

5-2020

The influence of state political orientation on firm environmental practices

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Coberly, Trisha, "The influence of state political orientation on firm environmental practices" (2020).
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THE INFLUENCE OF STATE POLITICAL ORIENTATION ON FIRM ENVIRONMENTAL PRACTICES

A Thesis Submitted
in Partial Fulfillment
of the Requirements for the Designation
University Honors

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May 2020

This Study by: Trisha Coberly

Entitled: The Influence of State Political Orientation on Firm Environmental Practices

has been approved as meeting the thesis or project requirement for the Designation

University Honors

4/25/2020

Date

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Date

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Abstract

The purpose of this thesis is to examine the correlation between the political environment of the state where a company is headquartered and the implementation of environmentally sustainable practices. Additionally, I add firm specific factors as moderating variables to see if they will positively or negatively influence this relationship. Although there is an abundance of research on Corporate Social Responsibility (CSR) and its effects on firm performance this paper will look more narrowly at the environmental aspect of CSR and use state political orientation as the independent variable with firm characteristics acting as the moderating variables. Our results conclude that firms headquartered in Democratic leaning states invest more heavily in CSR and environmental practices than do companies headquartered in Republican leaning states. Firm leverage and performance were found to have a negative moderating effect on state political orientation and environmental practice adoption by firms.

1. Introduction

Over the past few decades, the pressure placed on firms to adopt more socially responsible practices has been amplified. With the rise of globalization, CSR is becoming increasingly important as firms of today are realizing their increasing impact on people all around the world (Haigh and Jones, 2006). While generating profit is still the main focus of business, there has been a significant paradigm shift since the 1970s — when CSR was introduced — which places a larger emphasis on the social, cultural, and environmental aspects of the triple bottom line model, in addition to the economic aspect (Collins et al., 2010; Haigh and Jones, 2006; Lu and Liu, 2014). Since profit is the main purpose of existence for a business, it is no surprise that there is an abundance of research available centered around the financial payoff of CSR implementation. There have been mixed results regarding monetary returns, but a majority of existing literature finds a positive correlation between CSR and financial performance. This is a result of the firm being forced to find ways to eliminate waste while maintaining efficiency, coupled with the fact that consumers favor more socially responsible firms (Haigh and Jones, 2006; Epstein and Roy, 2001). As society continues to place a greater emphasis on long term sustainability over short term profit, it is important to understand the internal and external drivers of sustainability practices.

Some studies have identified the increasing trend of CSR adoption as being influenced by the desire to create a favorable reputation and brand for the company to sustain a competitive position (Artiach et al., 2010; Collins et al., 2010). Other studies have found the values and beliefs of upper management, who ultimately decide company strategy, as being the critical drivers (Collins et al., 2010). One paper analyzed the effect of firm size and capacity for growth on CSR and found strong positive correlations. This may be due to the fact that large firms have greater access to resources for implementing sustainable practices, with one of those resources being knowledge. A study that looked at the adoption of CSR practices in large firms as compared to small and medium sized enterprises found that lack of knowledge influenced the relationship by threefold, meaning that small firms may have the desire to adopt CSR strategies but lack the knowledge to transform ideas into practice (Horisch et al., 2015). In addition to having more available resources, large firms also have more stakeholders, meaning more people publicly scrutinizing their sustainability practices and encouraging them to take advantage of CSR resources. This study defines stakeholders as “any group or individual who can affect or is affected by the achievement of the firm’s objectives” (Artiach et al., 2010). Stakeholder theory proposes that stakeholders ultimately control a firm’s access to scarce resources and firms must manage their relationship with key stakeholders to ensure that such access to resources is maintained” (Artiach et al., 2010). With the amount of power that stakeholders have over a company it is not surprising to see this as a key driver for adopting sustainable performance practices.

Additionally, government policy, competitors, and customer pressures also drive sustainability practices, as well as pressure from community and environmental interest groups. Some studies also note industry associations are tied to sustainability practices, or a lack thereof, as a firm is most likely to adopt strategies similar to firms which they are closely associated with (Delmas and Toffel, 2004). Lastly, the state of the economy can also influence CSR adoption, with research finding the logical correlation between a healthy economy and greater implementation of CSR, with the opposite holding true when the economy is in the midst of a

downturn (Campbell, 2007). However, despite the wealth of research available regarding determinants of CSR, there is a lack of research that focuses just on the environmental aspect.

