

Beyond Local Protectionism

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Abstract

This article presents a large-scale, systematic study of politically connected firms in China through compiling a database that includes all the publicly traded firms in China in 1993, 2002, and 2012 through coding the biographies of hundreds of thousands of board members. I find that there has been a significant increase in the percentage of firms that are connected with the national government in the last 20 years, which casts doubt on a popular argument that businesses in China have primarily relied on “local protectionism.” I interpret this as a result of firms’ need to connect with powerful and stable institutions. I test this by examining the impact of the fall of Chen Liangyu on firms in Shanghai.

Keywords: Local protectionism, political connections, central-local relations, event study, corruption

Ping An Insurance (中国平安), a big financial services company registered in Shenzhen, became widely known after a *New York Times* article reported that one of its largest shareholders is Yang Zhiyun (杨志云), China's former Premier Wen Jiabao (温家宝)'s mother.¹ An examination of Ping An's public records reveals that it is probably one of the most politically connected firms in China: two of its board members used to work in the national government, five in local governments, including a vice mayor of Shenzhen, and the firm's president is a delegate to the Chinese People's Political Consultative Conference. Ping An Insurance is not alone. As unveiled in the recent anti-corruption campaign in China, many firms are connected to powerful politicians, such as China National Petroleum Corporation (中石油)'s connection to Zhou Yongkang (周永康) and Dalian Shide (大连实德)'s connection to Bo Xilai (薄熙来). The downfall of a politician in China is often preceded or followed by the fall of one or more companies.

However, despite the prevalence of politically connected firms in China, we have little comprehensive knowledge about them beyond anecdotes and case studies. This article presents a large-scale, systematic study of politically connected firms in China through compiling a database that includes all the publicly traded firms in China in 1993, 2002, and 2012 through coding the biographies of hundreds of thousands of board members. I distinguish connections with seven political organizations: the national government, local government, the national parliament, local parliament, the National Party Congress, local Party congress, and the People's Liberation Army (PLA). A firm is defined as being

¹ Nytimes.com 2012.

connected if at least one of its board members is formerly or currently an employee or a member of these organizations.

I find that, first, political connections are ubiquitous among listed firms in China: almost 90 per cent of firms are connected. Second, firms are overwhelmingly connected with the government rather than the parliament, which is a more common form of connection in democracies. Third, while more firms are connected with local governments than the national government, there has been a significant increase in the percentage of firms that are connected with the national government in the last 20 years. The proportion of firms connected with the national government has tripled from 1993 to 2012, whereas the proportion of firms connected with local governments has increased only by 30 per cent.

This last finding casts doubt on a popular argument that businesses in China have primarily relied on collusive relationships with *local* politicians. For example, Oi argued that “Growth will result as long as there are secure property rights for some organized unit and sufficient incentives for that unit to pursue growth. In the process *local* governments have taken on many characteristics of a business corporation, with officials acting as the equivalent of a board of directors” (italics by the author).² In the same vein, Wank contended, “[P]rivate business operated in networks of personal ties centered on the *local* government. Personal ties with state agents enhance access to profit opportunities located in the state’s bureaucracy and protect subsequent wealth accumulations” (italics by the author).³

This article offers new data and methods to challenge this conventional wisdom. My interpretation of the trend is that local connections can make investors vulnerable by

² Oi 1992, 100.

³ Wank 1999, 4.

exposing them to political uncertainties. Especially in authoritarian regimes in which political processes are opaque, and political wind shifts quickly, business people can easily bet on the wrong side. Therefore, firms in a politically uncertain environment need to build *robust* connections to minimize political hazards. Connections with powerful and stable institutions, such as the national government, are less susceptible to political shocks.

There are two primary reasons why national connections are more robust than local connections. First, while local politicians must rotate across localities and, therefore, cannot stay in one place for a long time, central government officials are less frequently rotated.⁴ Second, local officials are more likely to become targets of anti-corruption campaigns than central officials,⁵ so local connections are more vulnerable than central connections to shifts in political winds.

I am not arguing that firms have moved away from local connections; instead, many firms build both national and local connections. The diversification of connections provides double insurance for firms under uncertain political circumstances. My analysis shows that older and bigger firms are more likely to diversify their political connections.

To empirically show that national connections are more robust than local connections, I conduct an event study of the removal of Chen Liangyu (陈良宇), Party chief of Shanghai, in 2006. Around the time of the announcement of Chen's dismissal, firms that were connected only with the Shanghai *local* government experienced a significant five-day cumulative abnormal return of -2.34 per cent. The political earthquake caused an \$830

⁴ Huang 2002.

⁵ Wedeman 2012.

million loss to locally connected firms. In contrast, firms connected with only the national government were unaffected.

This article contributes to the political connection literature by disaggregating different types and levels of connections and examining the various functions they serve. In addition, the findings challenge the conventional wisdom based primarily on the case studies that postulated that Chinese firms have overwhelmingly relied on “local protectionism,”⁶ and show that central connections are more important than previously believed. While local protections are still important, they expose firms to political risks under certain circumstances.

I also join the debate about whether the significance of “*guanxi* (关系)” has declined in China as a market economy is established.⁷ My findings imply that the focus of future “*guanxi*” studies should shift from whether “*guanxi*” is important to what type of “*guanxi*” is important and why.

DATA

I construct a Chinese Listed Firms Database (CLFD) that includes the personnel and financial information of all listed firms in China in 1993, 2002, and 2012. One advantage of focusing on listed firms is that financial market data are often incredibly detailed and comprehensive compared to firm-level surveys that can only ask a limited number of questions and are subject to perception bias. In addition, the longitudinal nature of financial market data makes it possible to examine trends over time, which is the main purpose of this study, while long-term panel firm-level surveys are non-existent. However, one disadvantage is that non-listed

⁶ Oi 1992; Montinola, Qian and Weingast 1995; Wank 1999.

⁷ Guthrie 1998.

firms are excluded in my sample. This might introduce selection bias to my analysis, but this study is concerned with the *relative* importance of national connections over time rather than the *absolute* level of importance in a given year. So a sample of listed firms suits the purpose of the study well. Besides, listed firms are the biggest economic players that carry a disproportionate weight in the Chinese economy and politics, which makes the findings more indicative, if not more representative, than a random sample of firms.

China's stock market was established in 1991, and the number of listed firms increased from 53 in 1992 to 2,465 in 2012. I select three years to collect the data: 1993, 2002, and 2012. 1993 was the first year that I can find a decent number of observations (there were only 53 listed firms in 1992), and 2002 and 2012 were both "transition" years in which the national leadership experienced successions. And I choose a ten year gap to assure that it is long enough for firms to replace old board members with new ones, so that I am observing firm-level rather than individual-level changes, for example, a board member changes from a local people's congress delegate to a national delegate.⁸ A total of 183, 1,224, and 2,465 companies were listed on the Shanghai or Shenzhen Stock Exchange in 1993, 2002, and 2012, respectively. I obtained the biographical information of over 67,000 board members (chairperson, president, vice-president, CEO, executive director, non-executive director, or secretary) in all of the companies from Wind Info, a leading integrated service provider of financial data based in Shanghai.⁹ I then checked the reliability and consistency of the Wind data using public information found in a random sample of companies' annual reports to verify their accuracy. I then manually coded the career information of each board member in

⁸ Board members in most firms have a three year term, and most of them have two to three terms.

