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and Firm Performance in China**

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# Business Cycles, Political Connectedness, and Firm Performance in China

Shun Wang\*

September 2016

**Abstract:** In this paper I examine the impact of firms' political connectedness on firm performance in private listed Chinese firms in the manufacturing sector, exploiting a policy shock, that is, the 4-trillion-yuan (\$586-billion) economic stimulus plan in 2009 in response to the 2008 financial crisis. I use the difference-in-difference (DID) method to estimate the impact of political connectedness, comparing the change of firm performance in association with the stimulus between politically connected firms and non-connected ones. I find that political connectedness, particularly executives or directors being political delegates, enable firms to have better access to bank credit but have no direct impact on firm sales. Moreover, the two types of political connectedness, being political delegates or former officials, have different impact on firm profitability.

**Keywords:** Financial crisis; 4-trillion-yuan economic stimulus plan; Political connectedness; Debt ratio; Return on Assets; Return on Equity; Sales

**JEL:** D02; D22; H32; L1; L25

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## **1 Introduction**

In a developing country with underdeveloped markets and market-supporting institutions, firms are found to have incentives to develop connections with governments (Jia, 2016; Li, Meng, & Zhang, 2006; Liu, Luo, & Xu, 2015) and thus political connectedness is particularly prevalent in developing countries (Faccio, 2006). To what extent and through which channels political connectedness affects firm performance attracts more and more attention among researchers recently in many fields.

Many studies find that political connections have a positive effect on firm performance (Do, Lee, & Nguyen, 2015; Leuz & Oberholzer-Gee, 2006; Feng, Johansson, & Zhang, 2014, 2015; Feng & Johansson, 2014; Fisman, 2001; Goldman et al., 2009; Haveman, Jia, Shi, & Wang, 2016; Li et al., 2008; Liu, Uchida, & Gao, 2012; Su & Fung, 2013). The potential reasons are that politically connected firms enjoy benefits such as bank loans (Boubakri, Cosset, & Saffar, 2012; Charumilind, Kali, & Wiwattanakantang, 2006; Claessens, Feijen, & Laeven, 2008; Feng et al., 2015; Khwaja & Mian, 2005; Su & Fung, 2013; Xu, Xu, & Yuan, 2011; Yeh, Shu, & Chiu, 2013), favorable tax treatments (Adhikari et al., 2006; Claessens et al., 2008; Feng et al., 2015; Wu, Wu, Zhou, & Wu, 2012), easier access to state-controlled resources and lower risks of expropriation (Bunkanwanicha & Wiwattanakantang, 2009; Chen, Newman, Sun, & Wu, 2010; Cho & Joh, 2014; Cull & Xu, 2005; Faccio, Masulis, & McConnell, 2006; Feng et al., 2015; Li & Zhang, 2007; Li, Meng, Wang, and Zhou, 2008; Wu, Wu, & Rui, 2010; Yuan, 2011), market power (Johnson & Mitton, 2003), and rent seeking (Feng et al., 2014; Guo, Jiang, Kim, & Xu, 2014).

Besides the Besides those directly channels, there are also indirect channels through which political connectedness may have impacts on firm performance, for example, Xu, Yuan, Jiang, and Chan (2015) find that politically connected founders are more prone to appoint a second generation as a family firm executive or director, and second generation involvement improves firm performance with the curtailment of tunneling as an important channel of performance enhancement.

Political connectedness is also found to have other impacts other than firm performance. Li, Song and Wu (2015) find a significant and positive relationship between political connectedness and the likelihood and extent of corporate philanthropy, and the effect is stronger in private firms in China. Ang and Jia (2014) find that politically connected firms are more prone to use courts over informal avenues of dispute resolution.

