Political Connection as an Investor Endorsement Device

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Abstract

Due to its value to private firms, a firm's political connection (PC) enhances the alignment of external investors with insiders, thereby mitigating the adverse impact of market frictions on corporate financing and investment. This has important implications on corporate policies and governance. Using various identification strategies, we show that PC firms are more likely to issue equity and invest more, while paying out less in dividends. The market responds more positively to news of equity issuance and investment, but less so to news of dividend payouts by PC firms. Moreover, external investors vote more favorably on managerial proposals in PC firms' annual meetings. And analysts are more optimistic in their forecasts of earnings by PC firms. The evidence is consistent with PC as an investor endorsement device, which in turn incentivizes unconnected firms to proactively seek PC.

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1. Introduction

Corporate finance theories suggest, supported by rich empirical evidence, that in a world with market frictions, external financing is costly and even inaccessible. As a result, firms often have to give up positive NPV projects and tend to underinvest. Firms thus strive through various channels to cope with the impact of market frictions, including information disclosure, credible signaling, and third-party certification, etc. [2] Regulators also mandate the standards of corporate governance (e.g., the independence of the board and its key committees) and information disclosure to enhance corporate transparency.

In this paper, we explore a firm's political capital, manifested in the form of corporate political connection ("PC" hereinafter), as an economic mechanism that is instrumental in moderating the adverse impact of market frictions. In particular, we examine how PC affects firms' equity financing, investment, and governance, and how external equity investors evaluate managerial decisions in PC firms. The bulk of the extant PC literature has focused on the connected firms' advantage in securing various resources and preferential treatments, but surprisingly less attention has been paid to the implications of external investors' view of PC for corporate policies and governance.[3]

We hypothesize that PC, due to its value for privately owned firms in economies with prevalent government involvement in economic activities, serves to increase the alignment of external investors with insiders and hence enhances investor endorsement of managerial decisions. This role of PC as an endorsement device, in turn, incentivizes unconnected firms to proactively seek PC, especially for those who are more subject to the adverse impact of market frictions in corporate financing.

Our analysis builds on the prior literature that although PC is not costless to external investors, the net effect of PC is positive to private firms in institutional domains where the government restricts

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[2] Numerous studies have shown that firms increase disclosure to mitigate information asymmetry between insiders and investors; they also send costly signals or make credible commitments to investors. For example, firms can increase cash payout, provide high-quality earnings guidance, facilitate effective communication with large institutional investors and financial analysts, obtain certification from reputable financial intermediaries, and employ reputable auditing services.
[3] There are a few notable exceptions, e.g., Berkman, Cole, and Fu (2010) and Chaney, Faccio, and Parsley (2011). We will provide a more detailed discussion in Section 2.

economic activity.[4] In particular, the literature shows that connected firms enjoy advantages in access to government-controlled resources, low-cost bank loans, government-sponsored bailouts, government investment/procurement contracts, as well as preferential treatment in regulated entry, subsidies, and taxes.[5] These advantages, despite probably socially inefficient, increase shareholder value in PC firms, which helps align the interest and view of external investors with insiders on their decision making.

This investor endorsement hypothesis has important implications on corporate financing, investment, and governance. The intuition is simple. Consider a situation in which a firm demands external financing to invest in projects that it believes to have positive NPVs. With the conventional market frictions, external financing might be either too costly or simply unavailable due to information asymmetry, agency concerns, and/or disagreement between external investors and insiders arising from their heterogeneous prior beliefs about the projects' value. The projects may thus have to be abandoned. However, PC firms have better access to valuable projects that are not available to unconnected ("NPC" hereinafter) firms, and even mediocral projects can succeed with political support. External investors may thus be less concerned of information asymmetry on the quality of projects (Myers and Majluf, 1984). Likewise, external investors are also likely to downplay or even ignore their own priors about the payoff of the projects, so that the level of investor-insider agreement (Dittmar and Thakor, 2007) tends to be higher in PC firms.

On the other hand, poor accounting quality, governance, and information environment in PC firms documented in the literature (e.g., Berkman, Cole and Fu, 2010; Chen, Ding, and Kim, 2010; Chaney, Faccio and Parsley, 2011) can aggravate the agency concerns (Jensen and Meckling, 1976). Minority investors might thus be exposed to a higher risk of expropriation by insiders in PC firms. However, it is not clear that these investors bear a net loss.[6] Indeed, Chaney, Faccio, and Parsley (2011) suggest that PC firms afford a poorer disclosure quality because of a lesser need to respond to market

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[4] This is evident by the widely-documented positive market responses to news of a firm getting politically connected. See, for example, Fisman (2001), Johnson and Mitton (2003), Faccio (2006), Claessens et al. (2008), Li, Meng, Wang, and Zhou (2008), Goldman, Rocholl, and So (2009), Calomiris, Fisman, and Wang (2010), Nee and Opper (2010), and Wu, Wu, and Rui (2012).

[5] A more detailed literature review is in Section 2.

[6] For instance, Wang (2015) finds that although there are more related-party transactions with controlling shareholders in PC firms, PC firms outperform their NPC counterparts due to their access to key resources.

pressure. In particular, they show that poorer disclosure quality is associated with a higher cost of debt *only* for NPC firms. From external investors' point of view, the net benefit of PC suggests that they can benefit from a larger pie (even probably with a smaller share due to expropriations). To summarize, the net value of PC enhances investors' confidence and results in strong investor endorsement for managerial decisions in PC firms, thereby attenuating the adverse impact of the conventional market frictions.

The above analysis yields several testable predictions. First, because PC firms are less subject to the adverse impact of information asymmetry and are likely to have a higher level of investor-insider agreement, the cost of equity is lower for PC firms and thus they are more likely to issue equity. Second, PC firms invest more than NPC firms. Third, PC firms pay out less than NPC firms, because on the one hand, PC firms have more investment opportunities (due to their better access to positive NPV projects) and on the other hand, dividends are less needed as a credible signal to mitigate the impact of information asymmetry (Gan, Lemmon, and Wang, 2014). Fourth, the market responds more positively to PC firms' investment and equity financing decisions. And consistent with investors' preference for PC firms to retain earnings to invest more, the market responds less positively to dividend payouts by PC firms. Also, external investors are more likely to approve managerial proposals by PC firms. Lastly, given the role of PC as an investor endorsement device, NPC firms that are beleaguered more by the adverse impact of market frictions are more likely to proactively seek PC, e.g., through the hiring of a connected CEO.

We test these predictions using a sample of 1,252 publicly listed non-state-owned firms (non-SOEs) from 2002 to 2016 in China, the largest emerging economy where the government impact prevails in economic activities. A total of 42% of the sample firms are politically connected. Consistent with our hypothesis, we find strong support for all of the above predictions. Moreover, as further evidence in support, we find that the effect of PC on equity issuance, investment, and dividends is more pronounced in industries or geographic regions with a greater extent of government interventions.

