime and multinationals originating in countries with relatively high state intervention in the economy. When the political transition was drastic but smooth, this strategy does not show to have a significant effect in the companies' performance.

Keywords: Political Strategy; Economic Transitions; Political Transitions.

## INTRODUCTION

The corporate strategies developed by large private corporations and their degree of freedom to operate is highly determined by the institutional environment in which they operate. The main institution that creates or modifies the legal framework that defines, protects, or restricts the firms' market strategies is the state (North, 1990; Weingast, 1995). This legal framework or the national economic policies are not only the result of purely economic cost-benefit calculations, but also the outcome of historically-determined elements such as the type of regime in power, the rulers' strategies of political survival, dominant processes of regime change, the country's social structure, international relations, the pre-existing economic regime, and internal power struggles (Acemoglu and Robinson, 2006; Bueno de Mesquita, et al., 2003; Przeworski and Limongi, 1993). The complexity created by these factors forces firms to develop non-market strategies to assure their growth or survival in which the so-called "political activity" defined as "corporate attempts to shape government policy in ways favorable to the firm" (Hillman, et al., 2004: 838) is particularly relevant. Companies' political activity can take many forms, being one of them the appointment of individuals with ties to the government in their corporate boards (Etzion and Davis, 2008; Hillman, et al., 1999). Although research on this type of political strategy is still relatively scant for countries outside the United States (Hillman, et al., 2004; Lester, et al., 2008), recent studies have shown its importance by both domestic and foreign firms operating in emerging economies such as South Korea (Siegel, 2007), China (Li, et al., 2008), and Brazil (Perkins, et al. 2008). In this paper, we analyze this particular political strategy in an emerging economy and address the following two questions:

(a) What types of firms are more likely to appoint directors with the same political affiliation as the incumbent government?

(b) Does having directors with political ties to the government improve the company's performance?

In order to answer these questions we need to consider several important characteristics the major emerging economies share. First, they have gone through relatively recent and dramatic processes of political or economic transition (or both). In the late 1980s, the world witnessed both a democratization wave when many countries replaced dictatorships for pluralistic regimes (Huntington, 1991) and a globalization wave when a large number of countries adopted free trade policies (Jones, 2005). However, not all the emerging economies adopting free market policies have gone through a process of political liberalization, nor does one of the two processes have necessarily preceded the other, as we show in Table 1.

**Table 1: Timing of Globalization and Democratization After the 1970s in Selected Emerging Economies**

<b>Democratization Preceding Globalization</b>	<b>Globalization Preceding Democratization</b>	<b>Globalization With No Democratization</b>	<b>Both Processes Occurring Simultaneously</b>
India, Pakistan, Spain	Chile, Argentina, Brazil, South Korea, South Africa, Bolivia, Ecuador	China, Vietnam	Poland, Hungary, Czech Republic, Slovakia

The timing of both processes is important for our analysis because the host country's institutional environment determines the firms' non-market behavior and strategies (Henisz and Zelner, 2003; Murtha and Lenway, 1994; Lenway and Murtha, 1994).

Moreover, transitions involving regime change can also mean unexpected (and potentially unfavorable) legal or regulatory changes in the environment where foreign investors operate. Therefore, depending on the kind of arrangements made between firms and previous governments, regime changes can be beneficial or detrimental to private firms (Henisz and Delios, 2004).

Second, the so-called business groups are major actors in emerging economies. Countries like India, South Korea, Chile, or Brazil are important examples of economies dominated by these actors (Guillén, 2000; Khanna and Ghemawat, 1998; Khanna and Palepu, 1999, 2000; Khanna and Rivkin, 2000; Schneider, 2004; Siegel, 2007; Perkins, et al., 2008). A business group is roughly defined as a collection of firms bound together in formal and/or informal ways (Granovetter, 1995) in which the participants are linked together by “interpersonal trust, on the basis of similar personal, ethnic, or commercial background” (Leff, 1978: 663). Most business groups present in emerging economies emerged in periods of protectionism when they shared their governments’ long-term economic agenda and had close linkages with political decision makers (Guillén, 2000). Business groups’ existence and their strong influence make it imperative to consider them in our analysis of corporate political strategy.

Third, in the last few years a significant amount of the foreign investment flowing to emerging economies has gone to regulated industries, such as telecommunications, electricity, banking, or services linked to social security (García-Canal and Guillen, 2008; Henisz and Zelner, 2001). The investment rush over these industries resulted from the liberalization of the emerging economies when governments privatized many industries formerly under their control, providing great investment opportunities for both foreign and domestic investors (including the business groups). Given that most of these industries although privatized remained regulated,

firms investing in these sectors had to adapt to regulatory regulations or negotiate the terms of the regulations (Garcia-Canal and Guillen, 2008).

And, fourth, the second wave of globalization led to the rise of MNCs originating in countries different from the dominant home countries of the post-World War II period, such as United States, Great Britain, or Japan. The last two decades witnessed the rise of MNCs of non-traditional capital exporting countries such as India, China, Mexico, Spain, Russia, or Brazil (Ramamurti and Singh, 2009). This is relevant for our analysis because the political strategies developed by firms not only do they depend on the host country's institutional environment (as argued by Henisz and Zelner, 2003), but also in the case of MNCs they are determined by the institutional environment in their country of origin (Hillman and Wan, 2005). Therefore, distinguishing the regulatory and political environment of the country of origin of an MNC can provide us with useful insights to understand their political strategy abroad and some of the new MNCs investing in emerging economies originate in countries with different regulatory environments and relationships between the private sector and the state than the traditional capital exporting countries.

This paper is divided as follows: in the next (second) section we show the main elements that explain why we study the particular case of foreign direct investment in Chile between 1980 and 2007. The third section discusses the political strategy of foreign corporations, business groups, and the possible effect of having directors with political ties to the government, which permits us to state our hypotheses. In the fourth section we provide our quantitative analysis, and the fifth section discusses our quantitative results.