Several studies find that political connections could be costly for firms and thus may have a negative impact on firm performance (Bertrand, Kramarz, Schoar, & Thesmar, 2007; Boubakri, Cosset, & Saffar, 2008; Faccio, et al., 2006), due to inefficient hiring (e.g. Bertrand

et al., 2007; Fan, Wong, & Zhang, 2007; Faccio, 2010; Saeed, Belghitar, & Clark, 2015; Wu, et al., 2010; Wu et al., 2012; Yuan, 2011), CEO incompetence and the insensitivity of CEO turnover to performance (Yuan, 2011), or inefficient investment (Liu et al., 2015; Saeed et al., 2015). Though politically connected firms are more likely to get bank credit, they are also more likely to default (Khwaja & Mian, 2005), which may suggest their low efficiency in firm operation.

Political connections may have other negative effects on firms. For example, politically connected firms are more likely to have poor quality of earnings report (Chaney, Faccio, & Parsley, 2011), tends to avoid potentially costly compliance measures by reporting fewer violations of safety compliance (Fisman & Wang; 2013), and are less likely to access international financing (Leuz & Oberholzer-Gee, 2006).

In this paper I follow this strand of literature to study the net impact of political connectedness on Chinese firms' performance, exploiting one recent policy shock in China. The subprime mortgage crisis originated from U.S. started to affect China's economy in late 2008. To cope with the economic difficulties caused by the crisis, China government launched the so-called "4-trillion-yuan (\$586-billion) economic stimulus plan" in 2009 to stimulate the economy. The overall stimulus plan mainly included three interrelated components: an investment plan, an explosive increase of bank credit, and a series of industrial policies (Naughton, 2009; Fardoust, Lin, & Luo, 2012). Thus we may expect that politically connected firms benefit more than the non-connected ones from the stimulus program. Firstly, politically connected firms may get more support from government particularly during the crisis (Leuz & Oberholzer-Gee, 2006), for example, to get more government contracts (Cho & Joh, 2014). Secondly, politically connected firms are more likely to have access to bank credit. The stimulus plan thus provides us a good opportunity to examine whether politically connected firms can benefit more than those non-connected firms from the massive economic stimulus program.

This study aims to test the impact of political connectedness exploiting the economic stimulus program. For this purpose, I restrict the study period near 2008-2009, covering the three years before the 2008 financial crisis, i.e. 2005-2007, and the three years following the 2009 4-trillion-yuan stimulus program, i.e. 2010-2012, so that firms' political connectedness are relatively stable. This sample of firms is those non-state-owned enterprises publically traded in Shanghai and Shenzhen Stock Exchange. There are two reasons why I choose the listed firms for the study. Firstly, In China, the listed firms are generally among the largest firms and are most important players in the economy, thus it is important to learn their behaviors. Secondly, much more abundant and reliable information is available on listed firms than on

non-listed firms. I further restrict the sample to private listed firms in the manufacturing industry to yield a more uniform sample.

I use the difference-in-difference (DID) method, comparing the change of firm performance in association with the 4-trillion-yuan economic stimulus plan in 2008-2009 between politically connected firms and non-connected ones. Firm-level political connectedness is defined by executives and directors' current political delegates status and past employment history in public sectors following Ang and Jia (2014).

I find that the two types of political connectedness play different roles for firms. Executives or directors being delegates enables firm to have more access to loans, particularly short-term loans, but undermine firm's profitability. However, executives or directors being former government officials have no significant impact on firm's access to financing, but is positively correlated with firm profitability. Both types of connectedness have no contribution to firm's sale, either domestically or internationally. This study may help reconcile the conflicts in previous studies regarding the impact of political connectedness on firm performance that some find positive impacts while others find negative impacts: different types of political connectedness may have different impacts on firm performance.

The rest of this paper is organized as follows. Section 2 introduces data and research methodology. Section 3 presents the results. Section 4 concludes.

## **2 Data and Empirical Methodology**

Firms' financial data are extracted directly from the China Security Market and Accounting Research (CSMAR) database, which covers all the listed firms in China stock market. Political connectedness is hand-collected from the resumes of each listed firm's executives and directors (excluding independent directors), as many previous studies have done (e.g. Ang & Jia, 2014; Feng & Johansson, 2014; Feng et al., 2015; Haveman et al., 2016).