⁹ Wind.com.cn 2013.

each firm to determine if a member is politically connected.¹⁰ This “board” approach is consistent with the identification of political connections in the previous literature.¹¹

Different from previous studies that only examine one type or level of connection,¹² I distinguish seven types of connections. A board member could be connected with one of the following organizations: the national government, a local government (from province to township), the national parliament (including the National People’s Congress and the Chinese People’s Political Consultative Conference), a local parliament (including local People’s Congress and local People’s Political Consultative Conference), the National CCP Congress, a local CCP Congress, or the PLA.

The rationale of disaggregating different types and levels of connections is that there are different logics behind these connections. Political connections with the government can be supplied by politicians who “descend from heaven” through retirement. In China, Deng Xiaoping carefully and gradually enforced policies and norms of cadre retirement in the late 1970s.¹³ Many officials also resign from public office to take a corporate job for two reasons.¹⁴ One is simply that not everyone gets promoted to the top in the bureaucracy.¹⁵ The

¹⁰ Every board member was double-coded by a group of research assistants and me. Table A2 in the web appendix shows two examples of board members’ biographies.

¹¹ Agrawal and Knoeber 2001; Boubakri, Cosset and Saffar 2008; Sun, Xu and Zhou 2011.

¹² Faccio 2006.

¹³ Manion 1993.

¹⁴ The Civil Servant Law of China stipulates, “Where a civil servant resigns his post or retires, he shall not take any post in an enterprise or any other profit-making organization, which is directly related to his original post, or shall not engage in any profit-making activity directly related to his original work within three years after he leaves his post, if he is a leader before resignation. For any other civil servant, the time limit is two years.” However, this law is rarely enforced. For the law, please see <http://alturl.com/swa2e>. Accessed 17 September 2013. And for a discussion of its enforcement, please see <http://alturl.com/th8qv>. Accessed 17 September 2013.

¹⁵ Landry 2008; Shih, Adolph and Liu, 2012. It is estimated that the probability of a civil servant in China finally being elevated to the ministerial level is 0.04%. Please see <http://alturl.com/cwnhs>. Accessed 1 August 2013.

second is the differential salaries of public and private sector jobs.¹⁶

Another way to establish political connections is for business people to enter politics (“wealth into power”).¹⁷ Legislatures in autocracies have intentionally incorporated opposition forces including the business class into politics to co-opt potential threats to the regime.¹⁸ In China, the CCP has aggressively involved private entrepreneurs in politics by making them Party members or People’s Congress representatives. These “red capitalists” are shown to be more sympathetic than non-Party members to the authoritarian regime.¹⁹

The reason to distinguish national connections from local connections is that there exist different incentive structures for politicians under a decentralized vs. centralized systems,²⁰ and as Shleifer and Vishny showed, “decentralized corruption” is more costly for society than “centralized corruption.”²¹

A board member is identified as being connected with one of these organizations if she was previously or currently an employee or a member. A person could have multiple connections; for example, a resigned mayor who was also a local People’s Congress representative. For government connections, I define them very strictly, excluding any semi-governmental organizations such as research institutes affiliated with a government

¹⁶ Although there is no reliable data on public sector pay, a survey shows that government employees in China are the unhappiest due to their low salary compared to employees of foreign enterprises, private enterprises, and state-owned enterprises. Please see <http://alturl.com/7zrpd>. Accessed 1 August 2013. And according to official reports, the yearly salary of Yu Zhengsheng – then the Party secretary of Shanghai and a Politburo member – was 132,000 *yuan* (\$20,000) compared to Wang Shi’s – Chairman of China Vanke, a real estate company – which was 15.6 million *yuan* (\$2.5 million). For Yu’s salary, please see <http://alturl.com/wwu68>. Accessed 1 August 2013. For Wang’s salary, please see <http://alturl.com/tgw2q>. Accessed 1 August 2013. Certainly, these comparisons should be taken with a grain of salt due to the other sources of income for government employees such as graft, health care, pension, housing, and other government-subsidized services.

¹⁷ Dickson 2003; Truex 2014.

¹⁸ Gandhi and Przeworski 2007.

¹⁹ Dickson 2003; Tsai 2006.

²⁰ Treisman 2007.

²¹ Shleifer and Vishny 1993.

organization.²² A company is connected if one of the company's board members is connected.

Trends

The time-series cross-sectional nature of the data allows me to arrange the data in two different ways. One is to construct a panel dataset of firms in 1993, 2002, and 2012 to track the same set of firms over time. Second is to examine three cross sections. Both procedures give similar results. First, most Chinese listed firms have political connections of some sort. If a firm is defined to be connected when at least one of its board members is connected with at least one of those seven organizations, then almost 90 per cent of firms are connected. Second, firms are overwhelmingly connected with the government rather than the parliament, which is a more common form of connection in democracies.²³ Third, while it is still the case that more firms are connected with local governments than the national government, which is consistent with the "local protectionism" argument, there has been a significant increase in the percentage of firms that are connected with the national government in the last 20 years. Both the panel and the three cross sections show that the proportion of firms connected with the national government has tripled from 1993 to 2012, whereas the proportion of firms connected with local governments has increased only by 30 per cent. And the higher percentage of firms connected with the local government might be simply due to the fact that there is a higher supply of retired or resigned local officials than central officials given the larger pool of the former. As calculated by Ang, the number of local officials (province and

²² For my code book, please see "Code Book for Government Connections" in the web appendix.

²³ Eggers and Hainmueller 2009; Jayachandran 2006.

below) are four times that of central officials in most years between 1954 and 1998.²⁴

Adjusted for the availability, the demand for national officials has increased even more dramatically over the last 20 years. Figure 1 presents some of the key results.²⁵

[INSERT FIGURE 1 HERE]

In the analysis above, the political connection variable is coded as binary. An alternative measure is the degree of connectedness of a firm, e.g. the number of connections per firm. Table A13 in the web appendix shows the trend using the alternative measure, which is very similar to Figure 1.

One might wonder whether the increase has been driven by an increase of state-owned enterprises (SOEs) in the sample. While it is true that the state often appoints SOE managers, and many SOE managers are former bureaucrats,²⁶ the data actually show a decrease of SOEs from 1993 to 2012. The average state-owned share among all listed firms in 1993 was 38.23 per cent; this number decreased to 36.03 per cent in 2002, and further decreased to 7.88 per cent in 2012. If we look at the percentage of listed firms that had the state as their ultimate share holder, the number was 43.40 per cent in 1993, 38.81 per cent in 2002, and 6.22 per cent in 2012.

Where did China stand in comparison with other countries? I compare my 2012 measure of connection with the national government with Faccio's measure of connection with a minister or Members of Parliament (my measure is a subset of Faccio's).²⁷ The highest ranked country in her sample was Russia with 12 per cent of firms connected while in China

²⁴ Ang 2012.

²⁵ Data used to generate this figure are presented in Tables A3 and A4 in the web appendix.

²⁶ Burns 1989.

²⁷ Faccio 2006.

there was 12.25 per cent. China was also much higher than the usual suspects of highly connected countries such as Indonesia (7.79 per cent), Thailand (8.24 per cent), Malaysia (5.17 per cent), and Italy (10.30 per cent); other BRICS states, including Brazil (0.00 per cent), India (2.29 per cent), and South Africa (0.00 per cent); other post-communist states, including Czech Republic (0.00 per cent), Hungary (3.70 per cent), and Poland (0.00 per cent); the rest of East Asia, such as Japan (1.29 per cent), South Korea (2.24 per cent), Hong Kong (0.74 per cent), Taiwan (0.84 per cent), and Singapore (7.86 per cent); and developed democracies, including the United States (0.08 per cent), the United Kingdom (7.17 per cent), and Germany (1.31 per cent).