Information surrounding global issues such as climate change have become more prevalent, sparking consumers to adopt more sustainable lifestyle practices and simultaneously place pressure on companies to adopt similar practices (Artiach et al., 2010). The question remains as to whether or not that pressure translates into actual transformations in firms towards more environmentally sustainable practices. One study broke down the drivers of environmental practices into the external and internal factors. The most influential external factors were government regulation and customer pressure, stating that many companies comply with government regulation to avoid punishment, but strive to go beyond requirements to create customer loyalty and gain competitive advantage (Del Mar Miras et al., 2018). Supplier audits and certifications such as ISO 14000 create a basis for customers to judge suppliers on their green practices, forcing companies to focus on their processes and its impact on the environment (Hofmann et al., 2012). The combined effect of these external pressures may induce a company to adopt more stringent environmental practices.

However, there must also be internal factors that create value for the company, driving them to adopt environmentally friendly practices. The most influential internal factors included top management support, employee support, and realized cost savings through efficiency and resource savings. Industry differences also play a role in the adoption of environmental practices, specifically citing that manufacturing industries have greater pressure to adopt sustainable practices as their processes inherently create more waste and pollution (Del Mar Miras et al., 2018). Other research found the ability of a firm to partner with another company, including a supplier or customer, as a driver of environmental practice implementation due to the shared organizational risks that are associated with adjustments in strategy (Hofmann et al., 2012). Lastly, because of technology, society is much more connected creating pressure from the media as it exploits firms with poor environmentalism measures, pressuring them to adopt sustainable practices to save their public image (Kassinis and Vafeas, 2006; Delmas and Toffel, 2004). However, there may be more factors at play in determining corporate environmental policy.

One aspect that is missing from the available research is the political dimension. There is significantly less research existing that explores how political orientation effects adoption of environmentally sustainable practices. One study conducted by Richard Borghesi found that CSR is largely influenced from the bottom up, with the political orientation of the firm's employees affecting the intensity of CSR practices. His results conclude that Democrat ideology leads to greater CSR support while Republican beliefs lead to more financial conservativeness and less development of CSR practices (Borghesi, 2018). Because of the effects these beliefs can have on sustainable practice adoption among firms, the purpose of this paper will be to fill the current gap in knowledge regarding the relationship between political affiliation of a state where a firm is headquartered and environmental practices, with firm attributes acting as moderating factors.

2. Background literature and hypotheses

2.1 Political Orientation and CSR

Since the main purpose for existence of a firm is to create value for its shareholders, a firm may be more inclined to act in the interest of shareholders within closer proximity to its headquarters. Attig & Brockman state that since the "corporate headquarters are the center of

information exchange between the firm and its investors” that it makes sense to align core business activities with the attitudes of those residing near the firm, which often includes many of the firm’s employees and business executives (Attig and Brockman, 2017). Furthermore, a study conducted on U.S. investment managers, found a strong preference for including locally headquartered firms in their portfolios, illustrating the “Home Bias” phenomenon (Coval and Moskowitz, 1999). This preference for investing in proximal firms may translate to greater influence for corporations to make business decisions in line with the values of their local investors. Corporations essentially act as mini societies. In accordance with the theory of normative behavior, a firm would be motivated to align its strategy with the beliefs of those housed within its mini society through stakeholder engagement (Husted et al., 2016) (Miles et al., 2006). Community isomorphism is also looked at as driver of corporate action, where a firm desires to appear just as legitimate as the corporations with which it is in direct competition (Hoi et al., 2018). Should a company fall below the standard set by other firms within the industry, it could negatively impact their competitive advantage.

In analyzing the research available regarding drivers of corporate action, I look more narrowly at the influence of political ideology as a driver of corporate decision making, specifically on CSR adoption. Our personal values, influenced by our perception of what is “right” or “wrong” and how society should function, shapes political alignment on the liberal-conservative spectrum. One study discussed the fluid nature of political beliefs, and how they are continuously refined as a product of personal experiences (Graham et al., 2009). Once a person has identified themselves as a member of a party, they become subject to partisan influence and information filtering, where information aligning with their party’s orientation are quickly accepted and ideas supporting the opposing party’s beliefs are met with stark criticism and rejection. This bias brings rise to the increasing polarization between liberal (Democrat) and conservative (Republican) platforms we see today (Rubin, 2008). There are some very fundamental issues that the two political parties have conflicting viewpoints on.