There are several non-mutually exclusive alternative explanations for our findings on the positive (negative) effect of PC on equity issuance and investment (dividends). The stock market in China is heavily regulated and corporate stock issuance requires the preapproval from the regulator. Thus the positive effect of PC on equity issuance might be due to PC firms' advantage in obtaining the approval of issuance (the "regulation" view).[7] Also, capable private entrepreneurs with a good track record of outstanding firm performance are often invited to participate in politics (Feng, Johansson, and Zhang, 2014 and 2015). It is thus likely the capability of PC management that explains more investment by PC firms (the "capability" view). Further, because PC helps to insulate management from the governance pressure from external investors, PC firms may pay less dividends to divert firms' free cash flows for private benefits of management/controlling shareholders (the "agency conflict" view).

We show that our findings are more consistent with the investor endorsement hypothesis than the alternative explanations. Specifically, the regulation view suggests that the market may respond either indifferently (because it shall be well expected given PC is common knowledge), or even more *negatively* to the news of equity issuance by PC firms because they are better able to get their issuances of overvalued stock (that time the market) to be approved by the regulator. This is inconsistent with our finding of the more positive market reactions to PC firms' equity issuance as suggested by our investor endorsement hypothesis. Also, the regulation view is inconsistent with our finding that the impact of PC on equity issuance is more pronounced in industries and regions with intensive government interventions. This is because the advantage of PC in winning the regulator's preapproval for equity issuance should not depend on the conditions of industries/regions. Likewise, our finding that the impact of PC on firm investment is sensitive to the extent of government interventions in different industries/regions invalidates the capability view, because capable management shall invest in industries/regions with investment opportunities regardless of the extent of government interventions.

Under the agency conflict view, the market shall respond more *positively* to the news of dividend payments by PC firms. This is suggested by the signaling story of dividends, in which

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[7] Liu, Tang, and Tian (2013) show that executives' political connections increase the chance of IPO approval of entrepreneurial firms.

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dividends are used to build the reputation of not expropriating minority shareholders (Gan, Lemmon, and Wang, 2011). However, the less positive market reactions to dividend payouts by PC firms are more consistent with our investor endorsement hypothesis than the agency conflict view.

Lastly, a firm's PC is not exogenous. Indeed, as suggested by our hypothesis, NPC firms may proactively seek connections when they are more beleaguered by the adverse impact of market frictions. Also, an unconnected CEO may be invited to participate in politics when the firm is expected to make substantial contributions to the local economy. Such a firm also tends to raise more external financing, invest more, and retain more earnings (paying out less). As such, there arises the reverse causality concern on the effect of PC. To address this, we repeat our main tests focusing on a group of firms that are born to be politically connected, i.e., the founding Chairman/CEO of a firm acquired the PC status before the firm was founded. This ensures that PC is not caused by corporate decisions, negating the reverse causality possibility. With this group of firms, we continue to find that the impact of PC holds as predicted by our hypothesis.

Alternatively, both corporate policies and PC can be affected by some unobserved factor and hence our estimate of the impact of PC can be biased by this omitted variable. To address this, we rely on a policy shock that lowers the value of PC, the anti-corruption campaign launched by the Chinese central government at the end of 2012. The campaign has been shown to be effective in cutting off corruptions and reducing government interventions, and as a result, the value of PC to firms is moderated after the campaign. To the extent that this policy shock affects corporate policies only through its impact on the value of PC, it serves as a quasi-natural experiment for us to examine the change in the effect of PC around the campaign.[8] Indeed, consistent with the role of PC as an investor endorsement device being weakened following the campaign, we find that the impact of PC on these aforementioned corporate policies and governance is mitigated and so are the market responses to them.

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[8] One might be concerned that the campaign has unintended economic consequences that vary across industries. For instance, sectors of luxurious goods/services are found to have experienced a more negative impact from the policy because of the significant drop in demand resulting from the clampdown of corruptions. But with the industry fixed effects applied in our estimation, we focus on within-industry differences in the impact of this policy shock between PC and NPC firms. Therefore, the varying impact of the policy on different industries is unlikely to bias our estimation.

Overall, we show that neither the reverse causality concern nor the omitted variable bias is likely to be seriously affecting our findings, and the documented impact of PC is causal.

Our study makes several contributions to the literature. First, it highlights the role of PC as an investor endorsement device in facilitating firms' access to the public equity market. We show that the market reacts more positively to equity financing and investment decisions in PC firms. Calomiris, Fisman, and Wang (2010) document a negative announcement effect of the sale of government ownership and a symmetric positive effect at the policy's cancellation, suggesting that the benefits of political ties are perceived by the market to outweigh the efficiency costs of government shareholdings. Unlike their focus on the effect of government ownership, we examine privately owned firms and the impact of PC on their decision making. More importantly, we show that PC, in enhancing the alignment of external investors with insiders, has profound implications for corporate governance. In particular, external investors are more likely to vote for managerial proposals in shareholder meetings of PC firms. We therefore provide a novel economic rationale for unconnected firms' incentives to seek PC proactively, especially when they are more subject to the adverse impact of market frictions on external financing and investment. Overall, our study identifies an interesting interaction between institutional, market quality and corporate actions.

Second, while a rich set of studies focus on the performance of PC firms and their access to debt financing, relatively fewer have examined the effect of PC on equity financing and investment. Leuz and Oberholzer-Gee (2006) show that Indonesian PC firms choose not to list in foreign markets, but to enjoy private benefits through tapping domestic markets. Our study differs by showing that external shareholders tend to endorse PC firms' equity financing decisions. Boubakri, Guedhami, Mishra, and Saffar (2012) show that the cost of equity is lower for PC firms, which is consistent with our investor endorsement hypothesis. Unlike both of the two studies, we go beyond equity financing and also examine the implications of PC on firm investment and governance.

Fan, Wong, and Zhang (2007) show that the newly partially privatized SOEs in China experience poorer market and operating performance when PC CEOs are appointed. Our study differs

by focusing on publicly listed non-SOEs in which the ultimate controlling shareholders are neither the local government nor the state. We show that external investors have a higher level of endorsement on managerial decisions in connected non-SOEs. Our finding is generally consistent with Wu, Wu, and Rui (2012), who reconcile the mixed evidence on the value of PC by showing that the value of PC depends on a firm's ownership structure, i.e., PC is valuable for non-SOEs while it is less obvious for SOEs.

Finally, our study also contributes to the literature of corporate dividend policy. Dividends lower the risk of insider expropriation for external investors as they reduce free cash flows from insider control. Prior literature thus suggests that dividends mitigate agency issues (e.g., La Porta, Lopez-de-Silanes, Shleifer, and Vishny, 2000; and Faccio, Lang, and Young, 2001) and serve as a signal of commitment to treat minority shareholders fairly, enhancing the firm's reputation in capital markets (Gan, Lemmon, and Wang, 2011). We find that PC firms are less likely to pay cash dividends and if they pay, they pay less. More strikingly, the market responds *less* positively to dividend payments by PC firms. It appears that investors tend to value PC firms' investment more and thus prefer them to retain earnings to invest. Our results suggest that PC can play a similar role of aligning external investors with insiders as dividends and be a substitute of them in dealing with the adverse impact of market frictions in emerging markets. Our finding on the relation between PC and dividend policy is novel, suggesting a role of PC that has been neglected before.

The remainder of this paper is organized as follows. Section 2 presents the development of our hypothesis and its testable predictions as well as the discussions on the delineation from alternative explanations. Section 3 describes the sample, variable construction, and summary statistics. Section 4 presents our main empirical results and robustness tests. We conclude in Section 5.