A couple of caveats need to be borne in mind. My measure of connections is far from comprehensive. First, in some instances, politicians' families may control firms through share-holding, nominee accounts, or shell entities. As the well-known *New York Times* article shows, China's former Premier Wen Jiabao's mother was a large share-holder of Ping An Insurance.²⁸ However, there is no comprehensive and accurate disclosed finance information of Chinese politicians. Nonetheless, my "board" approach can produce results that resonate largely with unobserved connections. For example, using the "board" procedure, Ping An Insurance is coded as a highly connected firm with two board members connected with the national government, five connected with local governments, and one connected with the national parliament. Second, there are many ways to build a connection, such as friendship, marriage, and bribery. I only focus on a direct measure that is observable for all firms.

²⁸ Nytimes.com 2012.

Characteristics of Connected Firms

What are the characteristics of politically connected firms? I compare connected and non-connected firms on the following dimensions using the 2012 cross section: assets, profit, return on assets, tax, leverage, and state-owned share. Accounting data for Chinese listed companies were taken from the China Securities Market and Accounting Research (CSMAR).²⁹

ASSETS is defined as the natural log of total assets. PROFIT is defined as the natural log of total profit of a firm. Return on assets (ROA) is the ratio of a company's net income prior to financing costs to total assets $\times 100$. TAX is calculated as the ratio of tax and fees to total profit $\times 100$. Leverage is a proxy for access to debt financing. LEVERAGE is defined as the ratio of long-term debt to total assets $\times 100$. State-owned share (SOE SHARE) is defined as the ratio of state-owned shares to total shares $\times 100$.

I then conduct regression analysis using one of the aforementioned variables as the dependent variable and one of the connection variables as the independent variable. The ordinary least squares (OLS) regression being performed is:

$$Y_i = \alpha + \beta CONNECTION_i + \mathbf{X}\mathbf{B} + \sum INDUSTRY + \epsilon_i, \quad (1)$$

where Y_i is one of the variables measuring the characteristics of firm i , including ASSETS, PROFIT, ROA, TAX, LEVERAGE, and SOE SHARE. $CONNECTION_i$ is one of the dummy variables measuring the connectedness of firm i . \mathbf{X} includes a group of controls, including AGE, all the characteristic variables except the dependent variable, and the firm's

²⁹ I accessed CSMAR through Wharton Research Data Services (WRDS), a web-based business data research service from The Wharton School at the University of Pennsylvania. <http://wrds-web.wharton.upenn.edu>. Accessed 9 August 2013.

geographic distance to Beijing (DISTANCE TO BEIJING). INDUSTRY is the industry fixed effects to control for cross-industry variance. I calculate the standard errors of the estimates clustered at the provincial level to avoid overstating the precision of my estimation.³⁰

[INSERT FIGURE 2 HERE]

Figure 2 summarizes the results of 78 regressions, highlighting the effects of various connection variables with one line representing a separate regression.³¹ Since most firms are connected with the government (either national or local), let us first focus on the effects of government connections. First, firms connected with the national government have significantly bigger ASSETS and SOE SHARE than firms unconnected with the national government. However, national government connections do not make a difference to firms' PROFIT, ROA, TAX, and LEVERAGE. This implies that bigger, state-owned firms are more likely to be connected with the national government. Second, firms connected with local governments have significantly higher LEVERAGE and SOE SHARE than firms unconnected with local governments; local government connections do not differentiate firms by ASSETS, PROFIT, ROA, and TAX. This finding is in line with previous studies that found political connections to be important for firms to obtain loans.³²

As for other types of connections, firms connected with parliament (either national or local) have a significantly higher level of PROFIT but a lower level of SOE SHARE, suggesting that “red capitalists” are disproportionately private entrepreneurs, and they are usually from more profitable firms, which is consistent with the findings in prior studies.³³ I

³⁰ Moulton 1990.

³¹ The full results of the 78 regressions are presented in Tables A5-A10 in the web appendix.

³² Malesky and Taussig 2009.

³³ Dickson 2003; Truex 2014.

do not find any differences between firms connected and unconnected with the CCP Congress (either national or local), but this is probably due to the small number of connected firms. In addition, firms that have former PLA members on their boards have more SOE SHARE, and firms that have at least one CCP member on their boards have bigger ASSETS, higher LEVERAGE, and SOE SHARE.

Another way to examine the data is to see what kind of firms is more likely to have political connections. In the following analysis, I switch the dependent and independent variables to investigate the determinants of political connections. Specifically, the dependent variable CONNECTION is an ordinal variable that has the values of 1-4 indicating no government connection, only local government connection, only national government connection, and both national and local government connection, respectively. A higher value implies more robust connections. I then use ordered probit to predict CONNECTION using a set of firm-level variables, including AGE, ASSETS, PROFIT, LEVERAGE, TAX, ROA, SOE, and DISTANCE TO BEIJING. The results (Table A14 in the web appendix) show that older, bigger (measured by ASSETS), and state-owned firms are likely to have stronger connections, and firms located further away from Beijing are less likely to have strong connections.

These relationships are obviously only correlational rather than causal. It might be that bigger and more profitable firms have more resources to hire connected politicians (or politicians prefer to take jobs in bigger firms), or political connections help firms grow larger and more profitable. The next section will provide an interpretation for the results.

WHY ARE NATIONAL CONNECTIONS ROBUST?

Connections between politicians and businesses are not a unique, contemporary Chinese phenomenon. Dick Cheney, before he was elected America's 46th Vice President, was chairman and CEO of Halliburton Company, one of the world's largest oilfield service companies. Silvio Berlusconi had built a property-and-media empire and reinvigorated one of the world's greatest soccer clubs, AC Milan, before he was elected Italy's Prime Minister. Political connections exist everywhere around the globe from Hitler's Germany,³⁴ Suharto's Indonesia,³⁵ Mahathir's Malaysia,³⁶ to Great Britain,³⁷ and the United States.³⁸ In a cross-national study of political connected firms, Faccio found connections that exist in 35 of the 47 countries in her sample.³⁹

However, political connections in China have some interesting characteristics and have experienced noticeable changes in the last two decades as shown in the previous section. The finding that Chinese listed firms have been increasingly connected with the national government as opposed to local governments is puzzling given the overwhelming literature that focuses on local protectionism.⁴⁰ I interpret this as Chinese firms' need to build robust connections that are *powerful* and *stable* under uncertain political circumstances, and as a result of China's economic reforms.

Powerful Connections

³⁴ Ferguson and Voth 2008.

³⁵ Fisman 2001.

³⁶ Johnson and Mitton 2003.

³⁷ Eggers and Hainmueller 2009.

³⁸ Roberts 1990; Acemoglu et al. 2013.

³⁹ Faccio 2006.

⁴⁰ Oi 1992; Wank 1999; Wedeman 2003.

There are several secular trends in the Chinese economy and polity that incentivize firms to build more connections with the national government because the national government has become more powerful. If we could characterize the first half of China's economic reforms in the last three decades as "decentralization," which was designed to encourage local officials to ally with entrepreneurs to develop the local economy and, therefore, support the bold reform initiatives of Beijing,⁴¹ then starting in the mid-1990s, the reforms have shown signs of "recentralization."⁴² The turning point was the 1994 fiscal reform that shifted part of the tax-collecting authority from provinces to the center.⁴³ This reform made local governments and economic actors more dependent on the center for fiscal transfers and tax deductions.⁴⁴

Another change occurred in the late 1990s when China's then Premier Zhu Rongji (朱镕基) started to push for state-sector downsizing. A policy termed "grasping the large, letting the small go" was implemented to privatize small, inefficient SOEs while strengthening the state control of big, profitable SOEs in critical industries.⁴⁵

In addition, Beijing also centralized its power to examine and approve major construction projects. In 1998, the old soviet-style State Planning Commission was renamed as State Development and Planning Commission, and in 2003 transformed into the National Development and Reform Commission (*Guojia fazhan yu gaige weiyuanhui*, 国家发展与改革委员会), which granted broad administrative and planning power over the Chinese economy. For example, a central government document issued in 2004 required that opening

⁴¹ Shirk 1993; Naughton 2007.

