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Executive political connections and firm performance: Comparative evidence from privately-controlled and state-owned enterprises

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ABSTRACT

This study examines the effects of ultimate control and the political connections of top executives on firm's performance and the monitoring role played by boards of directors. It investigates whether the political influence of ownership and that of management are complements or substitutes in their effects on board independence and accounting performance. The findings indicate that the state holding in SOEs (state-owned enterprises) weakens board independence, but improves accounting performance. The positive effect of a board chair's political connections on firm-level performance is only documented in SOEs.

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1. Introduction

The effects of political connections[4] have been extensively examined in an international framework. Prior studies (Acemoglu & Johnson, 2005; Berkman, Cole, & Fu, 2010; Bunkanwanicha & Wiwattanakantang, 2009; Faccio, 2006; Fan et al., 2007; Fisman, 2001; Gul, 2006; Khwaja & Mian, 2005; Shleifer & Vishny, 1994, 1998) have demonstrated that such connections are typical in countries with underdeveloped property rights protection, although a recent study has also found them to be prevalent in the U.S. (Goldman, Rocholl, & So, 2009). Political connections thus appear to constitute a global issue. Evidence has shown that politically connected firms enjoy extensive benefits, including favorable government policies that prevent competitors from entering the market (Bunkanwanicha & Wiwattanakantang, 2009), lower tax rates (Adhikari, Derashid, & Zhang, 2006; Faccio, 2006), a greater likelihood of being bailed out in times of economic distress (Faccio, Masulis, & McConnell, 2006), and favorable bank lending (Claessens, Feijen, & Laeven, 2008; Khwaja & Mian, 2005; Li, Meng, Wang, & Zhou, 2008). Furthermore, Chaney, Faccio, and Parsley (2008) provide convincing evidence that politically connected firms with lower quality disclosures are not punished through a higher cost of debt. This negative association between accounting disclosure and the cost of debt holds only for firms without political connections.

When it comes to the impact of senior executives' political connections on firm performance, however, prior studies have yielded mixed results (Berkman et al., 2010; Fan et al., 2007; Francis, Hasan, & Sun, 2009; Li et al., 2008; Sun & Tong, 2003). Fan et al. (2007) examine politically connected firms in China, and conclude that political connections are not “conducive” (p. 332), as they negatively affect a firm's post-Initial Public Offering (IPO) performance and board composition. In contrast to Fan et al. (2007), Francis et al. (2009) show that politically connected firms have a “higher offering price, lower underpricing, and lower fixed costs during the going-public process” (p. 696). Li et al. (2008) also find a positive relationship between private companies' political connections and their performance. These mixed findings provide the impetus for uncovering the reasons underlying the inconsistency in this literature.

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[4] As discussed below, we follow Fan, Wong, and Zhang (2007) and define political connections on the executive level. If executives are, or were, government bureaucrats, then we define them as having political connections. Firms whose executives have such connections are defined as politically connected firms.

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An examination of political connections, by necessity, bears a certain similarity to one important stream of the literature concerning government ownership, because such ownership and political connections are employed as proxies for political influence in this literature. The role played by government ownership also remains controversial, with prior studies demonstrating that privately owned firms are preferable, as they are more efficient and less likely to be subject to government extortion (La Porta, Lopez de Silanes, & Shleifer, 2002; Megginson & Netter, 2001; Shleifer & Vishny, 1998; Wang, Wong, & Xia, 2008). Yet a number of empirical evidence suggests that government ownership can actually enhance firm-level performance (Bai, Liu, Lu, Song, & Zhang, 2004; Sun & Tong, 2003; Tian & Estrin, 2008; Wang, Xu, & Zhu, 2004).

Given these two streams of literature, two conceptually important questions immediately arise. First, which has a more significant impact on firm performance, the political influence of government ownership or that of management? Second, do the two interact to influence firm performance? If the answer to the latter is yes, then we must examine whether the two factors are substitutes or complements to each other. In other words, the aim of this study is to integrate these two strands of literature, one on government ownership and the other on executive political connections.

Possible similarities notwithstanding, the two constructs differ if they are examined through the typical principal-agent lens. In this view, the government is the principal, and politically connected executives are the agent, and the two have different goals. Put differently, government owners are concerned with the political influence of ownership, whereas political connections are concerned with the political influence of management. To the best of our knowledge, no prior study has examined the possible interaction between political connections and government ownership, and a variety of related questions may be worthy of examination. For instance, if politically connected executives are favored by government officials, as suggested by most of the prior literature, then how is such favorable treatment affected by government ownership? That is, given the existence of both government-owned firms and firms with politically connected executives, what influence does government ownership have on the role played by the politically connected executives? Furthermore, the effect of political connections on corporate governance, particularly their effect on board independence, is rarely addressed, let alone the possible interactive effect of political connections and government ownership.

