

# Political Connections and Firm Performance

## Evidence from ST Firms of China

Shanshan Yao

Southwest Jiaotong University

Chengdu, China

E-mail: shanshanyao01@126.com

**Abstract**—Using Heckman two stage regression, this paper investigates the effect of political connections of ST firms on firm performance. We find that political connections do play a positive role on the firm performance, but the influence is effective in the short term. What's more, the influence varies from the ownership of distress firms, for private distressed firms, the influence of political connections on firm performance is significant positive, but such a pattern is not observed in stated-owned enterprises.

**Keywords**—political connections; firm performance; ownership

### I. INTRODUCTION

Political connections are a widespread phenomenon in developing and transition countries and their effects have attracted growing research interest. Many studies have found that political connections have a positive effect on firm performance (Fisman, 2001; Goldman et al., 2009). Prior research also documents that this positive effect is derived from government-related benefits, where political connections help firms to attain key resources, including bank loans, government subsidies and market power (Adhikari et al., 2006; Claessens et al., 2008).

However, fewer studies focus on the influence of political connections on the special groups-financial distressed firms. Some scholars distinguish normal listing companies and distressed companies, but few people study the effect of the political connection of ST firms on the recovery from financial distress. After plunged into financial distress, political connections can really help the enterprise improve the firm performance? Are influences the same for firms with different ownership? Based on the existing studies of home and abroad, this paper starts from the view of political connections of distressed firms, to empirically test the effect of political connections on the improvement of firm performance.

### II. LITERATURE AND HYPOTHESES

Faccio (2006) compared 900 politically connected enterprises and non-connected enterprises in 35 countries around the world between 1997 and 2002, the results show that politically connected firms have higher debt ratio, and politically connected firms are more likely to get debt relief or even direct handouts when fallen into dilemma.

Ovtchinnikov (2012) found that individual political contributions are associated with improvements in operating performance of firms in industry clusters. The relation between contributions and firm performance is strongest for poorly performing firms, firms closer to financial distress, and for contributions in close elections. The results imply that individual political contributions are valuable to firms, especially during bad economic times. Hu (2011) choose SOEs in China between 2001 and 2005 as samples, and found that, in the face of crisis, the state-owned enterprises are more likely to replace and appointed politically connected executives, the newly connected executives improves the performance of the company. All the above results show that, in financial crisis, corporate political connection have may bring more bank loans, financial subsidies and so on, which are helpful to the recovery from the financial crisis.

Based on the foregoing analysis, we propose hypothesis 1:

Hypothesis 1: On the whole, for ST firms, political connections owned by company executives will significant improve the firm performance.

But the influence of political connection on the firm performance may differ from the ownership of enterprises. For the state-owned enterprises, the influence may be insignificant. As the government holds shares in all listed SOEs, either directly or indirectly, SOEs have ownership links with the government. These ties are more explicit and stable than a politically connected manager's personal link with the government, which indicates that the role of politically connected SOE managers in attaining government-related benefits is not as important as that of their counterparts in private firms. In other words, the value of the political connections of SOE managers may be diluted by government ownership. Moreover, politically connected SOE managers may detract from firm performance because they need to implement the government's social and political objectives. But for private enterprises, the influence of political connection on the recovery from financial distress may be significant. As they are controlled by non-government units, private firms lack official connections with the government. However, in an institutional environment marked by a highly interventionist government and weak property rights protection, private firms need to establish connections with the government to reduce

discrimination and seek rents (Li and Zhou, 2005). Hiring politically connected managers is a convenient and effective channel for private firms to forge links with the government, which can help to overcome their institutional disadvantages and bring some government-related benefits. As documented in previous studies (Adhikari et al., 2006; Claessens et al., 2008), the politically connected managers of private firms use their ties to help their firms to obtain key government resources and support, such as government subsidies. Thus, these politically connected managers have a positive impact on the recovery from financial distress.

Based on the foregoing analysis, we propose hypothesis 2:

Hypothesis 2: For private distressed firms, the influence of political connections on the improvement of firm performance is significant, while the influence is insignificant for SOEs.

### III. RESEARCH DESIGN

#### A. Sample selection and data sources

The data of ST firms from 2002 to 2010 are obtained from the China Securities Markets and Accounting Research (CSMAR) database. We exclude the financial service firms, delisted companies, and the firms which have been Special Treatment for two or more times. In this way, our sampling procedure yields 224 sample firms. As we calculate that the sample ST firms use 2.67 years on average to recover from the financial distress, we examine the 3 years performance of firms after been special treatment. Information on the political backgrounds of the chairmen, CEOs is collected by reading annual reports or summaries of top management resumes published on the finance Web pages such as Sina finance.

