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Political connection, founder-manager and their impact on tunneling in China's listed firms

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Abstract

Reciprocal relationship, often regarded as mutually beneficial and secure, can actually be destructive and result in inefficiency. We provide evidence of such double-blade by studying the impact of political connection on corporate governance. Private firms in countries where the government controls the allocation of resources have incentives to seek political connections by hiring politicians or ex-politicians as top executives. Such political capital, however, may turn into political constraint when the CEOs fail to perform but use connections to entrench themselves. We take advantage of the unique setting in China to illustrate this argument. We show that politically connected CEOs have significantly weaker performance, longer tenure, lower turnover, and lower turnover-performance sensitivity than non-politically connected CEOs in China's privately controlled firms. Firm performance improvement is also less following forced turnover of the former than the latter. These entrenchment effects are alleviated in firms that are politically secured through alternative connection channels. The overall results suggest that political capital often turns into political constraints causing sizable inefficiency in Chinese private firms.

Keywords

firms, founder, listed, connection, political, china, tunneling, their, manager, impact

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

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

Abstract:

We investigate the impacts of manager's political connections and founder status on tunneling using a sample of China's listed firms from 2004 to 2010. We find that the impacts and the interactive impact of manager's political connections and founder status on firms' tunneling behaviors are related to firms' ownership types. More specifically, managers' political connections increase tunneling for the local SOEs firms that the state ownerships are not large enough for effective control, while managers' political connections reduce tunneling for the central SOEs firms. Funder-managers resisting tunneling behavior can be observed across all types of ownership firms, although it is more significant at private and central SOEs firms. When the political connected managers are also firms founders, the negative impact on tunneling is stronger at central SOEs firms. We also find that although newly promulgated criminal laws and regulations have reduced the market-wide severity of tunneling, they are less effective for SOEs and firms with politically connected managers. We further examine the differences between official-type political connections and CPC/CPPCC-type political connection, and the differences between a chairman's political connection and a CEO's political connection, with regard to their impacts on tunneling.

1 Introduction

Well-dispersed ownership is rare outside the US and Japan, while most companies in Europe and Asia are controlled by large blockholders (La Porta, Lopez-de-Silanes, and Shleifer 1999, 2000; Claessens, Djankov, and Lang 2000; Faccio and Lang 2002). The conflict of interest between large shareholders and minority shareholders that arises from such a concentrated ownership structure has been the focus of research into corporate governance in recent years. Controlling shareholders and other insiders (e.g., managers) have strong incentives and the capabilities to extract private benefits from listed firms and expropriate minority shareholders. This expropriating behavior is commonly referred to as "tunneling" (Johnson, La Porta, Shleifer, and Lopez-de-Silanes 2000) or "self-dealings" (Djankov, La Porta, Lopez-de-Silanes, and Shleifer 2008).

The nature and scope of tunneling depends on the legal and regulatory protection of minority shareholders and financial market development that exists in a country (Djankov, La Porta, Lopez-de-Silanes, and Shleifer 2008). Due to the unique process of privatization, the lack of effective external governance mechanisms and weak investor protection, publicly listed firms in China are frequently subject to expropriation by controlling shareholders and other insiders. Researchers have documented various forms of tunneling in Chinese markets, such as seasoned equity offerings (Aharony, Lee, and Wong 2000), cash dividends (Deng, Gan, and He 2006), transfer pricing (Cheung, Rau, and Stouraitis 2006; Peng, Wei, and Yang 2011), loan guarantees to related parties (Berkman, Cole, and Fu 2009) and inter-corporate loans (Jiang, Lee, and Yue 2010), to give some samples.

Existing studies on tunneling practices in China have so far largely focused on their effect on firm valuation and performance (Li, Wang, and Sun 2004; Cheung, Rau, and Stouraitis 2006; Berkman, Cole, and Fu 2009; Jiang, Lee, and Yue 2010). While some other studies examined the determinant factors of such tunneling behaviors, they concentrated

mainly on ownership structures and firm characteristics (Bai, Liu, Lu, Song, and Zhang 2004; Deng, Gan, and He 2006; Gao and Kling 2008; Jian and Wong 2010; Peng, Wei, and Yang 2011); very little attention has been paid to the relationship between tunneling and managerial attributes. To fill this gap, we use a sample of China's listed firms from 2004 to 2010 to investigate the relationship between a firm's tunneling behavior and manager's political connection and founder status.

Due to a weak institutional environment and highly concentrated ownership structure, the Chinese stock market is conducive to tunneling. Thus, in this paper, we focus on a particular form of tunneling — fund occupations by the largest shareholder and other insiders. Fund occupation is a widespread tunneling practice in China that has been repeatedly targeted by the China Securities Regulatory Committee (CSRC). In an unprecedented prevision of punishment, senior executives of listed firms will hold criminal responsibility if they cause substantial loss to the firm by helping to facilitate or failing to prevent such fund occupations.[1] But this problem still remains high because the enforcement is weak in real practice.

Our results show that, from 2004 to 2010, about 34% of the sample firms reported fund occupation by the largest shareholder and other insiders. The funds lent to largest shareholder and insiders were at low or no interest charge, and a large proportion of these funds were occupied for a long periods, even never paid back to the firm (Jiang, Lee, and Yue 2010).

We find that both political connection and the founder status of managers definitely affect the severity of tunneling through fund occupations. We also show that the impact of political connection and founder status on tunneling depends on a firm's ownership types, that is the identity of the largest ultimate shareholder. We further demonstrate that the

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[1] See Article 169, Amendment Six to the Criminal Law of the People's Republic of China, effective of June 29, 2006.

relationship between a manager's political connection and tunneling depends on whether the largest ultimate shareholder has effective control of the firm. Specifically, we find that politically connected managers at local SOEs significantly increase the severity of tunneling by the largest shareholder and other insiders, whereas politically connected managers at central SOEs reduce tunneling. Such a relationship exists only when the largest shareholder (i.e., different levels of governments) has no effective control of the firm. Across all three ownership types, there is less tunneling in firms with founder-managers than firms with non-founder managers, but the impact of the interaction between political connection and founder status differs among firms with various ownership types.

We then examine the effectiveness of CSRC regulations and law enhancement, by dividing our full sample into two periodic sub-samples, and find that while the overall severity of tunneling has declined across all firms of three ownership types, the percentage of decline was smaller at SOEs and firms with politically connected managers. This suggests that related regulations and laws have had less effect on these firms. Indeed, they have been least effective in local SOEs with politically connected managers.

Finally, we test whether there is any difference between a Chairman's political connection and a CEO's political connection, in terms of their impact on tunneling. We find that for both private firms and local SOEs, a politically connected Chairman is more influential than a politically connected CEO with regard to tunneling, but for central SOEs, neither the Chairman nor the CEO alone determines the relationship between political connection and tunneling.

Our study develops the existing literatures in several ways. First, we identify a channel through which political connected managers tunnel firms' assets. . Existing literature has illustrated several effects of political connection such as preferential access to financing (Khwaja and Mian 2005; Leuz and Oberholzer-Gee 2006), lower equity costs (Boubakri,

Guedhami, Mishra, and Saffar 2010), a higher probability of government bailouts (Faccio, Masulis, and McConnell 2006), less regulation and more favorable treatment in the legal system (Li, Meng, and Zhang 2006), as well as lower CEO pay-performance sensitivity (You and Du 2012), and less effective boards (Fan, Wong, and Zhang 2007). We find that tunneling through fund occupations is another important channel through which political connection affects a firm's behavior, and in turn its valuation and performance.

Our paper complements two other related studies. Chang and Wong (2004) find that party control restrains the largest shareholders from expropriation at SOEs. Peng, Wei, and Yang (2011) find that political connection is negatively associated with the announcement effect of related party transactions (RPTs), suggesting that politically connected firms are more likely to conduct tunneling-motivated RPTs. We show that the impact of political connection on tunneling really depends on the firm's ownership types. To this extent, our paper is also closely related to Wu, Wu, and Rui (2010), who find that the impact of political connection on firm performance, government subsidiary, and policy burden is subject to firm ownership.

Second, our paper develops the exisitngliterature on investor protection and relevant law enforcement in China. Authorities in China have made a substantial effort to introduce laws and regulations that will improve corporate governance and investor protection (MacNeil 2002). However, the lack of an independent judiciary and effective court system means that enforcement of these laws and regulations remains weak (Pei 2001; Allen, Qian, and Qian 2005). Levine (1998) finds that both legal codes and rigorous enforcement of laws and contracts are crucially important to maintain a smoothly functioning banking system and encourage long-term economic growth. Pistor, Martin, and Gelfer (2000) examine a sample of 19 transition economies and find that the effectiveness of laws is even more important than the completeness of written laws for a country's economic growth. We find that political

connection is an important factor that affects the effectiveness of laws and regulations to protect investors. To this extent, our study is closely related to Berkman, Cole, and Fu (2010), who examine the reaction of stock market to the introduction of three regulations designed to improve minority shareholder protection, and find that firms with strong ties to government do not benefit from the regulations. Our study provides similar evidence but from a more direct perspective.

Third, our study develops the existing literature on founder-managers. The behavior of founder-managers and their impacts on firm valuation and performance have attracted great academic interest. Both positive and negative evidence has been presented in existing literature (for example: Anderson and Reeb, 2003; Adams, Almeida, and Ferreira,2005 and 2009; Villalonga and Amit,2006; Leone and Liu, 2008; Anderson, Duru, and Reeb, 2009 and Fahlenbrach,2009). China's stock market is still in its early stage of development and the number of listed firms is fast growing, suggesting there is a higher percentage of firms with founder-managers than in Western markets.[2] Yet there are only a few studies that have directly examined the impact of founder-managers on the Chinese market (e.g., Wang and Wang 2011; Zhang, Ji, Tao, and Wang 2011). These two papers examine the relationship between founders and venture-capital performance, and the relationship between a CEO's founder status and turnover. We study the impact of founder-managers from a different perspective so our paper helps to give a better understanding of the impact of founder-managers in China and provides an important complement to the literature that focuses on Western markets.

Finally, we find that the largest shareholders' tunneling behavior (and the impact of political connection on tunneling) differs whether or not they have effective control of the

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[2] More than 21% of all our sample firms have founder-managers, with the percentage of 33% for private firms and 15% for SOEs, respectively. This almost doubles the ratio in the US, where only about 11% of firms have founder-managers.

firm. Most of the existing literature simply regards the largest shareholder as the controlling shareholder (e.g., Chen, Firth, Xin, and Xu 2008; Wu, Wu, and Rui 2010). Our results, however, show that the largest shareholder does not always effectively control the firm. About 18% of private firms and 9% of SOEs in our sample have their largest shareholders controlling less than 20% of the firms, a threshold we consider appropriate for effective control. Our paper therefore may shed some new light on the behavior of firms in China.

