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Political Connections, Productivity and Firm Sales

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Abstract

We explore the significance of political connections vs. productivity for firms' domestic sales and export performance in developing countries, using the data from the listed firms in China's Shanghai and Shenzhen stock markets. We estimate firms' total factor productivity and manually build a detailed dataset on firm's political connections using public information released by firms. We find that more productive firms have larger sales in both domestic and international markets, but the effect of political connections differ. Political connections matter in a positive way for domestic sales, and employing a current member of a political body in China is more significant for domestic sales than employing a former government official. However, political connections are not significant for firm's export sales.

Keywords: Political connections, firm productivity, domestic sales, export

JEL: D22; D24; D72; F10; L2

1. Introduction

Firms in developing countries with underdeveloped markets and weak market-supporting institutions, tend to develop connections with governments (Jia, 2016; Li, Meng, & Zhang, 2006; Liu, Luo, & Xu, 2015). Firm's political connectedness is thus particularly prevalent in developing countries (Faccio, 2006). To what extent and through which channels political connectedness affecting firm performance have attracted lots of attention among researchers in recent decades. Firms' performance are one of the mostly studied outcomes. Many studies find that political connections have a positive effect on firm performance (Do, Lee, & Nguyen, 2015; Leuz & Oberholzer-Gee, 2006; Feng, Johansson, & Zhang, 2014, 2015; Feng & Johansson, 2014; Fisman, 2001; Goldman et al., 2009; Haveman, Jia, Shi, & Wang, 2017; Li et al., 2008; Su & Fung, 2013).

The potential reasons are that politically-connected firms can enjoy more benefits in many areas, such as more banking credits (Boubakri, Cosset, & Saffar, 2012; Charumilind, Kali, & Wiwattanakantang, 2006; Claessens, Feijen, & Laeven, 2008; Feng et al., 2015; Khwaja & Mian, 2005; Su & Fung, 2013; Xu, Xu, & Yuan, 2011; Yeh, Shu, & Chiu, 2013), favorable tax treatments (Adhikari et al., 2006; Claessens et al., 2008; Feng et al., 2015; Wu, Wu, Zhou, & Wu, 2012), easier access to state-controlled resources and lower risks of expropriation (Bunkanwanicha & Wiwattanakantang, 2009; Chen, Newman, Sun, & Wu, 2010; Cho & Joh, 2014; Cull & Xu, 2005; Faccio, Masulis, & McConnell, 2006; Feng et al., 2015; Li & Zhang, 2007; Li, Meng, Wang, and Zhou, 2008; Wu, Wu, & Rui, 2010, Yuan, 2011), market power (Johnson & Mitton, 2003), and rent seeking (Feng et al., 2014; Guo, Jiang, Kim, & Xu, 2014). Besides those direct channels, there are also indirect channels through which political connectedness may have impacts on firm performance, for example, Xu, Yuan, Jiang, and Chan (2015) find that politically connected founders are more prone to appoint a second generation as a family firm executive or director, and second generation involvement improves firm performance with the curtailment of tunneling as an important channel of performance enhancement.

Political connectedness is also found to have other impacts on firms, other than firm performance. Li, Song and Wu (2015) find a significant and positive relationship between political connectedness and the likelihood and extent of corporate

philanthropy, and the effect is stronger in private firms in China. Ang and Jia (2014) find that politically connected firms are more prone to use courts over informal avenues of dispute resolution. Moreover, the impact of political connections on firms may not always be positive (Bertrand, Kramarz, Schoar, & Thesmar, 2007; Boubakri, Cosset, & Saffar, 2008; Faccio, et al., 2006). The reasons include inefficient hiring (e.g. Bertrand et al., 2007; Fan, Wong, & Zhang, 2007; Saeed, Belghitar, & Clark, 2017; Wu, et al., 2010; Wu et al., 2012), or inefficient investment (Liu et al., 2015; Saeed et al., 2017). Moreover, politically-connected firms are more likely to avoid potentially costly compliance measures by reporting fewer violations of safety compliance (Fisman & Wang; 2013), and are less likely to access international financing (Leuz & Oberholzer-Gee, 2006), and also more likely to default (Khwaja & Mian, 2005).