2. Institutional background and hypothesis development

2.1 Literature review and institutional background

PC is widespread around the world and has been shown to be valuable to firms, especially non-stated-owned firms, in institutional domains where the government restricts economic activity (e.g., Fisman,

2001; Johnson and Mitton, 2003; Faccio, 2006; Claessens, et al., 2008; Li, Meng, Wang, and Zhou, 2008; Goldman, Rocholl, and So, 2009; Calomiris, Fisman, and Wang, 2010; Nee and Opper, 2010; and Wu, Wu, and Rui, 2012). In particular, the literature shows that connected firms can secure advantages in their access to: government-controlled bank loans (e.g., Sapienza, 2004; Dinc, 2005; Khwaja and Mian, 2005; Charumilind, et al., 2006; Claessens, et al., 2008; and Fan, Rui, and Zhao, 2008), cheaper loans from commercial banks (Houston, Jiang, Lin, and Ma, 2014), favorable tax treatment (e.g., Adhikari, Derashid, and Zhang, 2006; Feng, Johansson, and Zhang, 2015), higher IPO pricing (Francis, Hasan, and Sun, 2009; Feng, Johansson, and Zhang, 2014), government-sponsored bailouts (Faccio, Masulis and McConnell, 2006), and government investment/procurement contracts (Duchin and Sosyura, 2012; Goldman, Rocholl and So, 2013). PC firms also receive preferential treatment in regulated market/industry entry and subsidies (e.g., Fan, Wei, and Xu, 2011; Feng, Johansson, and Zhang, 2015; Haveman, Jia, Shi and Wang, 2017). Not surprisingly, the value of PC is more pronounced in emerging countries under transition in which government arguably plays a more active role and government intervention is prevalent in economic activities. Consistent with this, Faccio (2006) finds that preferential treatment for PC firms is more pronounced in countries with interventionist governments and weak protection of property rights.

To examine the real implications of PC on the capital market, it is desirable to have an institutional environment in which both the value of PC is salient and the market frictions are severe. The emerging capital market in China constitutes such an ideal institutional setting for this purpose. First, it features a business system that discriminates against non-SOEs due to historical reasons (Li, et al., 2008). Particularly, due to government interference, the overall economy is characterized by the grabbing hand (Shleifer, 1998). Compared to SOEs, non-SOEs often face great disadvantages in market entry, external financing, and taxation. PC therefore plays an exceptionally important role in non-SOEs to overcome the disadvantages or even discriminations, and hence is greatly valuable for shareholders of non-SOEs. Second, while it has witnessed rapid growth in the volume of security issuances and trading, the capital market in China has been characterized by the market-wide dominance of retail investors and the still-growing competence of financial intermediaries in providing monitoring and

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certification services. Further, because of the weak legal system in China, minority shareholders are poorly protected (e.g., Kato and Long, 2005). In sum, information asymmetry and the risk of expropriation by insiders are profound frictions faced by minority investors in their investment decisions. Therefore, how minority shareholders may take political connection of management/controlling shareholders in coping with these frictions is an important question empirically.

2.2 Hypothesis development and delineation from alternative explanations

Classic corporate finance theories suggest that in a frictionless capital market, a firm's optimal financing and investment are solely determined by its investment opportunities. However, imperfect market conditions often lead to suboptimal financing and investment. For instance, information asymmetry (Myers and Majluf, 1984) or disagreement due to heterogeneous prior beliefs (Dittmar and Thakor, 2007) on the quality of investment projects, causes undervaluation of a firm and hence its external financing to be costly. Investment projects with positive NPVs have to be abandoned due to financial constraints.

The value of PC can help to mitigate the negative impact of these frictions. PC firms have access to government-controlled projects that are often with high guaranteed returns, and even mediocral projects can succeed with political support and resources. Hence investors are likely to downplay or even ignore their own signal of the project quality, attenuating the impact of information asymmetry. Likewise, although rational agents may disagree on whether a particular project choice will enhance or destroy firm value due to different prior beliefs (see Kurz (1994)), the value of PC renders a high degree of investor confidence in the management decisions, which leads to a high level of agreement between investors and insiders in PC firms. The above analysis implies that the value of PC serves to align the view of investors and insiders, so that investors are more likely to endorse the choice of projects by PC management. We label this argument as the "endorsement" view.

On the other hand, PC has its dark side for external investors even in non-SOEs. Chaney, Faccio, and Parsley (2011) find that PC firms have a lower quality of accounting information, while Chen, Ding, and Kim (2010) demonstrate that PC firms experience lower analyst forecast accuracy. Berkman, Cole,

and Fu (2010) indicate a negative impact of PC on corporate governance. Similarly, Cao, Pan, Qian, and Tian (2017) show that PC CEOs are more entrenched. Poor accounting quality and governance can exacerbate the agency concerns (Jensen and Meckling, 1976) if minority shareholders are more likely to be expropriated in PC firms. However, it is not clear that this is always the case. For instance, Chaney, Faccio, and Parsley (2011) suggest that PC firms afford a poorer disclosure quality because of a lesser need to respond to market pressure. In particular, they show that poorer disclosure quality is associated with a higher cost of debt *only* for NPC firms. In a similar spirit, Hung, Kim, and Li (2018) find that PC firms issue fewer management earnings forecasts, and such less active voluntary disclosure is due at least partly to a lower level of capital market pressure. This is indeed consistent with our investor endorsement hypothesis – PC helps mitigate the impact of market frictions so that firms find it less necessary to take actions that are conventional in overcoming the adverse impact of the frictions.

A probably more direct cost for minority shareholders in PC firms is the heightened risk of expropriation by controlling shareholders. Wang (2015) shows that related-party transactions with controlling shareholders are in greater magnitudes in PC firms than in NPC firms. Nevertheless, she finds that PC firms outperform their NPC counterparts due to PC firms' access to key resources. Overall, to the extent that the market can efficiently capture the net benefit (or cost) of PC to shareholders, the widely-documented positive market responses to the news of a firm getting politically connected are consistent with the benefits of PC outweighing the costs. From minority investors' point of view, the net benefit of PC suggests that they can benefit from a larger pie (even probably with a smaller share due to expropriations like related-party transactions).

From the above analysis, we conclude that PC firms are less subject to the adverse impact of information asymmetry and disagreement between external investors and insiders. Theories by Myers and Majluf (1984) and Dittmar and Thakor (2007) would then both suggest that PC firms are more likely to issue equity. This leads to the first testable prediction of our investor endorsement hypothesis:

Prediction 1: *PC firms are more likely to issue equity than NPC firms, ceteris paribus*.

Note that because PC firms have also been shown in the literature to have better access to bank loans, the overall implication of the PC status on a firm's capital structure is not clear.