The reminder of this paper is organized as follows. Section 2 provides a review of existing literature. Section 3 presents the institutional background in China and lays out our hypotheses. Section 4 introduces the samples and data. Section 5 reports our empirical results, and Section 6 concludes our paper.

2 Literature review

2.1 Tunneling and largest shareholders

A large number of papers have studied the relationship between a firm's ownership structure and the level of tunneling by the largest shareholder. Berkman, Cole, and Fu (2009) and Jiang, Lee, and Yue (2010) find that the severity of expropriation through loan guarantee issuance and related lending is greater for private firms. Chen, Firth, and Xu (2009) and Cheung, Rau, and Stouraitis (2010) both find that firms controlled by the central government are more likely to be propped up, while firms controlled by local government are more likely to be expropriated. La Porta, Lopez-de-Silanes, and Shleifer (1999), Claessens, Djankov, and Lang (2000) and Faccio and Lang (2002) provide empirical evidence showing that firms belonging to business groups and being controlled by the ultimate owner through a chain of companies are more likely to be tunneled. The ultimate controlling shareholder exerts control over lower-level firms without necessarily having a majority of cash flow rights, which

separates control rights from cash flow rights. This gives the controlling shareholder a strong incentive to extract private benefits and expropriate minority shareholders. Bertrand, Mehta, and Mullainathan (2002) and Jian and Wong (2010) provide further empirical evidence that supports this finding.

2.2 Literature on political connections

A rapidly growing body of literature examines the impact of political connection on firm behavior, valuation, and performance. On the positive side, Khwaja and Mian (2005) and Leuz and Oberholzer-Gee (2006) find that politically connected firms have preferential access to loans from state-owned banks. Li, Meng, and Zhang (2006) and Li, Meng, Wang, and Zhou (2008) find that political connection gives a firm favourable regulatory and legal treatment. Mobarak and Purbasari (2006) estimate that being politically connected triples the likelihood of receiving valuable import licenses in Indonesia. Boubakri, Guedhami, Mishra, and Saffar (2010) find that politically connected firms enjoy a lower cost of equity capital than their non-connected peer because investors consider them to be less risky. Faccio, Masulis, and McConnell (2006) find that politically connected firms are significantly more likely to be bailed out by governments. Leuz and Oberholzer-Gee (2006) and Faccio and Parsley (2009) indirectly demonstrate the positive effect of political connection by showing that politically connected firms decrease in value when they lose their connections.

On the negative side, Cheung, Jing, Rau, and Stouraitis (2005) find that political connection worsens the expropriation of minority shareholders and is detrimental to the firm. Fan, Wong, and Zhang (2007) find that there are more bureaucrats and fewer professionals on the boards of politically connected firms. You and Du (2012) find that political connection weakens CEO pay-performance sensitivity. Fan, Wong, and Zhang (2007) and Faccio (2010)

use Chinese and cross-country data respectively and show that politically connected firms underperform their non-connected peers both in both the short-term and long-run.

In this paper, we study the impact of political connection from a different perspective and provide new evidence on how political connection affects firm behavior which in turn affects firm valuation and performance.

2.3 Literature on founder-managers

Researchers have paid a lot of attention to the effects that founder-managers have on firm behavior and performance and thus far have presented mixed evidence. Anderson and Reeb (2003), Villalonga and Amit (2006), and Adams, Almeida, and Ferreira (2009) all find that founder-manager firms have a higher market value and better performance than non-founder-manager firms. Fahlenbrach (2009) finds that founder-CEO firms invest more on R&D, have a higher capital expenditure and make more focused M&A. Li and Srinivasan (2011) find that CEO pay-performance sensitivity is higher and the level of pay is lower when there is a founder-director on the board. In contrast, Johnson, Magee, Nagarajan, and Newman (1985) find that stock markets react positively when a company founder suddenly dies, which suggests that founder control has a negative effect. Leon and Liu (2008) find that, in comparison to non-founder-CEOs, founder-CEOs are significantly less likely to be fired following accounting irregularity, which indicates that they are entrenched. Anderson, Duru, and Reeb (2009) find that both founder- and heir-firms are significantly more opaque than firms with diffuse shareholders, and founders and heirs tend to exploit this opacity to expropriate minority shareholders.

Firms with founder-managers account for about 11% of the largest public firms in the US, which is considered to have the most widely dispersed ownership. However, firms with founder-managers make up more than one fifth of all the firms in our sample, and yet they

have not attracted very much attention. He, Wang, Mei, and Lian (2010) find that a founder-manager's turnover has a significant and immediate negative effect on firm performance. Pi and Lowe (2010) study the patterns of CEO turnovers from 1997 to 2006 and find that being a founder makes a CEO less likely to be replaced involuntarily. Wang and Wang (2011) find that a cross-border venture-capital firm's performance is strongly related to the founder's departure. They argue that the departure of the founder indicates the firm's transition to a modern corporation.

Existing literature on founder-managers for the Chinese market has so far focused on its effects on firm valuation and performance, but very little is understood about the mechanism of such effects. Our paper attempts to fill this gap by studying the effect a founder-manager has on a firm's tunneling behavior and its joint effect with political connection.

3 Institutional background and hypotheses

3.1 Unique features that make the Chinese stock market conducive to tunneling

China started its economic reform in the late 1970's, but more than a decade of gradual reform has done little to revitalize state-owned enterprises (SOEs). In fact, their overall performance deteriorated significantly. In the early 1990's about 40% of SOEs were losing money and by 1994 almost half of them had zero or negative equities (Deng, Gan, and He 2006). This was even more striking considering the fact that most SOEs were profitable when the reform first started. As a result of this, Shanghai Stock Exchange and Shenzhen Stock Exchange were set up as part of government initiatives to recapitalize and partially privatize SOEs, alongside with the share issue privatization (SIP) reform.

However, in transiting itself from a highly centralized planned economy to a modern market-oriented economy, China has been unable to synchronize other necessary and complementary reforms such as property rights, investor protection, and corporate laws. For the following reasons, the Chinese stock market offers a natural setting to study tunneling activities by large shareholders and other insiders.

First, in the pre-IPO restructure of SOEs, only about a quarter of all SOEs have gone through a complete restructure. Most were only partially restructured when part of the firm was either carved-out or spun-off to become publicly listed firms where the parent companies owned the majority of shares in the listed firms and also served as the controlling shareholders. And the listed firm and its controlling shareholder maintain a close relationship in terms of production and services. Deng, Gan, and He (2006) argue that such a parent-subsidiary structure provides insiders with strong incentives and the capabilities to engage in tunneling activities.[3] Second, external corporate governance mechanism is weak in China which means that takeovers and other forms of competition for corporate ownership (e.g., proxy contest) are far from common. Other forms of non-market monitoring forces, such as the media, play a significant role in improving corporate governance in Western markets (e.g., Miller 2006; Dyck, Morse, and Zingales 2010), but in China, the media is still tightly controlled by the government and therefore hasn't become an effective external monitor. Third, China's lack of a well-developed legal and investor protection system means that minority shareholders have few channels through which to take action against controlling shareholders when their rights are jeopardized (McNeil 2002; Allen, Qian and Qian 2005). Fourth, the China Securities Regulatory Committee (CSRC) is the official regulator of

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[3] Bae et al. (2002) and Bertrand et al. (2002) find similar evidence that compared firms not belonging to a business group, firms belonging to business groups are more prone to tunneling, using data in South Korea and India, respectively.

Chinese stock markets, but its lack of investigative and prosecuting power and minimum amount of resources ultimately results in a weak enforcement of its own rules.

To sum up, this unique and salient institutional environment makes the Chinese stock market conducive to frequent tunneling by large shareholders and other insiders.

3.2 Hypotheses development

3.2.1 Impact of manager's political connection on tunneling

After realizing that centralized economic decision making mechanism was actually hampering the early stages of economic reform, the central Chinese government gradually decentralized economic decision making by delegating decision right at a contain level to local governments. The decentralization also includes that attributed some SOEs to local government for administration, and separation of local state tax bureau system and central state bureau system. During the SIP reform, the most profitable business units at SOEs were often carved out and listed on the stock market, with the government retaining the largest stake in these now publicly listed SOEs.[4]

Due to the two levels administrated SOEs, this partial privatization therefore created two types of listed SOEs, commonly referred to as local SOEs (where different levels of local government are the largest shareholders) and central SOEs (where the central government is the largest shareholder). It has been well documented that local governments and the central government have divergent interests (Bai, Li, Tao, and Wang 2000; Bai, Lu, and Tao 2005). As part of the decentralization, local governments also assumed the legacies of a planned economy such as the heavy social and political burdens of maintaining surplus labor and providing social welfare (Qian 1996). The political responsibility of local government

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[4] Of course in some cases, the government may choose to relinquish its stake by selling it to private entities, resulting in "private control transfer". However, as Chen, Firth, Xin, and Xu (2008) find, there are only 62 such private control transfers from 1996 to 2000.

officials is often closely related to the social stability of their governed regions. Cheung, Rau, and Stouraitis (2010) find that expropriation is prevailing in areas where government bureaucrats are less likely to be prosecuted for misappropriating state funds, suggesting that local governments can offer SOEs under their control certain administrative protection against unfavorable court rulings. As a result, local governments have strong incentives to extract resources from these firms in order to fulfill the political and personal interests of government officials.

To facilitate tunneling, local governments have a strong incentive to appoint politically connected manages to local SOEs, who in turn, being more concerned about their political careers, [5] are often willing to collude with local governments to engage in tunneling activities. Therefore, we propose that:

H 1a: For local SOEs, manager's political connection is positively related to tunneling.

In contrast to local SOEs, most central SOEs are very large firms with strategic importance for national security and economic growth. Central SOEs have much lighter policy burdens than local SOEs (Wu, Wu, and Rui 2010), so the central government wants to ensure their financial success for economic, national security, or public image reasons. It therefore appoints politically connected managers mainly to ensure full operational control of these central SOEs, although these politically connected managers are not under the same pressure from as their peers at local SOEs.