From the literature we find that firms with political connections are more likely to have domestic financing but less likely to have international financing, which may indicate the different roles of political connections played in domestic and international market. Aligning with the research, this paper further explores whether political connections play different roles in firms performance in domestic and international market. The performance indicator employed is firm sales. Many channels through which political connections affecting firms' performance discussed in the literature may not affect firms' sales in different markets, however, some channels may result in differential impact on firms' domestic and international sales, such as market power (Johnson & Mitton, 2003) and rent seeking (Feng et al., 2014; Guo, Jiang, Kim, & Xu, 2014) which are often only useful for domestic sales.

We exploit the data of publically-listed firms in Shanghai and Shenzhen Stock Exchange in China for our empirical analysis. There are two reasons why we choose the publically-listed firms for the study. Firstly, the listed firms in China are generally among the largest firms and are most important players in the economy, thus it is important to learn their behaviors. Secondly, much more abundant and reliable information is available on listed firms than on non-listed firms. I further restrict the sample to listed firms in the manufacturing industry to yield a more uniform sample. Their financial data and the background of all the senior managers are publically available. Firm-level political connectedness is defined by executives and directors' current political delegation status and past employment history in public sectors as in

Ang and Jia (2014). Firms' total factor productivity (TFP) is also controlled for in the study, as research shows that firms' productivity are key to firms' performance.

From the panel fixed effect regressions, we find that more productive firms tend to have larger sales in both domestic and foreign markets, but the effect of political connections shows differential impacts. Political connections are positively correlated with domestic sales, and more specifically employing a current member of a political body in China is more significant for domestic sales than employing a former government official. However, political connections are not significant for firm's export sales. Our results provide novel insights into the interplay between international trade and cronyism, suggesting that international trade reduces the value of political connections.

The rest of this paper is organized as follows. Section 2 describes data and empirical methodology. Section 3 presents the main results. Section 4 discuss the robustness of the main results. Section 5 draw conclusions.