As suggested in the literature, PC firms have advantages in securing government-controlled, profitable projects. And our investor endorsement hypothesis suggests that insiders' investment choices in PC firms are more likely to be endorsed. As such, according to the Q-theory of corporate investment, firms should invest in all projects with positive NPVs when financing is not constrained, which is more likely the case for PC firms since they have arguably better access to both equity (*Prediction 1*) and debt financing. This yields the second testable prediction:

Prediction 2: *PC firms invest more than NPC firms.*

Note that our investor endorsement hypothesis does not speak to investment efficiency in PC firms. The existing evidence shows that, while PC reduces investment efficiency in state-owned enterprises (SOEs), it does not do so in non-SOEs (e.g., Chen, Sun, Tang, and Wu, 2011). Our hypothesis predicts that minority investors are more likely to endorse investment decisions made by PC firms, which we will discuss further below in *Prediction 4.*[9]

According to the Pecking-order theory on capital structure, PC firms shall retain earnings instead of paying them out because they have better investment opportunities and invest more, as suggested by *Prediction 2*. Furthermore, while dividends have been shown to be a credible signal in building a shareholder-friendly reputation in the capital market to cope with market frictions (e.g., Gan, Lemmon, and Wang, 2011), our hypothesis suggests that such signaling is less needed for PC firms with a higher level of investor endorsement.[10] In other words, dividends and PC can be substitutes in their role for firms to deal with market frictions. Taken together, we have the third testable prediction:

Prediction 3: *PC firms are less likely to pay dividends and pay less than NPC firms.*

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[9] Nonetheless, we conduct a test to see whether PC firms invest more efficiently than NPC firms in Section 4.1.
[10] Note that in the Chinese market, share repurchase was not a legal mode of payout until 2018 when the regulator allowed listed firms to buy back shares to offset the dilution from stock options to executives and employees.

To the extent that our investor endorsement hypothesis builds on the value of PC, a natural extension of the above three predictions is that the effect of PC shall vary with the level of government interventions in different industries and geographic regions. In industries/regions with more government interventions, the value of PC is more pronounced and so is its impact on firms' financial policies and investment.

There are, however, possible alternative explanations for the above three predictions on the impact of PC. The stock market in China is tightly regulated and intervened by the government. For instance, without preapproval from the regulator, firms cannot issue new shares either through initial public offerings (IPO) or seasonal equity offerings (SEO). Liu, Tang, and Tian (2013) show that PC entrepreneurial firms have a higher IPO approval rate. The effect of PC on equity issuance can thus be due to the positive role of PC in helping firms to win approval of equity issuance (the "regulation" view). Also, capable private entrepreneurs with a good track record of outstanding firm performance are often invited to participate in politics (Feng, Johansson, and Zhang, 2014 and 2015). The more investment by PC firms is thus likely because more capable PC management is better able to identify investment opportunities (the "capability" view). Moreover, PC firms may pay less dividends and divert firms' free cash flows for private benefits of PC management/blockholders, because PC helps to insulate them from the governance pressure from the market (the "agency conflict" view).

While our hypothesis shares some predictions with the alternative views, it does have other predictions that contrasts with these views. We rely on them to delineate our hypothesis from them. In particular, under the capability view, the effect of PC on investment shall not depend on the level of government interventions in different industries or geographic regions because a capable management shall be able to identify investment opportunities regardless. This is in contrast to the prediction of our hypothesis as discussed above.

Also, the other two alternative views yield predictions that are opposite to our hypothesis on the market responses to PC firms' equity issuance and dividend decisions, respectively. Specifically, under the regulation view, the market shall not respond more positively to the news of equity issuance by PC

firms than by NPC firms, because the approval of it shall be well expected (given PC is common knowledge). Further, the market may instead respond more *negatively* to equity issuance by PC firms, because they are better able to get their issuance of overvalued stock (that times the market sentiment) to be approved by the regulator. In contrast, our investor endorsement hypothesis predicts a more positive market reaction to PC firms' equity issuance and investment decisions. Likewise, under the agency conflict view, if PC firms pay less dividends to divert free cash flows away, then conditional on a firm's dividend payment, the market shall respond more positively to dividend payments by PC firms. This is consistent with the signaling story of dividends, in which dividends are used to build the reputation of not expropriating minority shareholders (Gan, Lemmon, and Wang, 2011). In contrast, our investor endorsement hypothesis suggests that investors prefer PC firms to retain earnings and invest more (since they have better investment opportunities), so that the market shall respond less positively to dividend payments by PC firms.

A probably more direct test of our investor endorsement hypothesis is to examine how external shareholders vote on proposals made by management/blockholders in the annual meetings of PC firms. Our hypothesis suggests a higher approval rate of these proposals. To summarize, here is the fourth testable prediction of our hypothesis:

Prediction 4: *The market responds more positively to the news of equity issuance and investment and less positively to the news of dividends by PC firms than by NPC firms. Also, external shareholders are more likely to approve managerial proposals in PC firms.*

Lastly, given the role of PC in aligning external investors with insiders, unconnected firms that are more subject to the adverse impact of market frictions are more likely to acquire PC, e.g., hiring a PC CEO. This leads to the last prediction of our hypothesis:

Prediction 5: *NPC firms that are beleaguered more by the adverse impact of market frictions are more likely to acquire PC.*

3. Data, variables, and summary statistics

3.1 Data and sample

We compile the data from a collection of datasets from CSMAR, the most widely used database for the Chinese capital market. They include the Chinese Listed Firm Seasoned Equity Offerings Database, Cash Dividend Database, Merger and Acquisition Database, Annual Report Database, Corporate Governance Database, Stock Market Index Return Database, Shareholder Meeting Database and Personal Characteristics Database as well as the Database of Chinese Listed Firms with Private Ultimate Owners.

We focus on a sample of all publicly listed firms in the main board of Chinese capital market in which the ultimate controlling shareholders are private investors (non-SOEs) for the period of 2002-2016.[11] We exclude state-owned enterprises (SOEs) for the following reasons. First, SOEs are all politically connected in nature, so there are few cross-sectional variations in their political capital. Second, corporate policies of SOEs are often made out of political and social considerations, and thus the role of market-based rules and principles in their decision making is limited. We also exclude: (1) financial firms (firms with a unique accounting standard and special financial characteristics) that are heavily regulated, (2) ST (special treatment) firms or negative-equity firms (financially distressed firms), and (3) firms with missing relevant data. The final sample consists of 1,252 firms and 7,253 firm-year observations for the sample period.

3.2 Key variable construction

3.2.1 Political connection

Due to the specific nature of the political system in China, we adopt a broader definition of a firm's political connection, which is a combination of the conventional political connection measure in studies like Fan, Wong, and Zhang (2007) and Wu, Wu, and Rui (2010) and the political participation measure

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[11] We choose to start the sample from 2002 because the new Chinese Accounting principle, the first modern Accounting principle in China, was implemented in 2001, which would ensure the comparability of accounting numbers throughout the sample period. Besides the main board, there are two additional boards called the Small and medium sized market (SME) and the Growth and Enterprise Market (the GEM). We exclude listed firms in that two board because firms in that two boards are relatively young and without an established financial policy in SEO, investment and payout.

in studies like Feng, Johansson, and Zhang (2014, 2015). [12] Specifically, we define a firm as being politically connected if either its controlling shareholder, chairman, or general manager/CEO currently serves or formerly served in the government or military, or serves/served as a deputy of the National/Provincial People's Congress or of the People's Political Consultative Conference.