## **POLITICAL AND ECONOMIC TRANSITION IN AN EMERGING ECONOMY: THE CASE OF CHILE**

In this study we focus on the case of Chile, a country that in many ways represents the quintessential emerging economy. With an average GDP annual growth of around 5% between 1980 and 2009 (IMF, 2009), Chile has been considered a showcase of the benefits of free trade and small government for economic prosperity. Chile adopted its free market policies between the mid-1970s and the 1980s breaking with a long past of state-led capitalism. Between 1925 and 1973, Chile had an import substitution industrialization (ISI) model they sought to achieve through protectionism and direct participation of the state in the economy through subsidies to domestic industries and the creation of state-owned enterprises. Despite the adoption of an ISI model, Chile also became a world's major exporter of mining products exploited mainly by highly taxed foreign corporations. This sector allowed the government to spend in social welfare without increasing taxation to domestic economic actors.

The transition from the protectionist model to the free trade one was not a smooth one and involved a complex political process. Between 1932 and 1973, Chile enjoyed a stability of uninterrupted democratically elected regimes. A powerful left and highly organized unions constantly pressured to keep welfare spending high (Arellano, 1985), while simultaneously, the business community organized itself in business groups with strong ties with the government and direct participation in economic policy decision making, defending the protectionist model (Schneider, 2004). The left and the business groups did not share the same interests, but the relative power of each of them contributed to the long-term stability of the welfare and protectionist economic regime.

Chile's political economy changed radically after 1973, when General Augusto Pinochet overthrew Socialist president Salvador Allende. During his short administration (1970-1973) Allende (who led a left-wing coalition) faced constant opposition from the Chilean business groups, foreign multinationals, and the US government due to policies such as the nationalization of foreign assets in the copper industry and the transfer of management from the employers to the employees in some industries (DeVylder, 1976, 1989; Sigmund, 1978). Pinochet's coup interrupted this process (although he did not re-privatized the copper industry) and between 1975 and 1982 the military government experimented with a radical version of laissez faire economics by carrying out one of the world's most aggressive processes of privatization of state-owned companies created during ISI and eliminating subsidies and protection to the private sector (Fourcade-Gourinchas and Babb, 2002; Silva, 1997). Although some of the, until then, unchallenged business groups were threatened by these policies, others took advantage of the privatizations and liberalization of the economies to build even more gigantic conglomerates (Dahse, 1979).

Pinochet's new model crumbled in 1982 when a global credit tightening led to a severe economic crisis. In 1983, facing mass demonstrations from the unemployed and subtle messages from a private sector threatening to join the growing opposition, Pinochet re-approached the traditional business elite by providing some new basic protection (without abandoning the country's new free trade model) and appointing businessmen as ministers of the ministries linked to their specific conglomerates. After these initiatives, Pinochet built a solid relationship with Chile's business elite (Silva, 1997; Schneider, 2004). With the new globalized economy, some business groups reinvented themselves and changed their orientation from domestic markets to foreign ones (Del Sol and Kogan, 2007; Khanna and Palepu, 1999, 2000).

In 1990, Chile went through another political transition after Pinochet stepped down finishing seventeen years of military rule. Joining the worldwide third democratization wave, Chile elected a center-left coalition known as the Concertación composed by the Christian Democratic Party (which ruled Chile before Allende) and the Socialist Party (Allende's party). Between 1990 and 2010 the Concertación won all presidential elections with the Christian Democrats and Socialists alternating presidents. The Concertacion kept the existing economic model but with a stronger emphasis on social welfare.

## **CORPORATE GOVERNANCE, POLITICAL STRATEGY, AND PERFORMANCE**

The drastic economic and political transitions taking place in Chile in the last three decades makes of this country an interesting case to study domestic firms, MNCs, and business groups political strategies. This country shows two very different types of political regimes and economic development models, and experienced remarkable economic growth through both private domestic and foreign investment. Our findings can permit a comparison with countries following different timings as the ones we show in Table 1.

### **Transferring Corporate Governance and Political Strategy**

Following Hillman and Wan (2005) we assume that the institutional framework of the country of origin of an MNC can determine its political strategies abroad. Moreover, companies that have operated in several countries (different from their own)

accumulate experience that will allow them to develop a more beneficial corporate strategy (Delios and Henisz, 2003). Creating political ties between companies and governments, however, is not equally used in all countries (Faccio, 2006), which can be a result of different legal restrictions or traditions in business practices (Rodríguez, et al., 2006). In countries with relatively high government interventionism in the economy, firms have to develop stronger political capabilities because markets do not define which company prevails and which one fails. Similarly, in countries where the government lets markets to define winners and losers, companies can focus on market strategies rather than political ones (Murtha and Lenway, 1994). For a country receiving large influxes of foreign direct investment from companies of diverse origins, we have to consider the type of political strategy these companies developed in their different institutional frameworks in which they evolved.

For the particular case of Chile during the years of rapid economic growth, we find a variety of home countries. Between 1974 and 2007, the country investing the most in Chile was the United States, followed by Canada, Spain, the United Kingdom, and Australia in that order (see Table 2). These major investors represent countries with different institutional environments for business. While the US, the UK, Canada, and Australia usually rank among the top 15 countries in the Index of Economic Freedom (with Chile), Spain has not made it to the top 30 countries (Heritage Foundation, 2010).

Since the late nineteenth century, the American and British investors have had a strong presence in Chile, particularly in the mining and manufacturing sector. On the other hand, Spanish MNCs are relative newcomers not only to Chile but the global economy in general. The Spanish MNCs' presence in the world only started after Spain's acceptance to the European Economic Community (EEC) in 1986 (Campa and Guillen, 1996). The entry of Spain to the EEC started a process of internationalization

of the major Spanish firms, through which some of them became major MNCs, such as Telefónica, Banco Santander, Entel, or BBVA (Guillen, 2005; Guillén and Tschoegl, 2000; Salmon, 2001). The main geographic area in which these Spanish MNCs invested was Latin America, with Chile receiving a significant portion of these investments (Guillen, 2005).

