Journal of Banking & Finance 55 (2015) 92–106

Contents lists available at ScienceDirect

Journal of Banking & Finance

journal homepage: www.elsevier.com/locate/jbf

Protection or expropriation: Politically connected independent directors in China ☆

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ARTICLE INFO

Article history:
Received 6 May 2014
Accepted 15 February 2015
Available online 21 February 2015

JEL classification:
G32
G34

Keywords:
Political connections
Independent directors
Ownership
Value effect
Expropriation

ABSTRACT

This paper empirically investigates politically connected independent directors among Chinese listed firms using 7487 firm-year observations from the Shanghai stock exchange during the period of 2003–2012. We distinguish between privately controlled firms and state-controlled firms. We find that the value effect and incentives of appointing independent directors with political ties are shaped by a firm's ownership structure. More exactly, Chinese listed privately controlled firms with a large fraction of politically connected independent directors tend to outperform their non-connected counterparts, due to the ease of access to external debt financing and more subsidies from the government. However, the appointment of politically connected independent directors also enlarges the magnitude of related-party transactions with the controlling party in listed privately controlled firms. In contrast, having politicians as independent directors does not help to add value to listed state-controlled firms, especially firms controlled by the local government, due to the expropriation of minority investors via more related-party transactions and more severe over-investment problems.

1. Introduction

Independent directors are considered an important corporate governance mechanism to protect the interests of investors, especially minority rights. By definition, independent directors should maintain no relations with the controlling party. However, in the Chinese context, the government as a controlling shareholder tends to appoint government-affiliated persons as independent directors to represent their own interests. In addition, privately controlled firms in China assign politically affiliated persons as independent directors to foster connections with the State. As a result, many retired politicians are appointed by Chinese listed firms as independent directors because their previous work experience in the government or at state-owned enterprises enables them to establish important connections with key party and government officials (see also Fan et al., 2007; Wu et al., 2012). Therefore, taking into account the specific context in China, this study empirically examines the presence of politically connected independent directors among Chinese listed firms. In particular, we explore their distinct effects on the protection of property rights versus the expropriation of minority rights in Chinese listed privately controlled firms and state-controlled firms.

Researchers have paid significant attention to political connections in recent years. Acting as a substitute for formal institutions, some studies show that political connections help to promote firm performance and firm value (see, e.g., Adhikari et al., 2006; Leuz and Oberholzer-Gee, 2006; Claessens et al., 2008; Francis et al., 2009), especially in regions where investors have poor legal protection and there is a lack of formal institutions (see also Fisman, 2001; Faccio, 2006; Faccio and Parsley, 2009). More exactly, connections with the government afford firms certain advantages over their non-connected counterparts, such as access to bank loans, subsidies, tax benefits, and waivers of non-tax levies. Some other studies note that although political connections help firms to maximize their own profits, their rent-seeking behavior also distorts the allocation of economic resources and therefore may bring about costs to society overall (see also Khwaja and Mian, 2005; Claessens et al., 2008). Furthermore, some studies argue that in the process of privatization, the likelihood of observing politically

☆ The author would like to thank the editor and two anonymous reviewers for suggestions that substantially improved the article. We would also like to thank Nancy Huyghebaert, Yuanqin Li, Wei Li, Yinghui Wang, Wenfeng Wu, and Siming Yan for their suggestions and comments on an earlier draft of this article. The author acknowledges the National Natural Science Foundation of China (NSFC-71302072) and the Fundamental Research Funds for the Central Universities in China (2011221051) for financial support.

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http://dx.doi.org/10.1016/j.jbankfin.2015.02.015
0378-4266/

connected CEOs or directors is positively related to the government's residual ownership, and politically connected firms exhibit poor accounting performance compared with their non-connected counterparts (see also Fan et al., 2007; Boubakri et al., 2008).

In the Chinese context, although previous studies have extensively documented the presence of political connection and its economic outcomes, many of them focus on politically connected managers (see, for example, Fan et al., 2007; Li et al., 2008; Wu et al., 2012).[1] Notably, the literature has also shown that because all important corporate decisions start in the boardroom, it is necessary to explore the role of politically connected boards in corporate governance (see also Boubakri et al., 2008; Su et al., 2008; Goldman et al., 2009). One exception on politically connected boards within the Chinese context comes from Chen et al. (2011). Using 276 Chinese firms that made an IPO between 1993 and 2008, Chen et al. (2011) examine the rent-seeking incentives of local governments to appoint politically connected directors to boards and how political connections affect the ownership concentration after listing. They show that privately controlled firms are more inclined to appoint politically connected directors in regions in which the government has more discretion in allocating economic resources. A concentrated ownership structure facilitates rent seeking through political connections and allows controlling shareholders to retain all the benefits arising from connections with politicians. However, in their analysis of political connections, they do not take independent directors into account.[2] Instead of investigating politically connected managers, this paper turns its attention to the role of politically connected directors in the governance of Chinese listed firms. In addition, we take the existing research one step further by focusing on independent directors. The reason is that although independent directors are supposed to be the guardians of the interests of (minority) investors, they are widely used by both Chinese state-controlled firms and privately controlled firms to enhance/establish connections with the State (see also Fan et al., 2007; Li et al., 2008). This feature of independent directors in China thus distorts the original role that they should play in a firm's governance. Indeed, it has been shown that independent directors are frequently used by controlling shareholders to represent their own interests (in state-controlled firms) or to obtain favorable treatment by the government (in privately controlled firms).