#### B. Measurement of the key variables

This paper selects ROA of adjacent years after been special treatment (adjusted by the median of annual market) to measure the operating performance of distressed firms, where  $\Delta ROA_1$  represents the difference of ROA between the

first year after been special treatment and the year been special treatment, similarly,  $\Delta ROA_2$  represents the difference of ROA between the second year after been special treatment and the first year been special treatment,  $\Delta ROA_3$  represents the difference of ROA between the third year after been special treatment and the second year been special treatment.

We define PC as a dummy variable that equals one if a firm has a politically connected chairman and/or CEO, and zero otherwise. The chairman of the board or CEO is identified as having political expertise or political background if i) he or she has had experience working in government or the military; or ii) has held one of two main party position-CPPCC or Representative of the National People's Congress. What's more, we have other control variables, including firm size (SIZE), the liability ratio (LEV), the largest shareholder stake (OWN1) and whether to change the controlling shareholder (HOLD), etc.. In addition, Routledge (2004) and Chowdhury (1996) also pointed out that the free asset ratio (FREE) and efficiency-oriented strategy (EOS) are also effective for the improvement of firm performance. The calculation formula of free asset ratio is (tangible assetst - liabilities)/tangible assetst. The calculation formula of EOS is (tangible assetst+1 - tangible assetst)/tangible assetst, where t and t+1 represent the ST year and the next year respectively.

#### C. Model

Previous studies confirmed that political connections may be endogenous, there is selection bias. Therefore, the paper selects Heckman two-stage method to eliminate the effects. Using probit model, the first stage estimates the emergence of political connection (ie, Model 1), where, ENROLL is a dummy variable, if the firm is registered in the sub-provincial or provincial administrative center, the value is 1, otherwise 0; LNGDP represent the logarithm of per capital GDP of the registered province; ROA is the company's return on assets. The first stage regression yields inverse Mills ratio (IMR), then we add the IMR into the second stage regression.

$$PC = \alpha + \beta_1 * ENROLL + \beta_2 * LNGDP + \beta_3 * OWN1 + \beta_4 * HOLD + \beta_5 * ROA + \beta_6 * SIZE + \beta_7 * LEV + \beta_8 * INDUS + \varepsilon \quad \text{Model (1)}$$

$$\Delta ROA_i = \alpha + \beta_1 * PC + \beta_2 * FREE + \beta_3 * EOS + \beta_4 * SIZE + \beta_5 * LEV + \beta_6 * OWN1 + \beta_7 * HOLD + \beta_8 * INDUS + \varepsilon \quad \text{Model (2)}$$

### IV. EMPIRICAL RESULTS

#### A. Descriptive statistics

Descriptive statistics for our main variables are presented in "Table I". About 54% ST firms have political backgrounds. The mean of FREE and EOS is 0.214 and 0.163 respectively, indicating that the distressed firms have certain free assets to cope with financial difficulties, which is conducive for them to get out of financial trouble. The average debt ratio of ST firms is higher than 74%. In the first two years after been special treatment, the performance has improved slightly, but fell in the third year.

#### B. Univariate Analysis

According to the sample firms have political connections or not, we divide our sample into two categories: "PC firms" and "Non-PC firms" "Table II". The results show that political connected firms improve the operating performance in the first two years after the dilemma, but the improvement can't continue until in the third year. While the performance of distressed firms without political connections continue to deteriorate, but the degree of deterioration decreases.

TABLE I. SUMMARY STATISTICS OF MAIN VARIABLES

	N	Mean	SD	Min	Max	Median
PC	224	0.536	0.500	0.000	1.000	1.000
FREE	224	0.214	0.549	-4.464	0.949	0.316
EOS	224	0.163	0.845	-0.936	6.580	0.002
SIZE	224	20.710	1.003	17.707	25.000	20.607
LEV	224	0.738	0.483	0.051	4.083	0.658
OWN1	224	36.604	15.780	7.750	74.690	33.100
HOLD	224	0.500	0.501	0.000	1.000	0.500
$\Delta ROA_1$	224	0.041	0.645	-2.730	6.550	0.008
$\Delta ROA_2$	224	0.017	0.795	-6.055	8.198	0.004
$\Delta ROA_3$	224	-0.025	0.670	-7.638	5.462	-0.001

TABLE II. UNIVARIATE ANALYSIS OF PC AND NON-PC FIRMS

	PC firms	Non-PC firms	T test
$\Delta ROA_1$	0.140	-0.073	-2.4962**
$\Delta ROA_2$	0.086	-0.063	-1.4044
$\Delta ROA_3$	-0.024	-0.025	-0.0133
N	120	104	

Note: \*, \*\* and \*\*\* denote significance at the 10%, 5% and 1% levels, respectively.