⁴² Naughton 2007, 101.

⁴³ Wong 2000.

⁴⁴ Ibid.

⁴⁵ Steinfeld 2000.

a coal mine with production over 500,000 tons/year should be approved by Beijing rather than a local government, and similar bars are applied to a wide range of projects from gas and electric to highway and tobacco.⁴⁶

Meanwhile, after over 30 years' industrialization, the sheer size of the Chinese economy and the number of large companies have increased dramatically. China's aggregate GDP's world ranking has jumped from the 15th in 1978 to the second in 2013, and the number of firms on Fortune's 500, a list of the 500 largest companies in the world, has increased from three in 1995 to 95 in 2013.⁴⁷ As a consequence, big firms are no longer satisfied with only accessing local markets; they want to gain access to the national market. For example, for Shanghai Automotive Industry Corporation (SAIC), having a close relationship with the Shanghai municipal government would position the firm to insure that the Shanghai taxi fleet was almost entirely composed of SAIC Santanas. But it would do nothing to help the firm breakdown barriers to the Hubei market and sell more Santanas after it was saturated the Shanghai taxi market.⁴⁸

The Chinese political system also motivates firms to build connections with the national government. Beijing still has the prerogative to appoint, rotate, and remove provincial-level officials.⁴⁹ The *nomenklatura* power gives the center both *ex ante* and *ex post* mechanisms to influence local politics.⁵⁰

These stylized facts about the Chinese economy and polity cast doubt on conventional

⁴⁶ Gov.cn 2004.

⁴⁷ Fortune.com 2014.

⁴⁸ I thank an anonymous reviewer for pointing this out and providing the example.

⁴⁹ Yang 2006.

⁵⁰ Burns 1994; Huang 1995; Sheng 2007; Kung and Chen 2011.

models that focused on the local state's role in China's economic development, be it "local corporatism,"⁵¹ "local protectionism,"⁵² or "federalism: Chinese style."⁵³ As Yang pointed out, they have "gone too far."⁵⁴ We expect to see a broader coalition built by firms and a more active and powerful role played by the national state in China's economic transitions.

Stable Connections

National connections are also more stable than local connections for two reasons. First, as a control mechanism of the center, Chinese local officials are constantly rotated among equally-ranked positions. For example, the Party chief of Fujian may be appointed as Party chief of Shanghai after working in Fujian for more than five years. Huang listed two rationales for this practice.⁵⁵ One is that "Rotation curbs factionalism by requiring the rotated officials to work with new officials." A second rationale is that "rotation conveys information to the control level that is otherwise unavailable." For example, the malpractices of the former Fujian Party chief can be detected by his successor and reported to the center.

However, rotation of local politicians can cause partial regime changes at the local level. Because of prevalent factionalism in the appointment of officials,⁵⁶ as political winds shift, a partial regime change often follows a major official's departure. In a systematic study of political clientelism, Ang estimated that when a provincial leadership transition occurs, it will cause a change of 0.51 public employees per 1,000 residents or 22,813 positions in the

⁵¹ Oi 1992.

⁵² Wedeman 2003.

⁵³ Montinola, Qian and Weingast 1995.

⁵⁴ Yang 2006, 143.

⁵⁵ Huang 2002.

⁵⁶ Shih, Adolph and Liu 2012.

bureaucracy, on average.⁵⁷

Therefore, rotation of local officials exposes firms that build connections only with the local government to political uncertainties. In contrast, national officials are less frequently rotated. As Huang showed, because central bureaucrats' outputs are more visible to the center, and ministerial appointment decisions are more based on expertise specialization, rotation is rarely applied to them.⁵⁸ In a dataset that Huang collected, of the 70 new Party secretaries appointed between 1985 and 1995, eleven of them – 15.7 per cent – had served as Party secretaries or governors in other provinces immediately prior to assuming their current posts.⁵⁹ However, for ministerial officials, rotation is seldom applied. Of the 64 new appointments between 1984 and 1995, only one minister had clearly arrived immediately from another ministry.

A second reason why national connections are more stable than local connections is that local officials are more likely to be targeted during anti-corruption campaigns. Figure 3 shows the percentages of local and national officials that have been indicted for corruption from 1988 to 1998.⁶⁰ The probability of a local government official being caught for corruption is approximately 200 times that of a central government official. A possible explanation for this discrepancy is the need for autocrats to maintain elite unity at the top level,⁶¹ or it is due to the center's blame-shifting strategy so the national government can

⁵⁷ Ang 2010.

⁵⁸ Huang 2002, 72-73.

⁵⁹ Ibid.

⁶⁰ The percentage is the ratio of the total number of officials indicted for corruption to the total number of officials $\times 100$. The data for the number of officials at various levels indicted for corruption are from Wedeman (2012, 101), and the data for the total number of Chinese officials are from Ang (2012, 693). The data used to generate the figure are presented in Table A1 in the web appendix.

⁶¹ Geddes 1999; Svolik 2012.

enjoy a high level of trust among the masses.⁶²

[INSERT FIGURE 3 HERE]

ARE NATIONAL CONNECTIONS ROBUST?

To show that firms that have connections with the national government are less vulnerable to political shocks, I examine how a corruption scandal affected the market values of connected and unconnected firms. The corruption scandal I select is one of the most significant political events in the last twenty years in China: the removal of Shanghai Party chief Chen Liangyu in September 2006. There are a couple of reasons to analyze the Chen Liangyu event. First, although there have been many corruption investigations as discussed earlier, there are very few cases that have caused a regime change that is significant enough to examine the impact of such an event systematically. Given the limited number of listed firms, I need an event that is big enough to generate a political earthquake.⁶³ Second, for an approach to estimate the impact of an event on the stock market to work, the event must be exogenous and surprising. There have been many corruption scandals that were endogenous to political connections, and the information of the dismissals has been leaked before the official announcements, such as most of the events during the recent anti-corruption campaign, which does not justify the use of such an approach.⁶⁴

On Monday, September 25, 2006, the Chinese official media announced the dismissal

⁶² Li 2004.

⁶³ Another significant event is the downfall of Bo Xilai. However, Bo's political career mixed central and local experiences, which makes the estimation of the impact less clean. For a comparison of Chen and Bo, please see Wang (2014).

⁶⁴ A recent example is the corruption scandal involving Zhou Yongkang, and the news had been circulated long before the actual investigation was announced.

and detention of Chen Liangyu because of his involvement in the Shanghai social security fund scandal.⁶⁵ Chen made his last public appearance as the Shanghai Party boss on the evening of September 23, and the purge was kept strictly confidential before September 25.⁶⁶ The fall of Chen Liangyu involved decisions made by people at the very top. The available evidence shows that Chen Liangyu fell because he misallocated social security funds, and some observers believe that the fall of Chen was due to his resistance to central policies,⁶⁷ none of which was related to firms hiring former politicians.

One might argue that examining how *national* connections are immune to a *local* political shock is not strong evidence that national connections are more robust. As I discussed earlier, national connections are more robust not because firms connected with the national government are unsusceptible to political shocks (they are actually susceptible to national shocks). However, the key is that local political shocks happen far more often than local shocks. So from a long-term perspective, connecting with the national government is a much safer strategy for firms.