The relationship between manager's monetary compensation and firm performance, although generally found to be positive (Mengistae and Xu 2004; Firth, Fung, and Rui 2007), is nonetheless weak (Firth, Fung, and Rui 2006). In this concern, non-politically connected managers at central SOEs, who are not concerned about their political careers, may have

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[5] In a year 2000 survey cited by Chang and Wong (2004), local party committees and governments have remained involved in all major corporate decision in listed local SOEs, particularly personnel decisions.

some incentive to extract private benefits through tunneling. In contrast, a politically connected manager has another implicit incentive – political promotion, which can be a substitute for weak monetary compensation (Cao, Lemmon, Pan, Qian, and Tian 2011). [6]And the probability of political promotion is positively related to firm performance (Li and Zhou 2005). Therefore, politically connected managers at central SOEs would be vitally interested in having the firms perform well, and it would reduce his incentive to engage in tunneling. [7] We expect that:

H 1b: For central SOEs, manager's political connection is negatively related to tunneling.

3.2.2 Different impacts on tunneling between two types of political connections

In China, a manager's political connection can be categorized into two broad types. It's necessary to distinguish the impacts of these two types of political connections, due to their different natures. The first type of political connection is established when a listed firm appoints a manager who is a current or former government official or military officer. For private firms, these politically connected mangers, through their personal network with current government authorities (or *guanxi*), bring the firms many benefits, such as fiscal grants, licenses, government procurements, bank loans, and other highly sought-after resources. In doing so, these managers have strong incentives to seize some private benefits as rewards for the benefits they bring to the firms. For SOEs, managers who were or still are government officials usually keep their official position rankings. Their business and political career largely depend on how well they carry out policies and instructions of the relevant local or central government (the largest ultimate shareholder of SOEs). Combining it with our earlier analysis, we therefore expect:

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[6] For example, Mr. Wei Liucheng, the then Chairman of China National Offshore Oil Corp., was promoted to the position of deputy Secretary of Hainan provisional Party committee in September 2003.

[7] It's true that politically connected managers at local SOEs are also interested in good firm performance, but they face high pressure from local government to help tunnel. Compared with their peers at central SOEs, managers at local SOEs are more likely to be protected from prosecution by local government. Furthermore, the potential (political career) cost of not being promoted is higher for a central-SOE manager than a local-SOE manager.

H 1.1a Manager's government-official-type political connection is positively related to tunneling at private firms and local SOEs, but negatively related to tunneling at central SOEs.

The second type of political connection arises when a manager becomes a member of the Chinese People's Congress (CPC) or the Chinese People's Political Consultative Conference (CPPCC). For political reasons, the Communist Party generally requires that members of the CPC and CPPCC have relatively good images. To maintain such a good image, a manager who is a member of the CPC /CPPCC is less likely to engage in tunneling, than a manager who isn't a CPC/CPPCC member. Therefore, we propose that:

H 1.1b Manager's CPC/CPPCC-type political connection is negatively related to tunneling at both private firms and SOEs.

3.2.3 Effectiveness of laws and regulations enforcement across firms

On October 19, 2005, the State Council of China issued a "Notice on Improving the Quality of Listed Firms" put forward by the CSRC. It explicitly reuqired that controlling shareholders must pay back their occupied funds to listed firms by the end of 2006. Then on June 29, 2006, the 10th Standing Committee of the National People's Congress passed Amendment Six to the Criminal Law of China. Article 169 of this amendment states that senior executives and directors of publicly listed firms would be jailed for 3 to 7 years (in addition to fines), if they cause severe loss to the firm by providing company funds to other parties under obviously unfair conditions or with the knowledge that these funds will not be repaid. This unprecedented move shows that the authorities are determined to tackle the server problem of fund occupation by large shareholders and other insiders. We therefore expect that these laws and regulations would reduce the severity of tunneling through fund occupation.

However, weak and selective enforcement of laws and regulations has long been a major issue in China (e.g., Pei 2001; Cheung, Rau, and Stouraitis 2010). Berkman, Cole, and Fu (2010) examine the reaction of the market to changes in regulation designed to better protect minority investors and find that firms with strong ties to governments benefit little from these regulations, suggesting the market does not expect strong enforcement from regulators.

We therefore expect that:

H 2: to the new laws and regulations can reduce the overall severity of tunneling through fund occupations. But they are less effective for SOEs and firms with politically connected managers.

3.2.4 Impact of founder-managers and the political connections of founder-managers on tunneling

Founder-managers are those managers who were founders or main executives when a firm was first incorporated or spun-off. We will demonstrate that it's crucial to distinguish founder-managers from non-founder-managers and the political connection of founder-managers from the political connection of non-founder-managers when it comes to their impact on tunneling activities. First, despite the fact that the private sector has been the main engine of China's economic growth over the past two decades, private firms are still being discriminated and disadvantaged in many areas. Governments, either central or local, still maintain considerable control over the allocation of resources such as land, energy, awarding of government projects and procurements, etc. Bank loans, a primary source of external financing, flow disproportionally to SOEs despite their poor performance (Cull and Xu 2000). Private firms often face many administrative obstacles trying to obtain licenses and enter certain industries. Furthermore, the quality of law and effectiveness of law enforcement are low and below the average of other transition economies (Pistor and Xu 2005). Private

firms are frequently discriminated when it comes to the enforcement of contracts with governments or SOEs. To overcome these imperfect market and market-supporting institutional hurdles, private entrepreneurs have strong motivation to enter politics or to establish political connection (Li, Meng, and Zhang 2006).

Most of China's privately controlled firms were established by entrepreneurs who are most likely to have the largest ownership, often assume the position of Chairman, CEO, or both. [8] Founder-managers often consider their firms to be personal achievement and this motivation encourages them to take a long-term approach, rather than short-term actions (Fahlenbrach 2009).[9] As we discussed earlier, the motivation for private entrepreneurs to establish political connection is mainly to overcome institutional barriers; and it's usually costly to establish and maintain political connection (Shleifer and Vishny 1994). To maximize the returns from political connection, founders have an even stronger incentive in the long-term success of their firms. Furthermore, private business owners often face fierce competition in becoming and maintaining a delegate to the CPC or CPPCC, both of which are important channels for political connection. Ceteris paribus, a manager who is thought to have engaged in tunneling is more likely to lose delegate status (and the political connection) than a manager who isn't. Therefore, we propose that:

H 3a: For private firms, manager's founder status is negatively related to tunneling.

H 3b: For private firms, the political connection of a founder-manager is also negatively related to tunneling.

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[8] Indeed, we find that, for our sample, the ownership of the largest shareholder (which is often the founder) is 28.49% for founder-manager firms and 21.19% for non-founder-manager firms. The difference is significant at the 1% level.

[9] In China, the government maintains tight control and has the most influential power in deciding which firms can go public (Peng, Wei and Yang 2011). It's reasonable to assume that the government would give SOEs preferential treatment to go public. This means the listing status is probably one of the most valuable assets of a privately controlled listed firm.

Unlike founder-managers at private firms, founder-managers at SOEs are appointed by governments to head these newly established firms. In some cases they are instructed by the government to set up new businesses to help the local economy, or for other social issues such as high unemployment. To encourage them to better manage the firm, governments grant them a certain amount of share ownership. Indeed, our results show that the average equity ownership is 0.35% for a founder-manager at SOEs and 0.07% for a non-founder-manager. This difference is significant at the 1% level. And because of the presence of governments as the largest shareholders and the high visibility of these founder-managers, it is generally difficult for a founder-manager to tunnel through fund occupation. Therefore we expect that:

H 3c: For both local SOEs and central SOEs, manager's founder status is negatively related to tunneling.

Many managers were government officials before taking up their business roles, so they are politically connected. They often keep their official position rankings and are often promoted to a higher-ranking political position if their firms perform well. Again, when analyzing the political connections of these founder-managers, it's important to distinguish between local SOEs and central SOEs.

Local governments, as we discussed earlier, frequently intervene into the operations of local SOEs. As a result, founder-managers at local SOEs would find themselves not much more "powerful" than non-founder-managers, in terms of decision-making, so their political connection is the dominant factor in shaping their behavior. In other words, when controlling for political connection, a founder-manager is not much different from a non-founder-manager, in terms of the impact on tunneling. Therefore,

H 3d: For local SOEs, the negative relationship between a manager's founder status and tunneling becomes insignificant, after controlling for political connection.

In contrast, the central government usually does not directly intervene into the operations of central SOEs. The official position ranking and status of founder-managers gives them a high leverage over other executives at the firm. This could affect their behavior in two ways: on one hand, the incentive of political promotion encourages them to manage the firm well and restrain themselves and other insiders from tunneling through fund occupations, but on the other hand, their powerful status gives them the capacity to extract some private benefits from the firm. Under China's institutional environment, we expect the former effect to dominate.

H 3e: For central SOEs, the negative relationship between a manager's founder status and tunneling becomes stronger, after controlling for political connection.

4 Sample and data

4.1 Sample selection

Our initial sample consists of all non-financial A-share issuing firms that are listed on Shanghai Stock Exchange and Shenzhen Stock Exchange from 2004 to 2010. We deliberately choose 2004 as our beginning year because membership of the Chinese Communist Party was not officially open to private entrepreneurs until late 2002, when the 16th National Congress of the Communist Party amended its Party Constitution (Xinhua News Agency Nov. 18 2002). [10] As we know that an applicant joins Chinese Communist Party must go through a formal procedure. The procedure consists of submitting an application, discussion

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[10] Although Party membership is not a prerequisite for becoming a delegate to the People's Congress, in practice around 70% of all PC delegates are also Party members.

between the applicant and current leaders of a branch Chinese Communist Party, voting by executive members of the branch and formally accepted as a member. Normally this procedure may endure several a year, although there are short or longer exceptions. Thus, we choose 2004 as the first year of our sample period.

To avoid issues arising from different legal systems, we first delete firms where the largest ultimate shareholder is a foreign entity and firms that are cross-listed overseas (including Hong Kong).[11] We then delete observations for the first year of listing because Chinese firms are commonly engaged in pre-IPO earnings management and the first year of listing often sees unusually high levels of various forms of related party transactions. We then delete observations with missing data. As a result, our final sample include 1591 firms and 9499 firm-year observations, which is larger than most previous studies for the Chinese stock market.

4.2 Data source and variable measurement

We obtain our financial data from the China Stock Market & Accounting Research (CSMAR) database, compiled by Shenzhen GTA Information Technology Company Ltd. CSMAR has been widely used for researches on the Chinese stock market (e.g., Bai, Liu, Lu, Song, and Zhang 2004; Berkman, Cole, and Fu 2010; Jian and Wong 2010).

