Political Connections of Independent Directors and Firm Performance: Evidence of Chinese listed Manufacturing Companies over 2008-2013

Changzheng Zhang[1,a], **Yuefan Lv***[1,b], **Qian Guo**[1,c]

[1]Xi'an University of Technology, School of Economics & Management, Xi'an China
[a]zcz7901@163.com, [b*]561245907@qq.com,[c]383531334@qq.com

Keywords: Political connections, Independent directors, firm performance, listed companies

Abstract: The paper investigates the effect of the political connections of independent directors on firm performance by choosing the panel data consisting of 2994 firm-years observations in Chinese listed manufacturing listed companies during 2008-2013 as the sample. Empirical analysis by adopting multiple regression analysis based on OLS by with SPSS19.0 makes a new finding, i.e, there is a positive relationship between the political connections of independent directors and firm performance measured by ROE and EPS. Further investigation shows that the richness of independent directors' political connections improves firm performance by providing more resources instead of inputting extra knowledge, ideas or perspectives. Therefore, the political connections of independent directors has potential negative effects on firm's long-termed competitive edge, since current richer resources would lower the recognition of the top executives on the importance of enhancing internal core competence.

1. Introduction

A growing body of literature has addressed the role of political connections in affecting firm running. According to the existing literature, political connections are a double-edged sword. It can either enhance or jeopardize a firm's value. On the one hand, a negative effect of political connections on firm performance has been found. On the other hand, political connections of executives can play positive roles in helping firms to obtain more favorable bank loans(Firth et al., 2009), providing firms with easier access to equity capital (Boubakri, Cosset and Saffar, 2012) and debt financing(Faccio, 2006), bringing lower tax rates to firms(Faccio, 2010), striving for preferential regulatory treatments on firms (Faccio et al., 2006), and finally improving firm performance (Boubakri, Cosset and Saffar, 2012).

Obviously, though the effect of political connections on firm performance has received considerable research interest (Goldman, Rocholl, and So 2009), the question of whether political connection enhances firm value has mixed findings. A further systematic investigation on the existing studies on this issue shows that besides the differences in the choices of empirical samples, methods and measures, there are still other critical reasons which lead to the confused conclusions on the relationship between political connections and firm performance. According to our opinion, different owners of political connections would lead to various firm performance consequences, which have been ignored by the prior literature to a large degree.

In order fill this gap, this study advances the extant literature by investigating the effect of

political connections belonging to the independent directors on firm performance and contributes a new finding on this topic: there is a positive relationship between political connections of the independent directors and firm performance, while there is zero relationship between the two.

2. Literature and hypothesis

There is no any consensus as regards the impact of independent directors on firm performance because empirical evidence on the correlation between independent directors and firm performance is not consistent and even controversial. There exists either a positive or a negative correlation, or no correlation between independent directors and corporate performance.

First, there is a positive correlation between the two concepts. For example, Wagner et al. (1998) conduct a meta-analysis of 63 empirical studies on the correlation between board composition and firm performance and the result of their work indicates that the higher ratio of independent directors is associated with higher firm performance. Lots of subsequent studies confirms to their result (Ferris et al., 2003; Hillman, 2005; Masulis et al., 2012).

Second, a negative correlation exists between the two concepts. For example, there is an influential and valuable empirical study by Bhagat and Black (1996). They conclude that there is a strikingly significant negative correlation between the proportion of independent directors and firm performance measured by a large variety of accounting measures. The finding is also confirmed by a stream of other empirical literature(Boone et al., 2007; Bhagat and Bolton, 2008).

Third, there is no association between independent directors and firm performance. For example, the earliest evidence confirming to this view is perhaps provided by Baysinger and Butler (1985), who indicate that there is no significant and stable relationship between the proportion of independent directors and the firm's profitability in the same year in 1970s under the condition of controlling the possible endogeneity issue at the same time. several other following studies also find such a results (Daily, and Dalton, 1993; Duchin et al., 2010).

We argue that the existence of different views on the effect of the independent directors on firm performance derives from the ignorance on the political connections of the independent directors. in China, political connections of independent directors would have substantial effects on firm performance based on the following reasons.

First, independent directors of rich political connections can help their firms obtain more preferential regulatory treatments and lower taxes rate in China; Second, independent directors of rich political connections can help firms get enough loans with rather lower interest from the state-owned banks; Third, independent directors of rich political connections would bring the firms with the newest information on industry policies; Fourth, independent directors of rich political connections would provide a signal of rich state-owned background, which would have great attraction for high talents, who actually favor the stability and high-reward of such enterprises; Finally, independent directors of rich political connections would help firms explore a new market in the other provinces of China by facilitating the coordination among local governments.

