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Political connections, founder-managers, and their impact on tunneling in China's listed firms☆

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ABSTRACT

We investigate the impact of manager political connection and founder status on tunneling in China's listed firms from 2004 to 2010. By classifying the political connections into three dimensions with two categories of controlling ownerships, we find that overall manager political connection is negatively related to tunneling in private firms but positively related to tunneling in SOEs. The CPC/CPPCC-type connection is likely to protect firms from tunneling, while the official-type connection facilitates tunneling from firms. The impact of these two types of political connection on tunneling is stronger at the central level than the local level. A chairman's political connection has significantly greater influence on tunneling than a CEO's connection. We also find that firms with founder-managers have a stronger resistance to tunneling than those with non-founder-managers, which is still observed in firms with politically connected founder-managers. Our results show that the incentives of various managers towards tunneling depend on their motivation for establishing relevant political connections.

1. Introduction

When larger shareholders or other insiders such as managers have the capability of controlling the firms they may have an incentive to extract private benefits as well. The practice of expropriating value from a firm is commonly referred to as "tunneling" (Johnson et al., 2000) or "self-dealing" (Djankov et al., 2008). Friedman et al. (2003) find that tunneling by entrepreneurs who control the firms is prevalent in

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countries with a weak legal system. The Chinese market has been criticized for its generally ineffective institutional system, weak investor protection, and lack of internal monitoring and external discipline mechanism. Tunneling behavior has frequently been detected in China's publicly listed firms.

Some studies have tried to identify the specific factors, in addition to the common regulatory environment, that determine tunneling in China's publicly listed firms. Li et al. (2004) document that concentrated ownership exacerbates the expropriation of assets by block shareholders. Chen et al. (2005) indicate that the state as the controlling shareholder facilitates tunneling. Tang et al. (2004) concede that institutional ownership is favorable for tunneling, while Gao and Kling (2008) argue that having the state and institution as principal shareholders is not necessary to facilitate tunneling. Jiang et al. (2010) show that institutional investors avoid investing in firms that experience severe tunneling and this problem is much greater in non-state owned firms.

It is obvious that the existing literature on tunneling in China's listed firms provides inconsistent evidence. In this research, we do not intend to duplicate any of the evidence to align with some viewpoints because we conjecture that there is a 'hand' behind the factors identified by the abovementioned studies, which is the ultimate determinant of the tunneling behavior in China's listed firms. This 'hand' is the powerful 'Guan Xi' (relationship) in China — political connection. Political connection and its impact on firms' performance in various ways have been found in many countries (Friedman et al., 2003; Faccio et al., 2006), but it is more profound in China because political connection in China represents a complicated framework with three dimensions and permeates various enterprises.

First, political connection in China can be categorized into two types. One is an official-type political connection where a firm's manager is a current or former government official or military officer. The other is a CPC/CPPCC-type political connection where a firm's manager is a current or former member of the Chinese People's Congress (CPC) or the Chinese People's Political Consultative Conference (CPPCC). Second, political connection in China is attributed to two levels of administrative hierarchy. One is that a firm's manager holds or held a political position in local (provincial or regional) government organizations. The other is that a firm's manager holds or held a political position in central (national) government organizations. Finally, firm manager in China is a brief concept that in reality can be either a chief executive officer (CEO) or chairman of the board who plays different roles in the firm. Thus, a firm can be politically connected by either its CEO or chairman, or both. These differently politically connected managers represent a diverse form of interests of shareholders, government organizations, and themselves and thus should have various incentives for tunneling.

If a manager is the establisher of the firm, the manager is entitled to be a founder manager and the firm is entitled to be a founder firm. The founder manager may be a block shareholder of the firm or an expert in the production, marketing, and management of the firm. Literature shows that founder managers and non-founder managers have different incentives in a firm's decision making (Anderson and Reeb, 2003; Anderson et al., 2009; Li and Srinivasan, 2011). It is expected that when founder managers are politically connected their incentives may have changed.

In this paper we investigate the function of the 'hand' – political connection – in firm's tunneling behavior. The novelty of this research is that we are the first to classify political connections in China's publically listed firms into three dimensions: official-type and CPC/CPPCC-type, local level and central level, CEO's connection and chairman's connection. Accordingly, we fill a gap by analyzing the motivation of managers with different political connections towards tunneling, intertwined with firms' ownership and managers' founder status.

We show that both political connection and founder status determine tunneling behavior and their impact varies in private firms and SOEs (state owned enterprises). Specifically, we find evidence that overall, manager's political connection reduces tunneling in private firms, whereas it facilitates tunneling in SOEs. There is less tunneling in both private firms and SOEs with founder-managers than in firms with non-founder-managers, but the tunneling between founder-manager firms and non-founder-manager firms is significantly greater in private firms than in SOEs. When founder managers are politically connected they can still resist tunneling to some extent.

We find that for private firms, CPC/CPPCC-type political connection significantly reduces firm tunneling, while official-type political connection has a positive but insignificant impact on tunneling. On the contrary, official-type political connection in SOEs significantly increases tunneling, while CPC/CPPCC-type political connection has a negative but insignificant impact on tunneling. These results are consistent with the nature of these two types of political connections.