Some of the areas where Democrats and Republicans differ are in regards to equal rights, the economic system, and role of the government in maintaining the economic system. Supporters of the Democratic party focus on betterment of the collective group and often support government intervention as means of protection. They focus on society as a whole and often support welfare programs to assist the poor and disadvantaged, as well as affirmative action programs to increase representation of minorities (Di Giuli and Kostovetsky, 2014; Graham et al., 2009). To support such programs, countries with social democracies often have higher taxes and government spending (Rubin, 2008). Research shows liberal views also lead to greater openness to change and new experience than their conservative counterparts who prefer stability and predictability (Hutton et al., 2014; Graham et al., 2009). Republicans also favor less government intervention and a free market economy. They emphasize individual liberty, property rights, and natural market corrections with the government’s role being to step in only on issues the market is unable to correct (Hutton et al. 2015). With ideas favoring economic individualism as opposed to government social programs, countries with more libertarian systems have lower taxes as a result of less government spending (Rubin, 2008). These political views largely shape how we view things and the decisions we make. In fact, research shows that political ideology influences economic and financial decisions, as conservatives tend to favor financial security and be more risk and debt averse (Hutton et al., 2014). Given that these beliefs can influence personal decisions, I next explore how these beliefs can influence decisions made in the corporate setting, specifically related to CSR.

Bringing together the drivers of corporate action explored above and the political beliefs of those in the immediate geographical bounds of the community, I argue that these beliefs have a substantial influence on the decision of a corporation to invest in CSR practices. Because local stakeholders have a more vested interest in the performance of a firm, the combined effects of community norms and isomorphism create institutional pressure on the firm to make strategic decisions that appease to the beliefs of these stakeholders. Thus, firms located in liberal/Democratic states will tend to invest in CSR in greater amounts due to the liberal's holistic approach to maximizing value for everyone, including nonshareholder-stakeholders. On the contrary, I argue that firms headquartered in conservative/Republican states will invest in CSR to a lesser extent due to greater emphasis on creating wealth for its direct shareholders who are the ones funding the businesses decisions. We see evidence of this in a study that found that liberal firms spent on average \$18 million more on CSR than did conservative firms, and a 10% increase in votes for a Democratic candidate in the prior election translated to a .11 standard deviation increase in CSR (Di Giuli and Kostovetsky, 2014). A few studies also find a positive correlation between Democratic leaning CEO's and firms invested in CSR (Di Giuli and Kostovetsky, 2014; Gupta et al., 2017). Based on this information I form the following baseline hypothesis:

Hypotheses 1: The relationship between level of liberal/left state political orientation and firm CSR practices will be positive

2.2 Political Orientation and Environmental Practices

With evidence of studies supporting the baseline hypothesis, I look more narrowly at the corporate environmental responsibility (CER) subset of the broader CSR idea to see if the same relationship will hold true. There is literature available focusing on the larger CSR aspect, however minimal literature exists narrowing in on the environmental aspect of this. To explore the relationship between political orientation and environmental practices adopted by the firm I use the stakeholder theory approach. Stakeholder theory poses that the organization has in its best interest to act in favor of its stakeholders (Briscoe et al., 2014). Stakeholders of a firm can include the firm's shareholders as well as the non-voting constituents such as suppliers, creditors, or other members of the local communities (Hoi et al., 2018). Anyone affected by a firms' actions are considered stakeholders and thus exert stakeholder influence or pressure onto the firm. Since political ideology helps shape beliefs, the firm is then subject to these stakeholders' political beliefs as well.