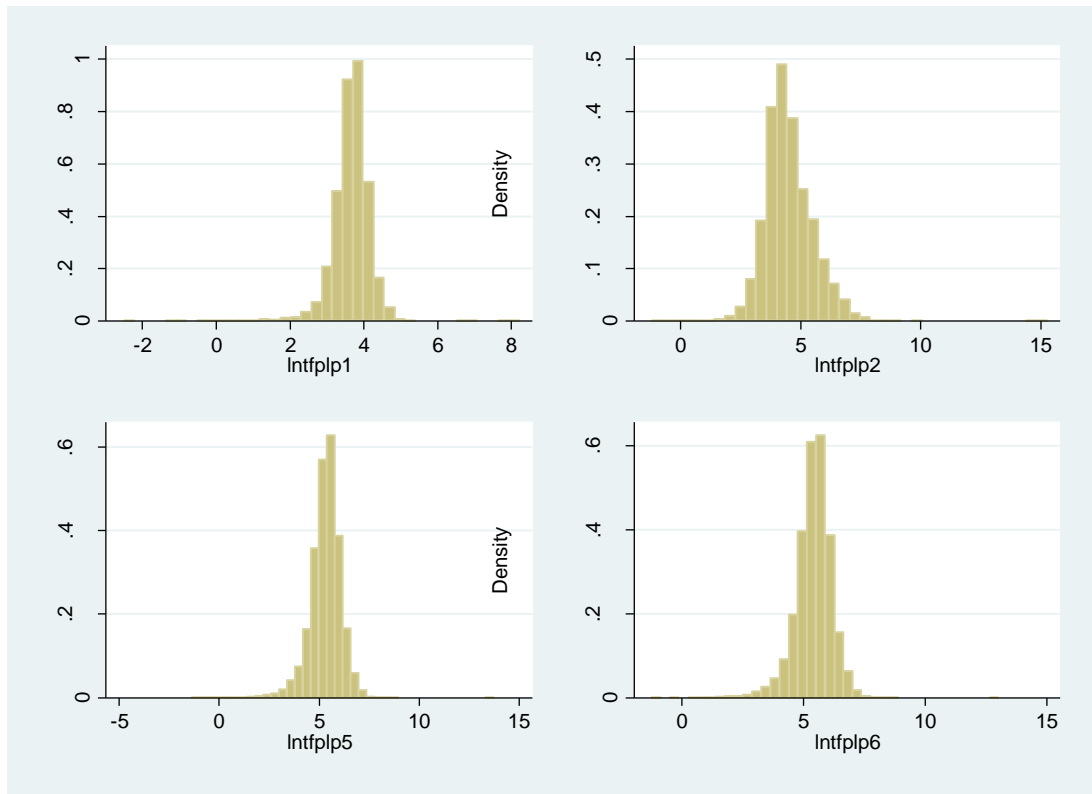
2. Data and Method

We extract firms' data directly from the China Security Market and Accounting Research (CSMAR) database, which covers all the listed firms in China's stock market. Political connectedness is hand-collected from the resumes of each listed firm's executives and directors (excluding independent directors). We focuses on Chinese publicly listed private firms in the manufacturing sector (1,464 firms in total), with a sample period 1993–2014, so that the firms are relatively comparable. The main outcome variables are firms' sales in domestic and foreign markets.

To estimate each firms' TFP, we consider firm i ' production at time t as $y_{it} = f(x_{it}, \varepsilon_{it}; \beta)$, where y and x refer to output and inputs respectively. β is the parameters of the production function. ε_{it} indicates the Hicks neutral productivity shocks to firm i at time t . Because of contemporaneous correlation between input x_{it} and exogenous shocks ε_{it} , the OLS estimation techniques result in estimates that are not consistent. We thus follows Levinsohn and Petrin (2003)'s instrumental variable (IV) approach to estimate firms' TFP. To check the robustness of our result, we also estimate firm TFP following the method developed by Olley & Pakes (1996), using

investment as the proxy for the exogenous shocks. The distribution of TFP estimated by different methods are illustrated in Figure 1, in which *lntfpp1* and *lntfpp5* are estimated by Levinsohn and Petrin (2003) method, and *lntfpp2* and *lntfpp6* are estimated by Olley & Pakes (1996) method.

