



# Mixing business with politics: Political participation by entrepreneurs in China



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## ABSTRACT

We study how Chinese private entrepreneurs benefit from participating in politics. Using original hand-collected data on listed firms controlled by private entrepreneurs, we document a significant positive relationship between political participation and subsequent change in firm performance. We also provide evidence that the change in social status cannot explain the change in performance. We then identify several ways through which firms gain preferential treatment when the controlling entrepreneur participates in politics: better access to debt financing, preferential tax treatment, more government subsidies, and superior access to regulated industries.

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## 1. Introduction

This paper investigates the economic consequences of mixing politics and business, particularly the channels through which political participation facilitates business. Business leaders are invited to participate in politics due to their expertise and in the name of the common good. However, the political capital derived from political participation can also be utilized by businessmen for their own benefit. Previous studies have shown that political relations can bring benefit to entrepreneurs and their firms (Fisman, 2001; Johnson and Mitton, 2003; Faccio, 2006; Faccio et al., 2006; Claessens et al., 2008). In these studies, benefits are channeled to the firm through a specifically established connection. We will show in this paper that entrepreneurs may actually gain access to political capital by means of a one-time participation

in politics. This act of political participation does not guarantee the participant political power, but creates an opportunity to interact with politicians. We further show several channels through which the entrepreneur benefits from the political capital he or she has derived from political participation. Potentially important channels for preferential treatment include better access to debt financing, preferential tax treatment, more government subsidies, and superior access to regulated industries through corporate deals.

China is especially well suited for our study. Chinese private entrepreneurs have only had the opportunity to participate in politics for a relatively short time period. This opportunity increased considerably after former President Jiang Zemin welcomed business leaders into the Chinese Communist Party (CCP) in 2001. In a business environment marked by poor legal protection, ambiguous property rights, and rent seeking, many Chinese private entrepreneurs have tried to develop close ties to local and national politicians (Shambaugh, 2009; Wright, 2010). Political participation does not guarantee the establishment of a

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specific political connection, but it allows an opportunity to interact with politicians. Since entrepreneurs are purportedly invited to participate in politics for the common good and democracy, the public deserves a systematic analysis of whether these entrepreneurs are seeking private benefits in the process. The answer is unclear *ex ante*. On the one hand, engagement in public affairs will distract the entrepreneur from operating his or her own business, which should result in firm underperformance. On the other hand, political participation may help the entrepreneur to build up his or her political capital, which in turn will contribute to firm performance. However, such political capital may not necessarily turn out to be as solid as that derived from a specific political connection, but may instead be relatively weak. It is therefore important to investigate the actual economic consequences of such political participation and, in particular, whether and how private entrepreneurs receive private benefits even though political participation is in the name of the common good and democracy.<sup>1</sup>

The key event of our study, the initiation of political participation, is defined by an entrepreneur (or one of his or her family members) becoming a member of the National People's Congress (NPC) or the Chinese People's Political Consultative Conference (CPPCC) at the national or provincial level. Our hand-collected data set covers all listed entrepreneurial firms between 1993 and 2011. Using this, we identify 86 cases of listed firms controlled by private entrepreneurs who begin to participate in high-level politics in 1998, 2003, or 2008. We compare the change in performance after these events with all the remaining privately controlled firms in the same year as a control group. We find that political participation has a significant positive effect on long-run stock performance and operating performance. When exploring potential channels of performance enhancement, we document that political participation facilitates debt financing as shown by higher leverage and longer maturity in debt for firms after their controlling owner begins to participate in politics. Political participation also reduces firms' tax burden (measured as the effective tax rate) and increases the amount of government subsidies granted to firms. Finally, political participation facilitates access to regulated industries through merger and acquisitions (M&As). Overall, our empirical findings shed light on a number of benefits that stem from political participation by private entrepreneurs in China. These results have important implications for our understanding of political participation as crucial factor for doing business in China. The findings in this paper explain why business owners in emerging economies may seek the opportunity to participate in national politics.