Generally, three approaches have been used to measure tunneling in China: related party transactions (Cheung, Rau, and Stouraitis 2006), loan guarantees to related parties (Berkman, Cole, and Fu 2009) and funds occupation (i.e., inter-corporate loans in Jiang, Lee, and Yue 2010). We do not use the first two measurements because (1) the issuance of any new loan guarantee was banned by the CSRC in June 2000; and (2) the approach by Cheung, Rau, and Stouraitis (2006) requires an a priori subjective judgement on whether a certain

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[11] We include in our sample those firms that also issue B-shares as these firms must abide Chinese laws, although we exclude B-shares in our study.

RPT is beneficial, expropriating, or neutral to the firm. Such an approach has its limits. For example, Cheung, Rau, and Stouraitis (2006) consider all asset sales to related parties as expropriating, but it's obvious that the nature of such transactions depends on whether the prices paid are above, below, or the same as in arms-length deals. Therefore, we follow Jiang, Lee, and Yue (2010), who use the total amounts reported in "other receivables" to measure the level of tunneling.[12] This approach is used because it's easy to tell who the beneficiary is. In addition, this practice is so widespread that the CSRC has issued several rules or decrees aimed specifically at tackling this issue. Our measurement is narrower than that used by Jiang, Lee, and Yue (2010) in that it specifically includes "other receivables" by (1) the largest shareholder and other firms controlled by the largest shareholder; and (2) senior executives and their family members.[13]

Following Li, Meng, and Zhang (2006) and Fan, Wong, and Zhang (2007), we consider a manager to be politically connected if he is a current or former (1) government official; (2) military officer; (3) member of the Chinese People's Congress (CPC); and (4) member of the Chinese People's Political Consultative Conference (CPPCC). We hand collect this data by checking the "Directors and Senior Executives' Profile" that are included in annual reports, and in some cases by searching the internet.

Consistent with Anderson and Reeb (2003) and Adams, Almeida, and Ferreira (2005, 2009), a manager is considered to be a founder-manager if he was a founder or a main executive when the firm was first incorporated or when it was spun-off. Unfortunately, the annual reports rarely explicitly mention whether a manager is a founder. Therefore, we search the internet extensively through Google, Baidu, and Wikipedia. We consider a manager to be

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[12] "Other receivables" is an account item that includes receivables that are not part of ordinary business transactions. These receivables are essentially interest- free loans made by listed firms to other parties.

[13] The reasons why we only include these two parts of "other receivables" are: first, we are mainly interested in tunneling by these two groups of insiders; and second, "other receivables" by some other parties such as joint venture partners may be not of the nature of tunneling.

a founder-manager if any one of these sources explicitly mentions so and no other sources indicate otherwise.

Lemon and Lins (2003) point out that "having a significant degree of control over the firm's assets is a necessary condition for expropriation of minority shareholders" (p1462). So it's crucial to define an effective control. In China, researchers commonly assume that the largest ultimate shareholder has effective control over the firm (e.g., Chen, Firth, Xin, and Xu 2008; Wu, Wu, and Rui 2010), but this is not always the case. There are 102 observations in our sample where the largest ultimate shareholder has less than 10% of control rights, which is considered to be the lowest threshold for effective control (La Porta, Lopez-de-Silanes, and Shleifer 1999). CSRC sets 30% of total control rights as one of the criteria in defining effective control.[14] However, CSRC also sets 30% as the threshold for a shareholder to make a compulsory tender offer.[15] Some shareholders would deliberately keep their control rights below 30% to avoid making a tender offer. Therefore, we believe that 20% is the most appropriate threshold for effective control in China. The cut-off of 20% of control rights is also used by many existing studies for Western markets (e.g., Claessens, Djankov, and Lang 2000, Faccio and Lang 2002).

Following Lemmon and Lins (2003), we introduce a dummy variable *Effective control dummy*, to test possible different tunneling activities.[16] The definitions of other variables are consistent with existing literature and are reported in Table 1.

< Insert Table 1 about here >

5 Empirical results

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[14] "Notice about Issuing 'Guides to Constitutions of Listed Companies'", CSRC, December 16, 1997 (in Chinese, title is translated by the authors).

[15] "Regulatory Methods for Acquisitions of Listed Companies", CSRC Decree No. 35, July 30, 2006 (in Chinese, title is translated by the authors).

[16] There is a difference in definition between the dummy variable used in Lemmon and Lins (2003) and the one used in our paper. Lemmon and Lins (2003) set the dummy variable to 1 if the management control rights are above the median and 0 if below the median. We instead use a cut-off of 20%.

5.1 Descriptive summary

5.1.1 Sample distribution

Table 2 reports the distribution of our sample firms by year and industry in relation to ownership types.

< Insert Table 2 about here >

Panel A shows that of the whole sample of 9499 firm-year observations, 3416 (or 35.96%) firms have a private entity as the largest ultimate shareholder; 4394 (or 46.26%) firms have a local government and 1689 (or 17.78%) firms have the central government as the largest ultimate shareholder, respectively. The proportion of private firms in our sample is higher than that in many previous studies (e.g., Chen, Firth and Xu 2009; Peng, Wei and Yang 2010; Chen, Sun, Tang and Wu 2011), mainly because our sample covers a more recent period and private firms account for a large proportion of all newly listed firms in this period.

Across three types of firm ownerships, local SOEs have the highest percentage of politically connected managers (39.24%), followed by private firms (36.50%) and central SOEs (24.87%). This is not surprising given the different incentives for these groups to establish political connection (please refer to our analysis in Section 3). On a year-by-year base, the percentage of politically connected managers is relatively stable, which is consistent with Chen, Sun, Tang, and Wu (2011) who find that the changes (establishment or loss) in political connection are small. This is also why we do not test how changes in political connection affect tunneling activities.

As for managers' founder status, private firms have the highest percentage of founder-managers (33.08%), which is much larger than that of local SOEs (15.38%) and central SOEs (12.85%). This is not surprising given the definition of founder-manager and the nature of the

ownership. Noticeably, as a whole, 21.30% of all our sample firms have at least one founder-manager, nearly double the percentage of founder-manager firms in the US at about 11% (Anderson and Reeb 2003; Adams, Almeida, and Ferreira 2005, 2009). This substantial difference clearly reflects the fact that the Chinese stock market is in its early stage of development. Across ownerships, the percentage of private firms with founder-manager is steadily rising, while the percentage of founder-manager firms in the state sector is declining overall. There are two possible explanations, the increasing number of newly listed private firms (which often have a founder-manager) and the promotion or retirement of founder-managers at SOEs.

Panel B reports the breakdown of our sample based on industry. The manufacturing industry has by far the largest number of firms, accounting for more than half of the whole sample. Cross-industry variations of political connection are obvious. For private firms, the transport industry has the highest percentage of political connection (64.71%), followed by agriculture and wholesale & retail trade, with both having about 42% of firms politically connected. For local SOEs, these three industries all show a high percentage of political connectedness (around 50-57%), although the social service industry has the highest percentage of politically connected managers. For central SOEs, the most connected industries are agriculture, power and gas, and transport. These different patterns clearly indicate that political connectedness is closely related to the type of ultimate ownership of the firm. For example, in the construction industry, 40.63% of private firms have politically connected managers, which are important for gaining access to government projects such as railways, highways, and other infrastructure development. But only 22.89% of local SOEs and 16.33% central SOEs in the same industry have politically connected managers because the nature of substantial government ownership reduces the importance of political connection.

There is no particular pattern in the percentage of founder-managers across industries.

5.1.2 Patterns of tunneling

Table 3 presents the descriptive statistics of tunneling, measured by fund occupation by the largest shareholder and other insiders. Overall, 3226 firms (or 33.96%) report tunneling during the sample period, with average tunneling representing 2.90% of the total assets (or 132 million RMB).

< Insert Table 3 about here >

Table 3 reveals three clear patterns. First, across three types of ownerships, private firms have the highest level of tunneling in terms of percentage of total assets, although the percentage of firms reporting tunneling is the lowest. This is true either on an aggregated base or on a year-by-year base, except for 2008 where local SOEs have a slightly higher level of tunneling than private firms. Central SOEs, in contrast, have the lowest level of tunneling, except for 2006 and 2010, when they have slightly higher level of tunneling than local SOEs.

Second, since 2005, the level of tunneling has been on the decline. Although there are some variations across ownerships, the overall pattern is clear. As a whole, tunneling represents 0.35% of total assets in 2010, a significant drop from the 5.30% level in 2005. This suggests that changes to laws and regulations have generally been effective.

Third, despite the overall decline in the level of tunneling, the magnitude of difference in the level of tunneling across ownerships has also declined. For example, in 2005, the level of tunneling is 6.32% in private firms, 5.47% in local SOEs, and 3.33% in central SOEs, with a difference of 0.85% between private firms and local SOES and a difference of 2.99% between private firms and central SOEs. But in 2010, the difference drop to 0.14% and

0.03%, respectively, suggesting that the enforcement of laws and regulations has had different effects across firms with various ownership tyes.

5.1.3 Variable mean analysis

Table 4 presents a simple analysis of the mean comparison for variables based on political connectedness and founder status across three types of ownership.

< Insert Table 4 about here >

Across all ownerships, firms with founder-managers report less tunneling than firms with non-founder-managers. This difference is significant at the 1% level for private firms and local SOEs and at the 5% level for central SOEs.

For private firms and central SOEs, those with a politically connected manager report less tunneling than those without such connection; while for local SOEs, firms with a politically connected manager report more tunneling than firms without such connection. The difference is significant at least at the 10% level. These statistics confirm our earlier analysis in the paper that ownership does matter when examining the relationship between political connection and tunneling.

Table 4 also reveals that founder-managers are more likely to be politically connected than non-founder-managers. This is a significant difference across all three types of ownerships, although the reasons for the difference are not the same (please refer to our analysis in Section 3). It also supports our approach to investigate the interaction effect between manager's political connection and founder status.

It's also clear that firms with a politically connected manager or founder-manager are likely to be largerand have a lowe financial leverage. The divergence between the largest

ultimate shareholder's control rights and cash flow rights is also lowe in firms with a politically connected manager.

Table 5 reports the results for Pearson's pair-wise correlation analysis for the main variables used in this paper. The correlation among variables are generally weak (none of the correlations is larger than 0.2). More formally, we run a variance inflation factor (VIF) test immediately after each regression. Except for the dummy variable representing the manufacturing industry, [17] the VIF values are all below 10, indicating that multicollinearity is not an issue.