Contrary to the British, American, or Canadian MNCs, the Spanish firms matured in a country dominated by business groups. Similarly to what happened in Chile, Spanish business groups emerged during years of state-led industrialization (before Spain's entry to the EEC) (Guillen, 2000, 2001). Prior their internalization the major Spanish firms developed strong ties with the government, frequently through the appointment of politically connected individuals in their boards (Valdaliso, 2002). This practice was used both during the dictatorship of Francisco Franco (1936-1975) and the democratic regime that came after Franco's death including the times when the center-left Socialist Party ruled Spain (Cabrera and Del Rey, 2007; Pérez, 1997). Following Murtha and Lenway (1994), economic interventionism by the Spanish state led Spanish firms to strongly rely on non-market strategies to assure their survival and growth. On the other hand, while firms originating in the US, UK, Australia, and Canada also develop their own political strategies (mostly through lobbying) market conditions and competition have a stronger effect on the firms' success than political connections.

Several Chilean top executives we interviewed for this study expressed that in their view, Spanish firms tended to approach politicians more than the American firms. Referring to the Spanish firms obtaining concessions from the Concertación government to manage the highway system, one of the executives said that Spanish firms tended to operate through constant negotiations with policy-makers in order to obtain government's benefits (Authors' interviews with top executive, Santiago, 2009).

The evidence shows that the Spanish firms were not shy regarding the type of center-left directors they appointed. One good example is the telecommunications firm Telefónica Internacional, which arrived in 1990 after acquiring 80% of the Telefónica CTC (a domestic telecommunications firm formerly owned by the American firm ITT and whose control by foreign capital was the source of heated political debate, particularly during the Allende administration) ([www.Telefonicactcchile.cl](http://www.Telefonicactcchile.cl)). In 1991, Telefónica Internacional appointed its first left-wing director: Oscar Garretón. Garretón's résumé was clearly different from what the Chilean business elite had been used to. Garretón had been Allende's under-secretary of economy (1970-1972) and member of the parliament for the Socialist Party in 1973, right before the coup. Moreover, during the Allende administration Garretón was in charge of the expropriation of private property, one of the issues foreign multinationals and the national business elite disliked the most about Allende's government (Collier and Satter, 2004). Before the coup, Garretón unsuccessfully tried to convince some sailors to mutiny against their superiors to abort the possibility of a military coup (*The Economist*, 2008). After Pinochet's coup, Garretón exiled in Cuba for eight years and lived in Argentina temporarily before returning to Chile where he joined the new Socialist Party in 1989. Given this background it is understandable that the Chilean business community was shocked when learning about Garretón's appointment as Telefónica's director (Authors' interviews with Center-Left directors, Santiago, 2008). After acquiring Provida in 1999, the Spanish bank BBVA also appointed directors who worked for the Allende regime and had recently returned to Chile after years of exile during the dictatorship (Corke, 1999; Chile, Biblioteca del Congreso, 2008). Other Spanish firms also appointed directors who either worked for the pre-Pinochet Allende

and Christian regimes, or had close ties to the center-left Concertación coalition (Corporate annual reports of selected firms).

Research on Spanish MNCs in Brazil has shown a similar pattern, with these firms seeking to establish several points of contact with the government including directors with political ties or connected to business groups favored by the government (Perkins, et al., 2008). Thus, we predict that:

*Hypothesis 1: MNCs originating in countries with a relatively strong government intervention in the economy will be more inclined to develop direct ties with the incumbent government through members of the board than MNCs coming from countries with less government intervention in the economy.*

### **Business groups' background and corporate political strategy**

Scholars studying business groups have usually defined their close linkages with the state as one of their main characteristics (Leff, 1978; Khanna and Palepu, 1999, 2000; Guillén, 2000). Although true for most countries with economies dominated by business groups, we argue that political and economic transitions can generate different types of business groups when it comes to their relationship with the government. Considering their role under the two political and economic regimes ruling Chile in the period we study and the effects of regime change and economic transition, we define two types of business groups: traditional and non-traditional.

We define “traditional” business groups as those who benefited by Pinochet’s regime, had their roots back to the first business federations organized in the 1930s, and made their decisions from Santiago, Chile’s capital city. We classify under “non-

traditional” business groups those that did not benefit from Pinochet’s regime, those coming from provincial cities, those established after Pinochet, or those privatized under *capitalismo popular*, a modality for privatization developed under the Pinochet regime which consisted on selling a large number of shares to a large number of small investors (Fazio, 1997).

The traditional business groups include the powerful Cruzat-Larraín Group, which controlled a wide variety of economic sectors, benefited from Pinochet’s privatization policies, and remained allied to the political right after Chile’s return to democracy. In 1982, the Cruzat-Larraín Group created Provida, the first pension funds management firm (a type of firms known by the Spanish acronym of AFP) after Chile became the first country in the world privatizing social security (Century Foundation, 1998; Kotlikoff, 1995; Diamond, 1996; Piñera, 1995). The Pinochet government even bailed out Provida in 1983 after the company faced financial hardships (Fazio, 1997). After initially conflicting with Pinochet, Chile’s most powerful business groups in the late 1980s and 1990s were those who allied themselves with the military regime (Silva, 1996) and adapted their strategy and structure to the new open market economic model by developing more international-oriented operations (Del Sol and Kogan, 2007; Khanna and Palepu, 2000).

Although belonging to individuals who were part of Chile’s elite, non-traditional business groups had a different fate during the dictatorship and the Concertación period. One example is the Cueto Group. The Cuetos were a wealthy family, but considered “outsiders” by the Chilean, which traditionally shunned them because of their background as descendants of Spanish Republican refugees who escaped to Chile after Franco’s triumph (Gancedo, 2007). In 1994, the Cueto Group acquired LAN (Chile’s main airline, formerly belonging to the state but privatized by Pinochet in 1989), a

company that suffered several setbacks when it was forced to compete with foreign airlines under Pinochet's "open skies" policy (Ingram, 2000). Another example is the Luksic Group, which successfully developed businesses in different areas (from car sales, fisheries, and coal mining) since the 1950s (Stillerman, 2004). In spite of this background, the traditional business groups broke with them when in the midst of Allende's nationalizations of private property. Andrónico Luksic (the group's patriarch) sold some of his business to the government as a strategy to protect other more profitable enterprises. The Chilean business elite, who opposed Allende as a single bloc, considered Luksic's action as opportunism and betrayal and was not willing to forgive his action. In addition, the Luksics were not from Chile's capital city, so the Santiago elite never considered this Croatian-descent family one of their own. As a result, Chile's business elite shunned the Luksics and the group was barred from investing in Pinochet's first wave of privatizations. Their fortune reversed after the early 1980s, when they were one of the few surviving the financial crisis almost intact, which allowed them to invest in the financial sector (Kandell, 2009). Another type of non-traditional business group is the Pathfinder Group, which was created *after* Pinochet's dictatorship and therefore did not owe any allegiance to that government.

