



The value of local political capital in transition China

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ABSTRACT

This paper documents stock market responses to the arrest of Shanghai's top leader by the Chinese central government in September 2006. The effects of personal-level and organizational-level connections to the local state are found to be negative and insignificant, respectively, on cumulative abnormal returns (CARs). Furthermore, companies having both personal and organizational political ties experienced the most adverse market reaction.

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1. Introduction

There has been a growing stream of literature on the determinants, valuation, and consequences of firm-level political connections in both developed and emerging economies (Agrawal and Knoeber, 2001; Faccio, 2006; Faccio and Parsley, 2009; Fisman, 2001; Goldman et al., 2009). It is found that the development of personal connections to prevailing political leaders, networks, and regimes helps firms to generate political capital, which in turn translates into higher profitability and company valuation through various forms.

This paper extends the existing studies by introducing another dimension of political capital/connections – *institutional* linkages with prevailing political organizations and regimes. Political scientists and sociologists have long recognized that firm-level political capital refers to both organizational (e.g., ownership stakes held by government agencies) and personal affiliations (e.g., politicians sitting on corporate boards) with political organizations/networks, which can be exploited to achieve outcomes that serve the firm's perceived interests (Birner and Witter, 2003). However, we are aware of few systematic studies that combine these two levels of political capital and explore how the two interact to affect firm value. Our paper attempts to narrow this gap through an empirical study of the values

of both personal connection and organizational affiliation in China during institutional transition.

Prior research shows that both personal and institutional ties to political agencies matter for firm value in transition China. At the personal level, Fan et al. (2008), Li et al. (2008), and Zhou (2009) identified positive values of political connections in bank financing, profitability, and market capitalization, while Fan et al. (2007) found in a sample of partially privatized firms that the presence of politically connected CEOs served to reduce post-IPO stock returns and sales/earnings growth.

At the institutional level, ownership affiliation with local governments constitutes an important form of political capital, as the state still controls a wide range of financial and regulatory resources and maintains a tendency of channeling them to the state sector. Firms that can link themselves to the government through ownership arrangements often enjoy a privileged treatment and less policy discrimination from the state (e.g., Tian, 2000). On the other hand, partial government ownership may lead to value-destroying political interference, as local governments with controlling stakes can advance their own political and financial interests by expropriating minority shareholders (Jiang et al., 2010). Consequently, the balance of firm-level benefits and costs from government ownership affiliation is hard to predict *a priori*. Studying the capital market responses to an event of government share sales at the turn of this century, Calomiris et al. (2010) found significant *net* benefits of Chinese government shareholdings in domestic listed companies.

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Given the preceding discussions about the respective values of personal-level and organizational-level political capital, extant studies are surprisingly silent on whether there can be any *additional* value for firms combining both personal and organizational political ties. This paper integrates the two levels of analysis by examining stock market reactions to a truly unexpected political event: the arrest of the top Communist official in Shanghai – Chen Liangyu – on September 24 2006, which signified a sudden crackdown of the Shanghai-based political clique from the Chinese central government.¹ The event study approach allows for a measure of the lost value of firm-specific local political capital that should be reflected in a company's stock price.

The local political economy in Shanghai makes the event an ideal context for research. Typical of many Shanghai government officials, Chen had his entire public-sector career in Shanghai, starting from a factory manager in the 1970s to municipal Party secretary and a member of China's ruling Politburo since 2002. Thus, the presence of a cohesive local political network facilitated the emergence of what was known as “Shanghai Inc.”. According to *Wall Street Journal*, “giant construction projects got funded from public coffers; choice assets moved out of state hands in elaborate transactions; and plum contracts went to the well-connected.”² The fall of Chen, consequently, indicates a big blow not only to Chen and his associates, but also to the whole political network in Shanghai.

To investigate the value of political capital provided by this local network, we study the stock market reactions to a sample of publicly listed companies headquartered in Shanghai after the announcement of this political shakeup. Around 72% of the sample firms can be identified as those with intensive local political capital: They had the Shanghai government act as the ultimate controlling shareholder through stock pyramids and/or had board members with long career experience in the municipal government. These firms suffered negative market-adjusted returns over all the relevant event windows chosen.