Figure 1: The distribution of firm TFP

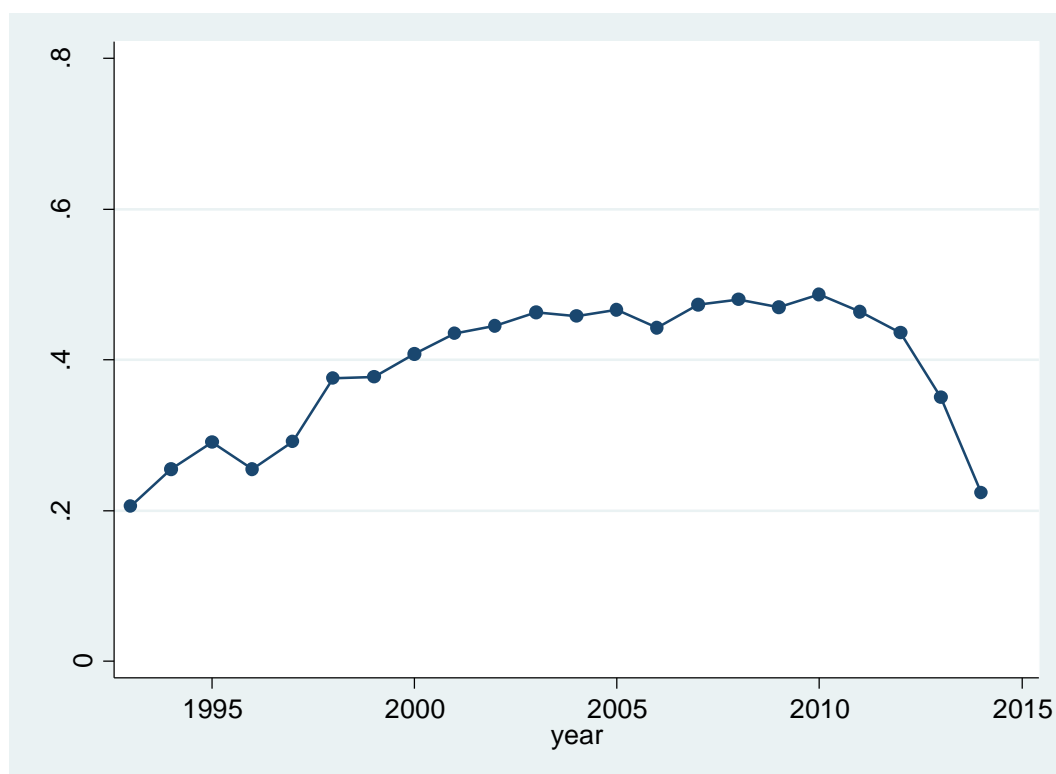


Notes: *lntfplp1*: Using revenue as firm output, intermediate inputs as proxy; *lntfplp5*: Using value added as firm output, intermediate inputs as proxy; *lntfplp2*: Using revenue as firm output, investment as proxy; *lntfplp6*: Using value added as firm output, investment as proxy.

In the China context, senior managerial personnel of a firm being a political delegate or a former government official constitutes two main avenues by which firms directly connect to the government (Ang & Jia, 2014). The political connectedness captured in this paper is different from political connections gained without frequent interactions with government officials, such as Chinese Communist Party (CCP) membership (Li, Meng, & Zhou, 2008). It is also different from measures of indirect connections, such as whether one has friends working in the government (Tsai & Xu, 2014), whether one has relatives working in the government (Kung & Ma, 2016), or whether the firm are in the industry and the city a top political leader ever worked for and the leader was in power in the year (Qin, 2012).

Political delegation indicates whether any executives or directors serves as a delegate of the People’s Congress (NPC), the Congress of the Chinese Communist Party (CCCCP), the Chinese People’s Political Consultative Conference (CPPCC) at the national and provincial levels. Another is whether any executives or directors is a former government official at the division level (*chu*, a county head’s official rank) or above in the cadre hierarchy. This threshold level is commonly used in previous studies of defining firms’ political connectedness since the division level or above is viewed as political elite and lower levels may not have enough political influence (see e.g. Ang & Jia, 2014; Haveman et al., 2016). We first construct an aggregate indicator of political connectedness indicating whether a firm has either current political delegation or former government officials. The Figure 2 below illustrates the dynamics of the share of firms with political connections. The figures show are inverted U shape. The share of firms building political connections increased in the first decade, then remained almost constant for a few years, and started to drop sharply since 2010.

Figure 2: Share of firms with aggregate political connections, 1993-2014



We also further split the two dimensions of political connections into two levels, specifically at the national or local level, as we suspect that the local connections

might be more important for firms as firms are more influenced by local policies and regulations. We show the dynamics of the four indicators of political connections in Figure 3. Among them, the share of firms having former government officials at local level are almost always the highest, while the share with former officials at national level are the lowest in most years. Political delegation at national and local levels also show different patterns, with a general declining trend for the delegation status national level, but an increasing trend until 2010 for the delegation at provincial level. A decline in all four variables are observed since 2010, which indicate that more and more firms listed in China's stock market are less likely to be connected tightly with government.