With the aim of answering these questions, this study draws on data from the Chinese economy, currently one of the world's most important emerging markets, thanks to its distinct social, political, and economic environment. Many listed companies in China have converted from state-owned enterprises, and hence it is not unusual for the government to continue to exert ultimate control or for top executives to be politically connected. In China's unique setting, both ownership and management have a political dimension, and, thus provides a valuable opportunity to address the aforementioned issues. We manually collected political connection and ultimate control data from annual reports in the 2004–2006 period; all the other data are gathered from existing databases.

Different from prior studies that investigate the effect of political connections on market-based performance, we focus on firm-level accounting performance. Our reason for adopting such an accounting-based performance, rather than the market return, as our major focus is that the latter is a forward-looking measure and is based on the change in stock prices. If the market is believed to be efficient, then the value of political influence should be reflected in stock prices; hence, market returns may not highlight the effects of political influence.

Our findings indicate that the political influence of ownership is associated with weaker board independence, which supports previous theoretical work regarding such ownership (La Porta et al., 2002; Megginson & Netter, 2001; Shleifer & Vishny, 1998). Furthermore, we find that management's political influence may induce a reaction from the board of directors, as we document a positive association between the political connections of the board chair and board independence regardless of government ownership level. These findings suggest that the political influence of government ownership is sufficiently powerful to weaken board independence, while that of management is not. Our main explanation for these findings is that politically connected executives, as agents, are less powerful than government owners in affecting corporate governance. At the same time, because politically connected executives are arguably more powerful than the non-politically connected counterparts, and hence given China's political–economic environment, more likely to escape control, firms seem to increase the number of independent directors to monitor these executives, even in government-owned firms.

We find that the political influence of government ownership enhances firm's accounting performance, suggesting that government-owned firms enjoy certain advantages from the government. Shleifer and Vishny (1998) and Megginson and Netter (2001) report that government-owned firms are less effective and efficient than privately held firms, but our findings suggest that such ownership actually benefits shareholders. We also confirm the findings of prior empirical studies of Chinese firms suggesting that government ownership leads to better firm performance (e.g., Bai et al., 2004; Sun & Tong, 2003; Tian & Estrin, 2008; Wang et al., 2004). Our findings further indicate that the political influence of management has a differential impact on firm performance, depending on the type of ownership. In privately-controlled firms, for example, board chairs' political connections have no effect on accounting performance. In contrast, when the government holds ultimate control of the firm, these connections significantly boost such performance. The interactive effect between the political influence of government ownership and the political connections of management on firm performance seems to suggest that government ownership provides an indispensable platform for politically connected executives to receive favorable treatment, and thus achieve better performance. Our employment of Tobin's Q as an alternative dependent variable confirms our findings.

We expect this study to contribute to the existing literature both conceptually and practically. Conceptually, we demonstrate the importance of examining the political influence of management and government ownership simultaneously. Doing so enables us to add to the literature on political connections by viewing such connections through the lens of principal-agent conflicts of interest. In mature markets such as the U.S., although some CEOs are politically connected, the firms in which they are employed are usually independent of the government. Any possible favorable treatment from the government would thus be via the CEOs. In underdeveloped jurisdictions such as China, however, many listed firms are formerly state-owned enterprises and thus have strong connections with the government; and hence, the ultimate control of many of these firms is held by government agencies. It is therefore crucial that we differentiate between the political influence of ownership from that of management, and examine the effects of executives' political connections by considering the nature of ultimate control of a firm. By so doing, we shed new light on whether one of these two groups has a dominant influence.

Our sample includes both privately-controlled and state-owned enterprises listed on China's two stock exchanges during the 2004–2006 period. This sample period has witnessed unprecedented development of Chinese capital markets and the unfolding of new legal protections and governance reforms, thus offering a unique setting in which to examine the interactions among political connections, the political–economic environment, ongoing governance reforms, and ownership structure, as well as important insights into other jurisdictions undergoing similar processes. In addition, most prior studies of political connections have left the effects of these connections on corporate governance unexamined. Fan et al. (2007) offer interesting results on the effect of a CEO's political connections on board characteristics, such as the political

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