In looking at the literature describing the correlation between Republican versus Democrat party alliances and support for environmental regulations, we see that as of the 1980's these beliefs have become increasingly polarized. Prior to the 1980's these environmental beliefs were more nonpartisan with Democrats only 10% more likely to vote for environmental policies than Republicans (Dunlap and McCright, 2008). However, following the Ronald Reagan era these beliefs began to diverge, leading us to the current state where Republicans support environmental policy to a lesser extent than Democrats (Dunlap and McCright, 2008). Similar to the foundations discussed for hypothesis 1, Republicans tend to be pro-business and favor regulation that facilitates company growth. On the contrary, Democrats tend to favor governmental regulation that encumbers degradation of the environment, such as pollution control laws. This relationship is evidenced by a study that analyzed the voting patterns of

legislators over 19 years and found that left leaning officials were more likely to vote in favor of environmental regulation than their right leaning counterparts (Lester, 1995). As a result of the underlying differences amongst Republican and Democrats and the resulting pressure the political ideologies of stakeholders place on firms, I propose the following hypothesis:

Hypothesis 2: The relationship between level of liberal/left state political orientation and firm environmental practices will be positive

2.3 Moderating Influence of Financial Performance

Additionally, there is little research exploring the moderating influence of financial performance on the relationship between political beliefs and environmental practices. Some studies have been conducted exploring the relationship between corporate social responsibility and firm performance, but less exploring the reverse relationship using financial performance as a driver of corporate social responsibility (Mishra and Suar, 2010; Saeidi et al., 2015) and especially to the narrower extent of environmental practices. To do this I turn to slack resource theory to help explain the role of excess financial resources from superior financial performance as a preceding factor to adoption of environmental responsibility practices. Although I refer to slack in financial terms, it can more broadly be defined as any potentially utilizable resource that can be deployed to either act as a buffer in times of stress, or serve as a catalyst in employing innovative or new strategic objectives that potentially have inherent risks and uncertain outcomes associated with them (George, 2005; Melo, 2012; Waddock et al., 1997). As corporations are under increased pressure from stakeholders and government regulations to become more environmentally and socially responsible, slack resources are imperative for meeting political objectives of competing coalitions by investing in innovation while still maximizing value for shareholders (George, 2005). Additionally, slack allows a firm to undertake those initiatives stemming from external pressures that might have a longer payback period, arguably the case with CER (Melo, 2012). One study found comparable results with improved financial performance preceding the allocation of funds to initiatives housed within the social domain (Waddock et al., 1997). It is with this evidence that I state prior financial performance as an indicator of CER in the following hypothesis:

Hypothesis 3: Firm performance will positively moderate the relationship between level of liberal state political orientation and firm environmental practices

2.4 Moderating Influence of Firm Leverage

Although the direction of causality and influence of firm performance on CSR has been researched to a greater extent, other financial determinants such as firm leverage have been left out of the research focus. Due to the limited literature available exploring the effects of firm leverage on environmental practice adoption, I turn to agency theory to explain this relationship.

Firm leverage refers to the means the company uses to acquire capital and is commonly referred to as capital structure. If a firm employs large debt financing from institutional sources it is highly leveraged, while firms largely financed by equity provided by selling stocks to shareholders are considered minimally leveraged (Hovakimian et al., 2001). As people buy

stocks from the company, thus becoming shareholders, they are essentially giving the corporation agency to invest their money into strategies adopted by upper management. The shareholders serve as principals to the company's leadership, who act as the agents to use their money (Jensen and Meckling, 1979; Denis et al., 1999). This relationship exists in many different segments such as real estate, where the real estate agent acts on behalf of the home buyer or sellers' interest. This concept is referred to as agency theory. Because of the nature of the relationship, it is impossible for the agent to always act in accordance with the expectations of the principal. This also holds true in the relationship between corporations and shareholders. When these beliefs are mismatched it creates agency costs (Denis et al., 1999). Therefore, it is in the best interest of the firm to act according to its shareholders' interests and reduce agency costs.

Since the shareholders exhibit pressure on the firm to act within their interests, this spills over into the political segment as well (Mishra and Modi, 2013). As argued above, the political leanings of the shareholders in the state where a company is headquartered can influence the corporate strategy and decision making of the company agents responsible for their money (Karassin and Bar-Haim, 2016). Thus, when a firm is largely equity financed it will have a greater incentive to act within the shareholders' interests, which are shaped through political ideology. On the contrary, when a firm is highly leveraged and financed largely by institutions who exert less political influence on the firm, they will have a decreased incentive to base their corporate strategy off the source of their debt financing. The financial institution takes on the role of a de facto shareholder in this instance and is likely far more interested in mitigating risk of default over environmental concerns. Hence, when a firm is highly leveraged the relationship between political ideology and environmental practices is negatively influenced. With this evidence in mind I state the following hypothesis:

Hypothesis 4: Firm leverage will negatively moderate the relationship between level of liberal state political orientation and firm environmental practices.