3.2.2 Corporate policies, investors' reactions, and other control variables

As our sample is comprised of publicly listed firms, we focus on their seasoned equity offerings (SEOs) in examining their equity issuance decisions, using three measures: (1) *SEODUM*, defined as a dummy that equals one if a firm conducts an SEO during a specific year, (2) *SEOSIZE*, defined as the total gross proceeds from the SEO, and (3) *SEO RATIO*, defined as the ratio of the gross proceeds from the SEO to the firm's market capitalization as of the year end prior to the SEO. We measure a firm's investment in a given year as the total capital expenditure divided by total assets (labeled as *CAPEXTA*).

For a firm's dividend payout policy, following La Porta, Lopez-de-Silanes, Shleifer, and Vishny (2000) and Faccio, Lang, and Young (2001), we use three measures for the size of cash dividends: *DTE* (the total cash dividends to earnings), *DTS* (the total cash dividends to sales), and *DTM* (the total cash dividends to the market capitalization of the firm). For brevity, we report *DTE* in the paper and the results with the other two measures are similar and available upon request. We also construct a dummy variable (*CD_DUMMY*) that equals one if a firm pays cash dividend in a year. Somewhat unique to the Chinese stock market, Chinese listed firms often also pay dividends in stock (in a form of bonus stocks). In this study, we focus on cash dividends, as stock dividends are not relevant in examining the firm's cash payout.[13] For completeness in examining the dividend policy, we include stock dividends in some of our analyses. Thus, two additional dummy variables are defined as follows: *SD_DUMMY* that equals one if a firm pays stock dividends, and *TD_DUMMY* that equals one if a firm pays either cash or stock dividends (or both).

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[12] Please see Faccio (2006) and its references for a comprehensive description of political connections across different countries.
[13] A stock dividend payment does not involve paying cash out of the firm's earnings. It is similar to stock splits, with some differences of treatment in accounting terms.

We use two measures for investors' responses to corporate policies. First, we estimate the three-day cumulative abnormal stock returns (*CAR (-1, +1)*) around a firm's announcement (day 0) of SEOs, dividend initiations or increases, and mergers and acquisitions (M&As).[14] To circumvent the empirical challenge that managerial investment decisions are often unobservable, we examine the market reaction to the publicly announced M&As, one of the most significant investment decisions for a firm, to capture investors' responses to the firm's investment decisions. The *CAR (-1, +1)* is estimated using the conventional market model with the value-weighted return as the market portfolio. The parameters of the market model are estimated using the daily returns of the period (-365 days, -60 days) relative to the announcement date.

Second, a more direct measure of external investors' endorsement of managerial decisions is their approval of proposals by management in annual shareholder meetings. Since most annual meetings approve all proposals among Chinese listed firms in practice, we take this measure as a dummy variable that equals one if at least one of the corporate policies proposed by management is rejected in the annual shareholder meeting and 0 otherwise (labeled as *REJECTION*). In analyzing external investors' voting decisions, we also take into account both the number of shareholders who attend the shareholder meeting (labeled as *ATTEND*) and the total voting rights held by these attending external investors (*OUTSIDE*).

We follow the prior literature to choose control variables in the regressions that may affect a firm's financial and investment policies as well as the market reactions to them, which will be discussed in specific tests below. The detailed definitions of all variables used in the analyses are in the Appendix.

3.3 Descriptive analysis

Table 1 presents the summary statistics for sample firms. Panel A summarizes firm characteristics. 42% of sample firms are politically connected, confirming the prevalence of PC among Chinese non-SOEs. SEOs are conducted in 4.7% of firm years, and conditional on an SEO, the average issuance size is

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[14] For robustness, we also examine the cumulative abnormal stock returns for other time windows, e.g., (-1, 0) and (-2, 2), and the results, available upon request, are qualitatively similar.

large, about 40.8% of market cap. On average, sample firms spend 5.8% of the total assets on capital expenditures. 65% and 20% of firms pay cash and stock dividends, respectively. Among firms paying cash dividends, the average ratio of cash dividends to earnings is 35.8%.

Panel B presents the statistics of market responses to corporate decisions and external shareholders' voting in annual corporate meetings. The average (median) three-day cumulative abnormal returns (*CAR (-1, +1)*) around the announcements of SEOs, dividend initiations or increases, and M&As are 0.79% (0.00%), 0.12% (0.08%), and 2.27% (2.25%), respectively. In about 2% of annual shareholder meetings, at least one of the policies proposed by management/controlling shareholders is rejected. As indicated in Panel A, on average, about 21 shareholders attend the annual shareholder meetings, consistent with the low attendance rate of the meetings in general. But among these attending shareholders, external shareholders own 16% of the shares in aggregate. Note that the average share ownership by the largest shareholders and management is 34% and 11%, respectively. As such, the voting power by the attending external shareholders is substantial, especially on those proposals which the largest shareholders are required to abstain on (e.g., related-party transactions).

<Table 1>

Table 2 presents a univariate comparison of firm characteristics, corporate policies, and investors' reactions to these policies between PC firms and NPC firms. The last two columns present the differences in means and medians and their statistical significances estimated based on t-test and Wilcoxon test, respectively. Consistent with *Predictions 1 – 3*, Panel A shows that compared with NPC firms, PC firms are more likely to conduct SEOs (and the size of their SEOs are also significantly larger), invest more, but are less likely to pay dividends and pay out less if they pay.

Moreover, consistent with *Prediction 4*, Panel B indicates that the market responds more positively to SEOs and M&As by PC firms, but less so to dividend increases or initiations by PC firms. In particular, the three-day *CARs (-1, +1)* around SEO announcements for PC firms are significantly positive while they are insignificantly different from zero for NPC firms. While the *CARs (-1, +1)* around M&A announcements are positive and significant for both PC and NPC firms, they are

significantly greater for the former. The *CARs (-1, +1)* around dividend initiations or increases are insignificantly different from zero for NPC firms.[15] More interestingly, they are significantly negative for PC firms. It appears that the market prefers PC firms to retain earnings instead of paying them out in cash dividends. Lastly, the rejection rate of the proposals made by the largest shareholders or management is significantly lower for PC firms than for NPC firms.

In Panel C, we find that PC firms are similar to NPC firms in many dimensions except that they are slightly larger and have slightly higher institutional ownership; also, consistent with *Prediction 5*, external investors of PC firms appear to be more subject to information asymmetry (higher stock return volatility) and insider appropriation concern (greater WEDGE, the difference between insiders' control rights and ownership).

<center>*<Table 2>*</center>

4. Empirical analysis and discussions

To test the predictions of our investor endorsement hypothesis while accounting for a full set of factors, we examine the impact of PC on corporate policies and investors' reactions in multivariate analyses. We further investigate how the impact of PC varies with the extent of government interventions in different industries/regions. We then analyze unconnected firms' decisions to acquire PC and relate them to the firms' subjectivity to market frictions. Lastly, we address the endogeneity of PC with two identification strategies and show that the effect of PC is causal.