After Chile's transition to democracy, we see the non-traditional business groups more open to the idea of appointing center-left directors than the traditional ones. The Cueto Group appointed several individuals who occupied high-ranking positions in the Christian Democrat Frei Montalva's administration (1964-1970) in LAN, while the Pathfinder Group did the same in IANSA (Chile's largest sugar company, previously owned by the state and privatized during Pinochet). In 2000, the Luksic Group acquired the Banco de Chile and appointed center-left directors (Banco de Chile, 2001; Khanna, 2007). While the non-traditional business groups followed a similar path to that

followed by Spanish MNCs, the traditional business groups did not appoint center-left directors. Given the different political background of traditional and non-traditional business groups we argue that:

*Hypothesis 2: After a political transition, business groups that benefited from the previous regime (traditional business groups) will be less likely to appoint directors with political ties to the incumbent regime, than business groups that did not benefit from the previous regime or were created after the transition (non-traditional business groups).*

### **Political ties and economic performance**

The literature on the use of political ties by firms as political strategy argues that having connections with the incumbent government can have a positive effect in the companies' economic performance (Faccio, 2006), but with a regime change the political ties built by a company can turn into a liability and the new incumbent government can punish firms connected to the previous regime (Siegel, 2007; Henisz and Zelner, 2003; Henisz and Delios, 2004). Faccio (2006) reached this conclusion after her worldwide study of political connections of companies' CEOs, while Siegel (2007) analyzed how firms connected to the South Korean military dictatorships ruling between 1948 and 1987 were punished after the country's adoption of a democratic regime in 1987, and Henisz and Zelner (2003) show how firms with political ties to Suharto (and rewarded by the dictator) in Indonesia were also punished after his removal in 1998. In summary, these authors argue that building political ties with

individuals connected to the incumbent government should have beneficial effects in the corporations' performance.

Some Spanish investors in Chile, like Telefónica, have maintained in their corporate reports and in official corporate histories that the appointment of center-left directors have had a positive effect in the company's bottom line. After beginning its operations in Chile, Telefónica's control over both the domestic and international phone markets could potentially violate Chile's anti-trust legislation. Chile's Anti-Trust Commission studied the case and in 1993 it decreed that the company was not violating the anti-trust law (Telefónica CTC, 1993). According to a company's official history the presence of Concertación directors was crucial for this favorable outcome. The closed-door negotiations between the firm and the government took place in Chile's presidential palace in December 1993. The Minister of the Presidency invited representatives of Telefónica and Entel for these talks and the negotiations shifted from being technical to be political (Covarrubias, 1997). These negotiations were highly controversial, but Garretón informed the shareholders that the final agreement permitted Telefónica CTC to emerge as a powerful telecommunications company at the international level (Telefónica CTC, 1994).

Telefónica's argument seems to be sustained by using a counterfactual. Between 1998 and 2000 the company did not appoint any Concertación director and in 1999, the Chilean government considered a new regulatory framework for the telecommunications industry, which meant lower phone rates. Telefónica negotiated with the government but focused on purely technical issues while ignoring political ones (Authors' interviews with corporate directors, Santiago, 2008). The government ignored Telefónica's arguments and approved the new phone rate system, which led Telefónica CTC go from a \$290 million profit in 1999 to a \$95,626 million loss in 2000

(Telefónica, 1999, Covarrubias, 1997). After 2000, the company appointed new center-left directors with very close links to the government to lead a restructuring of the company, negotiate new deals with the government, and gain government support in the company's negotiations with the unions, which were going to face lay-offs. Telefónica succeeded with the restructuring process and had a strong recovery after 2001 (*El Mercurio*, 2001). Thus, given the apparent positive effect of political ties with the incumbent government with economic performance we predict that:

*Hypothesis 3: Having directors with ties to the incumbent government has a more positive effect in the company's performance than having directors linked to the political opposition.*

## **DATA AND METHODS**

### **Sample and data collection**

Our sample is composed by 24 firms operating in regulated industries, had the largest market share in the industry they belonged to, and had large government ownership before the Pinochet regime, mainly air transportation, telecommunications, health insurance, agribusiness, infrastructure, electricity, mining, and finance, particularly retirement funds management and banks). Table 2 displays the list of these companies and firm-years organized by industry and type of ownership. We defined five types of ownership: (a) traditional Chilean business groups; (b) non-traditional Chilean business groups; (c) the Chilean State; (d) MNCs from countries with relatively high state intervention in the economy (Spain and Italy); and, (e) MNCs from countries with relatively low state intervention (US, UK, Canada, and Australia). We defined the level

of state intervention in the economy according to the rankings on economic freedom published by the Heritage Foundation (2010). We started working with a sample of 501 firm-years, but excluded the cases with no complete data available ending up with a final sample of 480 firm-years.

**Table 2. Sample selection 1980-2006**

<i>Ownership/Industry/Firm</i>	<i>Firm-years</i>	<i>Firm-years (complete data)</i>
<b>Traditional Chilean Business Groups</b>	<b>172</b>	<b>165</b>
<i>Pension Funds</i>	<i>52</i>	<i>45</i>
AFP Cuprum	18	18
AFP Provida	11	4
AFP Habitat	23	23
<i>Banking</i>	<i>27</i>	<i>27</i>
Banco de Crédito e Inversiones	27	27
<i>Health Insurance</i>	<i>19</i>	<i>19</i>
Banmédica	19	19
<i>Electricity</i>	<i>39</i>	<i>39</i>
CGE	27	27
Empresas Emel	12	12
<i>Oil and Mining</i>	<i>27</i>	<i>27</i>
COPEC	27	27
<i>Telecommunications</i>	<i>8</i>	<i>8</i>
ENTEL	8	8
<b>Non Traditional Chilean Business Groups</b>	<b>109</b>	<b>109</b>
<i>Banking</i>	<i>27</i>	<i>27</i>
Banco de Chile	27	27
<i>Electricity</i>	<i>16</i>	<i>16</i>
Endesa	8	8
Enersis	8	8
<i>Oil and Mining</i>	<i>21</i>	<i>21</i>
Cia. Minera del Pacífico	13	13
Minera Michilla	8	8
<i>Agribusiness</i>	<i>11</i>	<i>11</i>
IANSA	11	11
<i>Transportation and Logistic</i>	<i>34</i>	<i>34</i>
LAN Airlines	13	13
Agencias Universales	12	12
SCL Terminal Aereo	9	9
<b>State</b>	<b>48</b>	<b>42</b>
<i>Electricity</i>	<i>23</i>	<i>18</i>