A firm's political connectedness is defined by two binary variables. The first is whether any executives or directors serves as a delegate of the People's Congress (PC), the Congress of the Chinese Communist Party (CCCCP), the Chinese People's Political Consultative Conference (CPPCC) at the national and provincial levels. As a delegate of PC, CCCC, or CPPCC, an executive may enjoy a wide range of benefits such as social and political recognition, connections with important government bureaucrats, and policy influence (Li et al., 2006; Liu et al., 2015). The second is whether any executives or directors was a former government official at the division level (*chu*, a county head's official rank) or above in the cadre hierarchy. This threshold level is commonly used in previous studies of defining firms'

political connectedness since the division level or above is viewed as political elite and lower levels may not have enough political influence (e.g. Ang & Jia, 2014; Haveman et al., 2016).

In the China context, senior managerial personnel of a firm being a political delegate or a former government official constitutes two main avenues by which firms directly connect to the government (Ang & Jia, 2014). The political connectedness captured in this paper is different from political connections gained without frequent interactions with government officials, such as Chinese Communist Party (CCP) membership (Li, Meng, & Zhou, 2008). It is also different from measures of indirect connections, such as whether one has friends working in the government (Tsai & Xu, 2014), whether one has relatives working in the government (Kung & Ma, 2016), or whether the firm are in the industry and the city a top political leader ever worked for and the leader was in power in the year (Qin, 2012).

Figure 1 presents the share of firms in the manufacturing sector being politically connected in the period of 2005-2012. The shares of firms with executives or directors being delegates and former officials are slightly above 20% and 60% respectively. Moreover, the two indicators of political connectedness are quite stable in the study period, though there seems to exist a mild downward trend.

Firm performance is measured by three sets of indicators. The first set is about firm financing, including debt ratio (total liabilities/total assets), short-term debt to asset ratio, and long-term debt to asset ratio. The second set is about sales, including logged total sales, logged domestic sales, and logged export. The third set is about profitability, including return on assets (ROA) and return on equity (ROE). The control variables include firm size measured by logged total assets, a dummy variable indicating a firm being listed in the main-board market (as opposed to the second-board market), and industry and year dummies to control for industry and year fixed effects.

The empirical method is Difference in Difference (DID), which compares the change of firm performance in association with the 4-trillion-yuan (\$586-billion) economic stimulus plan in 2008-2009 between politically connected firms and non-connected ones, using the following equation:

$$y_{it} = \beta_0 + \beta_1 Post_i + \beta_2 C_{1it} + \beta_3 Post_i \times C_{1it} + \beta_4 C_{1it} + \beta_5 Post_i \times C_{2it} + X'_{it}\gamma + \varepsilon_{it}.$$

$y_{it}$  denotes a firm's performance, measured by financing, sales, and profit indicators.  $Post_i$  indicates post-2008 financial crisis (and the massive economic stimulus) dummy, with the value equals to 1 if year is between 2010 and 2012, and 0 if year is between 2005 and 2007. Years 2008 and 2009 are excluded from the analysis, since in those two years the financial shock happened and the massive economic stimulus police was launched.  $C_{1it}$  and  $C_{2it}$  represent a firm's political connectedness, indicating any executives or directors being

delegates and former officials respectively. To capture the intensity of treatment, I calculate the numbers of years each firm has connections in the period 2005-2007 and 2010-2012 and use them as the values of connectedness in the pre-2008 and post-2008 period respectively.  $Post_i \times C_{1it}$  and  $Post_i \times C_{2it}$  are the two interaction terms.  $\beta_3$  and  $\beta_5$  are thus the two parameters of interest, the treatment effects of political connectedness.  $X_{it}$  is a vector of firm characteristics.  $\varepsilon_{it}$  is the error term. Standard errors are clustered by firm in the regressions.