4.1. The effect of PC on corporate policies

We first examine the effect of PC on corporate policies with the following baseline regression model:

$$Y_{i,t} = \alpha + \beta_1 \times PC_{i,t-1} + \beta_2 \times X_{i,t-1} + FE_t + FE_{industry} + \varepsilon, \tag{1}$$

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[15] This is in contrast with the finding in developed markets where dividend payments are generally positive news. The difference is likely due to the divided regulation in China that listed firms are required to pay cash dividends if they have positive net incomes and do not have large capital expenditures. As a result, dividends are not always paid on a voluntary basis and thus so informative like in developed markets. Of course, firms still have discretion on the magnitudes of dividend payments above what the regulation requires.

where $Y_{i,t}$ is firm i's SEO, investment, and dividend payment decisions in year t. X is a vector of control variables, the definitions of which are in Appendix. It includes firm size (*LNSIZE*, the natural log of *SIZE*), leverage (*LEV*), Tobin's Q (*Q*), stock return (*SR*), measures of operating performance such as ROA (*ROA*) and net operating cash flows (*NOCF*), retained earnings (*RETAINE*), share ownership by institutions (*INSTITUTIONAL*), management (*MANAGER*), and the largest/controlling shareholder (*LARGEST*) as well as earnings volatility, a proxy for information asymmetry (*VOLATILITY*). Unless otherwise specified, we include year and industry dummies in all regressions to account for the impact of time-specific and industry-specific factors.[16] In case of a dummy variable being the dependent variable, we estimate with a linear probability model because it helps us estimate the economic significance of the results more easily and in an intuitive manner.[17] The results, reported in *Table 3*, are consistent with *Predictions 1-3*.

4.1.1. Equity issuance

In Panel A pertaining to *Prediction 1*, we examine the decision to conduct SEOs (Column (1)), the absolute size of SEO (Column (2) with the dependent variable being the natural log of *SEOSIZE*), and the relative size of SEO (Column (3) with the dependent variable being the ratio of SEO size to market cap). The coefficients on *PC* in all three columns are positive and statistically significant. Economically, the coefficient on *PC* in Column (1) suggests that the probability of SEOs is two percentage points higher in PC firms than in NPC firms, which is substantial given the unconditional probability of an SEO in the sample firms is 4.7 percent. Similarly, in terms of the SEO size, the coefficient on *PC* in Column (3) shows that the SEO size ratio in PC firms is 1.47 percentage points

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[16] Following the industry classification of China Securities Regulatory Commission (CSRC) that took effect in 2012, listed firms in China are classified into 19 industries: Agriculture; Mining; Manufacturing; Hot water and electricity; Construction; Wholesale & Retail; Transportation; Accommodation and restaurant; Information technology; Finance; Real estate; Leasing and business service; Scientific research and technical services; Water conservancy, environmental and public facilities management; Resident service; Education; Health and social service; Culture, sports and entertainment; and Comprehensive. Our sample covers all 18 industries except Finance.

[17] A logit model is also estimated and our findings generally hold. The results are not tabulated for brevity, but available upon request.

higher than in NPC firms, while the sample average of the size ratio is 2.74 percent.[18] In sum, PC firms are significantly more likely to conduct SEOs and their SEOs is much larger in size. Also, we find that larger firms with higher institutional and managerial ownership but less retained earnings are more likely to conduct SEOs. Further, the size of SEOs is larger in firms with higher valuation and lower leverage.

4.1.2. Investment

In Panel B on *Prediction 2*, we analyze whether PC firms invest more by regressing *CAPEXTA* on PC and other control variables. The results in Column (1) confirm that *CAPEXTA* is significantly higher in PC firms. Economically, the estimated coefficient on *PC* suggests that PC firms spend 1.05% more of their assets in capital investment than NPC firms, a magnitude that is equivalent to over a quarter of a median firm's *CAPEXTA*. Thus the economic impact of PC on investment is substantial. We also find that firms with greater ownership by institutions and insiders and firms with more growth opportunities and less information asymmetry invest more.

While our hypothesis does not speak to investment efficiency of PC firms as discussed in Section 2, we conduct a simple test of it in Column (2) where we augment the model in Column (1) with an interaction of *Q* and *PC*. Thus, a positive coefficient on the interaction indicates a greater sensitivity of investment to Tobin's Q in PC firms. From Column (2), we find that the coefficients on *PC*, *Q*, and their interaction are all positive and statistically significant. Overall, our results suggest that PC firms invest more, and their investment is at least not less efficient than NPC firms. It is likely that PC firms have better access to projects in government-supported industries such as new technology, new materials, new energy, etc., which have higher growth potentials. This in turn enhances the level of investor endorsement of PC firms' investment decisions.

4.1.3. Dividends

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[18] We also repeat the tests in Columns (2) and (3) within the subsample of firms that have conducted SEOs, and find that the size of SEOs in both measures is significantly larger for PC firms in this conditional subsample. The results are not tabulated for brevity but available upon request.

Panel C presents the results on the effect of PC on dividend policy (*Prediction 3*). Columns (1) and (2) pertain to the payment indicator (*CD_DUMMY*) and the size (*DTE*) of cash dividends, respectively. In both columns, the coefficients on *PC* are significantly negative. Consistent with the univariate evidence, PC firms are less likely to pay cash dividends and pay less, even after controlling for those well-documented determinants of dividend policy.[19] Economically, the decrease in cash dividends by PC firms amounts to 2.40% of their earnings, which is equivalent to over 18% of a median firm's cash dividends. In addition, we find that larger, less leveraged firms and firms with less information asymmetry are more likely to pay cash dividends and pay more. Ownership by institutions, management, and the largest shareholder is also positively related to a firm's cash dividend payment.

One might be concerned that the lower cash dividend payment by PC firms might be due to the expropriation of free cash flows by insiders in these firms. The literature suggests that minority shareholders are more likely to be expropriated by controlling shareholders if there is a larger ownership-control wedge (e.g., Claessens, Djankow and Lang, 2000 and 2002; Faccio and Lang, 2002; Lemmon and Lins, 2003; Lins, 2003; Maury and Pajuste, 2004; Faccio, Lang, and Young, 2010). We thus follow the literature and measure the expropriation risk by the difference between the controlling shareholder's control rights and cash flow rights (*WEDGE*). The sample size of this test drops slightly as data on the ownership wedge only become available since 2004.[20] We find that our finding is robust to the control for the expropriation risk that a firm's external investors are exposed to. On the other hand, the coefficients on *WEDGE* are significantly negative, suggesting that firms with a larger ownership-control wedge are less likely to pay cash dividends and pay out less.

Our hypothesis indicates that external investors prefer PC firms to retain earnings instead of paying them out as cash dividends, but the decision of stock dividends should be irrelevant because stock dividends do not result in cash payout. Thus, a natural falsification test of our hypothesis on

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[19] We also repeat the test in Column (2) within the subsample of dividend-paying firms, and find that the size of cash dividends is significantly larger for PC firms. The results are not tabulated for brevity but available upon request.

[20] In a robustness check where the *WEDGE* variable is excluded, the estimated coefficients on PC remain almost intact, both in economic magnitudes and statistical significance.

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dividends can be done to see whether PC firms tend to not pay stock dividends too. To verify this, we run the regression in Column (3) where *SD_DUMMY* is the dependent variable. Indeed, the results show that the coefficient on *PC* is neither economically nor statistically significant. For completeness, in Column (4) we also take *TD_DUMMY* as the dependent variable. Possibly due to its encapsulation by *CD_DUMMY*, the coefficient on *PC* in this case is similar, both economically and statistically, to that in Column (1).

