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Political connections, internal control and firm value: Evidence from China's anti-corruption campaign

Fangjun Wang[a], Luying Xu[a,b,*], Junrui Zhang[a], Wei Shu[c]

[a] School of Management, Xi'an Jiaotong University, Xi'an, Shaanxi, China
[b] College of Business, City University of Hong Kong, Hong Kong, China
[c] School of Business, Xi'an University of Finance and Economics, Xi'an, Shaanxi, China

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ABSTRACT

This paper investigates the relationship between political connections and firm value, as well as the moderating effect of internal control under exogenous shocks. By manually collecting 20 staggered downfall events during China's anti-corruption campaign since 2012, we observe that the termination of political connections results in an approximately 2% decline in equity value for private firms at the point of event, and effective internal control attenuates the negative price reaction to the loss of linkage. These findings infer the existence of benefits from maintaining political ties in business operations. Despite the value decline for connected firms, we further conclude that internal control system can be a useful channel of value protection in political shocks. Finally, our results survive a battery of sensitivity tests.

1. Introduction

Political connections are a common phenomenon in the worldwide context, particularly in developing and transition economies (Adhikari, Derashid, & Zhang, 2006). However, the effect of such connections has been debated for a long time in the literature. On the one hand, a set of studies find it beneficial to establish political connections because they not only provide a variety of advantages, including bank loans, tax breaks, government subsidies, direct contracts and regulation favors (Agrawal & Knoeber, 2001; Faccio, 2002; Johnson & Mitton, 2003; among others), but also enhance firms' value and accounting performance (Faccio, 2006; Feng, Johansson, & Zhang, 2015; Ferguson & Voth, 2008; Johnson & Mitton, 2003; Kim, Pantzalis, & Park, 2012; Li, Meng, Wang, & Zhou, 2008; Niessen & Ruenzi, 2010); on the other hand, political connections may also be a channel through which politicians extract rents from companies, and they eventually hamper the firm value and performance (Bertrand, Kramarz, Schoar, & Thesmar, 2006; Boubakri, Cosset, & Saffar, 2008; Faccio, Masulis, & McConnell, 2006; Fan, Wong, & Zhang, 2007; Li, Xia, Yu, & Zhang, 2008; Shleifer & Vishny, 1994). Moreover, an exceptional study even notes that under effective institutional systems, political connections yield no value to affiliated firms (Fisman, Fisman, Galef, Khurana, & Wang, 2012).

Given the mixed effects of political connections on firm value and performance, an increasing number of studies try to explore this issue reversely using exogenous shocks (e.g., event study on the sudden death of associated politicians) to examine whether and how the capital market reacts to the elimination of these associations (Claessens, Feijen, & Laeven, 2008; Cooper, Gulen, & Ovtchinnikov, 2010; Faccio & Parsley, 2009; Fung, Gul, & Radhakrishnan, 2015; Goldman, Rocholl, & So, 2009; Jayachandran, 2006; Knight, 2006; Roberts, 1990; Xu & Zhou, 2008). As expected, due to the ambiguous role of political connections in firms' operations, the termination of political ties can either eliminate the benefits or reduce the rent-seeking from the politicians. While different from the competing results in cross-sectional studies, most event studies, which are designed in the context of developed counties, show negative market reactions to the shocks.

Motivated by the unclear relationship, we believe that this topic is well worth discussing. First, this subject responds to the competing theories (i.e., “helping hand” or “grabbing hand”) concerning the role that government plays in firms' performance. Second, the recent anti-corruption campaign in China enables us to use an event study to identify a causal relationship. Third, compared with prior relevant event studies, it is also among the first to provide evidence in emerging settings where political connections are more prevalent. Finally, given the current market reaction to political shocks, if the damage from losing connections is inevitable, it is of interest to know what could be the mechanism to protect firm value in these events.

We therefore focus on the internal control system. On the one hand, as a formal institutional arrangement, effective internal control improves firms' risk management. For example, it will prepare

* Corresponding author at: School of Management, Xi'an Jiaotong University, Xi'an, Shaanxi, China.
E-mail addresses: wangfangjun@mail.xjtu.edu.cn (F. Wang), xuly13@stu.xjtu.edu.cn (L. Xu), zhangjr@mail.xjtu.edu.cn (J. Zhang), shuw@mail2.sysu.edu.cn (W. Shu).

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corresponding contingency systems, improve corporate conservatism, avoid idiosyncratic and systematic risk, and mitigate the negative impact of the failure in informal institution (Ashbaugh-Skaife, Collins, & LaFond, 2009; Goh & Li, 2011); on the other hand, effective internal control also signals better insurance-like protection that helps investors differentiate superior firms from inferior ones, reducing negative consequences for good firms when bad events occur. Therefore, effective internal control system may play an essential role in protecting firm value in the political shocks.

In this paper, we attempt to explore (1) whether the stock market responds to the termination of political connections for affiliated firms and (2) whether effective internal control system becomes a protection mechanism to moderate economic value when the political ties break. These findings are conductive to understanding the value of political connections, as well as the delicate role of internal control in preventing stock volatility derived from negative shocks.