< Insert Table 5 about here >

5.2 Multivariate regression results

5.2.1 Political connection and tunneling

Table 6 presents the results of the OLS regression for the relationship between political connection and tunneling. We classify all firms into three types of ownership – private firms, local SOEs, and central SOEs – depending on the identity of the largest ultimate shareholder. For each type of ownership, we divide firms into two sub-groups based on whether or not the largest shareholder has effective control. We run a separate regression for both sub-groups and an additional regression for all firms with the same ownership, by adding a dummy variable controlling for the largest shareholder's ability to effective control, and an interaction term between political connection and the effective control dummy. The constant term, year dummies, and industry dummies are included in the regressions but their coefficients are not reported in the table. The *p*-values reported in parentheses are based on standard errors adjusted for heteroskedasticity using White (1980).

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[17] Please be reminded that the manufacturing industry accounts for more than half of all firm-year observations.

< Insert Table 6 about here >

Model (1) and Model (2) of Table 6 show that for private firms, regardless of the largest shareholder's control status, manager's political connection is negatively related to tunneling but the coefficient is not significant. As mentioned earlier in Section 3, this insignificance may be due to the opposite impact of the founder-manager's political connection and non-founder-manager's political connection. We will test it further, later in the paper. The coefficient of *Effective control dummy* in Model (3) of Table 6 is significantly negative. One possible explanation is that private firms where the largest shareholder has effective control are more likely to be founder-manager firms, and founder-manager is negatively related to tunneling.

Model (4) and Model (5) show that manager's political connection is positively related to tunneling at local SOEs, but the relationship is only significant for firms where the government has no effective control. It confirms our expectation that local governments appoint politically connected managers to facilitate their tunneling from local SOEs. In Model (6), the significantly negative coefficient of *Political connection*Effective control dummy* indicates that after the local government gains effective control of the firm, the importance of the manager's political connection weakens. This is not surprising. When the government effectively controls the local SOE, it relies less on the politically connected manager to intervene into the operation and tunnel the firm through fund occupations. One may argue that a manager's political connection becomes less important because the local government tunnels less, but this argument can easily be rejected because the coefficient of *Effective control dummy* is significantly positive, indicating that the local government tunnels more from the firm as it gains effective control.

Model (7) to Model (9) of Table 6 show that the manager's political connection is negatively related to the level of tunneling at central SOEs, but this relationship is only significant for firms where the central government has no effective control.

Overall, the results in Table 6 support our hypothesis 1a and 1b.

As for the control variables, *Excess control rights* is positively related to tunneling in all models except for Model (1). But this positive relation is only significant for firms where the largest ultimate shareholder has effective control. This result is consistent with Lemmon and Lins (2003), who observe a positive relationship between cash flow leverage (calculated as control rights / cash flow rights) and expropriation in firms with high management group control. The coefficient of *Firm Size* is negative and significant across all three types of ownership. There are two possible explanations for the negative impact of firm size on tunneling: (1) large firms are subjected to more public scrutiny, and (2) large firms are more likely to be located in more developed areas, which are found to be negatively related to tunneling (Jiang, Lee, and Yue 2010). *Leverage* is significantly and positively related to tunneling at local SOEs and central SOEs, which is in line with our expectations. The primary source of debt financing in China is bank loans, which are disproportionately allocated to SOEs regardless of their performance (Cull and Xu 2000). Higher leverage indicates more government support (through state-owned banks), making an SOE less concerned about any negative market reaction to tunneling. The impact of *Board independence* on tunneling also depends on a firm's ownership. Noticeably, but it has little impact on tunneling for local SOEs.

5.2.2 Different impacts of official-type and CPC/CPPCC-type political connection on tunneling

In this section, we examine the differences between two types of political connection, namely political connection resulted from managers' current or former government official status and political connection resulted from managers' CPC / CPPCC status, in terms of their impacts on tunneling. We present the results in Table 7.

< Insert Table 7 about here >

The coefficient of *Official* is positive but insignificant in Model (1) to Model (3), providing weak support for our expectation that official-type political connection leads to more tunneling at private firms. The coefficient of *CPC/CPPCC* is negative and significant at least at the 10% level in Model (1) to Model (3). That is, CPC/CPPCC-type political connection is significantly negatively related to tunneling at private firms. Recall from Table (6), the overall political connection has negative but insignificant impact on tunneling at private firms. This can be explained by the positive but insignificant impact of official-type political connection and significantly negative impact of CPC/CPPCC-type political connection on tunneling at private firms.

The coefficient of *Official* is positive in Model (4) and Model (6) and is significant at the 5% level in Model (4) and Model (6). It confirms our expectation that government-official-type political connection does have a significantly positive impact on tunneling at local SOEs. The coefficient of *CPC/CPPCC* in Model (4) to Model (6) has mixed signs but none is significant, indicating that this type of political connection has little impact on tunneling at local SOEs.

The coefficient of *Official* in Model (7) to Model (9) has mixed signs but none is significant. The coefficient of *CPC/CPPCC* is negative and significant at the 1% level in Model (8), indicating that CPC/CPPCC-type political connection has a significantly negative impact on tunneling at central SOEs. Recall that from Model (6) in Table 6, the coefficient of the overall political connection is negative and significant at the 10% level; while both the coefficients of *Official* and *CPC/CPPCC* are negative but insignificant in Model (6) in Table 7. This suggests that neither official-type nor CPC/CPPCC-type political connection only has a dominant impact on tunneling at central SOEs; both types of political connection contribute to the overall negative impact on tunneling.

Overall, the results in Table 7 provide support to hypotheses H 1.1a and H 1.1b and demonstrate the importance in distinguishing between the two types of political connections.

5.2.3 Effectiveness of laws and regulations on tunneling

As mentioned in Section 3.2, Chinese authorities have introduced some laws and regulations designed to tackle the severe issue of tunneling through fund occupations. To test the effectiveness of these changes, we divide our sample period into sub-period 1(year 2004 to 2006) and sub-period 2 (year 2007 to 2010).[18] We make this division for at least two reasons. (1) On October 19, 2005, the State Council of China issues a "Notice on improving the quality of listed firms" on behalf of the CSRC. CSRC It explicitly demanded that all funds occupied by controlling shareholders must be repaid by the end of 2006. (2) On June 29 2006, the 10th Standing Committee of the National People's Congress passed Amendment Six to the Criminal Law of China. Article 169 of this Amendment states that senior executives and directors of publicly listed firms would be jailed for 3 to 7 years (in addition to fines), if they cause severe loss to the firm by providing company funds to other parties

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[18] In unreported tests, we divide the whole sample period into sub-period (2004 to 2007) and sub-period (2008 to 2010) and obtain similar results to those in Table 8.

under obviously unfair conditions or with the knowledge that these funds will not be repaid. This was an unprecedented move because all previous regulations were issued in the name of CSRC, which had no prosecuting power.

For each sub-period we run a regression for each of the three types of ownership and one regression for all three ownerships combined. In addition, we run a regression for the whole sample by adding a dummy variable *Late* and its interaction terms with political connection and ownership types. The dummy variable *Late* is coded 1if an observation is in the sub-period 2 and zero otherwise. It catches the changes in the impact of political connection and ownership on tunneling from sub-period 1 to sub-period 2. We report the results in Table 8.

< Insert Table 8 about here >

Model (1) and Model (5) show that for private firms, a manager's political connection, as a whole, is not significantly related to tunneling in either sub-period 1 or sub-period 2. A comparison between Model (2) and Model (6) shows that a manager's political connection at local SOEs has significantly positive impact on tunneling in sub-period 1, but the impact becomes insignificant in sub-period 2. In contrast, Model (3) and Model (7) show that a manager's political connection at central SOEs has negative but insignificant impact on tunneling in sub-period 1; but the negative impact becomes significant at the 1% level in sub-period 2. One possible explanation for the weaker positive impact at local SOEs and stronger negative impact at central SOEs is that the relationship between manager turnover (and compensation, political promotion) and firm performance has strengthened at both local and central SOEs, making managers more interested in improving firm performance.

The coefficient of *Central* in Model (4) is negative and significant at the 10% level, indicating that central SOEs have significantly less tunneling than private firms in sub-period 1. But the coefficient of *Central* becomes insignificant in Model (8), indicating that the difference in tunneling between central SOEs and private firms has narrowed substantially, which is consistent with the descriptive statistics in Table 3.

Model (9) of Table 8 is for the full sample (i.e., all firms across three types of ownership in the whole sample period). The coefficient of *Late* is negative and significant at the 1% level, indicating that for the full sample, the level of tunneling has dropped substantially from sub-period 1 to sub-period 2. The coefficient of the interaction term *Political connection*Late* is positive and significant at the 5% level, indicating that the impact of political connection on tunneling is stronger in sub-period 2 than in sub-period 1.The coefficients of both *Local*Late* and *Central *Late* are positive and significant at the 1% level, while both the coefficients of *Local* and *Central* are negative with the latter significant at the 5% level. This indicates that the decline in tunneling (from sub-period 1 to sub-period 2) is less in local and central SOEs than in private firms, although the absolute level of tunneling is still lower than private firms.

Overall, the results in Table 8 demonstrate that while changes in laws and regulations have reduced the severity of tunneling across the market, they are less effective for politically connected firms and SOEs. These results provide strong support for hypothesis 2.

5.2.4 Founder-manager, political connection of founder-manager and tunneling

We next examine the impact of a manager's founder status on tunneling. Based on our analysis in Section 3, a certain relationship exists between the manager's founder status and political connectedness. As a result we also test the interaction between founder-manager and political connection. The regression results are reported in Table 9.

< Insert Table 9 about here >

The coefficient of *Founder manager* is significantly negative in Model (1), Model (3) and Model (5). This indicates that the manager's founder status is negatively related to tunneling for firms across all three types of ownership. The coefficient of *Political connection*Founder manager* in Model (2) is negative and significant at the 5% level, indicating that the political connection of a founder-manager is negatively related to tunneling in private firms. It provides support for hypotheses 3a, 3b, and 3c. It also indirectly supports our expectation that founder-managers in private firms establish political connections to overcome any unfavorable institutional environment, rather than to facilitate tunneling.

Both coefficients of *Founder manager* and *Political connection*Founder manager* are insignificant in Model (4) of Table 9, while the coefficient of *Political connection* is significantly positive. This result indicates that manager's founder status has no significant impact on tunneling in local SOEs, after controlling for his political connection. This is not surprising given that local governments have a substantial influence on the operation of local SOEs and the employment of managers. Therefore, the impact of political connection would dominate the impact of founder status. And as we have already found, political connection is positively related to tunneling at local SOEs. So hypothesis 3d is supported.