<Table 3>

To summarize, with a high level of investment endorsement, PC firms are better able to mitigate the adverse impact of market frictions and thus are more likely to issue equity. Being financially less constrained, they also invest more to exploit greater investment opportunities. Moreover, PC firms tend to retain earnings (and invest) instead of paying cash dividends, due likely to a lesser need to use dividends as a shareholder-friendly signal.

4.2. Cross-sectional variations in the impact of PC

A natural implication of the role of PC as an investor-endorsement device is that such an impact of PC should be more pronounced in industries and regions where government intervention in economic activities is more intense. We provide a test of this. Specifically, first, we classify our sample firms into two groups based on an industry's sensitivity to government policies: firms in policy-affected industries and firms in less-policy-affected industries, and then repeat our tests in the two respective groups. A policy-affected industry is determined based on the five-year plans issued by the Chinese central government, which lists the set of industries that are encouraged and supported by the government during a five-year period. PC firms are in a better position to obtain supports in supported industries from the local or central government (Liu, Luo, and Tian, 2016). Our sample period spans three five-year plans, the 10th, 11th, and 12th, corresponding to the periods 2001-2005, 2006-2010, and 2011-2015, respectively. A firm-year is thus classified into a policy-affected industry if the industry of the firm falls into a respective plan during the year. As can be seen from the results presented in Panel A of Table 4,

the effect of PC is only significant, both economically and statistically, for firms in policy-affected industries.

On a separate dimension, we also classify our sample firms into two groups based on their geographic regions with different levels of government intervention in economic activities. According to the regional government intervention development index (GIID) of Chinese provinces provided by Fan, Wang, and Zhu (2009), the eastern regions, including Beijing, Tianjin, Hebei, Liaoning, Shanghai, Jiangsu, Zhejiang, Fujian, Shandong, Guangdong and Hainan, have relatively fewer government interventions, while other regions, such as Shanxi, Jilin, Heilongjiang, Anhui, Jiangxi, Henan, Hubei, Hunan, Inner Mongolia, Guangxi, Sichuan, Chongqing, Guizhou, Yunnan, Shaanxi, Gansu, Qinghai, Ningxia, Xinjiang, and Tibet, have more government interventions. The results, tabulated in Panel B of Table 4, find that the impact of PC holds only for firms in regions with more government interventions.

<Table 4>

Overall, the results on the cross-sectional variations in the impact of PC provide further support for our hypothesis. Further, they also help to differentiate our hypothesis from two alternative explanations for our findings on the impact of PC. First, as discussed in Section 2, the positive association between PC and SEOs might be due to the easiness of winning the regulator's preapproval by PC firms. However, such an explanation is inconsistent with the finding that the impact of PC on SEOs is only significant for firms in policy-affected industries and in regions with intensive government interventions. After all, the role of PC in winning the regulator's preapproval for SEOs should not depend on the conditions of industries or regions. Second, the alternative explanation for the positive association between PC and corporate investment is that PC managers may be more capable than NPC managers. However, such a capability story cannot explain why the impact of PC depends on the conditions of industries or regions either; a capable manager shall be able to identify investment opportunities and invest without excessive reliance on government support.

4.3. Do investors value corporate decisions in PC firms?

This section tests *Prediction 4* and provides direct evidence for our investor endorsement hypothesis by investigating the market reactions to corporate policies and investors' voting in annual meetings.

4.3.1 Market reactions to corporate decisions by PC firms

We first examine market reactions to firms' SEO and investment announcements. If firms rely on their PC status to obtain the SEO approval from the regulator, we shall not expect a significant difference in market reactions to SEO announcements between PC firms and NPC firms because it should be well expected (as PC is common knowledge). If there is any difference, we instead expect a more negative (or less positive) market reaction to PC firms' SEOs. This is because they are better able to have their SEOs approved so that they can time the market in issuance when their equity is overvalued. Also, if the PC status exempts management/controlling shareholders from regulatory pressure in expropriating minority shareholders (e.g., divert proceeds from SEOs or invest in projects for private benefits), we would expect an even more negative market response when PC firms announce SEOs and investments. In contrast, according to our investor endorsement hypothesis, investors are more likely to endorse PC firms' choices of projects and hence their decisions to finance them, which implies that the market would respond more positively to PC firms' investment and financing decisions.

Columns (1) and (2) of *Table 5* report the results of regressing CAR (-1, +1) around SEO and M&A announcements on PC and other control variables, respectively. Consistent with our hypothesis, the market responds more positively to SEOs and M&As by PC firms. The coefficients on *PC* in both cases are positive and statistically significant. Their magnitudes suggest that the three-day abnormal returns are 6.92 and 0.79 percentage points higher for PC firms, which amounts to 8.7 times and 0.3 times of their sample average, respectively. Therefore, the economic impact of PC is substantial. According to Column (1), investors respond more positively to small-sized SEOs, private offerings, and SEOs issued by smaller or more profitable firms or firms with lower valuation. SEOs by firms with more retained earnings, which are then likely for strategic purposes, are better received by the market. The results in Column (2) suggest that M&As with both the acquirer and the target being from the same geographic region, which might exhibit better post-deal integration, experience more positive market

reactions. Also, the market reacts more positively to deals by acquirers with higher managerial ownership.

We now turn to market reactions to dividend policy. One might be concerned that both our investor endorsement hypothesis and the alternative agency conflict view can explain the negative relation between PC and cash dividends. Under the agency conflict view, PC firms tend to pay less out to divert free cash flows for private benefits of connected management/controlling shareholders because they are less subject to capital market discipline and government regulation. Thus, the market should respond more positively to any dividend increase or initiation announcement. In contrast, our hypothesis has an opposite prediction because investors prefer PC firms to retain earnings and invest, as their investments are perceived to have higher returns than if external shareholders invest themselves with cash distribution through dividends.

The results, presented in Column (3) of *Table 5,* are consistent with our hypothesis. The three-day abnormal announcement returns around dividend increases or initiations are significantly lower in PC firms than in NPC firms. Specifically, the coefficient on *PC* is negative and statistically significant. Its economic magnitude is significant too; the decrease in abnormal returns is -0.32%, the absolute size of which is about three times of the sample average abnormal returns.

<*Table 5*>

4.3.2 External investors' voting in shareholder meetings

A more direct evidence of investor endorsement is investors' supportive voting in shareholder meetings, which are probably the only venue for external investors to vote on corporate policies. To capture investors' voting that is not affected by controlling shareholders/management, we impose two conditions in our test: (1) We examine votes of external investors by excluding the votes cast by controlling shareholders or their related ones, and (2) focus on voting in annual meetings, the holding of which is mandatory and is thus not under discretion of controlling shareholders or management. Examples of the proposals for shareholder voting in annual meetings include annual financial statement,

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annual work of the board of directors, annual report of the board of supervisors, annual report of financial budget and final accounts, payout decisions, auditor appointment, plan for SEOs, election of new board members, significant investment decisions, related party transactions, etc. Specifically, we regress *REJECTION* of the proposals on *PC* and related independent variables, which include *ATTEND* and *OUTSIDE* to control for the number of shareholders attending the meetings and share ownership by attending external shareholders, respectively.