Next, this paper adds further evidence to the growing literature on the implications of political connections and, in particular, the fact that the value effect and motivation to appoint politically connected independent directors could be shaped by a firm's ownership structure, i.e., state versus non-state. A key feature of many Chinese listed firms is the dominance of former state-owned enterprises (SOEs) that became listed through share-issuing privatization, with the government retaining a significant stake after the firm's partial privatization (Huyghebaert and Quan, 2011). Indeed, the findings of many previous studies indicate the need/importance to differentiate the effects of political connections in SOEs versus privately controlled firms, especially in an environment where the government still controls the allocation of economic resources (see, e.g., Fan et al., 2007; Li et al., 2008, 2012; Chen et al., 2011; Wu et al., 2012). More exactly, politically connected (independent) directors at listed SOEs are more inclined to be used by the government as controlling shareholder to represent its own political and social interests, e.g., cross-subsidizing other SOEs encountering financial difficulties to keep these firms afloat or over-investing to reduce unemployment and increase GDP. This behavior exacerbates the tunneling incentive of the controlling shareholder and contradicts the role of independent directors to protect the interests of (minority) investors. In contrast, without state ownership as a blood tie, listed privately controlled firms have to address an unfavorable economic environment. A potential way out for entrepreneurs at listed privately controlled firms is to establish close relationships with politicians, for example, appointing them as independent directors, to overcome any ideological discrimination associated with their non-state features and to obtain access to key resources controlled by the Chinese government. As a result, the appointment of politically connected (independent) directors acts as a substitute for the protection of property rights in listed privately controlled firms.

This study examines the distinct outcomes of having politically connected independent directors on boards across the state and non-state sectors, using data on all Chinese firms listed on the Shanghai stock exchange (SHSE) during the period of 2003–2012. According to the *Code of Corporate Governance for Listed Companies in China* published in 2001, it is recommended that the board of directors contains 5–19 directors and has a minimum of one third of such directors be independent.[3] Specifically, taking into account different incentives of privately controlled firms and SOEs to appoint politically affiliated persons as independent directors, we demonstrate that the value effects of politically connections are conditioned by ownership structure. In addition, we make a distinction between SOEs controlled by the central government versus those controlled by local governments to explore the helping hand and the grabbing hand of government control. Furthermore, we identify the channels through which politically connected independent directors detract from or improve firm value. More exactly, we are interested in whether politically connected independent directors help private entrepreneurs obtain any form of preferential treatment by the government, e.g., access to the credit market and more subsidies from the government. Regarding SOEs, we are interested in whether politically connected independent directors exacerbate the incentive problem between the government as the controlling shareholder and small stock market investors in listed firms controlled by the central government or local governments. Notably, on top of economic considerations, a government may exercise its control rights to achieve imperative social or political objectives, to the detriment of external investors (see also Shleifer and Vishny, 1994, 1997; Qian, 1996).

To examine these ideas, we first explore the value effects of having politically connected independent directors on the board. We use the market-to-book ratio (i.e., the ratio of the market value of equity plus the book value of total liabilities to total assets) as the dependent variable. In addition, to test whether having politi-

[1] Using a sample of 790 newly partially privatized firms in China from 1993 to 2001, Fan et al. (2007) find that political connections may lead to poor corporate governance of listed state-owned enterprises (SOEs) in China. This result is unsurprising given that the mangers of listed SOEs – and especially those with good government connections – have incentives other than profit maximization (e.g., political and social objectives). In addition, Li et al. (2008), utilizing a sample of 3258 (mostly non-listed) privately controlled firms in China in 2002, find that politically connected entrepreneurs help privately controlled firms overcome any economical and ideological discrimination by the government and thus help to maximize profits. Wu et al. (2012) use data on Chinese listed firms from 1999 to 2007 to investigate the impact of politically connected managers on firm performance, making a distinction between privately controlled firms and state-controlled firms. They show that privately controlled firms with politically connected managers outperform their non-connected counterparts and enjoy tax benefits, whereas SOEs with connected managers underperform with respect to those without such managers, partially due to more severe over-investment problems.

[2] Chen et al. (2011) argue that they exclude the number of independent directors in calculating the proportion of politically connected directors for two reasons. First, independent directors are required to be on the board in accordance with a CSRC rule that has been in place sine 2001. Second, the effectiveness of independent directors in influencing corporate strategy is debatable.

[3] The official definition of an independent director is a director who holds no positions at the listed company other than the post of director and who maintains no relations with the firm or its major shareholder that might prevent him or her from making judgments independently (Code of Corporate Governance for Listed Companies in China, article 1.1).