Procedure

I conduct an event study to estimate the impact of Chen's fall on firms registered in Shanghai. Event studies use financial market data to measure the impact of a specific event on the value of a firm. The rationale of such a study is based on the fact that, "given rationality in the marketplace, the effects of an event will be reflected immediately in security prices."⁶⁸ Event

⁶⁵ Please see <http://alturl.com/w7h8u> for more information about the scandal. Accessed 7 August 2013.

⁶⁶ Sun, Xu and Zhou 2011, 190.

⁶⁷ Nytimes.com 2006.

⁶⁸ MacKinlay 1997.

studies have been widely applied to a variety of economic events such as mergers and acquisitions, earnings announcements, issues of new debt or equity and announcements of macro-economic variables such as trade deficit.⁶⁹ Event studies have recently gained popularity in the study of political events.⁷⁰

A total of 121 companies registered in Shanghai that have daily return data were listed on the Shanghai Stock Exchange or the Shenzhen Stock Exchange in 2006. I obtained the biographical information of all 2,346 board members of these companies from Wind Info. I then follow the same procedure as discussed before to manually code the career information of each board member in each firm to determine whether a member was politically connected.⁷¹

This procedure gives me four types of firms: (1) firms unconnected with the government (either national or local), (2) firms connected with only the local government, (3) firms connected with only the national government, and (4) firms connected with both the national and local governments. There were firms that were connected with other political organizations as well, such as parliament or CCP Congress, but I will focus on government connections in the following analysis. Table 1 summarizes the frequencies of these four types.

[INSERT TABLE 1 HERE]

I follow the standard event study procedure to estimate the market-adjusted cumulative abnormal return for the five-day period (event window) around the event date (days -2 to +2).⁷² The event date for Chen's removal is straightforward: September 25, 2006,

⁶⁹ For a review of event studies, please see MacKinlay (1997).

⁷⁰ Roberts 1990; Fisman 2001; Bernhard and Leblang 2006; Acemoglu et al. 2013.

⁷¹ Every board member was double-coded by a group of research assistants and me.

⁷² MacKinlay 1997.

the day of the announcement and the first trading day after his last public appearance.⁷³ I estimate the abnormal return and cumulative abnormal return during the event window $[-2, 2]$ using the standard event study methodology. Normal return is the expected return without conditioning on the event taking place. Abnormal return (AR) is defined as the actual *ex post* return of security during the event window $[-2, 2]$ minus the normal return of the firm during the event window $[-2, 2]$. I use the estimation window $[-110, -10]$ to estimate the normal return based on the “market model”:

$$NORMAL\ RETURN_{it} = \alpha_i + \beta_i MARKET\ RETURN_{mt} + \epsilon_{it}, \quad (2)$$

where $NORMAL\ RETURN_{it}$ and $MARKET\ RETURN_{mt}$ are the period- t (in this case $[-110, -10]$) returns on security i and the market portfolio, respectively, and ϵ_{it} is the zero mean disturbance term with variance of $\sum \epsilon^2$. α_i and β_i are the parameters of the market model.

With the estimated parameters $\hat{\alpha}_i$ and $\hat{\beta}_i$, the AR is:

$$AR_{i\tau} = RETURN_{i\tau} - \hat{\alpha}_i - \hat{\beta}_i NORMAL\ RETURN_{m\tau}, \quad (3)$$

where $RETURN_{i\tau}$ is the daily return of stock i during event window τ ($[-2, 2]$), and $NORMAL\ RETURN_{m\tau}$ is the estimated normal return based on Equation (1) during event window τ .

And the cumulative abnormal return (CAR) is the sum of the abnormal return during the event window,

⁷³ I searched major newspapers to see whether there were major confounding events around September 25, 2006. I searched national media websites including xinhuanet.com, china.com.cn and sina.com.cn, and I searched shanghaidaily.com for Shanghai local news. No major events happened around that date.

$$CAR_{it}(\tau_1, \tau_2) = \sum_{\tau=\tau_1}^{\tau_2} AR_{it}. \quad (4)$$

Results

The CAR has a mean of -1.13 per cent with a standard deviation of 4.76 per cent. Figure 4 shows a simple box-plot of the average CARs across different categories of firms.⁷⁴ Firms connected only with the local government had a significant CAR of -2.34 per cent, firms connected with both the national and local governments had a significant CAR of -2.23 per cent, unconnected firms had an insignificant CAR of -0.81 per cent, and firms connected with only the national government had an insignificant CAR of 1.98 per cent.

[INSERT FIGURE 4 HERE]

These descriptive statistics imply that firms were the most vulnerable if they were connected with only the local government. Because Chen Liangyu spent his whole career in Shanghai, his removal caused a quasi-earthquake in Shanghai that affected firms with only local connections. Firms connected with both the national and local governments were also negatively affected: their supermajoritarian connections exposed them to risks at both levels. In contrast, unconnected firms and firms connected with only the national government were largely unaffected.

The following specification is OLS estimated to test whether the differences between these categories are significant:

⁷⁴ Data used to generate this figure are presented in Table A11 in the web appendix.

$$\begin{aligned}
CAR_{i\tau} = & \alpha + \beta_1 UNCONNECTED_i \\
& + \beta_2 BOTH\ NATIONAL\&LOCAL_i \\
& + \beta_3 NATIONAL\ GOVERNMENT\ ONLY_i \\
& + \mathbf{XB} + \epsilon_{i\tau},
\end{aligned} \tag{5}$$

where $CAR_{i\tau}$ is the estimated cumulative abnormal return of firm i during event window τ $([-2, 2])$, $UNCONNECTED_i$ is an indicator measuring whether firm i was unconnected with the government (either national or local), $BOTH\ NATIONAL\&LOCAL_i$ is an indicator measuring whether firm i was connected with both the national and local governments, and $NATIONAL\ GOVERNMENT\ ONLY_i$ is an indicator measuring whether firm i was connected with only the national government. Obviously, the reference group is firms connected with only the local government. \mathbf{X} includes a number of controls such as AGE to consider the maturity of a firm, ASSETS to control for size, SOE, and industry fixed effects to control for sectoral variations.⁷⁵ Robust standard errors are estimated to tackle heteroskedasticity.

Figure 5 presents the results.⁷⁶ The black dots are the estimated coefficients, the lines are the 95 per cent confidence intervals, and the small bars are the 90 per cent confidence intervals. As it shows, around the time when Chen was removed, compared to firms connected with only the local government (reference group), unconnected firms experienced a five-day CAR of 1.90 per cent, and this difference is significant at the 0.1 level. Firms connected with both the national and local governments are not significantly different from those connected only with the local government. Firms that had connections with only the

⁷⁵ Hsueh 2011.

⁷⁶ The full regression results are presented in Table A12 in the web appendix.

national government experienced a significant CAR of 4.57 per cent.

[INSERT FIGURE 5 HERE]

As for the controls, I find that older firms lost less than new firms during the shock. However, size and ownership of firms did not make a difference to their market values during the shock.

The results suggest that firms are much better off if they are unconnected or connected with only the national government in the face of a local political shock. However, unconnected firms, although they do not incur the costs, also do not benefit from political connections. Building connections with the national government is a safe, beneficial strategy.

CONCLUDING REMARKS

Social scientists have long been interested in how investors cope with uncertainties.⁷⁷ A popular argument is that investors in a weak rule-of-law regime rely on political connections to substitute for formal legal protection.⁷⁸ However, political connections can make investors vulnerable by exposing them to political uncertainties.