We further treat companies that had ultimate ownership ties to the Shanghai government as those having organizational-level political capital and firms that had board member(s) with career experience in the municipal government as those having personal-level political capital. Regression results show that personal-level political connections contributed significantly to adverse stock market reactions, whereas the impact of organizational ties on stock price was statistically insignificant. Different from Calomiris et al. (2010), the latter result suggests that, with the deepening of economic liberalization and institutional transition in the mid 2000s, ownership affiliation alone could not automatically guarantee policy favors and direct financial benefits for companies in China's most developed regions.

Finally, positive interaction is found between the two types of political ties, in that firms with both ownership ties and personal connections to the Shanghai government experienced the most severe negative market response around the disclosure of Chen's dismissal. Therefore, organizational ties translated into valuable local political capital *only when* the sample firms enjoyed personal access to the local political network prior to the event. While institutionalized favor for firms with government stakes may decline in the mid 2000s, the result confirms the enduring value of particularistic, personal-based political connections in transition China. Moreover, the organizational ties served as a facilitator in helping the personal-level political capital to realize greater value for firms studied in the sample.

2. Data and method

A total of 142 companies were both listed on the Shanghai Stock Exchange and headquartered in Shanghai as of December 31, 2005. Stock price, accounting, and ownership data for these firms were

obtained from the Sinofin database developed by the Center of Chinese Economic Research, Peking University. After deleting firms without necessary data to calculate CARs, we have 137 firms for our empirical analysis. In terms of ownership affiliation, the Shanghai municipal government was the *ultimate* controlling shareholder in 72 companies, where local state-owned/controlled enterprises acted as these companies' intermediate controlling shareholders in the stock pyramids.

In light of personal connections to the local political network, we manually collected the career information of all the board members in the sample companies, which may be found in their annual reports in various years. In line with the identification of political connections in previous literature (e.g., Agrawal and Knoeber, 2001; Boubakri et al., 2008), the paper considers a firm able to generate personal-level political capital if at least one of its board members was currently or once a government official in Shanghai. Therefore, this specification allows for a comprehensive measurement of personal links to the Shanghai-based political network. Following this procedure, we find that 87 out of our 137 firms fall into this category. A further breakdown of the sample firms is shown in Table 1, from which we can see that 61 firms are able to exploit local political capital by employing both ownership and personal connections.

On Monday, September 25 2006, the Chinese official media announced the dismissal and detention of Chen Liangyu on September 24. Information leakage is a minor concern, as the purge of Chen was kept strictly confidential and the media reported that Chen made public appearance even on the evening of September 23. Treating September 25 2006 as day 0, standard event study methodology is applied to estimate CARs at each company over various event windows.

3. Empirical results

Preliminary examination of stock market responses to the sudden removal of Shanghai local leader is shown in Table 2. It presents a classification of sample firms in two broad categories: those with organizational and/or personal ties to the local political authority and those without. Different from the latter group of companies, the stock market discounted the local-political-capital-intensive group with varying degrees depending on the event window chosen. The difference between the two groups is statistically significant.

Table 1
Distribution of sample firms by types of political capital.

	Presence of political capital via ownership affiliation	Absence of political capital via ownership affiliation	Total
Presence of political capital via board membership	61	26	87
Absence of political capital via board membership	11	39	50
Total	72	65	137

Table 2
Univariate tests of cumulative abnormal returns (CARs) for firms with and without local political capital over different event windows.

Event windows	Firms with local political capital (n = 98)	Firms without local political capital (n = 39)	Significance of the difference in CARs (t-statistics)
(−1, 1)	−0.005	0.016	−2.056**
(−1, 2)	−0.0102	0.0146	−2.454***
(−1, 3)	−0.0221	0.0024	−2.530***
(−2, 2)	−0.017	0.006	−2.144**
(−2, 3)	−0.0296	−0.006	−2.149**

** Significant at the 5% level.

*** Significant at the 1% level.

¹ “Top China Leader fired for Graft.” BBC NEWS, September 25, 2006.

² “Corruption Crackdown Targets Shanghai Inc.” *Wall Street Journal*, February 7, 2007.

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