H1: Political connections of independent directors have positive effects on firm performance.

3. Method

3.1 Measures

Political connections of independent directors (PCID_N, PCID_R). PCID_N is the number of independent directors who ever worked or are working in any governmental departments or authorities. That is to say, if any independent director has the experience of ever working in any

governmental departments, then PCID_N adds 1. PCID_R is the ratio of PCID_N to the size of the board.

Firm performance. Return on equity (ROE) is taken as the main measure of firm performance for hypothesis test, while earnings per share (EPS) is chosen as the alternative measure of firm performance, which will be used in robustness test.

3.2 Sample and data

Taking all the listed manufacturing companies over the years during 2008-2013 in Shanghai and Shenzhen stock exchange as the initial sample framework, 2994 firm-year observations are chosen as the final sample and correlation analysis results are shown in Table.1.

Table1. Descriptive statistics and correlation coefficients

	Mean	Standard Deviation	ROE	EPS	PCID_R	PCID_N	TI	RG	LNFS	CD	AGE	FLSR
ROE	5.983	16.678	1									
EPS	.289	.635	.170**	1								
PCID_R	.116	.145	.043*	.048**	1							
PCID_N	.63	.809	.056**	.048**	-.097**	1						
TI	.46	.499	-.013	.074**	.211**	-.022	1					
RG	.57	.496	.024	.003	.177**	-.113**	.083**	1				
LNFS	9.46	.503	.050**	.061**	.233**	-.039*	.121**	.103**	1			
CD	.16	.366	.031	.016	.349**	-.038*	.159**	.152**	.565**	1		
AGE	52.21	7.016	-.069**	-.041*	.121**	-.052**	.015	.009	.069**	.058**	1	
FLSR	.34	.141	-.050**	-.038*	.070**	-.023	.025	-.011	.048**	.051**	.902**	1

N=2994

** represents significance level of 0.05

*** represents significance level of 0.01

4. Empirical test

In order to test H1, we design Model 1 based on OLS which takes ROE as the dependent variable, PCID_R as the predictor, and TI, RG, LNFS, CD, AGE and FLSR as the control variables.

$$ROE_{it} = \alpha + \beta_0 PCID\_R_{it} + \beta_1 TI_{it} + \beta_2 RG_{it} + \beta_3 LNFS_{it} + \beta_4 CD_{it} + \beta_5 AGE_{it} + \beta_6 FLSR_{it} + \varepsilon_{it} \quad (1)$$

The paper makes the regression analysis on Mode1 1 by adopting the panel data with 2994 firm-years. Results are shown in Table 2.

Table 2. Regression results of Model 1

Model		Unstandardized Coefficient		Standardized Coefficient	T	Sig.
		B	Standardized Error	β		
Model 1	Constant	-69.652	5.700		-12.221	.000
	TI	1.203	.602	.036	1.998	.046
	RG	1.420	.606	.042	2.342	.019
	LNFS	6.643	.612	.200	10.853	.000
	CD	-.641	.816	-.014	-.786	.432
	AGE	.165	.043	.070	3.834	.000
	FLSR	7.076	2.134	.060	3.316	.001
	PCID_R	**4.097**	**2.031**	**.036**	**2.017**	**.044**
	R	.261	R^2	.068	Adjusted R^2	.066
	F	31.08	Model Sig.	.000	N	2994

Note: Dependent variable is ROE.

In Table. 2, the regression coefficient of PCID_R is 0.036 (T=-2.017, P<0.05). That means H1 is

confirmed. Our data supports that the ratio of independent directors has significant and positive effects on firm performance.

Table 3. Regression results of Model 2

Model		Unstandardized Coefficient		Standardized Coefficient	T	Sig.
		B	Standardized Error	β		
Model 1	Constant	-68.882	5.709		-12.065	.000
	TI	1.254	.602	.038	2.082	.037
	RG	1.432	.606	.043	2.363	.018
	LNFS	6.532	.615	.197	10.623	.000
	CD	-.586	.816	-.013	-.718	.473
	AGE	.168	.043	.070	3.887	.000
	FLSR	7.055	2.132	.060	3.308	.001
	PCID_N	.979	.368	.048	2.660	.008
	R	.262	R^2	.069	Adjusted R^2	.067
	F	31.54	Model Sig.	.000	N	2994

Note: Dependent variable is ROE.