Relying on a large dataset of Chinese listed firms, I show that although local connections are still the most prevalent form of political connections, firms in China have increasingly built connections with the national government. The reasons are twofold. First, national connections are more powerful as the Chinese polity has been centralized in the latter half of the reform era, and the Chinese economy has become too big for local governments to control. Second, national connections are more stable because local officials

⁷⁷ Dixit 1994; Henisz 2000.

⁷⁸ Oi 1992; Johnson et al. 2000; Hellman, Jones and Kaufmann, 2003; Gehlbach and Keefer, 2011.

are constantly rotated and more likely to be targeted during anti-corruption campaigns.

Building connections with the national government therefore provides a more robust form of protection for businesses under a weak rule-of-law regime.

The findings shed light on our understanding of the role of the state in development and coalition-building in authoritarian regimes. The “developmental state” literature championed the benefits of the state being “embedded” in the economy.⁷⁹ However, as I show, the embeddedness also exposes firms to political risks that are common in authoritarian regimes, and firms must strategize as to which institutions they want to be connected to. I have also disaggregated “the state” by level, which was often fused in prior studies of developmental states.

In addition, this paper also contributes to the theory of political coalitions. While the existing literature has been focused on the size of coalitions,⁸⁰ I show that members of a coalition are important. Firms do not necessarily consider along the lines of either “supermajoritarian” coalitions or minimal winning-coalitions; they must build coalitions with robust institutions that are powerful and stable.

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⁷⁹ Johnson 1982; Evans 1995.

⁸⁰ Riker 1962; Groseclose and Snyder, 1996.

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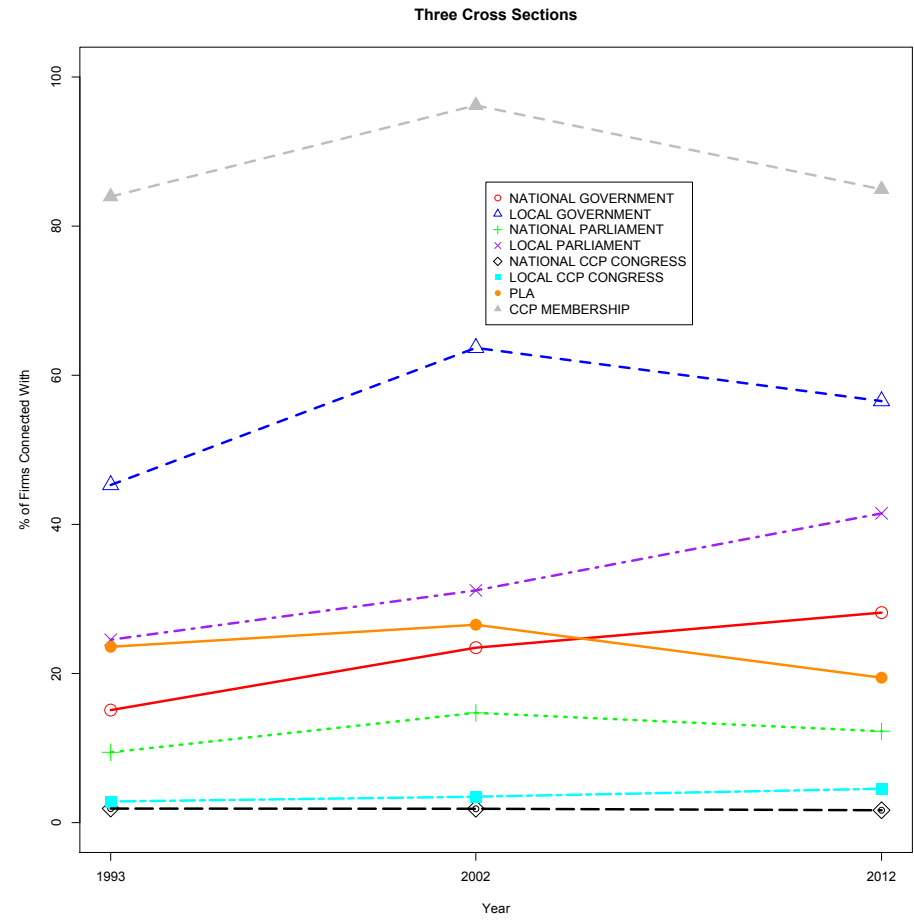
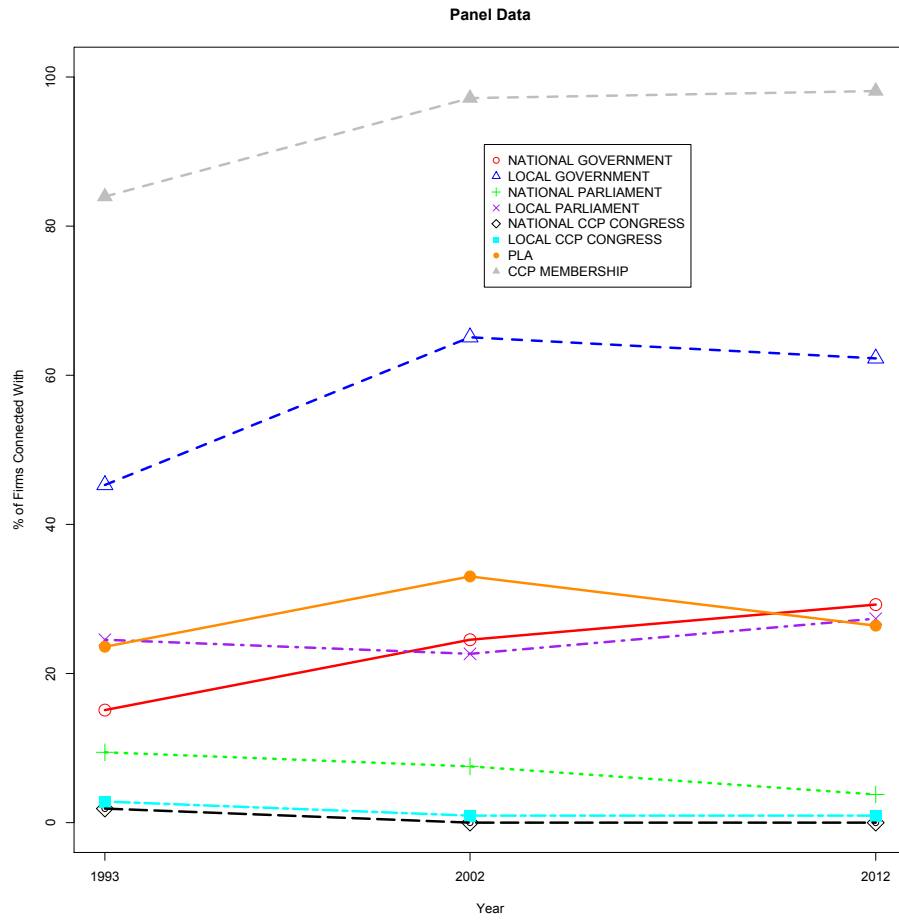


Figure 1: Connections of Chinese Publicly-Traded Firms (1993, 2002, 2012)

