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In the name of charity: Political connections and strategic corporate social responsibility in a transition economy[☆]

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ABSTRACT

This study investigates whether firms in China use corporate social responsibility (CSR) to build political networks and, if so, how such CSR decisions affect firm performance. We bypass the empirical difficulty of measuring the value of political networks by using an event study approach. Specifically, we examine how abrupt termination of existing political connections caused by replacement of city mayors affect Chinese listed companies' CSR choices. We find that when a mayor is replaced, the level of and the propensity for CSR activity increase. Such increases are more prominent in firms for which political connections are more valuable, namely, nonstate-controlled firms, smaller firms, and firms operating in cities ruled by more corrupt government. In addition, we find that firms that spend resources to bond with a new government via CSR activities are rewarded: these firms receive higher levels of government subsidies or have a greater propensity to receive future government subsidies. These firms also outperform firms that do not invest in political networking via CSR. Our study adds direct evidence to how and through what channel CSR affects firm performance. We also contribute to the CSR literature on politically motivated CSR strategies.

1. Introduction

This study uses an event-study approach to investigate politically motivated corporate social responsibility (CSR) and its impact on corporate financial performance. Two-thirds of the charitable giving in China in 2010 can be attributed to corporate donors; in sharp contrast, only 5 percent of charitable donations in the United States is made by corporations. About 57 percent of corporate donations in China are made by nonstate-owned enterprises (NSOEs), and 22 percent is made by state-owned enterprises (The Conference Board, 2012).[1] This interesting contrast between China and the United States motivates our study: why are Chinese companies so

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[1] These data include donations made by both listed and private companies. In the report issued by the corporate board (2012), the authors use "private companies" to contrast with "state-owned companies" and "foreign companies." We interpret "private companies" as a reference to the ownership nature rather than the listing status.

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generous? What are the motivation behind and the benefit of such CSR decisions? Why and how do ownership structures affect these CSR decisions?

Moreover, existing research on the relation between CSR and firms' financial performance has largely been inconclusive. On the one hand, CSR activities can benefit shareholders by promoting corporate image (Brammer and Millington, 2005; Dean, 2003), by enhancing cause-related marketing (Strahilevitz and Myers, 1998; Varadarajan and Menon, 1988), or by meeting stakeholders' expectations (Brammer and Millington, 2004; Buchholtz et al., 1999; Campbell et al., 1999). Reporting CSR activities can also provide positive signals to market participants and may lower cost of capital (Dhaliwal et al., 2011, 2012; Kim et al., 2012). On the other hand, CSR activities divert resources from uses that would otherwise earn higher returns for shareholders, and such diversions lower firm values (Brammer and Millington, 2008; Pava and Krausz, 1996; Seifert et al., 2004). Our study provides some evidences in this regard.

Our study adds to the debate on whether and, if so, how CSR promotes firm performance within a particular institutional setting, namely, transitional economies. This setting enables us to provide a channel through which CSR can affect firm performance: the role of political networking. Transitional economies are featured by extensive government interventions (Aoki et al., 1998), which increases transaction costs in various forms including windfall taxes, restrictive financing, and barricaded market entries (Claessens and Laeven, 2003; Cull et al., 2015; Gwartney and Lawson, 2009). Therefore, firms establish political connections with the government (e.g., Faccio, 2006, 2010) to enjoy benefits such as less taxation (De Soto, 1989), privileged access to debt financing from government-controlled banks (Fan et al., 2008; Li et al., 2008), and relaxed government oversight (Agrawal and Knoeber, 2001; De Soto, 1989).

The first part of our study establishes the link between CSR strategies and political connection. Theoretically, CSR can be adopted to meet a company's long-term political goals due to the demand for and the supply of politically motivated CSR in transition economies.[2] On the one hand, extensive government interventions that blend public administration with corporate management create political demand for CSR. In the case of China, government officials are evaluated on regional economic development and social welfare promotion such as illiteracy reduction and population control. When the government fails to fund adequate public services, it reaches out to firms for additional funding (Friedman et al., 2000). On the other hand, firms are willing to supply financial assistance in the form of CSR as they desire a close connection with the government and anticipate reduced transaction costs of dealing with government regulations (Hellman et al., 2003; Li et al., 2006). In fact, compared to other strategies such as corruption and bribery (Rose-Ackerman, 1999), CSR can be an even more deceptive bond with the government.

Empirically, however, the relation between CSR strategies and political benefits is difficult to verify because the political benefits of CSR cannot be easily measured (Wang and Qian, 2011).[3] We adopt an event-study approach to overcome the obstacle of measuring political benefits. Specifically, we identify city-level mayoral turnovers as exogenous shocks to existing political networks and investigate firms' CSR strategies subsequent to these events for two reasons. First, voluminous studies find that in China (and other countries) political connections are based on personal relationships between government officials and firm CEOs or board members (Fan et al., 2007; Leuz and Oberholzer-Gee, 2006).[4] When the mayor is replaced, the connection between the government and the firm is lost, and new connections will be sought (Leuz and Oberholzer-Gee, 2006). Second, local government officials are appointed by the central government, and such personnel decisions are exogenous; that is, the current connectors cannot influence the decision, nor do they have advantages once the new mayor comes into position. In sum, the underlying premise of our approach is that abrupt terminations of political connections – occur with mayoral replacements – shuffle the existing political network and trigger political competition among firms to seek new connections. If CSR is used as a means of political networking, we should observe that CSR activities increased subsequent to political power transitions. However, increases in CSR will not be uniform across firms due to the variant demand for political connections. For example, small or privately held firms have a greater demand for political connections (e.g., Chen et al., 2009; Cull and Xu, 2005).

In the second part of our analysis, we examine the effectiveness and consequences of using CSR to build political networks during mayoral transitions. We argue that firms build political connectedness with the government and expect future favors in exchange. Therefore, we examine whether firms increasing CSR during political transitions are more likely to receive future government subsidies or to receive higher levels of future government subsidies. We also examine whether these firms outperform their peers that do not increase CSR spending during a mayoral transition. One may be concerned that not all firms with increased CSR during mayoral transitions will receive higher level of future subsidies, because not all of these firms will successfully build connections via CSR. Our comparison is meaningful when a firm's CSR decision is conditional on its assessment of the probability of a successful outcome. That is, we are in effect comparing firms that have a higher probability of building connections (i.e., that increase CSR) with firms that have little or no hope of building political connections with the new mayor (i.e., that do not increase CSR), and we find differences in future subsidies and firm performance.[5]

[2] Hillman and Hitt (1999) point out that firms' political strategies could be *transactional* or *relational*, depending on whether the goal is to resolve political risks on an issue-by-issue basis or on a long-term relationship basis. In an Anglo-Saxon model, political strategies are usually transactional (e.g., Getz, 1997, 2001), but in transition economies they are more likely relational (Li et al., 2006).

[3] Several recent studies discuss how firms' CSR practices are motivated by political objectives, such as gaining political legitimacy (Sánchez, 2000) and meeting government requirements (McWilliams and Siegel, 2001). However, these studies do not provide large-sample evidence linking CSR and firms' political endeavors.

[4] Wang and Qian (2011) and Jia and Zhang (2012) suggest that firms use philanthropy to gain political access because a positive correlation exists between the amount of firms' charitable donations and CEOs' previous affiliations with government. Their studies are insightful but empirical links between CEO personal connections and CSR are weak due to the noise contained in the political connection proxies.

[5] We also investigate the consequence of CSR for the firms that do not experience turnover in their cities and discuss the results in Section 4.4.8. We thank our referee for pointing this out.