Figure 3: Share of firms with subcategories of political connections, 1993-2014

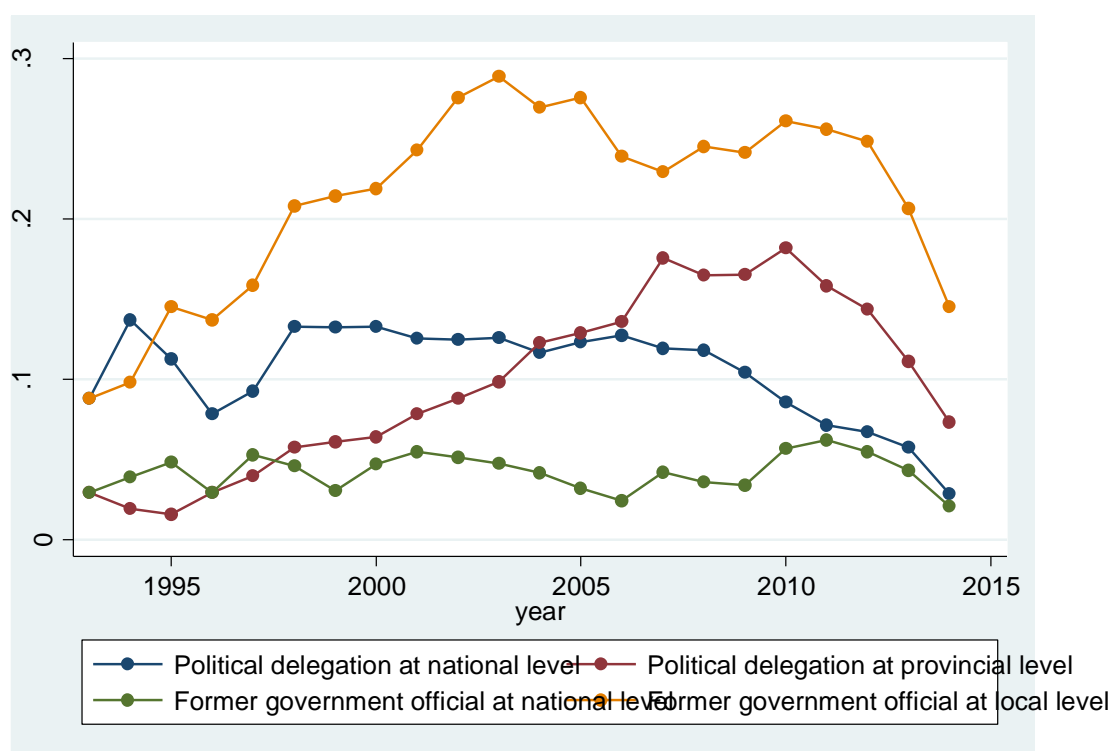


Table 1 reports the summary statistics of key variables. On average, 40.7 percent of observations have been connected with government through either executives' present political delegation or past working experience in government in the study period. The share of firm observations with political delegation at national and provincial levels are 8.8 and 4.4 percent respectively. While the share of firms with former government officials are higher, specifically, the share at national and local levels are 12.3 and 22.8 percent respectively.

Table 1: Summary Statistics

Variable	Obs.	Mean	Std. Err.	Min	Max
Log domestic sales	8,995	14.686	1.445	0	19.772
Log export sales	8,047	7.308	6.663	0	19.159
Political connectedness	9,234	0.407	0.491	0	1
Political delegation at national level	9,234	0.088	0.283	0	1
Political delegation at provincial level	9,234	0.123	0.329	0	1
Former government officials at national level	9,234	0.044	0.204	0	1
Former government officials at local level	9,234	0.228	0.420	0	1
Stock share owned by government	7,596	0.042	0.123	0	0.971
Log number of workers	8,518	7.200	1.193	0	12.139