3. Methodology

3.1 Variables and Measures

To test our hypothesis, I use the state where a company is headquartered as the independent variable in determining the relationship between state political environment and corporate social responsibility practices. I use CSR performance scores, broken down into its environmental, social, and governance components as the dependent variable. To get an individual score for each of the three components as well as a composite score for each of the S&P 500 firms, I use the intangible value assessment (IVA) report housed within the ESG Direct database which is maintained by MSCI and used in multiple prior studies (Lins et al., 2017; Nagy et al., 2016; Attig et al., 2013). This corporation publishes various portfolio analysis tools and index reports for use in analyzing investment opportunities in global markets. After exclusions due to international headquarters and incomplete IVA data, there were 462 companies included in the study. To determine the political environment of the state where a company is headquartered, I compiled election results from 1988-2016 for each state from various sources. Then to create the variable, I assigned a 1 to the state if it voted Democratic and a 0 being

assigned to the state if it voted Republican each election year. The year 1988 was chosen as a starting point as many attribute the origins of the term “sustainability” to the book *Our Common Future* which was published in 1988 (Keeble, 1988). The scores from each of the election years between 1988-2016 were averaged to create a proportional index for the political environment of the state. To determine the relationship between the states political environment (independent variable) and environmental practice of the firms (dependent variable) and how firm-specific moderating variables influence that relationship, the data was compiled and analyzed using Stata.

I used the following variables for controls and as moderating effects: firm performance, company leverage, size, and firm experience. Data regarding these company specific variables including ROA, debt to equity ratio, number of employees, and company age were utilized from the Mergent Online database for the most recent 5 years of available data (2014-2018) as aligned with prior studies using this database (Berrios, 2013; Chao and Kumar, 2010; Tailab, 2014) (Abebe and Alvarado, 2013). This database is maintained by FTSE Russell, which is owned by the London Stock Exchange for purposes of reporting stock market indices. For reliability and availability, I focus on companies housed within the S&P 500 as of October 2019 who have headquarters in the United States. Companies in the S&P 500 that do not have central headquarters in the U.S were excluded from the dataset.

3.2 Model Specification

We use normal OLS regression with robust standard errors to analyze the relationships. We employ robust standard errors to control for possible bias caused by non-constant error variance.

4. Results

Table 1

VARIABLES	(1) Overall Score	(2) Environmental Pillar Score	(3) Social Pillar Score	(4) Governance Pillar Score
Net ROA	0.035+ (0.019)	-0.022 (0.021)	0.020 (0.019)	0.031** (0.011)
Leverage	-0.008** (0.003)	-0.003 (0.003)	-0.002 (0.002)	-0.001 (0.001)
# of Employees	-0.000* (0.000)	0.000*** (0.000)	-0.000*** (0.000)	-0.000+ (0.000)
Age	0.008*** (0.002)	0.004 (0.003)	0.002 (0.002)	-0.001 (0.001)
Election Index	0.699** (0.244)	0.751* (0.315)	0.252 (0.189)	-0.060 (0.168)
Constant	4.181*** (0.241)	7.453*** (0.512)	3.682*** (0.370)	4.442*** (0.324)
Observations	462	462	462	462
R-squared	0.060	0.256	0.104	0.168

Robust standard errors in parentheses. *** p<0.001, ** p<0.01, * p<0.05, + p<0.1. Model 1 is an industry adjusted score. Industry controls for models 2, 3, and 4 added but not included.

