



# The costs of socializing with government officials: A new measure of corporate political connections



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## ABSTRACT

We construct a new measure to capture corporate political connections, which is based on the amount a corporation spends on socializing with government officials. We examine the validity of this measure using the exogenous turnover of top local officials and find that firms increase their political networking expenditures when top local officials are replaced. Compared to state-owned enterprises (SOEs), non-state-owned enterprises (non-SOEs) react more aggressively to changes in local officials, which implies that non-SOEs have stronger incentives to build political connections with officials through social intercourse. We also find that firms located in regions with low levels of marketization react more aggressively to the turnover of local politicians. In addition, we find a positive effect of corporate political socializing expenditures on corporate performance and valuation, which suggests that political connections built through social intercourse benefit corporations.

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## 1. Introduction

Due to the lack of comprehensive formal legal and governance mechanisms, remarkably effective alternative mechanisms have developed in China (Allen et al., 2005). Political connections are one such mechanism and they play an important role in the Chinese economic regime. Most previous studies of corporate political connections have used the presence or absence of state ownership or the political background of top executives

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to identify firms' connections. In fact, connections between corporations and the government can be built via other channels and it is meaningful to identify other important corporate strategies for building political connections.

Networking with government officials is a common corporate political strategy in the relationship-based Chinese regime. Unlike ownership-based or board member political experience-based political connections, the strategy of socializing with government officials is implemented through various social activities that are part of daily business practices and it is thus hard to capture explicitly. Although the political strategy of social intercourse has been discussed in previous studies, there is little empirical research that systematically identifies it. One exception is [Luo and Ying \(2012\)](#) who use a particular social activity, company visits of officials, to identify corporate political connections. In this study, we try to comprehensively capture corporate political connections built through social intercourse by measuring corporations' expenditures on political networking. We use evidence from a previous survey to construct a variable for measuring corporate expenditures on networking with government officials.

[Zhang and Zhang \(2005\)](#) surveyed hundreds of Chinese entrepreneurs and found that firms socialize with government officials in a number of ways including inviting them for a company visit, sponsoring overseas travel, offering gifts, holding banquets, and so on. Based on their research, we use the accounting items that are most commonly used to reimburse such expenditures to construct a measure of political networking expenditures. One of the contributions of this study is determining the validity of this measure using the exogenous turnover of top local officials. We find that firms increase their expenditures for socializing with government officials when local politicians are replaced. This suggests that our measure effectively captures firms' expenditures on political social intercourse.

We further find that non-SOEs react more aggressively than SOEs when local politicians are replaced and that firms located in regions with a low level of marketization react more aggressively to the turnover of top local officials. We also use our new measure of political connections to examine the economic consequences of political networking expenditures. Consistent with previous studies (see among others, [Fisman, 2001](#); [Johnson and Mitton, 2003](#); [Faccio, 2006](#)), we find that corporate political socializing expenditures have a positive effect on corporate performance and valuation, which suggests that the political connections built through social intercourse benefit corporations.

Our study makes the following contributions to the literature. First, we construct a new measure to capture corporate political connections, namely political socializing expenditures. Second, socializing with officials is a common corporate political strategy that has rarely been mentioned in previous empirical studies, perhaps because of the difficulty in quantifying political socializing. This study quantifies corporate political socializing by measuring corresponding expenditures and testing the validity of this measure by using the exogenous turnover of top local officials. Third, there are few empirical studies of the firm-level effect of the turnover of government officials in China and this study sheds some light on this research area.

The rest of this paper is structured as follows. Section 2 discusses the related literature and hypotheses. Section 3 describes the sample selection and data. Section 4 provides the research design and empirical results. In Section 5 we present our conclusions.

## 2. Literature review and hypotheses

Corporate political connections play an important role around the world (see among others, [Fisman, 2001](#); [Faccio, 2006](#); [Faccio et al., 2006](#); [Adhikari et al., 2006](#); [Niessen and Ruenzi, 2010](#); [Chen et al., 2010](#)). In Chinese studies, corporate political connections are generally correlated with the type of ownership (SOE vs. non-SOE) or the political experience of top executives (e.g. [Hu, 2006](#); [Yu and Pan, 2008](#)). US studies have documented a variety of strategies used by firms to make political connections, such as adding politicians to the board of directors (e.g. [Goldman et al., 2008, 2009](#)), making significant political campaign contributions (e.g., [Cooper et al., 2010](#); [Claessens et al., 2008](#)), or incurring significant lobbying expenditures (e.g., [Hill et al., 2009](#); [Chen et al., 2009](#)).

Unlike the US, lobbying does not publicly exist in China. However, Chinese firms can seek preferential treatment through their private networking channels. [Zhang and Zhang \(2005\)](#) surveyed hundreds of entrepreneurs in Wenzhou City and Suzhou Province and found that firms build political networks by socializing with

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