TABLE III. INFLUENCE OF POLITICAL CONNECTIONS ON FIRM PERFORMANCE

	Full sample			Private firms			SOEs		
	$\Delta ROA_1$	$\Delta ROA_2$	$\Delta ROA_3$	$\Delta ROA_1$	$\Delta ROA_2$	$\Delta ROA_3$	$\Delta ROA_1$	$\Delta ROA_2$	$\Delta ROA_3$
CONS	1.907 (1.55)	-0.558 (-0.35)	0.950 (0.72)	1.154 (0.52)	0.961 (0.49)	0.662 (0.78)	2.229* (1.73)	-0.075 (-0.04)	-0.485 (-0.26)
PC	0.166** (1.94)	0.153 (1.38)	0.022 (0.24)	0.380** (2.38)	0.251* (1.75)	-0.037 (-0.60)	0.018 (0.21)	0.058 (0.40)	0.082 (0.63)
FREE	0.534 (1.22)	0.355 (0.63)	0.653 (1.40)	-0.379 (-0.71)	-0.054 (-0.11)	0.429** (2.07)	-1.390 (-1.63)	0.623 (0.44)	1.625 (1.30)
EOS	-0.035 (-0.70)	0.014 (0.22)	-0.014 (-0.27)	0.035 (0.34)	0.070 (0.76)	-0.018 (-0.45)	-0.031 (-0.61)	0.003 (0.04)	-0.010 (-0.15)
SIZE	-0.066 (-1.37)	0.008 (0.14)	-0.066 (-1.28)	-0.051 (-0.53)	-0.018 (-0.21)	-0.038 (-1.04)	-0.007 (-0.17)	-0.029 (-0.38)	-0.088 (-1.28)
LEV	0.843* (1.67)	0.361 (0.56)	0.528 (0.98)	-0.957 (- 1.38)	-0.037 (-0.06)	0.437 (1.63)	-0.742 (-0.84)	0.847 (0.57)	1.512 (1.16)
OWN1	0.002 (0.08)	0.003 (0.09)	-0.002 (-0.10)	-0.005 (- 0.59)	0.006 (0.76)	0.006* (1.89)	-0.003 (-1.27)	0.009 (0.22)	-0.006 (-0.16)
HOLD	-0.318** (-2.05)	-0.078 (-0.39)	-0.134 (-0.81)	0.161 (0.63)	-0.420 (-1.84)	-0.230** (-2.34)	-0.248* (-1.89)	-0.068 (-0.31)	0.103 (0.54)
IMR	-1.517*** (-3.49)	-0.092 (-0.17)	-0.007 (0.00)	0.630 (0.86)	-0.938 (-1.42)	-0.451 (-1.59)	-1.152*** (-3.19)	-0.035 (-0.06)	1.035** (1.96)
INDU	YES	YES	YES	YES	YES	YES	YES	YES	YES
N	224	224	224	70	70	70	154	154	154
Adj- $R^2$	0.058	-0.028	0.003	0.137	0.075	0.231	0.257	-0.043	0.017
F	2.38	0.38	1.08	2.37	1.71	3.60	7.64	0.20	1.33

Note: The t-values, which are based on robust standard errors are presented in the parentheses below the estimates. \*, \*\* and \*\*\* denote significance at the 10%, 5% and 1% levels, respectively.

### C. Regression results analysis

Heckman regression results are shown in Table 3. For the full sample, after controlling for firm size, debt ratio, the free assets, political connections could enhance firm performance in the first year, while the influence is insignificant for the second and third years, which verify the hypothesis 1. After plunged into financial distress, corporate executives may actively use their social resources to seek assistance for businesses, such as obtaining bank loans, financial subsidies, but these measures can only be a lifesaver, but can't really improve the company's management.

Sub-Sample results show that, for private firms, in the first two years after plunged into financial distress, the coefficient of PC is significantly positive, indicating that political connections could indeed improve the company's operating performance. While for state-owned enterprises, the coefficient of PC is positive but insignificant. The results verify the hypothesis 2, the influence of political connection on performance vary from the nature of ownership. For private distressed firms, the influence of political connections on the improvement of firm performance is significant, while the influence is insignificant for SOEs.

## V. CONCLUSION

Using data of Chinese listed ST firms from 2002 to 2010, this paper investigates the effect of political connections of ST firms on firm performance. We find that political connections do play a positive role on the firm performance, and the influence is effective in the short term. What's more, the influence varies from the ownership of distress firms, for private distressed firms, the influence of political connections on firm performance is significant positive, but such a pattern is not observed in stated-owned enterprises.

This paper shows that political connection could improve firm performance to some extent, especially for private firms, which explains the motivation of domestic companies interested in establishing political connections. However, the improvement of political connection brings to firm performance is short-term, which could only be a temporary solution, not a permanent cure. In order to obtain long-term competitive advantage, the company has to strengthen their management, improve management efficiency of the board.

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