Table 2

VARIABLES	(1) Industry Adjusted Score	(2) Industry Adjusted Score	(3) Environmental Pillar Score	(4) Environmental Pillar Score
Leverage	-0.008** (0.003)	0.075* (0.031)	-0.004 (0.003)	0.061+ (0.034)
# of Employees	-0.000* (0.000)	-0.000* (0.000)	0.000*** (0.000)	0.000*** (0.000)
Age	0.008*** (0.002)	0.008*** (0.002)	0.003 (0.003)	0.003 (0.003)
Election Index	0.808+ (0.418)	0.958*** (0.263)	1.522** (0.539)	0.949** (0.332)
Net ROA	0.046 (0.037)	0.033+ (0.019)	0.059 (0.041)	-0.023 (0.021)
Election Index * Net ROA	-0.016 (0.049)		-0.111* (0.053)	
Election Index * Leverage		-0.164** (0.062)		-0.126+ (0.067)
Constant	4.107*** (0.321)	4.055*** (0.245)	6.928*** (0.602)	7.427*** (0.506)
Observations	462	462	462	462
R-squared	0.060	0.068	0.262	0.259

Robust standard errors in parentheses
 *** p<0.001, ** p<0.01, * p<0.05, + p<0.1

Table 1 Model 1 shows the results of the regression analysis. Based on preliminary research, I anticipated that there will be a positive correlation between state political orientation (Democrat = 1, Republican = 0) and corporate social responsibility practices. I found this relationship to hold true with positive and significant results ($p < 0.01$). As a result, hypothesis 1 is supported. I also tested several firm level factors to determine their influence on this expected result and found that firm leverage (debt to equity) and size (# of employees) were negative and significant ($p < 0.01$ for leverage; $p < 0.05$ for size). This suggests that companies headquartered in more Democratic leaning states invest in CSR to higher levels than do companies headquartered in Republican leaning states. However, as leverage and size of the company increase, this relationship is weakened suggesting that larger firms with higher debt financing are less likely to

engage in CSR practices. Social and governance pillars were also added in to show how these factor into the overall score.

In looking more narrowly at the environmental score, I anticipated based on prior research that there would be a positive correlation between state political orientation (Democrat = 1, Republican = 0) and environmental practices. The table shows that this relationship is positive and significant at the $p < 0.05$ level, and thus hypothesis 2 is also supported.

The results in Table 2 show a surprising result as firm performance, measured by ROA, has a negative moderating effect on the relationship between political orientation and environmental score ($p < 0.05$), thus failing to support hypothesis 3. As anticipated, leverage has a negative and significant moderating effect ($p < 0.01$) on the relationship for the overall score and a marginally significant effect on the environmental score ($p < 0.10$). As a result, hypothesis 4 is somewhat supported.

5. Conclusion

This study makes a contribution to the limited research available regarding implications of political orientation of the state where a firm is headquartered and environmental practices adoption. The inclusion of firm performance (ROA) and leverage (debt to equity ratio) as moderating variables also contribute to this gap in research. To start we set a baseline hypothesis that political orientation would be positively related to the all-encompassing Corporate Social Responsibility domain, which includes environmental, social, and governance aspects. As anticipated from prior research we found support for this hypothesis. This suggests that as the state where a company is headquartered votes more Democratic, the proximal firms will tend to invest more in CSR.

We then more narrowly looked at this relationship focusing on only the environmental aspect of CSR and found the same relationship to hold true, supporting hypothesis 2. Although prior research in this area was minimal, we suggest the influence of stakeholder theory is at play in this as firms have it in their best interest to align corporate policies with stakeholder beliefs. Our research shows that in general, people with more liberal views support environmental regulation to greater extent, suggesting that if a firm is headquartered in a more Democratic state it would be under greater influence to make investments in environmental initiatives.

We then explored how the moderating variables of ROA as a measure of firm performance, and debt to equity ratio as a measure of firm leverage would strengthen or weaken this relationship. Based on the application of the slack resource theory we predicted that better performing firms would have excess resources to spend on initiatives such as environmentalism, leading us to hypothesis 3 which stated a positive correlation between ROA and environmental practices. However, the results did not support our hypothesis and showed the opposite relationship to hold true, with firms that have lower ROA investing in environmental practices to a greater extent. Research underlying the cause of this negative relationship could be a starting point for further research.

Using aspects of agency theory, we predicted that highly leveraged firms would have lower investments in environmental practices due to the fact that they are funded by banking institutions to a greater extent than shareholders, and thus being under less influence to adopt corporate strategies aligning with the shareholders' beliefs. The results supported our hypothesis and show that highly leveraged firms weakened the relationship between political orientation and environmental policy adoption.

Overall this paper seeks to fill the gap in the knowledge relating political orientation to environmental practices adopted by the firm, in hopes that it can be used as a basis for further in depth research regarding this relationship.

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