This study relates to research that focuses on rent seeking and how entrepreneurs use political ties to benefit their business. In a seminal article, Krueger (1974) argues that it is natural for firms to devote economic resources toward rent seeking in order to compete for favorable treatment. In general, politicians are able to influence firms through a variety of policy decisions. Politicians may do this for political as well as personal objectives (e.g., La Porta et al., 2002; Rajan and Zingales, 2003). Government decisions can have a significant effect on firm performance through various channels, such as preferential access to finance, better access to different forms of government subsidies, tax benefits, and reduced regulatory constraints.

Our paper contributes to the literature in several ways. First, our setting allows us to carry out an event analysis by comparing

the change in performance, which is a variation of the difference-in-difference method (DiD), therefore alleviating serious endogeneity issues found in earlier related studies. Research focusing on the economic value of political connections of U.S. firms and Non-U.S. firms<sup>2</sup> is subject to potentially serious endogeneity problems due to the data used. For example, unobservable factors such as innate business competence may explain the existence of political connections as well as superior performance. Our analysis, which applies a change model, avoids such issues because we are able to fix all the fundamental issues related to the firms around the event. Event studies related to the establishment or elimination of political connections, such as Faccio (2006) and Fisman (2001), can avoid the endogeneity issues. However, these studies only focus on short-term effects. Our study investigates a window extending up to three years after the event. Second, we contribute to the literature by systematically identifying the channels through which political participation enhances firm performance. Earlier studies have focused on finding evidence of effects on value and performance. Only a limited number of more recent studies have attempted to identify potential rent-seeking channels. The channel that has arguably been analyzed most thoroughly is that of preferential access to financing (e.g. Charumilind et al., 2006; Dinc, 2005; Faccio et al., 2006; Johnson and Mitton, 2003; Khwaja and Mian, 2005). While these studies on political connections and rent-seeking channels are important, our study provides a considerably more comprehensive understanding of potential preferential treatment for selected business owners and their firms. In addition to analyzing political participation and access debt financing, we are able to identify several other channels that entrepreneurs in China exploit through political participation, including increased tax benefits and government subsidies as well as beneficial M&A deals, most of which have not been explored rigorously in previous studies.

Third, our analysis touches upon an alternative growth channel for Chinese privately controlled firms. Allen et al. (2005) argue that alternative channels, including mechanisms centering on relationships, have been driving the higher growth in the private sector during the last decades. Our results show that political participation facilitates the use of such alternative channels. Fourth, our study reveals important side effects of China's current political system. Fifth, this paper contributes to the literature on networks in finance (e.g. Allen and Babus, 2009). Finally, we believe that it is important to distinguish between the value of political connections and effects of political participation,<sup>3</sup> which represents an explicit commitment and direct involvement in a country's political process, especially in transition and developing economies, where entrepreneurs are often motivated to participate in politics (e.g. Li et al., 2006).

The remainder of this paper proceeds as follows. Section 2 discusses the institutional background and political participation by private entrepreneurs in China. It also develops hypotheses for the empirical analysis. Section 3 introduces the data and sample, while Section 4 presents the empirical results of the effects on stock performance and operating performance imposed by political

<sup>1</sup> Theoretically, all members in NPC and CPPCC are selected through democratic elections in a process that follows the Constitution of the People's Republic of China, the Electoral Law of the National People's Congress and Local People's Congresses of the People's Republic of China, and the Constitution of the Chinese People's Political Consultative Conference.

<sup>2</sup> For studies focusing on the U.S., see Roberts (1990), Kroszner and Stratmann (1998), Jayachandran (2006), Knight (2006), Benmelech and Moskowitz (2010), Goldman et al. (2009) and Cooper et al., 2010. For studies on other countries, see Fisman (2001), Johnson and Mitton (2003), Faccio (2006), Faccio et al. (2006, 2007) and Claessens et al. (2008).

<sup>3</sup> In previous research on China, political connections have often been identified by looking at the background of the CEO or Board Director. For example, Fan et al. (2007) find that such connections can hurt the value of state-owned enterprises (SOEs). Political participation, on the other hand, means that business owners actively participate in politics. In other words, political participation can be seen as a direct result of an act by the business owner.

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