Empresas Emel	5	5
Enersis	8	3
Endesa	10	10
<b>Telecommunications</b>	<b>17</b>	<b>16</b>
ENTEL	9	8
CTC-Telefónica	8	8
<b>Agribusiness</b>	<b>8</b>	<b>8</b>
IANSA	8	8
<b>MNCs from countries with high state intervention</b>	<b>124</b>	<b>123</b>
<b>Pension Funds</b>	<b>8</b>	<b>8</b>
AFP Provida (Spain)	8	8
<b>Banking</b>	<b>54</b>	<b>54</b>
Banco Santander (Spain)	27	27
Banco BBVA (Spain)	27	27
<b>Electricity</b>	<b>19</b>	<b>19</b>
Endesa (Spain)	9	9
Enersis (Spain)	10	10
<b>Agribusiness</b>	<b>7</b>	<b>7</b>
IANSA (Spain)	7	7
<b>Telecommunications</b>	<b>27</b>	<b>27</b>
ENTEL (Spain – Italy)	10	10
CTC-Telefónica (Spain)	17	17
<b>Transportation and Logistic</b>	<b>9</b>	<b>8</b>
Soc. Concesionaria Autopista del Maipo (Spain)	9	8
<b>MNCs from countries with low state intervention</b>	<b>48</b>	<b>41</b>
<b>Pension Funds</b>	<b>7</b>	<b>0</b>
AFP Cuprum (Canada)	7	7
AFP Provida (USA)	7	0
<b>Electricity</b>	<b>7</b>	<b>7</b>
Empresas Emel (USA)	7	7
<b>Telecommunications</b>	<b>2</b>	<b>2</b>
CTC-Telefónica (Australia)	2	2
<b>Oil and Mining</b>	<b>24</b>	<b>24</b>
Minera Escondida (Australia)	9	9
Empresa Minera de Mantos Blancos (UK)	15	15
<b>Agribusiness</b>	<b>1</b>	<b>1</b>
IANSA (UK)	1	1
<b>Total number of observations</b>	<b>501</b>	<b>480</b>

We gathered the data on the firms’ financial information and board composition from Chilean government regulatory agencies (*Superintendencia de Bancos e Instituciones Financieras*, *Superintendencia de AFP* and *Superintendencia de Valores y Seguros*), and corporate annual reports. We also interviewed fifteen senior officers, including companies’ directors with close connections to Chile’s center-left and right

wing parties, Spanish firms' directors, Chilean companies' directors, former CEOs, senior headhunters, and former managers from Chile's two largest pension funds. Due to the Chilean corporate elite's relatively small size, we are confident this is a representative sample.

## **Measures**

### ***Dependent variables***

Our unit of analysis is the firm. In order to analyze the likelihood of appointing directors with the same political orientation of the incumbent government we created a dichotomous variable, coded as 1 in a given year if the firm has at least one board member with the same political orientation of the government and 0 otherwise. Firms are not removed from the risk set following the appointment of the first directors connected to the government.

We define the political orientation of the board members only when these individuals were nationally recognized members of a party, occupied important government positions (like ministers or heads of influential government agencies), and publicly defined their political affiliation. We define as center-left those political parties belonging to the *Concertación* coalition: the Socialist Party (left), the Party for Democracy (PPD) (center-left), the Radical Social Democratic Party (center), and the Christian Democratic Party (center). The coalition's most influential parties are the Socialists and the Christian Democrats. On the other side of the political spectrum is the right-wing coalition *Alianza por Chile*. It includes the Independent Democratic Union (UDI, created in 1989) and the Party of National Renewal (RN, created in 1987). Chile has a third left wing coalition (*Juntos Podemos Más*) composed by the

Communist and Humanist parties. Their electoral results are negligible and no member of this coalition participated in the boards we study in this paper

We analyze the companies' performance by using the return on equity (ROE) as a proxy. In order to measure the impact of the presence of directors with the same political orientation of the incumbent government on the ROE, we created a dichotomous variable, coded as 1 in a given year if the firm has a return on equity above the mean and 0 otherwise.

### ***Independent variables***

This study analyzes the determinants of political connections at the board level (which we state as our first research question). We test the impact of ownership using the same definitions of ownership displayed in Table 2. We test the impact of the political orientation of the directors on the company's performance (our second research question) by using two variables: the proportion of board members with the same political orientation of the government and the proportion of directors from the opposition.

### ***Control variables***

In order to determine what types of firms are more likely to appoint directors with political ties to the incumbent party (our first research question), we use the following variables: (a) firm size, which we measure by the natural log of total assets (we expect larger firms to be more likely to appoint directors connected to the government); (b) firm's age; (c) ROE; and, (d) industry (banking, electricity, oil and mining, health insurance and pension funds, telecommunications, transportation and logistic or infrastructure).

In order to determine whether having directors with political connections to the incumbent party has an effect on the company's performance, we use as control variables the firm size, industry, firm's age and type of owners. A summary of the variables and their definitions is provided in Table 2.