The final dataset contains 3,917 firm-year observations in the study period, 2005-2007 and 2010-2012. The summary statistics of variables used in the empirical analysis are reported in Table 1.

### 3 Empirical Results

In this section I report the DID regression results for the three set of outcome variables in Tables 2-4 respectively. The regression structure is the same across the three tables.

Table 2 presents the regression results for firms' access to loans. Column 1 reports the results for debt ratio, i.e. total liabilities/total assets. The coefficient of the interaction between post-2008 dummy and the delegates indicator is 0.020 and is statistically significant at 0.01 significance level. It means that 1 standard deviation increase in the political connectedness measured by delegate's status will increase the debt ratio by about 1.5 percentage point. However, the coefficient of the interaction between post-2008 dummy and former officials indicator is, small and insignificant at the conventional significance level, though the sign is the same as the delegates indicator.

Next we check the impact of political connectedness on the two main components of total liabilities, i.e. current liabilities and long-term liabilities. Columns 2 and 3 report the regression results for short-term debt to assets ratio (current liabilities/total assets) and long-term debt to assets ratio (long-term liabilities/total assets) respectively. It is interesting to see that the impact of political connectedness on financing is mainly on current liabilities, and only the delegates indicator is significant which is similar to column 1. This is different from what was found in Charumilind et al. (2006) that political connectedness enable firms to have more access to long-term bank credit in Thailand before the Asian crisis of 1997.

In summary, political connectedness, particularly the delegates status does enable firm to have more access to short-term loans when there was a massive credit expansion in coping with the 2008 financial crisis.

Table 3 presents the regression results for firms' sales. Columns 1 to 3 show the results for logged total sales, logged domestic sales, and logged exports respectively. In all three



columns, the interaction terms between post-2008 dummy and political connectedness are not statistically significant. In other words, there is no evidence that political connectedness contribute to firm sales.

Table 4 reports the regression results for two profit indicators, return on assets (ROA) and return on equity (ROE) in columns 1 and 2 respectively. The coefficient of the interaction between post-2008 dummy and the delegates indicator is -0.009 in both columns 1 and 2, though the former one is statistically significant at 0.01 level, while the latter is only at 0.1 level. It means that 1 standard deviation increase in the political connectedness measured by delegates status will decrease the profit by about 0.65 percentage point, either measured by ROA or ROE. This is economically meaningful impact since the average ROA and ROE in the sample is just 4.6 and 7.9 percentage point. This result is consistent with Liu et al. (2015) that political status may negatively affect firm performance since firms may make inefficient investment, particularly severe in private firms, to gain the political representatives status.

In contrast to the delegates indicator, the coefficients of the interaction between post-2008 dummy and the former officials indicator for ROA and ROE are both positive. The coefficients are 0.004 and 0.012 in columns 1 and 2 respectively, however it is not significant for ROA but significant for ROE at 0.05 significance level. Thus we have some evidence that former government officials can contribute to firm profitability. This might because hiring former government officials are much less costly than getting political delegates status, since there is no need to distort much firm investment or hiring decisions.

#### **4 Conclusions**

This paper studies the impact of firms' political connectedness on firm performance in China, using the private listed firms in manufacturing sector during the period 2005-2012. Political connectedness of firms are measured by two indicators: the first one is whether any executives or directors serves as a delegate in the three main political congress, i.e. the People's Congress (NPC), the Congress of the Chinese Communist Party (CCCCP), the Chinese People's Political Consultative Conference (CPPCC) at the national and provincial levels; the second is whether any executives or directors ever worked for government at middle level or above. I find that both measures of political connectedness are quite stable in the study period, about 20% firms having executives or directors serving as delegates, and 60% of them have past working experience in government.

To study the impact of political connectedness on firm performance, I exploit one quasi-natural economic experiment, that is, the China government's 4-trillion-yuan economic stimulus in 2009 in response of the 2008 financial crisis. To my best knowledge, this is the

first paper on political connectedness in China considering the massive economic stimulus plan as an external shock.