The coefficient of *Founder manager* in Model (6) remains negative and becomes more significant than in Model (5). The coefficient of *Political connection*Founder manager* is negative and significant at the 5% level, indicating that the political connection of a founder-manager in central SOEs has strong negative impact on tunneling. This confirms our expectation that a politically connected founder-manager at central SOEs has strong

incentives for restraining from tunneling through fund occupation because if they are caught, it may well jeopardize their political future. So hypothesis 3e is also supported.

5.3 Additional tests

5.3.1 Chairman's political connection vs. CEO's political connection

So far we have not made any distinction between the Chairman and CEO when discussing the impact of manager's political connection and founder status. Existing literature however, has taken different approaches in determining who the top executive in Chinese firms is. Fan, Wong, Zhang (2007) regard the CEO as the top executive in China, whereas Firth, Fung, and Rui (2006) consider the Chairman as the top executive because they are often involved in day-to-day decision making at Chinese firms. Kato and Long (2006) also consider the Chairman as the CEO insofar that the Chairman is paid a salary by the firm.

We therefore examine whether there is any difference between a Chairman's political connection and a CEO's political connection, in terms of their impact on tunneling. The results are reported in Table 10.

<center>< Insert Table 10 about here></center>

Model (1) and Model (2) are regressions for private firms. The coefficient of *Chair political connection* in Model (1) is negative and significant at the 10% level. The coefficient of *CEO political connection* in Model (2) is positive but insignificant. One possible explanation for the difference in impact between the Chairman's and CEO's political

connection is that founders of private firms are more likely to take the position of Chairman and their political connection is negatively related to tunneling in private firms.[19]

The results for local SOEs are reported in Model (3) and Model (4). The coefficient of *Chair political connection* in Model (3) is positive and significant at the 10% level while the coefficient of *CEO political connection* in Model (4) is negative but insignificant. These results are not surprising. The Chairman is the legal representative of a firm and in most cases is directly appointed by the largest shareholder (for local SOEs, they are local governments). Apart from the financial performance of the firm, the Chairman is often responsible for carrying out government policies, maintaining social welfares, and helping out other local SOEs in the same region. As a result, the Chairman's compensation (monetary or political promotion) is often only weakly related to firm performance at SOEs (Zhao, Yang and Bai 2007). The role of CEO, however, is focused more on a firm's financial performance. Compared to the Chairman, the CEO's compensation is more closely related to firm performance (Zhao, Yang and Bai 2007). However, at the same time, CEOs at local SOEs also face pressure from local governments, which may explain the negative but insignificant relationship between CEO's political connection and tunneling.

The negative but insignificant coefficients in Model (5) and Model (6) show that for central SOEs, neither the Chairman's political connection nor the CEO's political connection alone substantially affects tunneling.

5.3.2 Self-selection and reverse causality

We don't believe that being a founder-manager is endogeneous to the level of tunneling, because tunneling does not exist until a firm is founded.

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[19] Indeed, we find that of the 1130 private firms with founder-managers, 1108 founders take the position of Chairman and 502 founders take the position of CEO (some founders take both positions).

We are, however, concerned about the possible endogeneity of the establishment of political connection. For example, those local SOEs with a high level of tunneling may be more likely to appoint politically connected managers. To address this concern, we follow Villalonga and Amit (2006) and run the Heckman's treatment effect regression, using a two-stage procedure.

In the first stage we create a probit model to examine the probability of a firm appointing a political connected manager. The independent variables in the probit model include those variables used in the OLS regressions, as well as two additional variables. We include the *Lagged tunneling* to test the possible reverse causality between political connection and the level of tunneling. We also include *Board size* (measured as the natural log of the total number of board directors) to serve as the instrumental variable. There is no systematic evidence to suggest that board size affects firm behavior or the level of tunneling in China. For our sample the mean of *Board size* is 2.22 for firms with politically connected manager and 2.18 for firms without politically connected manager. This difference is significant at the 1% level, suggesting there may be some relationship between political connection and board size. Therefore, it satisfies the two conditions as an instrumental variable.

In the second stage the dependent variable is the level of tunneling used in the OLS regressions earlier. The estimated probability of political connection generated in the first stage (the "treatment effect" in Villalonga and Amit 2006) is included in the second stage as an independent variable. Heckman's *Lambda* is also included. The results of the second-stage regressions are reported in Table 11. We also report in Table 11 the coefficient of *Lagged tunneling* from the first-stage regression.

< Insert Table 11 about here>

The coefficient of *Lambda* is significant in all three regressions, suggesting that there is sample selection bias in the OLS regression. The coefficient of *Lagged tunneling* is not significant in any of the three models, indicating that reverse causality is not an issue in this study. The coefficients of the *Treatment effect* (corrected for selection bias) have the same sign as in the OLS regression, but the significance becomes stronger. Therefore, our previous results remain.

6 Conclusion

In this study we investigate the impact of manager's political connection and founder status on a firm's tunneling practice in China from 2004 to 2010. We find that such impacts are subject to the ownership identity of the largest ultimate shareholder of the firm and whether the largest shareholder has effective control. Specifically, managers' political connections encourage tunneling at local SOEs firms that the state ownerships are not large enough for effective control, while managers' political connections mitigate tunneling at central SOEs firms, but have insufficient impact on tunneling at private firms.

Firms with funder-managers are reluctant to take tunneling, which can be observed across all types of ownership firms. In particular, when the political connected managers are also firms' founders, the negative impact on tunneling is stronger at central SOEs firms and still significant private firms, but becomes insignificant at local SOEs firms due to effect from the political connections.

We also find that there exist distinct differences between official-type and CPC/CPPCC-type political connection in terms of their impacts on tunneling. The overall negative impact at private firms are totally driven by managers' CPC/CPPCC-type political connection, as managers' official-type political connection is found to be positively related to

tunneling at private firms. For local SOEs, managers' official-type political connection has the dominant positive impact on tunneling. For central SOEs, both types of political connections contribute to the overall negative impact on tunneling; buy neither type alone is significant.

We also find that changes to laws and regulations have reduced the extreme market-wide tunneling by firm insiders. However, the effectiveness of those changes varies across firms. They are least effective for firms with politically connected managers and firms with governments as the largest ultimate shareholders.

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Table 1 Definition of variables

Variable	Description
Tunneling	The ratio of "other receivables" by the largest shareholder and other insiders to the total assets of the firm
Political connection	A dummy variable that equals one if either (or both) the Chairman or the CEO is a current or former government official, military officer or member of the People's Congress or the People's Political Consultative Conference; zero otherwise
Founder manager	A dummy variable that equals one if a manager is a founder or a main executive when the firm was first incorporated (including when spun-off); zero otherwise
Excess control rights	The divergence between the largest ultimate shareholder's control rights and cash flow rights
Board independence	The percentage of board members who are independent
Firm size	The natural log of total assets of the firm
Sales growth	The percentage change of the firm's total sales over the previous period
Leverage	The firm's financial leverage, calculated as total debts divided by total assets
Effective control	A dummy variable that equals one if the largest ultimate shareholder has at least 20% of control rights of the firm; zero otherwise
Private	A dummy variable that equals one if the largest ultimate shareholder of the firm is a natural person or a private company; zero otherwise
Local	A dummy variable that equals one if the largest ultimate shareholder of the firm is a local government agency or a company controlled by a local government; zero otherwise
Central	A dummy variable that equals one if the largest ultimate shareholder of the firm is a central government agency or a company controlled by the central government; zero otherwise

Table 2 Descriptive statistics of manager's political connection and founder status

This table presents the descriptive statistics of manager's political connection and founder status across ownerships. Panel A reports sample breakdown across years and Panel B reports sample breakdown across industries. *Political connection* and *founder-manager* are defined in Table 1. *Frequency* is calculated by dividing the number of firms with politically connection or founder–manager over the total number of firms in that category. For example, there are 339 private firms in 2004 with 119 of them politically connected, therefore, the frequency of political connection is 119/339=35.10%. The same method applies to Panel A and Panel B.

Panel A: Sample breakdown across years

Year	Private Firms			Local SOEs			Central SOEs			Full Sample		
	# of firms	Politically connected (frequency)	Founder-manager (frequency)	# of firms	Politically connected (frequency)	Founder-manager (frequency)	# of firms	Politically connected (frequency)	Founder-manager (frequency)	# of firms	Politically connected (frequency)	Founder-manager (frequency)
2004	339	119 (35.10%)	84 (24.78%)	643	254 (39.50%)	106 (16.49%)	199	52 (26.13%)	27 (13.57%)	1181	425 (35.99%)	217 (18.37%)
2005	400	140 (35.00%)	113 (28.25%)	658	256 (38.91%)	111 (16.87%)	220	54 (24.55%)	32 (14.55%)	1278	450 (35.21%)	256 (20.03%)
2006	429	152 (35.43%)	121 (28.21%)	618	241 (39.00%)	99 (16.02%)	232	55 (23.71%)	32 (13.79%)	1279	448 (35.03%)	252 (19.70%)
2007	474	172 (36.29%)	141 (29.75%)	614	244 (39.74%)	99 (16.12%)	235	61 (25.96%)	31 (13.19%)	1323	477 (36.05%)	271 (20.48%)
2008	538	192 (35.69%)	193 (35.87%)	627	252 (40.19%)	97 (15.47%)	257	67 (26.07%)	34 (13.23%)	1422	511 (35.94%)	324 (22.78%)
2009	596	228 (38.26%)	225 (37.75%)	618	241 (39.00%)	88 (14.24%)	268	69 (25.75%)	32 (11.94%)	1482	538 (36.30%)	345 (23.28%)
2010	640	244 (38.13%)	253 (39.53%)	616	236 (38.31%)	76 (12.34%)	278	62 (22.30%)	29 (10.43%)	1534	542 (35.33%)	358 (23.34%)
Total	3416	1247 (36.50%)	1130 (33.08%)	4394	1724 (39.24%)	676 (15.38%)	1689	420 (24.87%)	217 (12.85%)	9499	3391 (35.70%)	2023 (21.30%)