**Table 3: Variable definitions**

Variable	Type of variable	Description
Research Question 1: What types of firms are more likely to appoint directors with the same political affiliation as the incumbent government?		
Firm connected with the incumbent government	Dependent variable	A dummy variable with value 1 if the firm have at least one director with the same political orientation of the incumbent government otherwise takes value 0
Type of owner	Independent variable	We define five types of owners. Traditional business groups, Non traditional business groups, State, Firms owned by countries with tradition on state intervention in the economy and Firms owned by countries without tradition on state intervention in the economy
Industry	Control	We have six industries. banking, electricity, oil and mining, health insurance and pension plans, telecommunications, transportation and logistic or infrastructure
Firm age	Control	Firm age
Firm size	Control	The natural log of the firm's assets
Firm performance	Control	Return on Equity
Research Question 2: Does having directors with political ties to the government improve the company's performance?		
Firm performance	Dependent variable	A dummy variable that takes value 1 if the firm has a return on equity above the mean and 0 otherwise.
Director close to the	Independent variable	Proportion of board members with the same

government		political orientation of the government
Directors from the opposition	Independent variable	Proportion of board members from the opposition
Type of owner	Control	We define five types of owners. Traditional business groups, Non traditional business groups, State, Firms owned by countries with tradition on state intervention in the economy and Firms owned by countries without tradition on state intervention in the economy
Firm age	Control	Firm age
Firm size	Control	The natural log of the firm's assets
Industry	Control	A dummy variable. We have six industries. banking, electricity, oil and mining, health insurance and pension plans, telecommunications, transportation and logistic or infrastructure

### ***Method***

We tested our hypotheses using discrete time event history analysis (Allison, 1982). Event history models are especially appropriate for analyzing longitudinal data with time-varying explanatory variables when the dependent variable is a discrete event. In this case, the event of interest is the appointment of directors with the same political orientation of the government. We observed the appointment of directors close to the government from 1980 to 2006 with time units of 1 year, yielding 480 firm-years of data. The discrete-time model can be written in logit form (Allison, 1982):

$$\log\left\{\frac{P_t}{1-P_t}\right\} = \alpha + \beta x_{t-1}$$

where  $P_t$  is the probability to appoint/have a director with the same political orientation of the incumbent government,  $x_{it,s}$  are time varying independent variables hypothesized

to influence the likelihood of having directors close to the government, and  $\alpha$  and  $\beta$  are parameters. Given time varying covariates, a firm's likelihood of change is updated over time as the values of independent and control variables change.

Since the dependent variable, having a director close to the government, it is not a long-lasting change, we modeled the likelihood for each year (i.e., the firm is not removed from the risk set following the change). Finally, we included year dummy variables in all models. We use the same model to answer our second research question. In this case, the event of interest is the return on equity above the average or below.

## Results

### *Summary statistics*

Table 3 presents descriptive information for the sample of firms. This table provides means and standard deviations for all data pooled. The total sample consists of 480 firm-year observations.

**Table 4: Descriptive statistics**

<i>Variable</i>	<i>Obs</i>	<i>Mean</i>	<i>Std. Dev.</i>	<i>Min</i>	<i>Max</i>
Firm age	480	43.975	32.557	0	123
Log assets	480	13.316	1.888	5.081	17.151
Roe	480	0.123	0.387	-7	1.9
Proportion of directors close to the government	480	0.139	0.233	0	1
Proportion of directors from the opposition	480	0.204	0.284	0	1

Table 5 displays the correlation matrix for the independent variables. We used Sidak adjustment to calculated significance levels (Long, 2001).

**Table 5: Correlation between Independent Variables**

	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17
<b>1 Firm Size</b>	1.00																
<b>2 Firm Age</b>	0.63**	1.00															
<b>3 ROE</b>	-0.06	-0.10	1.00														
<b>4 Proportion Government directors</b>	0.06	0.01	-0.06	1.00													
<b>5 Proportion Opposition directors</b>	0.18*	-0.05	-0.01	-0.28**	1.00												
<b>6 Agribusiness</b>	-0.08	-0.02	-0.05	0.16*	-0.07	1.00											
<b>7 Banking</b>	0.48**	0.65**	-0.05	-0.06	-0.18*	-0.13	1.00										
<b>8 Electricity</b>	0.03	-0.01	-0.02	-0.11	-0.24**	-0.12	-0.27**	1.00									
<b>9 Transport &amp; Logistics</b>	-0.11	-0.33**	0.01	0.12	-0.15	-0.08	-0.17*	-0.16+	1.00								
<b>10 Oil &amp; Mining</b>	0.06	-0.06	-0.06	-0.07	0.68**	-0.10	-0.23**	-0.21**	-0.13	1.00							
<b>11 Pension funds and Health Insurance</b>	-0.57**	-0.42**	0.15	-0.12	-0.09	-0.11	-0.24**	-0.23**	-0.14	-0.19*	1.00						
<b>12 Telecommunication</b>	0.09	0.03	0.01	0.21**	0.06	-0.09	-0.19*	-0.18*	-0.11	-0.15	-0.16+	1.00					
<b>13 Traditional Chilean BG</b>	-0.29**	-0.09	0.09	-0.23**	0.04	-0.18*	-0.11	0.05	-0.22**	0.03	0.44**	-0.14	1.00				
<b>14 Non Traditional Chilean BG</b>	0.08	-0.04	0.01	0.08	0.06	0.11	0.03	-0.08	0.43**	0.06	-0.24**	-0.19*	-0.39**	1.00			
<b>15 State</b>	-0.12	-0.13	-0.07	0.23**	-0.22**	0.18*	-0.17*	0.17*	-0.10	-0.13	-0.14	0.27**	-0.22**	-0.17*	1.00		
<b>16 MNC from countries with high state intervention</b>	0.35**	0.31**	-0.05	0.11	-0.15	0.00	0.30**	-0.08	-0.05	-0.25**	-0.16+	0.20**	-0.42**	-0.32**	-0.18*	1.00	
<b>17 MNC from countries with low state intervention</b>	-0.05	-0.16+	-0.02	-0.12	0.30**	-0.04	-0.16*	-0.03	-0.09	0.37**	0.01	-0.06	-0.22**	-0.17*	-0.09	-0.18*	1.00

+significant at 10% level, \* significant at 5% level; \*\* significant at 1% level

***Results: Research question 1 (What types of firms are more likely to appoint directors with the same political affiliation as the incumbent government?)***

Table 6 presents panel logit regression results predicting the likelihood to appoint a director with the same political orientation of the government. Model I reports results for control variables, model II reports results for control variables and the independent variable (type of owners). This regression is calculated taking into account both the years when Pinochet was in power as well as the Concertación years. We ran a regression considering only the Concertación period, but the results did not vary.