The results show that the two types of political connectedness play different roles for firms. Executives or directors being delegates enables firm to have more access to loans, particularly short-term loans, but affect firm's profitability negatively. However, executives or directors being former government officials have no significant impact on firm's access to financing, but is positively correlated with firm profitability. Both types of connectedness have no contribution to firm's sale, either domestically or internationally. The results may suggest that not all types of political connectedness are alike. The underlying mechanism needs more research in the future.

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Table 1: Summary Statistics

variable	N	mean	sd	min	max
Debt ratio	3,730	0.385	0.213	0.007	0.996
Short-term debt ratio	3,751	0.339	0.197	0.003	1.000
Long-term debt ratio	3,865	0.039	0.073	0	0.792
Total sales (unit: million Chinese yuan constant 2005 price)	3,844	1452.746	3394.998	0	67139.172
Domestic sales (unit: million Chinese yuan constant 2005 price)	3,844	1217.495	2810.020	0	55864.066
Export (unit: million Chinese yuan constant 2005 price)	3,844	235.251	1117.051	0	36352.188
Total assets (unit: million Chinese yuan constant 2005 price)	3,869	2002.916	3827.046	1.257	75525.445
Return on assets (ROA)	3,853	0.046	0.099	-0.962	0.992
Return on equity (ROE)	3,675	0.079	0.130	-0.945	0.931
Post-2008 dummy	3,917	0.710	0.454	0	1
Delegates	3,917	1.147	1.375	0	3
Former officials	3,917	1.821	1.291	0	3
Main board	3,917	0.480	0.500	0	1

Table 2: Political Connectedness and Debt Ratios

	(1)	(2)	(3)
Post 2008	-0.110*** (0.017)	-0.120*** (0.016)	0.005 (0.005)
Delegates	-0.016** (0.006)	-0.017** (0.006)	-0.001 (0.002)
Post 2008* Delegates	0.020** (0.007)	0.020** (0.006)	0.001 (0.002)
Former officials	0.006 (0.006)	0.005 (0.006)	0.001 (0.002)
Post 2008*Former officials	0.003 (0.007)	0.002 (0.006)	-0.003 (0.002)
Logged assets	0.040*** (0.007)	0.014* (0.006)	0.021*** (0.002)
Main board	0.167*** (0.014)	0.142*** (0.013)	0.025*** (0.004)
Year dummies	Y	Y	Y
Industry dummies	Y	Y	Y
Adjusted R-squared	0.361	0.299	0.253
Number of observations	3,730	3,751	3,865

Notes: The dependent variable in columns 1 to 3 is debt ratio (total liabilities/total assets), short-term debt to assets ratio (current liabilities/total assets), and long-term debt to assets ratio (long-term liabilities/total assets) respectively. Standard errors in parentheses are clustered by firm. + p<0.1, \* p<0.05, \*\* p<0.01, \*\*\* p<0.001.



Table 3: Political Connectedness and Sales

	(1)	(2)	(3)
Post 2008	0.067 (0.064)	0.181* (0.080)	0.395+ (0.217)
Delegates	0.033 (0.025)	0.037 (0.029)	-0.007 (0.088)
Post 2008* Delegates	-0.000 (0.026)	0.034 (0.030)	-0.098 (0.092)
Former officials	0.006 (0.024)	0.052+ (0.028)	-0.087 (0.084)
Post 2008*Former officials	0.012 (0.023)	-0.037 (0.029)	0.026 (0.085)
Logged assets	1.108*** (0.026)	1.063*** (0.028)	0.944*** (0.079)
Main board	-0.099* (0.049)	0.055 (0.055)	-0.545** (0.166)
Year dummies	Y	Y	Y
Industry dummies	Y	Y	Y
Adjusted R-squared	0.771	0.695	0.285
Number of observations	3842	3842	3842