When we change PCID_R into PCID_N in Model 1, a new model investigating the absolute numbers of independent directors on firm performance is built, which can be named as Model 2. The regression results of Model 2 by adopting the research sample are shown in Table 3. Results indicate that more independent directors would lead to higher firm performance.

5. Conclusions

This paper investigates the determination of firm performance from the perspective of the political connections of independent directors, which has not been explored till today by the scholars. Data from the Chinese listed manufacturing companies over 2008-2013 prove that independent directors can improve firm performance by obtaining more resources for firm running with the application of their rich political connections to a certain degree. However, such improvement effect on firm performance does not comes from the new ideas, new knowledge, better perspectives which would improve firms' long-termed competitive edge. Therefore, it is not good choice for the listed companies to improve their managerial level and competitive edge by paying more attention to enriching independent directors' political connections.

In the future, more empirical studies should be done in the following aspects: (1) Samples should go beyond the limitation of manufacturing companies; (2) Methods should adopt more stringent empirical models which considers the possible endogenous problems; (3) Suggestions in policy should be addressed in a greater manner.

Acknowledgements

This research was supported by Projects of the National Social Science Foundation of China under the Grant "15BGL109", the Scientific Research Foundation of Ministry of Education of the PRC in Humanities and Social Sciences under Grant "14YJA630089" and "13YJAZH123", and the Shaanxi Social Science Foundation under Grant "2014P04", and National Natural Science Foundation of China under Grant "71402136".

References

[1] Goldman, Eitan, Jorg Rocholl, and Jongil So. (2009). Do Politically Connected Boards Affect Firm Value? Review of Financial Studies 22(6): 2331-60.

[2] M. Firth, C. Lin, P. Liu, S. Wong. (2009). Inside the black box: Bank credit allocation in China's private

sector. Journal of Banking and Finance, 33, pp. 1144-1155.

[3] N. Boubakri, J. Cosset, W. Saffar. (2012). The impact of political connections on firm's operating performance and financing decisionsJournal of Financial Research, 35 (3), pp. 397-423.

[4] M. Faccio. (2006). Politically connected firms. American Economic Review, 96, pp. 369-386.

[5] M. Faccio. (2010). Differences between politically connected and non-connected firms: A cross country analysis. Financial Management, 39, pp. 905-928.

[6] M. Faccio, R. Masulis, J. McConnell. (2006). Political connections and corporate bailouts. Journal of Finance, 61, pp. 2597-2635.

[7] N. Boubakri, J. Cosset, W. Saffar. (2012)The impact of political connections on firm's operating performance and financing decisions. Journal of Financial Research, 35 (3), pp. 397-423.

[8] Wagner III, J.A., Stimpert, J. L. and Fubara, E.I. (1998). Board Composition and OrganizationalPerformance: Two Studies of Insider/Outsider Effects. Journal of Management Studies, 35 (5),656-677.

[9] Ferris, S.P., Jagannathan, M. and Pritchard, A.C. (2003). Too Busy to Mind the Business?Monitoring by Directors with Multiple Board Appointments. The Journal of Finance, 3, 1087-1111.

[10] Hillman, A.J. (2005). Politicians on the board of directors: Do connections affect the bottom line?Journal of Management, 31, 464-481.

[11] Masulis, R.W., Ruzzier, C., Xiao, S. and Zhao, S. (2012). Do Independent Directors Matter?[Online] Available at: http://ssrn.com/abstract=2022831 [Accessed 15 December 2013], 1-44.

[12] Bhagat, S. and Black, B.S. (1996). Do Independent Directors Matter? [Online] Available at:http://www.law.columbia.edu/null/Working+Paper+No?exclusive=filemgr.download&file_id=64139&showthumb=0 [Accessed 10 November 2013]1-73.

[13] Boone, A.L., Field, L.C., Karpoff, J.M. and Raheja, C.G. (2007). The Determinants of CorporateBoard Size and Composition: An Empirical Analysis. Journal of Financial Economics, 85, 66-101.

[14] Bhagat, S. and Bolton, B. (2008). Corporate Governance and Firm Performance. Journal ofCorporate Finance, 14, 257-258.

[15] Baysinger, B.D. and Butler, H.N. (1985). Corporate Governance and the Board of Directors:Performance Effects of Changes in Board Composition. Journal of Law, Economics andOrganization, 1 (1), 101-124.

[16] Daily, C.M. and Dalton, D.R. (1993). Board of Directors Leadership and Structure: Control andPerformance Implications. Entrepreneurship Theory and Practice, 65-81.

[17] Duchin, R., Matsusaka, J.G. and Ozbas, O. (2010). When Are Outside Directors Effective?Journal of Financial Economics, 96, 195-214.