The results for the control variables indicate that firm size has a positive impact on the likelihood to have a director with the same political orientation of the government. Banking and electricity have a negative effect on the dependent variable. When type of ownership is introduced in the regression, the coefficients of firm size, banking and electricity do not lose statistical significance.

Hypothesis 1 predicted a positive association between MNCs from countries with high state intervention and the likelihood to appoint directors with the same political orientation of the government. This hypothesis is supported by our calculations. The results in model II indicate that hypothesis 2 is also supported. Our findings indicate a significant positive relationship between non-traditional Chilean business groups and the likelihood to have directors with the same political orientation of the government.

**Table 6: Regression Results**

	<b>Model 1</b>	<b>Model 2</b>
Firm size (log assets)	0.90** (0.29)	0.86** (0.27)
Firm age	0.01 (0.02)	0.02 (0.02)
Firm Performance (ROE)	0.62 (0.77)	0.51 (0.75)
Banking	-6.28* (2.42)	-6.03** (2.13)
Electricity	-4.62* (2.19)	-3.97+ (1.93)
Transport/Logistic	0.62 (2.35)	-0.03 (2.08)
Oil/Mining	-3.73+ (2.16)	-2.73 (1.92)
Telecommunications	-1.70 (2.36)	-1.05 (2.10)
Pension Funds/Health Insurance	-1.50 (2.27)	-0.11 (2.09)
<hr/>		
Non Traditional Business Groups		2.27* (0.91)
State owned		0.57 (0.91)
MNCs with high state intervention		2.38** (0.77)
MNCs with low state intervention		0.77 (0.88)
<hr/>		
Constant	-6.52+ (3.84)	-7.87* (3.57)
<hr/>		
Number of firm-year	480	480
Number of groups	24	24
Wald Chi square	83.92**	90.20**
<hr/>		

Standard errors are in parentheses

+significant at 10% level, \* significant at 5% level; \*\* significant at 1% level

Year is not reported but included in the regression

In order to have a clearer interpretation of our data, we calculate the marginal effect on the predicted probability to appoint directors with the same political orientation of the government for each type of owner for each year using the mean coefficients for the independent variables. We compare each type of owner against traditional Chilean business groups. The results displayed in Table 7 are consistent with what we obtained in the regression. For, example, in 2003 a MNCs from countries with high state intervention was 48% more likely to have a board member aligned with the government than a firm belonging to a traditional Chilean business group.

**Table 7: Marginal Effect on the probability to have at least one director with the same political orientation of the government**

	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	
Firms owned by Non Traditional Business Groups	8	1	5	4	2	8	6	8	10	0	23	8	7	6	43	44	51	42	13	26	51	51	49	43	39	43	
State owned firms	4	1	2	2	1	4	3	4	5	0																	
MNCs from countries with high state intervention	8	1	5	4	2	8	6	8	11	0	25	8	8	7	45	47	53	44	15	28	53	53	52	46	41	46	
MNCs from countries with low state intervention	5	1	3	2	1	5	4	4	6	0	4	1	1	1	10	11	15	9	2	5	15	15	14	10	8	10	

***Results: Research Question 2 (Does having directors with political ties to the government improve the company's performance?)***

Table 8 presents panel logit regression results predicting the likelihood of having a ROE above the mean (we do not find significant results using return on assets, ROA). We ran this regression for the Concertación Government (1990-2006) because during the Pinochet regime there were not directors from the opposition. Model I reports results for control variables, model II reports results for control variables and independent variables, proportion of director with the same political orientation of the government and directors from the opposition.

**Table 8: Regression Results**

	<b>Model 1</b>	<b>Model 2</b>
Firm size (log assets)	-0.10 (0.27)	-0.44 (0.32)
Firm age	-0.02 (0.02)	-0.01 (0.02)
Transport/Logistic	-2.86 (2.32)	-2.24 (2.20)
Agribusiness	-3.70 (2.36)	-5.27* (2.33)
Electricity	1.75 (1.61)	-1.30 (1.53)
Oil/Mining	-2.42 (1.73)	-7.63** (2.15)
Telecommunications	-1.16 (1.75)	-3.64* (1.77)
Pension Funds/Health Insurance	2.06* (2.36)	1.84 (2.40)
Non Traditional Business Groups	1.27 (1.16)	0.81 (1.21)
MNCs with high state intervention	-0.84 (0.87)	-0.48 (1.01)
MNCs with low state intervention	-1.19	-0.89

	(1.01)	(1.02)
Proportion of Government directors		1.31*
		(0.56)
Proportion of Opposition directors		7.77**
		(2.07)
Constant	3.50	6.25
	(4.25)	(4.71)
Number of firm-year	350	350
Number of groups	24	24
Wald Chi square	34.10	40.07+

Standard errors are in parentheses

+significant at 10% level, \* significant at 5% level; \*\* significant at 1% level

Year is not reported but included in the regression

Hypothesis 3 predicted that having directors with political ties to the incumbent government has a more positive effect on the company's performance than having directors from the political opposition. Our calculations, however, show that this hypothesis is not proved. The regression shows a positive relationship between a ROE above the mean and the proportion of both, directors with the same political orientation of the government and directors from the opposition. Moreover, the directors of the opposition show a more significant positive impact than those connected to the government.

## DISCUSSION AND CONCLUSION

In this paper we studied the appointment of individuals with political ties to the incumbent government in as a political strategy used by both domestic and foreign firms. We studied this strategy in the context of an emerging economy going through both a

political transition (from dictatorship to democracy) and an economic transition (from a protectionist model to a free market one). We also considered the presence of foreign investors coming from countries with different institutional backgrounds and the presence of business groups in the domestic economy. Our paper aimed to understand what types of firms were more likely to appoint directors with individual ties to the incumbent government and what effect did this strategy have in the companies' performance. We found that the firms more likely to appoint this type of individuals were those originating in countries where the relatively high level of government economic interventionism made this strategy necessary (and therefore had experience at following this kind of strategy), firms belonging to business groups with not ties or conflicting relationship with the previous political regime, and relatively large firms. Regarding the effect on performance, we found that having directors with ties to both the government and the opposition had a positive significance but although counter intuitively, the directors linked to the opposition seemed to have a higher significance than those linked to the government.

