Journal of Comparative Economics xxx (xxxx) xxx–xxx

Contents lists available at ScienceDirect

Journal of Comparative Economics

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

Estimating the value of political connections in China: Evidence from sudden deaths of politically connected independent directors

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A R T I C L E I N F O

Keywords:
Political connection
Sudden death
Retired government official
Independent director
Market calue

JEL classification:
G14
L25
P26
P31

A B S T R A C T

This paper estimates the value of political connections by examining stock price reactions to sudden deaths of retired government officials who were acting as independent directors of private firms in China from 2003 to 2012. Employing an event study, we find that, if a private firm loses political connections because of the sudden death of an independent director who was previously a government official, its stock price drops 3.61% on average within ten trading days. After the loss of political connections, we find that it is possible but infeasible for a private firm to reestablish political connections with the government in a short period of time. Moreover, the sudden death of a retired government official leads to a reduction in the economic benefits (e.g., bank loans, tax preference, and government subsidies) obtained by a private firm, which provides a reasonable explanation for the negative stock price reaction after losing political connections.

1. Introduction

Political connections are universally important (Faccio, 2006). Estimates of the economic value of political connections have been fascinating economists all around the world in the last several decades (Fisman, 2001; Faccio, 2006; Goldman et al., 2009; Do et al., 2014; Kim, 2015; Acemoglu et al., 2016; Zhang et al., 2016). But the growing body of research into the impact of political connections provides mixed evidence of their effects on the market value and performance of firms. Many studies focus on the benefits from such connections. They have shown that political connections can be used as an alternative mechanism to protect a firm's property rights and interests from infringement by other market participants, and can help firms get access to bank loans on favorable terms, as well as tax preferences and government subsidies or contracts, all of which ultimately increase firms' market value or improve their economic performance (Allen et al., 2005; Fan et al., 2008; Claessens et al., 2008; Faccio and Parsley, 2009; Goldman et al., 2013; Acemoglu et al., 2016). In contrast, other studies consider these connections from the perspective of the government and emphasize the associated costs of such linkages for the firm. Therefore, political connections have negative effects on the firm's economic performance because politically connected firms are more likely to pursue social objectives that are encouraged by the government or politicians, which leads to the misallocation of resources (Faccio et al., 2006; Fan et al., 2007; Boubakri et al., 2008; Marquis and Qian, 2014; Zhang et al., 2016).

In this paper, we estimate the value of political connections in China. As one of the largest transitional countries, China is an important counterexample to the findings in the law, institutions, finance, and growth literature: Neither its legal nor financial system is well developed, yet it has one of the fastest growing economies (so-called *Chinese Riddle*). Allen et al. (2005) once suggested that some alternative mechanisms play important roles in supporting the growth of Chinese economy. As one of such alternative mechanisms, political connections are good substitutes for standard corporate governance mechanisms and financing channels.

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http://dx.doi.org/10.1016/j.jce.2017.10.001
Received 24 March 2017; Received in revised form 18 October 2017; Accepted 18 October 2017
0147-5967/

Therefore, it is a common phenomenon to establish political connections with the government in China. For example, about 80% of the Chinese listed firms had some kind of political connections in 2013. But politically connected firms in China also have to undertake some policy and social burdens in order to exchange for economic privileges from the government (Sun et al., 2015; Zhang et al., 2016). Hence, China, traditionally placing high value on social networks, provides an interesting institutional setting in which to examine the mixed evidence of the value of political connections. In spite of a rich body of literature on the topic of political connections in other countries, direct empirical evidence on the value of political connections for Chinese firms is scant. This paper attempts to fill this void in the literature by examining the stock price reaction to sudden deaths of politically connected independent directors in China and provide some evidence to explain the *Chinese Riddle*.