We exploit the following panel fixed-effect models to estimate the relation between firms' political connections, productivity and sales in domestic and foreign market in China:

$$DS_{it} = \alpha_0 + \alpha_1 TFP_{it} + \alpha_2 PC_{it} + X'_{it}\delta_1 + \gamma_t + \mu_i + \epsilon_{it}, \quad (1)$$

$$ES_{it} = \beta_0 + \beta_1 TFP_{it} + \beta_2 PC_{it} + X'_{it}\delta_2 + \gamma_t + \mu_i + \epsilon_{it}, \quad (2)$$

where i and t indicates firm and year respectively. DS_{it} and ES_{it} represent log domestics sales and log export sales respectively. TFP_{it} indicates firms' log TFP and PC_{it} indicates political connections. X_{it} is a set of control variables, including firm size measured by the number of employees and the ownership share hold by the state. γ_t and μ_i represents year fixed effects and firm fixed effects respectively. ϵ_{it} is the error term. Our fixed effects analysis allow us to remove the estimation bias from the potential correlation between unknown firm characteristics μ_i and productivity and political connections.

3. Main Results

Table 2 reports the panel fixed-effect regression results of models 1 and 2. Political connectedness is a dummy variable with value one if any executives or directors serves as a political delegate or is a former government official above the division level, and zero otherwise. Firms' productivity is calculated by Levinsohn and Petrin (2003)'s method, which uses intermediate inputs to control for the correlation between inputs and the error term in the production function. There are two variants

of model to estimating the productivity, one using revenue as the output, and another using value added as the output. The productivity estimated by using revenue as output are reported in odd columns, and that estimated by using value added as output are reported in even columns.

Table 2: Political connections, productivity and firm sales

	Log domestic sales		Log export sales	
	(1)	(2)	(3)	(4)
Log TFP	1.055*** (0.075)	0.310*** (0.029)	0.680** (0.222)	0.253* (0.117)
Political connectedness	0.085** (0.030)	0.085* (0.037)	-0.116 (0.214)	-0.174 (0.216)
National share	0.056 (0.120)	0.110 (0.138)	-0.942 (0.978)	0.028 (0.967)
Log number of workers	0.492*** (0.040)	0.521*** (0.051)	0.875*** (0.167)	0.888*** (0.187)
Year dummies	Y	Y	Y	Y
Number of observations	6346	5945	6346	5945
Within R-squared	0.630	0.459	0.138	0.139

Notes: The method in Levinsohn and Petrin (2003) is exploited to estimate firms' TFP.

Robust standard errors are reported in parenthesis. + $p < 0.1$, * $p < 0.05$, ** $p < 0.01$, *** $p < 0.001$.

Columns 1 and 2 report the regression results for log domestic sales. Column 1 shows that the coefficient of log TFP is positive and statistically significant at 0.001 significance level, which means that 1 percent increase in TFP is associated with 1.055 percent increase in domestic sales. The coefficient of political connectedness is also positive and statistically significant at 0.01 significance level. The coefficient is 0.085, which implies that 1 percent increase in a firm's political connections is associated with 0.085 percent increase in firms' sales in domestic market. Column 2 shows similar results. The coefficient of log TFP (calculated based on firms' value added) is also positive and significant. The coefficient of political connections are unchanged, comparing to the coefficient in column 1. The two columns together suggest that both TFP and political connections contributes to firms' domestic sales in China. Next we report the regression results for log export sales in columns 3 and 4. Column 3 shows that the coefficient of log TFP is positive and statistically significant at 0.01 significance level. The impact is also sizable. The coefficient 0.068 implies

that 1 percent increase in TFP is associated with 0.68 percent increase in export sales. However, the coefficient of political connectedness is not significant anymore, and the coefficient is even negative. Column 2 reports consistent results. Thus we may conclude that a firm's TFP is important for both domestic and international sales, while political connections only matters for domestic market, as political connections is a context-specific asset. We also control for the share of ownership hold by the state (and local government), which is not significant in all models. The number of workers are positive and significant in all models, which shows the natural correlation between firm size and sales.