Our findings have several implications. First, although most studies on emerging economies take into account the important role played by business groups, we show that political and economic transitions (which took place in most emerging economies after the 1980s) can create different types of business groups: those benefited by the previous economic model and/or political regime and those created under or benefited by the new economic or political regime. The Chilean case shows that business groups originally benefited from protectionist policies (Schneider, 2007). When the Pinochet military dictatorship changed the economic model from a protectionist one into a free system one,

some of the previously privileged groups faced problems, while others adapted their business models (in close alliance and cooperation with the government) to more global oriented activities and by taking advantage of Pinochet's privatization policies (Silva, 1997; Khanna and Palepu, 2000; Del Sol and Kogan, 2007). These are the groups we define as *traditional business groups* in contrast to the *non-traditional business groups*, which were those who either did not benefit from the regime, whose leaders had not been considered part of Chile's traditional elite, or were created after Pinochet. We find that the non-traditional business groups were more open to the idea of appointing directors with political ties to the center-left incumbent regime. Intuitively, one would assume that building ties with the incumbent regime is the logical thing to do. If so, why did not the Chilean traditional business groups appoint center-left directors? If having center-left directors was good for business they should have followed this strategy. There are several reasons why traditional groups might have opted not to appoint individuals with ties to the government: on one hand, we can speculate that their ideological differences and the fact that some of these center-left politicians previously worked for a government that attempted to expropriate private property might have led the leadership of traditional business groups to reject this idea. It is not hard to imagine that a member of the Chilean business elite would see someone like Garretón, a former collaborator of Salvador Allende who lived exiled in Cuba as a "closeted commie." We just need to remember how shocked they were when Telefónica appointed Garretón as director. Another reason (which is not necessarily inconsistent with the previous one) can be that by the time Chile returned to democracy the traditional business had already built the networks they needed to continue thriving. In one of our interviews, an executive of a traditional business

group also mentioned that they had already developed their own political strategy consisting on approaching government officials through executives of lower level rather than board directors (Authors' interviews with Chilean high-ranking official, Santiago, 2008). Plus, given that the end the Pinochet regime did not lead to a purge of the ruling class that benefited economically from the dictatorship, the traditional business groups could continue using the business networks they had built both in Chile and abroad during the military government. Although more evidence is needed to prove this point, we clearly see that the non-traditional business groups or the Spanish MNCs (who not only were used to deal with the government, but also had a Socialist government ruling their country for years) did not share this history with the Chilean traditional business groups. Therefore, we believe that for studies analyzing business groups in emerging economies it is crucial to understand the relationship they had with both the incumbent and the previous regime.

Second, our study shows how the institutional environment of the MNCs country of origin affects their political strategy. This is particularly important now when contrary to what happened in the Cold War years, the world's main MNCs do not come only from rich countries with long-established and solid liberal democracies, but also from very diverse places like China, Brazil, or India (Ramamurti and Singh, 2009) and their firms will very likely develop political strategies that in some way reflect the environment in which they were created. For instance, recent studies on Chinese MNCs in Latin America show how these firms use the Chinese government as their main negotiator and how many of these firms do not invest anything until both the Chinese and the Latin American government have agreed in most aspects of the business (Ellis, 2009; Wise and

Quiliconi, 2007). This diversity of institutional frameworks in the MNCs home countries makes it imperative to avoid putting these firms together under the common label of “foreign firms” when analyzing their political strategies.

Third, other studies have argued that political ties between a company and the incumbent government have a positive effect in the company’s performance (Faccio, 2006). However, others argue that when there is a regime change (and particularly a transition from one dictator to another dictator or from dictator to democracy) the new government will punish firms that allied themselves with the previous regime (Siegel, 2007; Henisz and Delios, 2004). Our results show something different: first, the firms that allied themselves to Pinochet’s military regime were not punished by the democratic Concertación regime (in fact, they continued thriving). And, second, the presence of directors with political ties to the opposition seemed to have a higher significance on the company’s earning of higher than average profits, than the presence of directors with ties to the incumbent government’s political party. In order to understand this apparent contradiction, we argue that when studying regime change we need to understand the nature of the transition. Siegel (2007) and Henisz and Delios (2004) also studied the effects of the transition from dictatorship to democracy in South Korea and Indonesia, but the way the transition was done was very different from the Chilean case. While in both countries the end of the dictatorship came as a result of violent protests and the increasing political weakness of the dictator, in Chile the end of the Pinochet regime was decided through the 1989 plebiscite in which the opposition was relatively free to campaign against the regime. This plebiscite was made under the rules of the new Carta Magna written during Pinochet’s regime, which assured him personal safety and a life-long seat

in Congress in case he stepped down as president. This Constitution also guaranteed political privileges to the armed forces and judicial protection in case of prosecution. Pinochet lost the plebiscite and a negotiated transition process took place afterwards after which Pinochet stepped down and presidential elections took place bringing the center-left Concertación to power. Although considered abroad a model of democratic rule, Chile's Concertación did not change the economic model created under Pinochet, did not punish the sectors that enriched themselves during the dictatorship, and did not even go against previous members of the government. In fact, the Chilean democratic government played a crucial role at mobilizing resources to free Pinochet when he was arrested in London in 1998. The end of the Pinochet regime did not lead to mobs raiding and looting his house, members of his government rushing to the airport with suitcases stacked with cash, or summary trials of former government officials as happened with the fall of other autocrats such as Ferdinand Marcos in the Philippines, Suharto in Indonesia, or Nicolae Ceausescu in Romania. Pinochet died in Chile as a result of medical complications in 2006 and received military honors in his funeral, which was attended by around 60,000 loyal supporters (the government however, did not grant him the honors reserved to former heads of state). Therefore, this case shows that even in political transitions in which the country shifts from one type of regime dramatically different from the other one, studying the transition process (whether it is violent or not) can be crucial to understand the political strategies followed by domestic firms, MNCs, and business groups.

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