A major innovation of this paper is to measure a firm's political connections from a new perspective. In prior studies, most papers assumed that a firm has political connections if one of its large shareholders or senior executives once worked (or currently works) for the government (Faccio, 2006; Fan et al., 2007; Boubakri et al., 2008; Ferguson and Voth, 2008; Zhang et al., 2016). However, this measurement is rough and inaccurate, especially for China.[1] This paper uses retired government officials who were hired as independent directors to define the firm's political connections. Incumbent government officials usually have political power and social networks.[2] Even after government officials retire, their social networks accumulated before retirement still exist for a certain period of time. Therefore, it is not uncommon in China for listed firms to hire retired government officials as independent directors. Hereafter, we call them government official independent directors. As a scarce resource, retired government officials serve as a bridge linking firms and the government, and help firms obtain various government-related benefits by employing their social networks. Therefore, a government official independent director can be regarded as an exclusive political capital for a firm. Unlike former studies, we also provide detailed information about when retired government officials were hired as independent directors, what kind of job they held before retirement, and their administrative levels, all of which helps us to measure the strength of the firm's political connections. Moreover, we also collect information on independent directors from academia and business circles, most of whom did not have political backgrounds, and thus we use them as a comparison to show the importance of retired government officials to Chinese firms.

The main empirical challenge in estimating the value of political connections is the endogenous nature of establishing political connections (Adams et al., 2010). For example, there may exist reverse causality between the establishment of political connections and the firm's economic performance. On the one hand, political connections can help a firm obtain economic benefits and thus improve its economic performance. On the other hand, firms with good economic performance are more likely to attract retired government officials to work for them because such firms can pay higher salaries to them. Omitted variables can also induce endogeneity; it is plausible that unobservables such as business acumen are correlated with the ability to establish political connections. In this paper, we use sudden deaths of government official independent directors to address this endogeneity problem. If a government official independent director suddenly dies, then the firm that he or she works for unexpectedly loses its political connections. As opposed to studying the beginning of a political relationship (e.g., an announcement of the hiring of a retired government official), examining the unexpected termination of a political connection is cleaner. Because there is little chance of pre-announcement news leakage in the case of sudden death, the value of the lost connection should be fully reflected in the firm's stock price. So we can use this exogenous shock to eliminate the endogeneity problem.

Following the prior literature, we estimate the value of political connections from the angle of losing it (Fisman, 2001; Faccio and Parsley, 2009; Nguyen and Nielsen, 2010). In addition to eliminating the endogeneity problem, estimating the value of political connections in this way is very practical for developing or transitional countries, especially for China. Political connections are, in effect, an informal institution. With the increase in anti-corruption efforts and the development of the market economy in China, establishing and maintaining political connections became more and more difficult and costly in the last decade. First, China has greatly increased the anti-corruption efforts since the eighteenth National Congress of the Communist Party of China (CPC) in 2012. A large number of government officials and senior executives of SOEs have been arrested for corruption. According to statistics, only 30 deputy department cadres on average were arrested for corruption annually from 2003 to 2012 but this number suddenly increased to 186 in 2013 and even reached 380 in 2014 (Dang et al., 2015). Second, the Chinese market economy has greatly improved in the last decade. Wang et al. (2016) estimated the degree of marketization in China and found that the marketization index score increased from 5.48 in 2008 to 6.56 in 2014.[3] In this context, a large number of firms are gradually losing political connections. Therefore, it is meaningful to study whether politically connected firms are placed at an economic disadvantage if they suddenly lose political connections.

Using Chinese private listed firms from 2003 to 2012, we empirically examine the effects of the unexpected loss of political connections on the stock prices of private firms.[4] Employing the event study, we find that a firm's stock price drops 3.61% on average

[1] For example, this measurement doesn't tell us when the CEO or senior executives worked for the government. If the CEO or senior executives worked for the government a long time ago, then their political power may have disappeared. Faccio (2006) pointed out that connections with politicians who served farther back in time are less likely to have a major impact on firm activities. Moreover, this measurement doesn't provide any information about what kind of job they held in the government or their administrative levels. Both of these factors are related to political power. To sum up, a single dummy variable can't accurately measure a firm's political connections.

[2] According to Chinese law, incumbent government officials are prohibited from doing business or working for firms to prevent them from taking advantage of their political power to seek economic benefits or privileges for firms.

[3] http://finance.qq.com/a/20160414/041777.htm. The full score is 10. The larger the index is, the higher the marketization is.

[4] We use only private firms to conduct the empirical analysis because state-owned enterprises (SOEs) have close relationships with government from the start and have preferential access to government subsidies and other key resources. It is hard to differentiate between the value of political connections and the ``parental” assistance from government to SOEs.