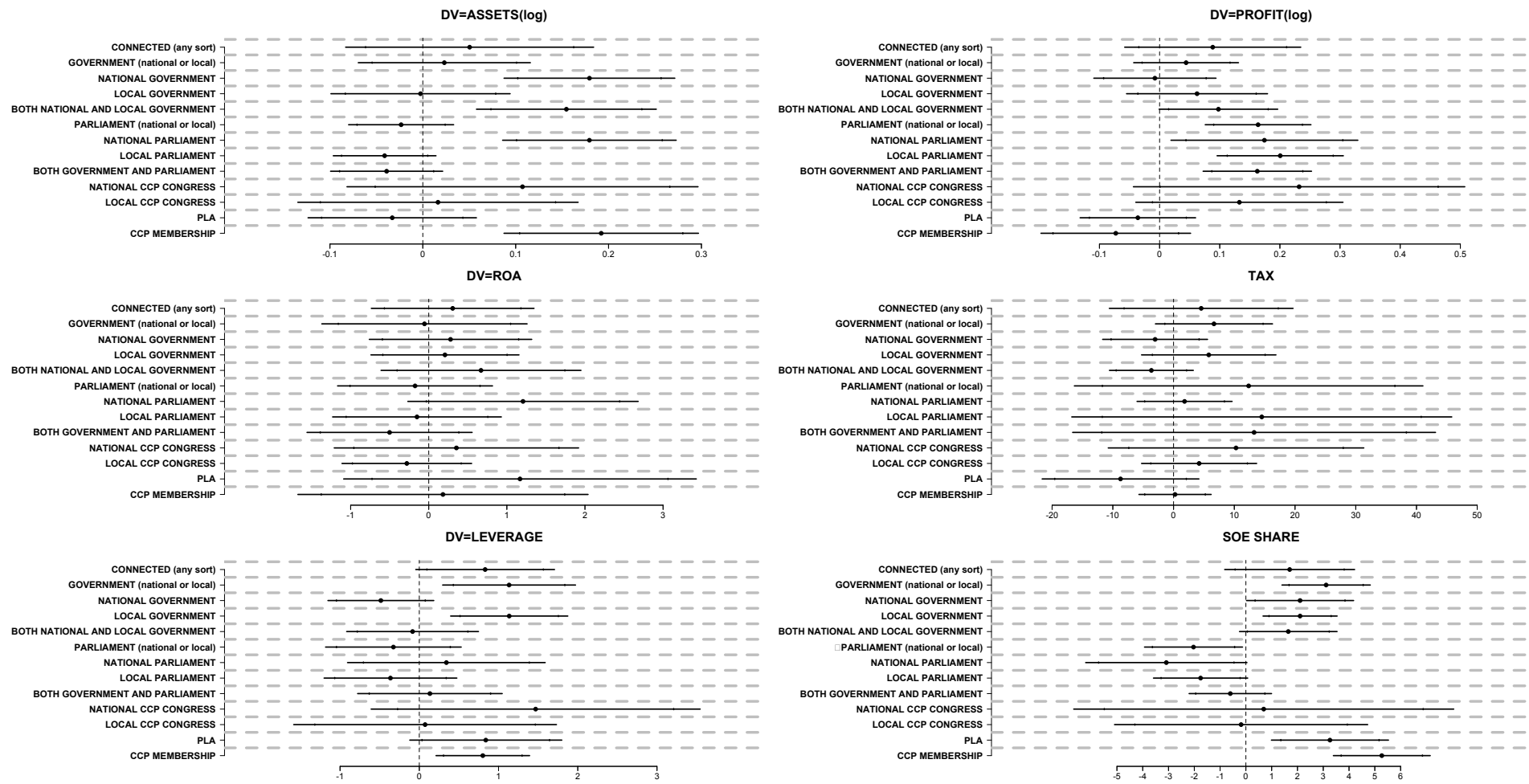


Figure 2: Characteristics of Chinese Connected Firms (2012)

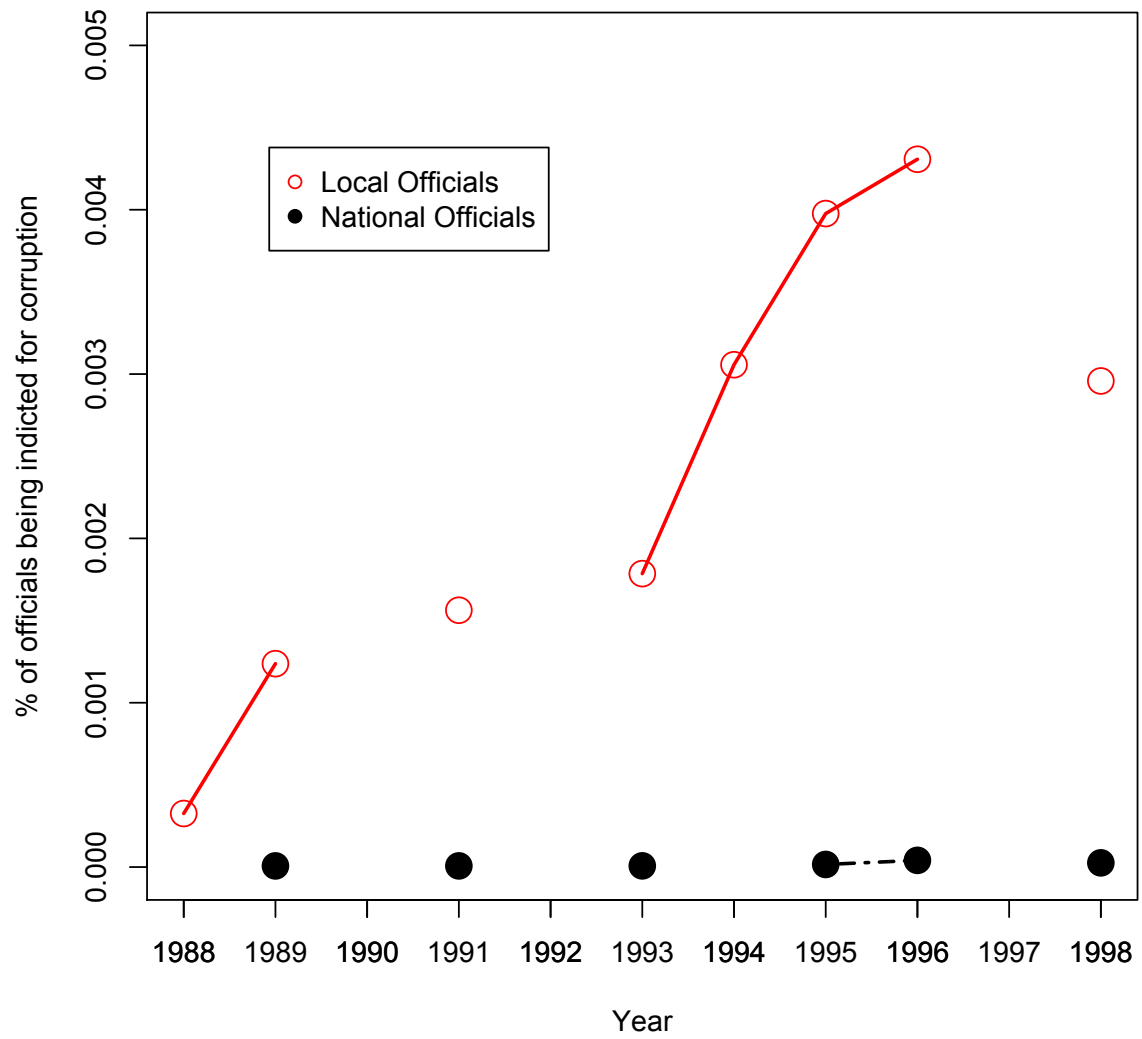


Figure 3: Percentages of Local and National Officials Indicted for Corruption (1988-1998)