Panel B: Sample breakdown across industries

Industry	Private			Local SOEs			Central SOEs			Full sample		
	# of firms	Politically Connected (frequency)	Founder manager (frequency)	# of firms	Politically connected (frequency)	Founder manager (frequency)	# of firms	Politically connected (frequency)	Founder manager (frequency)	# of firms	Politically connected (frequency)	Founder manager (frequency)
Agricultural, forestry, livestock & fishery (A)	90	38 (42.22%)	36 (40.00%)	97	48 (49.48%)	36 (37.11%)	27	13 (48.15%)	6 (22.22%)	214	99 (46.26%)	78 (36.45%)
Mining (B)	24	4 (16.67%)	2 (8.33%)	119	36 (30.25%)	32 (26.89%)	54	10 (18.52%)	8 (14.81%)	197	50 (25.38%)	42 (21.32%)
Manufacturing (C)	2025	803 (39.65%)	778 (38.42%)	2424	804 (33.17%)	394 (16.25%)	891	181 (20.31%)	99 (11.11%)	5340	1788 (33.48%)	1271 (23.80%)
Power, gas and water production and supply (D)	34	11 (32.35%)	7 (20.59%)	272	126 (46.32%)	22 (8.09%)	120	47 (39.17%)	19 (15.83%)	426	184 (43.19%)	48 (11.27%)
Construction (E)	64	26 (40.63%)	35 (54.69%)	83	19 (22.89%)	15 (18.07%)	49	8 (16.33%)	3 (6.12%)	196	53 (27.04%)	53 (27.04%)
Transport and storage (F)	34	22 (64.71%)	10 (29.41%)	244	139 (56.97%)	39 (15.98%)	64	24 (37.50%)	8 (12.50%)	342	185 (54.09%)	57 (16.67%)
Information Technology (G)	284	61 (21.48%)	129 (45.42%)	123	33 (26.83%)	8 (6.50%)	179	45 (25.14%)	42 (23.46%)	586	139 (23.72%)	179 (30.55%)
Wholesale and retail trade (H)	212	89 (41.98%)	27 (12.74%)	356	202 (56.74%)	53 (14.89%)	87	31 (35.63%)	7 (8.05%)	655	322 (49.16%)	87 (13.28%)
Real estate (J)	324	122 (37.65%)	34 (10.49%)	300	139 (46.33%)	16 (5.33%)	62	11 (17.74%)	7 (11.29%)	686	272 (39.65%)	57 (8.31%)
Social service (K)	97	24 (24.74%)	32 (32.99%)	138	79 (57.25%)	28 (20.29%)	57	18 (31.58%)	18 (31.58%)	292	121 (41.44%)	78 (26.71%)
Communication & cultural industry (L)	13	0 (0.00%)	5 (38.46%)	36	19 (52.78%)	0 (0.00%)	25	9 (36.00%)	0 (0.00%)	74	28 (37.84%)	5 (6.76%)
Comprehensive (M)	215	47 (21.86%)	35 (16.28%)	202	80 (39.60%)	33 (16.34%)	74	23 (31.08%)	0 (0.00%)	491	150 (30.55%)	68 (13.85%)
Total	3416	1247 (36.50%)	1130 (33.08%)	4394	1724 (39.24%)	676 (15.38%)	1689	420 (24.87%)	217 (12.85%)	9499	3391 (35.70%)	2023 (21.30%)

Table 3 Descriptive statistics of tunneling

This table presents the descriptive statistics of tunneling across ownerships. *Tunneling* is defined in Table 1. *Frequency (freq.)* is calculated by dividing the number of tunneling observations over the total number of firms in that group. For example, in 2004, there are 144 private firms that report tunneling and the total number of private firms in that year is 339 (see Table 2), therefore, the frequency of tunneling is 144/339=42.48%.

Year	Private firms				Local SOEs				Central SOEs				Full sample			
	No. (freq.)	Mean (%)	Median (%)	Std. Dev. (%)	No. (freq.)	Mean (%)	Median (%)	Std. Dev. (%)	No. (freq.)	Mean (%)	Median (%)	Std. Dev. (%)	No. (freq.)	Mean (%)	Median (%)	Std. Dev. (%)
2004	144 (42.48%)	5.30	0.56	9.71	300 (46.66%)	3.78	0.51	7.55	93 (46.73%)	2.58	0.18	6.30	537 (45.47%)	3.98	0.40	8.04
2005	261 (65.25%)	6.32	0.72	11.16	463 (70.36%)	5.47	0.73	10.15	175 (79.55%)	3.33	0.62	6.37	899 (70.34%)	5.30	0.71	9.90
2006	107 (24.94%)	4.46	0.34	10.17	179 (28.96%)	1.67	0.09	5.00	83 (35.78%)	1.89	0.07	6.34	369 (28.85%)	2.53	0.11	7.24
2007	107 (22.57%)	2.57	0.09	6.91	161 (26.22%)	1.79	0.06	6.37	86 (36.60%)	1.20	0.03	5.08	354 (26.76%)	1.88	0.06	6.26
2008	85 (15.80%)	1.36	0.04	4.54	171 (27.27%)	1.50	0.06	5.69	91 (35.41%)	0.67	0.06	2.46	347 (24.40%)	1.25	0.06	4.75
2009	101 (16.95%)	1.35	0.02	5.48	144 (23.30%)	0.77	0.02	3.46	106 (39.55%)	0.39	0.03	1.30	351 (23.68%)	0.82	0.02	3.75
2010	110 (17.19%)	0.42	0.01	1.93	163 (26.46%)	0.28	0.02	0.85	96 (34.53%)	0.39	0.03	1.16	369 (24.05%)	0.35	0.02	1.33
Total	915 (26.79%)	3.79	0.14	8.85	1581 (35.98%)	2.95	0.14	7.50	730 (43.22%)	1.67	0.10	4.98	3226 (33.96%)	2.90	0.13	7.48

Table 4 Mean comparison of variables based on manager's political connection and founder status

This table presents the statistics for variables across ownerships. Also reported are difference tests results for variables between firms with / without politically connected manager and with / without founder-manager. The variables are defined in Table 1. *, ** and *** indicate significance at the 10%, 5% and 1% levels, respectively.

	Private firms						Local SOEs					
	Politically connected	Non-connected	Difference	Founder manager	Non-founder manager	Difference	Politically connected	Non-connected	Difference	Founder manager	Non-founder manager	Difference
Tunneling	.695	1.198	-.503***	.366	1.336	-.970***	1.294	0.943	.351**	.654	1.137	-.483***
Political Connection				.512	.293	.219***				.499	.373	.126***
Founder-manager	.464	.254	.210***				.195	.127	.068***			
Excess control rights (%)	8.635	9.204	-.569*	7.526	9.723	-2.197***	2.667	3.969	-1.302***	2.451	3.642	-1.191***
Board Independence (%)	36.300	36.280	.020	36.341	36.261	.080	35.414	35.222	.192	35.308	35.295	.013
Firm Size	21.325	20.788	.537***	21.316	20.820	.496***	21.691	21.555	.136***	21.690	21.594	.096**
Sales Growth (%)	27.014	23.793	3.221	23.697	25.599	-1.902***	23.249	22.828	.421	21.263	23.308	-2.045
Leverage	.520	1.024	-.504***	.446	1.034	-.588***	.547	.549	-.002	.511	.555	-.044***

	Central SOEs						Full sample					
	Politically connected	Non-connected	Difference	Founder manager	Non-founder manager	Difference	Politically connected	Non-connected	Difference	Founder manager	Non-founder manager	Difference
Tunneling	.514	.793	-.279	.322	.783	-.461**	.852	1.059	-.207**	.457	1.128	-.671***
Political Connection				.323	.238	.085**				.487	.322	.165***
Founder-manager	.167	.116	.051**				.290	.170	.120***			
Excess control rights (%)	4.289	5.557	-1.268***	5.617	5.186	.431	5.063	6.158	-1.095***	5.625	5.805	-.180
Board Independence (%)	34.736	35.498	-.762***	35.092	35.340	-.248	35.656	35.655	.001	35.862	35.599	.263**
Firm Size	21.945	21.645	.300***	21.954	21.685	.269***	21.588	21.302	.286***	21.509	21.375	.134***
Sales Growth (%)	23.879	23.957	.078	27.457	23.419	4.038	24.712	23.405	1.307	23.287	24.030	-.743
Leverage	.500	.526	-.026*	.465	.528	-.063***	.531	.713	-.182***	.470	.696	-.226***

Table 5 Pearson correlation matrix of variables

This table reports the Pearson pair-wise correlations for the main variables. The variables are defined in Table 1. *P*-values are presented in parentheses. *, ** and *** indicate significance at the 10%, 5% and 1% levels, respectively.

	Political connection	Founder manager	Excess control rights	Board independence	Firm size	Sales growth	Leverage
Political connection	1.000						
Founder manager	.141*** (0.000)	1.000					
Excess control rights	-.064*** (0.000)	-.009 (0.380)	1.000				
Board independence	-.002 (0.871)	.025** (0.015)	-.022** (0.036)	1.000			
Firm size	.117*** (0.000)	.047*** (0.000)	-.018* (0.082)	.010 (0.336)	1.000		
Sales growth	.010 (0.341)	-.005 (0.644)	.007 (0.487)	.019* (0.059)	.097*** (0.000)	1.000	
leverage	-.034*** (0.001)	-.036*** (0.001)	.011 (0.291)	.038*** (0.000)	-.189*** (0.000)	-.031*** (0.003)	1.000

Table 6 Impact of manager's political connection on tunneling

This table reports the OLS regression results examining the impacts of political connection on tunneling. The dependent variable is *Tunneling*, measured by fund occupations by the largest shareholder and other insiders. All other variables are defined in Table 1. Standard errors are corrected for heteroskedasticity using White (1980). *P*-values are reported in parentheses. *, ** and *** indicate significance at the 10%, 5% and 1% levels, respectively. The constant term, year dummies and industry dummies are included in all regressions but not reported.