Table 3: Disaggregated political connections, productivity and firm sales

	Domestic sales		Export sales	
	(1)	(2)	(3)	(4)
Log TFP	1.051*** (0.075)	0.309*** (0.029)	0.676** (0.222)	0.247* (0.117)
Political connectedness				
Political delegation at national level	0.098+ (0.060)	0.141+ (0.074)	-0.017 (0.513)	-0.219 (0.538)
Political delegation at provincial level	0.134** (0.044)	0.110* (0.053)	0.294 (0.336)	0.153 (0.336)
Former government officials at national level	0.094 (0.096)	0.100 (0.089)	0.059 (0.334)	0.053 (0.342)
Former government officials at local level	0.030 (0.039)	0.023 (0.047)	0.171 (0.278)	0.168 (0.263)
National share	0.076 (0.121)	0.127 (0.139)	-0.869 (0.969)	0.067 (0.962)
Log number of workers	0.490*** (0.039)	0.519*** (0.052)	0.865*** (0.167)	0.882*** (0.187)
Year dummies	Y	Y	Y	Y
Number of observations	6346	5945	6346	5945
Within R-squared	0.631	0.460	0.138	0.139

Notes: The method in Levinsohn and Petrin (2003) is exploited to estimate firms' TFP.

Robust standard errors are reported in parenthesis. + $p < 0.1$, * $p < 0.05$, ** $p < 0.01$, *** $p < 0.001$.

Having shown the differential impact of political connections on firms' domestic and international sales in Table 2, we next further disentangle the measure of political connections in to different dimensions and examine if the role of different dimensions of political connections is different. Note that the measure used in Table 2 is a

combination of current status of political delegation and past government working experience. Now we separate it into two main groups. The first group are for the current political delegation status at national or provincial level, and the second group are for the status of being former officials at central or provincial government. All the four variables are included in each regression, and results are presented in Table 3. The four columns have the same structure as in Table 2, except that the variable of political connection is replaced by the four proxies. The coefficients of log TFP in all columns are very similar to their correspondents in Table 2 in terms of size and significance level. The results in columns 1 and 2 shows differential impact of the two different types of political connections on domestic sales. Political delegation at national level is marginally significant, while the delegation at province level is significant at 5 percent level. Columns 3 and 4 show that each dimension of political connections is not significant, which is consistent with results in Table 2.

4. Robustness Checks

To test the robustness of the main results, we run the regressions by using a different measure of firm productivity. The method was developed by Olley & Pakes (1996), in which investment is used as the proxy for exogenous shocks to estimate TFP. There are also two variants of model, one using revenue as firms' output, and another using firms' value added as the output variable. Table 4 reports the regression results using the new set of measures of TFP. The structure of the table is same as Table 2, except for different measures of TFP. The productivity estimated by using revenue as output is controlled for in odd columns, and that estimated by using value added as output are in even columns. The coefficients of log TFP are significant at conventional significance level in all models, confirming the importance of TFP in determining firms' sales, either domestic or international. Moreover, same pattern for the effect of political connections is observed. Specifically, the coefficients of political connectedness is positive and significant for domestic sales at 5 percent significance level, but not significant for export sales.