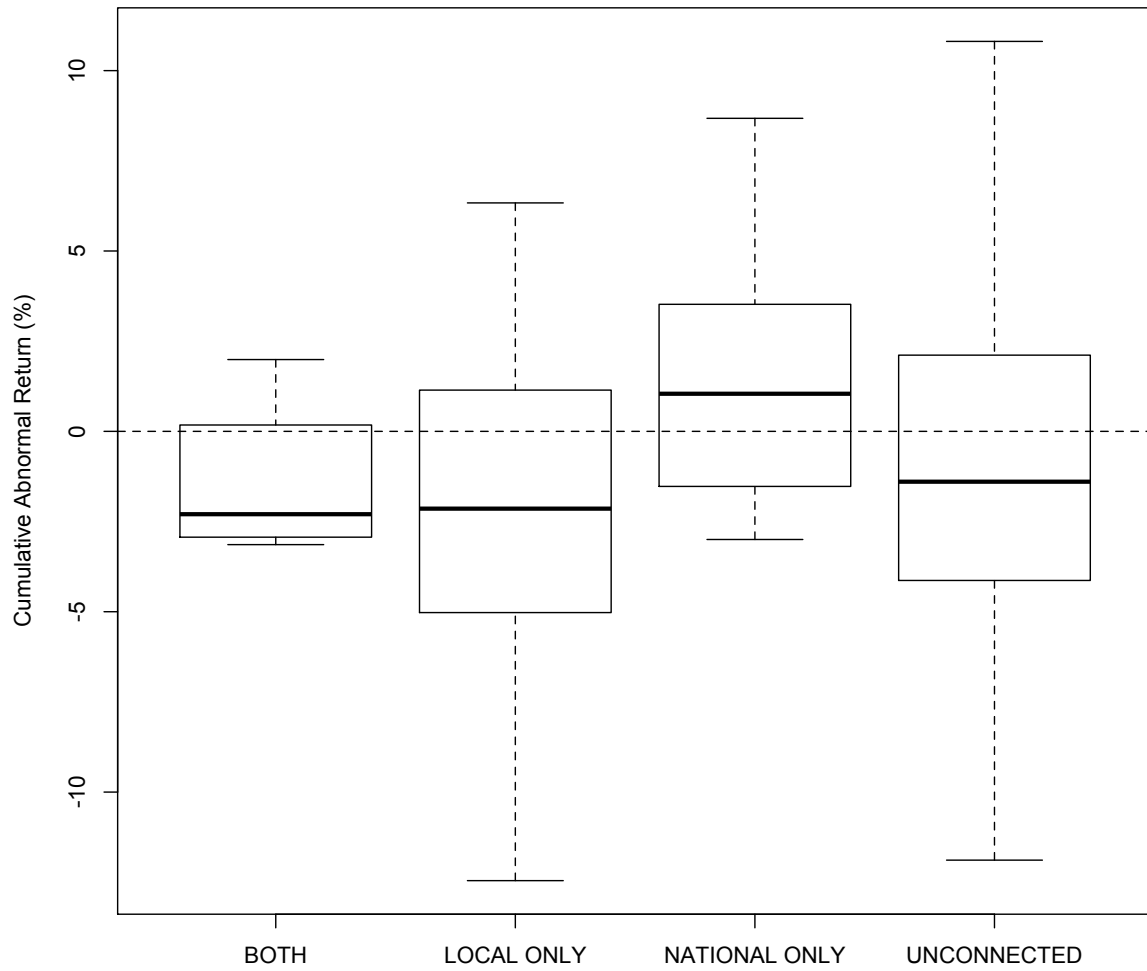


Figure 4: Mean CARs Across Different Categories of Firms During the Chen Liangyu Event

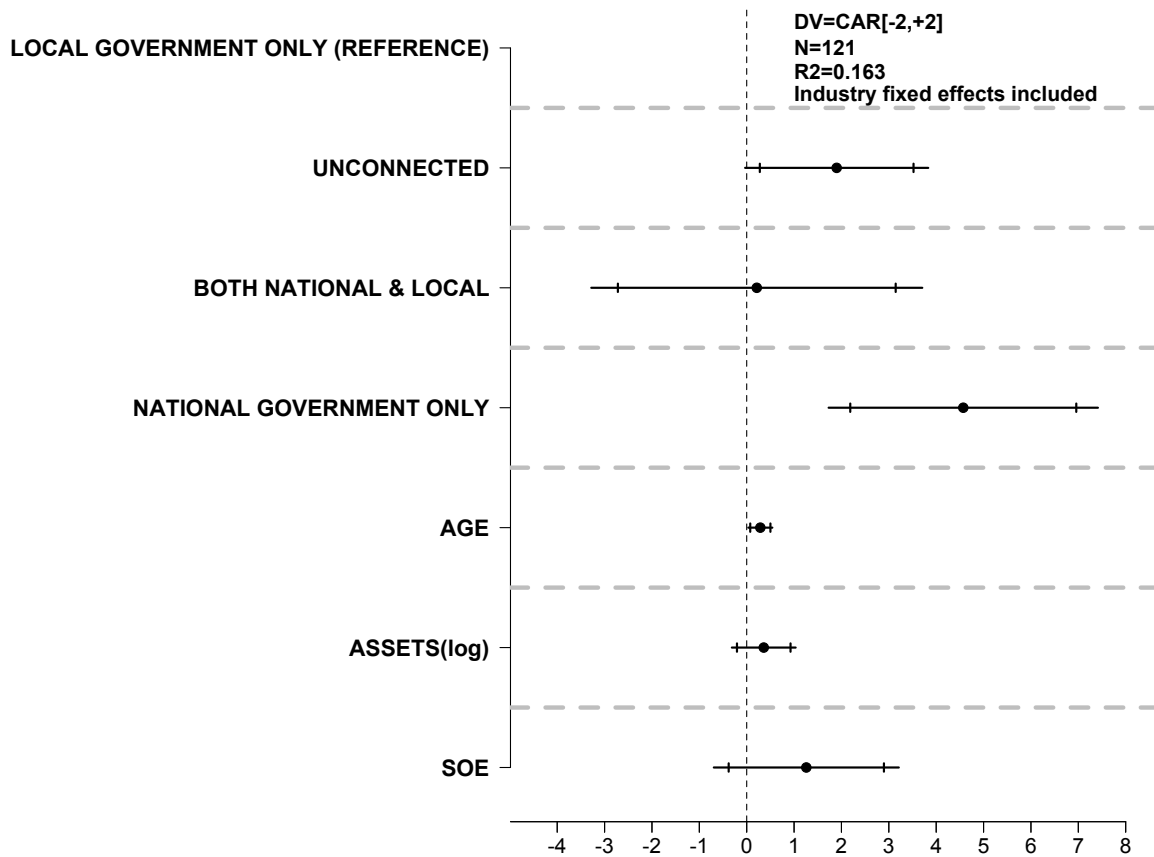


Figure 5: Categories of Firms and Their Relative CARs

Notes: The dependent variable is the five-day cumulative abnormal return. UNCONNECTED, BOTH NATIONAL & LOCAL, and NATIONAL GOVERNMENT ONLY are all dummy variables indicating their connectedness. AGE is a continuous variable measuring the age of the firm. ASSETS (log) is the natural log transformed total assets. SOE is an indicator measuring the ownership of the firm. The regression controls for industry fixed effects. The black dots are the OLS estimates, lines the 95% confidence intervals, and the small bars 90% confidence intervals, based on robust standard errors.

Table 1: Four Types of Firms in Shanghai (2006)

Type	Connectedness	N	%
1	Unconnected Firms	58	47.93
2	Locally Connected Firms Only	42	34.71
3	Nationally Connected Firms Only	13	10.74
4	Both Nationally and Locally Connected Firms	8	6.61
	Total	121	100.00