Accordingly, we examine our hypotheses by initially identifying 20 downfall cases that first occurred in each province from the website of the CPC (Communist Party of China) Central Commission for Discipline Inspection since the 18th National Congress of the CPC when this political earthquake began. Next, we collect all private firms[1] registered in the provinces that are under jurisdiction of the dismissed politicians. In addition, as firms are defined as politically connected if the disclosed ultimate owner, board members or CEO participates in two political organizations–the People's Congress (PC) or the People's Political Consultative Conference (PPCC), we also trace their political background. Based on such a design, our results show that political connections are negatively associated with firm value when the top official of relevant provinces is dismissed. Specifically, the difference in abnormal stock market returns to the events for connected firms versus non-connected firms is an economically significant −2.3% (−2%) in a three-day window (five-day window), which hints at the positive value of political connections for private firms. We also compare the differences in market reactions to events, as the internal control ability varies, and observe that connected firms with effective internal control system suffer weaker negative market reactions. This finding notes a conductive mechanism to protect firm value when firms are involved in political events. We further utilize a difference-in-differences approach to investigate the reason why the shock destroys firm value and find a negative relationship between political connections and quarterly accounting performance. The result implies that the negative market reaction is driven by the perceived declining operating performance as political ties break, supporting the initial conjecture of the positive role of political connections in firm value.

This paper contributes to the literature in the following ways: First, compared with the extant empirical literature on the effect of political connections on firm value, we look at a series of politicians' downfall cases in the context of China's anti-corruption campaign and use this exogenous shock to examine the mixed relationship, which helps to identify a causal, rather than a correlational, relationship. Our staggered downfall events also outweigh a single event by alleviating the unobservable confounding effects. These features of research design are conductive to enhancing the validity of our results. In addition, this identified event provides potentials for future research to explore other causal effects along the line of political connections. Second, a majority of prior studies explore the effect of internal control on promoting financial reporting quality, ensuring operating efficiency and safeguarding assets (Ashbaugh-Skaife, Collins, Kinney Jr, & La Fond, 2008; Cheng, Dhaliwal, & Zhang, 2013; Doyle, Ge, & McVay, 2007; Feng, Li, McVay, & Skaife, 2015; Gao & Jia, 2016; Goh & Li, 2011), while few studies have been conducted to examine its effectiveness on value protection when negative exogenous shocks are encountered. Our study fills this research gap by providing evidence that internal control plays an important role in mitigating the negative impact of political events. Third, we further clarify the reason why market negatively reacts to the shock by linking our analysis to the quarterly operating performance, and find that the negative market reactions to the downfall event originate from the declined profitability due to the termination of political connections.

The remainder of this paper is organized as follows. In Section 2, we introduce the institutional background. Section 3 reviews the literature and develops the hypotheses. Section 4 describes the sample selection and research design. Section 5 reveals the empirical results. Section 6 presents the additional analyses and robustness tests, and conclusions are given in Section 7.

2. Institutional background

2.1. Private firms' participation in politics in China

The incentive for private firms to become actively connected to politics is deeply rooted in the historical background concerning their social status in China. During the period between the foundation of People's Republic of China and its reform and opening up in 1978, private enterprises were totally banned. Although private businesses regained their legitimacy in the late 1970s, they were considered to be “a marginal sector to be tolerated temporarily” (Young, 1995) and still struggled with hostility and social prejudice. In 1993, the CPC established a market economy at the Fourteenth Party Congress, discarding the ownership discrimination perceived by the society. Private firms were beginning to have access to the PPCC or PC for participation in politics.

As an advisory body, the PPCCs at each administrative level are entitled to launch complaints or provide advice to the government that covers such areas as the enforcement of the constitution, laws and regulations, the implementation of major principles and policies, and the performance of government departments and their staffs. Moreover, the PPCCs are also responsible for garnering social information, monitoring the political condition and reporting the issues back to the Party-state through research reports, proposals, suggestions and other forms. Private firms' management strives for the membership of PPCC so that they can exercise policy recommendations and project proposals in the region.

The system of PC is an organizational form for the state power in China. Local PCs are accorded the right of legislation to adopt local regulations in the light of their regional political, economic and cultural characteristics. Within the limits of their authority, they are able to examine and decide on plans for local economic and cultural development, and for the development of public services in their respective administrative areas. In addition, local PCs have the right to elect and impeach high-ranking officials, such as governors and mayors. Private firms' management strives for the membership of PC so that they can exercise legislative and decision-making power in the region.

Due to the legitimate power of PCs in legislation and election and the political influence of PPCCs in consultation, the membership of these two political organizations is regarded as a formal political identity and the most effective way for Chinese private entrepreneurs to participate in politics (Li, Meng, & Zhang, 2006; Ma, Rui, & Wu, 2015). Being a member of the PCs or PPCCs contributes a lot to their firms because not only does it provide an opportunity to have a voice in the policy-making process, but also helps to cultivate informal ties with top bureaucrats. For example, as policymakers, entrepreneurs may directly influence regulation to benefit their own industries or firms, or indirectly through their established social connections to the officials with political power. Therefore, with senior executives introduced to the powerful political network through the PCs or PPCCs, private firms could receive unique resources and preferential treatments from the government, which are not available from the market, through both

[1] In this paper, “private firm” refers to publicly traded firms whose ultimate controlling shareholder is an individual.