Table 4: Political connections, productivity and firm sales with different measures of firm productivity

	Domestic sales		Export sales	
	(1)	(2)	(3)	(4)
Log TFP	0.306*** (0.025)	0.334*** (0.029)	0.307*** (0.086)	0.286* (0.120)
Political connectedness	0.100* (0.044)	0.082* (0.036)	-0.132 (0.226)	-0.178 (0.216)
National share	-0.070 (0.160)	0.107 (0.135)	-1.186 (0.988)	0.028 (0.968)
Log number of workers	0.681*** (0.049)	0.547*** (0.050)	0.975*** (0.164)	0.910*** (0.188)
Year dummies	Y	Y	Y	Y
Number of observations	5644	5945	5644	5945
Within R-squared	0.481	0.469	0.133	0.139

Notes: The method in Olley & Pakes (1996) is exploited to estimate firms' TFP. Robust standard errors are reported in parenthesis. + $p < 0.1$, * $p < 0.05$, ** $p < 0.01$, *** $p < 0.001$.

Table 5 reports the regressions for the new set of TFP measures and the same four variables of political connections as being used in Table 3. There are four columns of results, with the first two for domestic sales, and the last two for export sales. The productivity measures in odd and even columns are estimated by using revenue as output and by using value added as output respectively. The results are very similar to those in Table 3. Log TFP is positive and significant in all models. The coefficients of political connections also exist same pattern as in Table 3. Political delegation at province level is national level is statistically significant at 5 percent level, and political delegation at national level is only marginally significant, as shown in columns 1 and 2. Consistent with results in Table 2, columns 3 and 4 show that each dimension of political connections is not significant.

Table 5: Disaggregated political connections, productivity and firm sales with different measures of firm productivity

	Domestic sales		Export sales	
	(1)	(2)	(3)	(4)
Log TFP	0.305*** (0.025)	0.332*** (0.029)	0.307*** (0.086)	0.280* (0.120)
Political connectedness				
Political delegation at national level	0.131+ (0.073)	0.136+ (0.072)	0.013 (0.509)	-0.225 (0.538)
Political delegation at provincial level	0.162* (0.063)	0.106* (0.053)	0.205 (0.356)	0.148 (0.336)
Former government officials at national level	0.226* (0.108)	0.100 (0.089)	-0.152 (0.319)	0.052 (0.342)
Former government officials at local level	0.021 (0.055)	0.021 (0.046)	0.198 (0.303)	0.165 (0.263)
National share	-0.045 (0.159)	0.123 (0.135)	-1.131 (0.978)	0.065 (0.963)
Log number of workers	0.677*** (0.049)	0.545*** (0.050)	0.968*** (0.164)	0.904*** (0.188)
Year dummies	Y	Y	Y	Y
Number of observations	5644	5945	5644	5945
Within R-squared	0.484	0.470	0.133	0.139

Notes: The method in Olley & Pakes (1996) is exploited to estimate firms' TFP. Robust standard errors are reported in parenthesis. + $p < 0.1$, * $p < 0.05$, ** $p < 0.01$, *** $p < 0.001$.

5. Conclusions and Discussions

This paper studies how firms' productive and political connections affect firms' sales, using data from a large developing country with a strong government. We exploit the public information of those publically-listed firms for the analysis. Political connectedness is manually collected from each senior manager's profile disclosed to the public. It is mainly captured by senior executives and directors' current political delegation status and past employment history in public sectors.

We find that firms' productivity are important determinants of sales in both domestic and foreign markets, however the effect of political connections differs between domestic and export sales. Political connections only matter for firms' sales in domestic market, but not significant for the foreign market. In other words, firm's

political connections are only firms' local asset, which effect cannot be extended to global market. We also split the political connections into two groups and show that employing (or being) a current member of a political body in China is more significant for domestic sales than employing (or being) a former government official. Our empirical results show that the former is significant for domestic sales, while the latter not.

Our results provide novel insights into the interplay between international trade and cronyism, suggesting that international trade reduces the value of political connections. We thus may infer that, along with a country's opening to the foreign market, the political influence on firms will be alleviated as firms' incentive to build and maintain political connections will be lower. However, our results establish that political connections do matter for domestic sales within a weak institutional environment. International trade is often proposed as a remedy for improving economic and political institutions, and thus reducing cronyism. Our paper provides empirical evidence in line with this view.

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