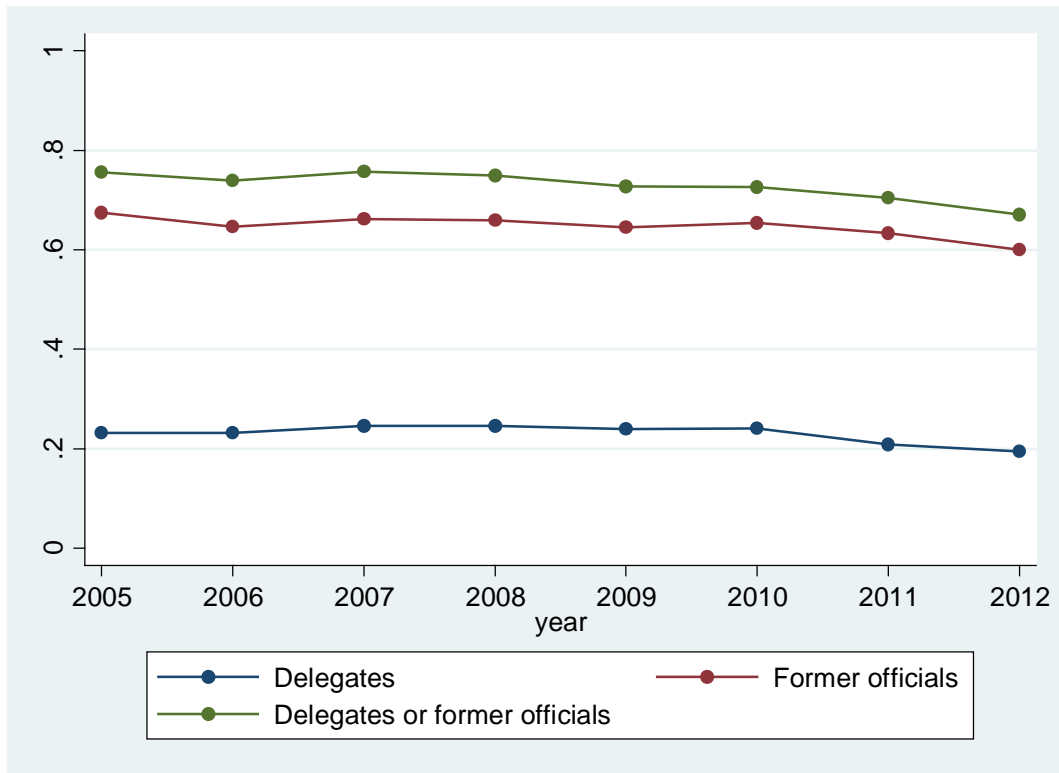
Notes: The dependent variable in columns 1 to 3 is logged total sales, logged total domestic sales, and logged exports respectively. Standard errors in parentheses are clustered by firm. + p<0.1, \* p<0.05, \*\* p<0.01, \*\*\* p<0.001.

Table 4: Political Connectedness and Return Rate

	(1)	(2)
Post 2008	0.021*	0.001
	(0.009)	(0.011)
Delegates	0.008**	0.007
	(0.003)	(0.005)
Post 2008* Delegates	-0.009**	-0.009+
	(0.003)	(0.005)
Former officials	-0.007*	-0.015**
	(0.003)	(0.005)
Post 2008*Former officials	0.004	0.012*
	(0.003)	(0.005)
Logged assets	0.016***	0.028***
	(0.004)	(0.004)
Main board	-0.043***	-0.042***
	(0.005)	(0.007)
Year dummies	Y	Y
Industry dummies	Y	Y
Adjusted R-squared	0.114	0.098
Number of observations	3,852	3,675
Number of firms	1,054	1,041

Notes: The dependent variable in columns 1 and 2 is return on assets (ROA) and return on equity (ROE) respectively. Standard errors in parentheses are clustered by firm. +  $p < 0.1$ , \*  $p < 0.05$ , \*\*  $p < 0.01$ , \*\*\*  $p < 0.001$ .

Figure 1: Share of Firms with Political Connectedness 2005-2012



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