	Private firms			Local SOEs			Central SOEs		
Dependent variable: Tunneling	Model 1	Model 2	Model 3	Model 4	Model 5	Model 6	Model 7	Model 8	Model 9
	No effective control	Effective control	All private firms	No effective control	Effective control	All local SOEs	No effective control	Effective control	All central SOEs
Political connection	-.649 (0.166)	-.171 (0.245)	-.200 (0.684)	.874** (0.020)	.032 (0.838)	1.162*** (0.009)	-.349* (0.051)	-.131 (0.440)	-.401** (0.046)
Effective control dummy			-.647* (0.052)			.525*** (0.000)			.152 (0.338)
Political connection* Effective control dummy			.089 (0.862)			-1.125** (0.015)			.292 (0.279)
Excess control rights	-.108 (0.831)	.020** (0.020)	.012 (0.141)	.029 (0.752)	.016** (0.035)	.015** (0.048)	.011 (0.627)	.013* (0.069)	.014* (0.054)
Board independence	-.170*** (0.006)	-.011 (0.502)	-.038* (0.051)	-.011 (0.648)	-.002 (0.896)	-.003 (0.817)	-.003 (0.805)	-.031** (0.012)	-.029*** (0.010)
Firm size	-.955*** (0.000)	-.239*** (0.002)	-.420*** (0.000)	-.535*** (0.001)	-.335*** (0.000)	-.353*** (0.000)	-.224*** (0.000)	-.130* (0.076)	-.203*** (0.005)
Sales growth	.000 (0.976)	-.003*** (0.008)	-.002 (0.147)	.002 (0.671)	-.006*** (0.000)	-.005*** (0.000)	-.002 (0.473)	-.001 (0.175)	-.001 (0.193)
Leverage	-.028 (0.475)	.038 (0.409)	.026 (0.466)	3.932** (0.040)	1.195* (0.055)	1.403** (0.031)	2.888*** (0.000)	1.045** (0.012)	2.215*** (0.000)
Year and industry dummies	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Obs.	629	2783	3412	405	3989	4394	144	1544	1688
R-squared	0.168	0.113	0.098	0.265	0.108	0.112	0.924	0.086	0.125

Table 7 Different impacts of two types of political connections on tunneling

This table reports the OLS regression results examining the differences between two types of political connection, namely political connection resulted from managers' current or former government official status and political connection resulted from managers' CPC / CPPCC status, in terms of their impacts on tunneling. The dependent variable is *Tunneling*, measured by fund occupations by the largest shareholder and other insiders. *Official* is a dummy variable that equals 1 if a manager is a current or former government official or military officer, and zero otherwise. *CPC/CPPCC* is a dummy variable that equals 1 if a manager is a current or former member of Chinese People's Congress (CPC) or Chinese People's Political Consultative Conference (CPPCC), and zero otherwise. All other variables are defined in Table 1. Standard errors are corrected for heteroskedasticity using White (1980). *P*-values are reported in parentheses. *, ** and *** indicate significance at the 10%, 5% and 1% levels, respectively. The constant term, year dummies, industry dummies and other control variables are included in all regressions, but their coefficients are not reported for brevity.

Dependent variable: Tunneling	Private firms			Local SOEs			Central SOEs		
	Model 1	Model 2	Model 3	Model 4	Model 5	Model 6	Model 7	Model 8	Model 9
	No effective control	Effective control	All private firms	No effective control	Effective control	All local SOEs	No effective control	Effective control	All central SOEs
Official	.126 (0.863)	.234 (0.457)	.719 (0.360)	1.009** (0.015)	.219 (0.231)	1.381** (0.020)	-.200 (0.311)	.051 (0.803)	-.205 (0.374)
CPC / CPPCC	-.980* (0.057)	-.291** (0.032)	-.917** (0.027)	.395 (0.489)	-.228 (0.357)	.468 (0.430)	-.291 (0.161)	-.650*** (0.000)	-.699** (0.023)
Effective control dummy			-.658** (0.043)			.442*** (0.003)			.153 (0.332)
Official*Effective control			-.512 (0.537)			-1.153* (0.060)			.272 (0.374)
CPC/CPPCC*Effective control			.709 (0.106)			-.700 (0.274)			.071 (0.828)
Other control variables	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Year and industry dummies	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Obs.	629	2783	3412	405	3989	4394	144	1544	1688
R-squared	0.174	0.114	0.100	0.265	0.108	0.113	0.923	0.087	0.127

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Table 8 Sub-period analysis of the effectiveness of law and regulation changes

This table reports the OLS regression results examining how effective related law and regulation changes in reducing tunneling. The whole sample period is divided into two sub-periods: 2004 to 2006 and 2007 to 2010. The dependent variable is *Tunneling*, measured by fund occupations by the largest shareholder and other insiders. *Late* is a dummy variable that equals 1 if an observation falls in between year 2007 and 2010; and 0 otherwise. All other variables are defined in Table 1. Standard errors are corrected for heteroskedasticity using White (1980). *P*-values are reported in parentheses. *, ** and *** indicate significance at the 10%, 5% and 1% levels, respectively. The constant term, year dummies and industry dummies are included in all regressions but not reported. For brevity, only coefficients of political connection dummy, ownership dummy, sub-period dummy and their interaction terms are reported.

Dependent variable: Tunneling	Sub-period 1 (year 2004-06)				Sub-period 2 (year 2007-10)				Full sample
	Model 1	Model 2	Model 3	Model 4	Model 5	Model 6	Model 7	Model 8	Model 9
	Private firms	Local SOEs	Central SOEs	Whole sub-group	Private firms	Local SOEs	Central SOEs	Whole sub-group	All firms
Political connection	-.575 (0.625)	2.470** (0.047)	-.595 (0.121)	.112 (0.894)	.082 (0.845)	.216 (0.113)	-.386*** (0.008)	.010 (0.918)	-.882** (0.032)
Local				-.336 (0.316)				.129 (0.223)	-.552 (0.106)
Central				-.668* (0.065)				.014 (0.879)	-.934** (0.012)
Political connection*Local				.912* (0.069)				-.104 (0.453)	1.122** (0.029)
Political connection*Central				.255 (0.634)				.033 (0.861)	.379 (0.488)
Late									-2.463*** (0.000)
Political connection*Late									1.025** (0.016)
Local*Late									.969*** (0.006)
Central*Late									1.258*** (0.001)
Other control variables	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Year and industry dummies	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Industry only
Obs.	1166	1919	650	3735	2246	2475	1038	5759	9494
R-squared	0.123	0.113	0.152	0.100	0.024	0.050	0.018	0.019	0.063

Table 9 Impact of founder-manager and political connection of founder-manager on tunneling

This table reports the OLS regression results examining the impacts of founder-manager and political connection of founder-manager on tunneling. The dependent variable is *Tunneling*, measured by fund occupations by the largest shareholder and other insiders. All other variables are defined in Table 1. Standard errors are corrected for heteroskedasticity using White (1980). *P*-values are reported in parentheses. *, ** and *** indicate significance at the 10%, 5% and 1% levels, respectively. The constant term, year dummies and industry dummies are included in all regressions but not reported.

Dependent variable: Tunneling	Private firms		Local SOEs		Central SOEs	
	Model 1	Model 2	Model 3	Model 4	Model 5	Model 6
Political connection		.133		.900*		-.692***
		(0.759)		(0.064)		(0.002)
Founder manager	-.665***	-.922***	-.471***	-.327	-.318*	-.574***
	(0.000)	(0.000)	(0.002)	(0.165)	(0.062)	(0.000)
Political connection*Founder manager		-.657**		-.401		-.917**
		(0.019)		(0.230)		(0.035)
Excess control rights	.002	.004	.017**	.015*	.012*	.013*
	(0.812)	(0.673)	(0.028)	(0.051)	(0.080)	(0.074)
Board independence	-.037*	-.037*	-.001	-.003	-.029***	-.030***
	(0.060)	(0.063)	(0.947)	(0.813)	(0.010)	(0.008)
Firm size	-.370***	-.373***	-.341***	-.340***	-.200***	-.189***
	(0.000)	(0.000)	(0.000)	(0.000)	(0.006)	(0.010)
Sales growth	-.002	-.002	-.005***	-.005***	-.001	-.001
	(0.105)	(0.116)	(0.000)	(0.000)	(0.206)	(0.219)
Leverage	.027	.025	1.417**	1.405**	2.187***	2.191***
	(0.442)	(0.468)	(0.031)	(0.031)	(0.000)	(0.000)
Year and industry dummies	Yes	Yes	Yes	Yes	Yes	Yes
Obs.	3412	3412	4394	4394	1689	1689
R-squared	0.099	0.101	0.112	0.113	0.125	0.127

Table 10 Difference between Chairman's and CEO's political connection

This table reports the OLS regression results examining the difference between Chairman's political connection and CEO's political connection. The dependent variable is *Tunneling*, measured by fund occupations by the largest shareholder and other insiders. All other variables are defined in Table 1. Standard errors are corrected for heteroskedasticity using White (1980). *P*-values are reported in parentheses. *, ** and *** indicate significance at the 10%, 5% and 1% levels, respectively. The constant term, year dummies and industry dummies are included in all regressions but not reported. For brevity, only coefficients of Chairman's and CEO's political connection and their interaction with ownerships are reported.

Tunneling	Model 1 Private firms	Model 2 Private firms	Model 3 Local SOEs	Model 4 Local SOEs	Model 5 Central SOEs	Model 6 Central SOEs	Model 7 Full sample	Model 8 Full sample
Chair political connection	-.700* (0.090)		.836* (0.056)		-.336 (0.123)		-.246* (0.097)	
CEO political connection		.422 (0.520)		-.236 (0.177)		-.273 (0.398)		-.115 (0.551)
Chair political connection*Local							.388* (0.062)	
Chair political connection*Central							.220 (0.362)	
CEO political connection*Local								-.222 (0.392)
CEO political connection*Central								.254 (0.424)
Other control variables	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Year and industry dummies	Yes	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Obs.	3412	3412	4394	4394	1688	1688	9494	9494
R-squared	0.099	0.099	0.112	0.111	0.125	0.125	0.089	0.089

Table 11 Heckman treatment - effects models

This table reports the results examining the impacts of political connection on tunneling, corrected for selection bias and potential reverse causality using Heckman treatment effect models. The dependent variable is *Tunneling*, measured by fund occupations by the largest shareholder and other insiders. All other variables are defined in Table 1. *P*-values are reported in parentheses. *, ** and *** indicate significance at the 10%, 5% and 1% levels, respectively.

Dependent variable: Tunneling	Model 1	Model 2	Model 3
	Private firms	Local SOEs	Central SOEs
Treatment effect	-39.393***	13.920***	-24.123***
	(0.000)	(0.001)	(0.000)
Lambda	-19.449***	-12.268*	-22.848***
	(0.001)	(0.065)	(0.000)
Excess control rights	.307***	.067***	.037***
	(0.000)	(0.000)	(0.008)
Board independence	.019	-.029*	.116***
	(0.267)	(0.055)	(0.006)
Firm size	7.508***	-.711***	-1.022***
	(0.000)	(0.000)	(0.000)
Sales growth	-.004**	-.004***	-.000
	(0.014)	(0.000)	(0.620)
Leverage	-2.186***	1.022*	3.925***
	(0.000)	(0.094)	(0.000)
Year and industry dummies	Yes	Yes	Yes
Obs.	2792	3658	1436
R-squared	0.172	0.139	0.165
Lagged tunneling (from stage-one)	-.005	.005	.006
	(0.378)	(0.251)	(0.525)