The results in *Table 6* show that external shareholders are less likely to reject managerial proposals in PC firms, as indicated by the significantly negative coefficient on *PC*. Economically, the coefficient suggests the impact of PC is substantial; the rejection rate is lower by one percentage point in PC firms while the average rejection rate in sample firms is less than two percent. The coefficients on both *ATTEND* and *OUTSIDE* are positive and statistically significant. It suggests that the more active are external investors with significant ownership in participating annual meetings, the more likely they are to vote against managerial proposals. It is likely that meetings with more controversial proposals are more likely to attract external investors' attendance, which results in the higher rejection rate. This is consistent with the effective governance role of "voice" by external shareholder in significant corporate decision making. The impact of PC nonetheless holds after controlling for these two variables. In addition, the rejection rate is higher in smaller firms with lower managerial and institutional ownership. Also, shareholders are more likely to vote no in firms with higher leverage or more information asymmetry (as proxied by higher volatility in quarterly earnings).

<*Table 6*>

To summarize, consistent with our investor endorsement hypothesis, we show that investors respond more positively to equity issuance and investment decisions, but less so to dividend policies in PC firms. These findings are contradictory to the predictions of the alternative views, and thus help to further differentiate our hypothesis from them. Furthermore, as more direct supportive evidence of investor endorsement, we find that external investors are less likely to vote against managerial proposals in PC firms.

4.4 The unconnected firm's decision to acquire PC

Lastly, we test *Prediction 5* that a NPC firm has a stronger incentive to acquire PC if it is beleaguered more by the adverse impact of market frictions. We regress a NPC firm's decision to acquire PC through appointing a politically connected CEO on a set of variables that are intended to capture the market frictions that the firm is subject to as well as other firm and industry characteristics. Specifically, we include institutional ownership (*INSTITUTIOAL*) and earnings volatility (*VOLATILITY*) as proxies for information asymmetry. Institutional investors have arguably better access to firm-specific information and are also more able to process it. Thus firms with higher institutional ownership are less subject to the adverse impact of information asymmetry. We also include the controlling/largest shareholder's (*LARGEST*) and manager's (*MANAGER*) ownership as well as the ownership-control wedge (*WEDGE*) as a proxy for agency concerns. External investors in firms with lower *LARGEST* and *MANAGER* and larger *WEDGE* have greater exposure to expropriation risk. Further, we also include two dummy variables that capture the value of PC for certain firms, i.e., the indicators for policy-affected industries and for regions with intensive government interventions, as discussed in Section 4.2. In the regression, we exclude firms that have already been politically connected.

The results, reported in *Table 7*, are consistent with *Prediction 5*. We find that NPC firms are more likely to appoint a PC CEO to become connected if they have lower institutional ownership and higher earnings volatility (the impact of information asymmetry), if they have lower ownership by managers or greater ownership-control wedge (the impact of agency concerns), or if they operate in policy-affected industries or in regions with intensive government interventions (the value of PC). The findings highlight the value of PC as an investor endorsement device that helps to alleviate the adverse impact of market frictions. They also provide an explanation for the stylized fact that firms, especially in emerging markets with poor institutional quality and severe market frictions, have strong incentives to get politically connected.

<Table 7>

4.5 Endogeneity of PC and identifications

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A firm's PC is not exogenous. Indeed, as shown in the last subsection, unconnected firms may proactively seek PC when they are more subject to the adverse impact of market frictions. Alternatively, when a company has (or is expected to) made substantial contribution to the local economy due to its (or expected) great performance, its CEO/chairman may be invited by the government to serve as a deputy of the National/Provincial People's Congress or of the People's Political Consultative Conference and thus become politically connected. Such a firm also tends to invest more, pay out less, and be fared better in capital market in raising external equity financing. As such, there exists the reverse causality concern on our estimate of the effect of PC. Furthermore, both corporate policies and PC can be affected by some unobservable and hence our estimate of the impact of PC can be potentially biased due to this omitted variable. In this section, we employ two identification strategies to address the endogeneity concern of PC.

4.5.1 The effect of the anti-corruption campaign in 2012

To address the omitted variable bias concern, we base our strategy of identification on a policy shock that reduces the value of PC, the anti-corruption campaign launched by the Chinese central government at the end of 2012. The campaign has been shown to be effective in cutting off corruptions, reducing government interventions, and hence lowering the value of PC to firms. There has been a burgeoning literature examining the impact of this campaign on corporate activities (e.g., Xu and Yano, 2016; Pan and Tian, 2017; Cao, Wang and Zhou, 2018; Hope, Yue and Zhong, 2019). To the extent that this policy shock affects corporate policies only through its impact on the value of PC, it serves as a quasi-natural experiment for us to examine the change in the effect of PC around the campaign.

One challenge for the validity of the precondition is that the campaign has unintended economic consequences that vary across industries. For instance, sectors of luxurious goods/services are found to have experienced a more negative impact from the campaign because of the significant drop in demand resulting from the clampdown of corruptions. Firms may respond by adjusting corporate policies and thus this policy shock can affect corporate policies through channels unrelated to its impact on the value of PC. However, with the industry fixed effects applied in our estimation, we focus on within-industry

differences in the impact of this policy shock between PC and NPC firms. Therefore, the varying impact of the policy on different industries is unlikely to bias our estimation.

Specifically, we expect the role of PC as an investor endorsement device to be weakened and correspondingly its impact on corporate policies following the campaign. To conduct the test, we include in our baseline estimation models a dummy variable *ANTI*, which equals one for sample years after 2012 (the campaign's starting year) and zero otherwise, and its interaction with *PC*. The results are reported in *Table 8* with Panel A for the impact of PC on corporate policies and Panel B for the effect of PC on the market reactions to these policies as well as shareholder voting in annual meetings. Clearly, after the anti-corruption campaign, the effect of PC on corporate policies is significantly moderated and so are the market reactions to the corporate policies and shareholder voting in PC firms. The coefficients on the interaction term of *PC* and *ANTI* (*PC*ANTI*) are in signs opposite to those on *PC* and are statistically significant in all cases. Consistent with the effectiveness of the campaign in reducing the impact of PC, the absolute magnitudes of the coefficients on *PC*ANTI* are close to those of the corresponding coefficients on *PC* in many cases. Overall, the evidence suggests that the investor endorsement effect of PC is unlikely subject to the omitted variable bias.

<*Table 8*>

4.5.2 The effect of born PC

To address the reverse causality concern, we focus on an alternative measure of firms' PC status condition on a firm being born to be politically connected. It is defined as a dummy (labeled as *BORNPC*) that equals one if the founding Chairman/CEO of the firm acquires the PC status before the firm is founded and zero otherwise. We then compare corporate policies and investors' reactions to them as well as shareholder voting between firms with born PC status and NPC firms. In this test, we exclude firms that acquire the PC status after the firm is founded. This ensures that PC is not caused by corporate decisions, negating the reverse causality possibility. In the sample, 12% of the firms are with born PC, which amounts to 28.5% of PC firms.

The results, reported in *Table 9*, show that all of our findings continue to hold, suggesting the robustness of the effect of PC. The economic magnitudes of the coefficients on *BORNPC* are even greater in absolute terms than those on *PC* in many cases. We conclude that the estimated effect of PC is unlikely driven by the reverse causality possibility.

<*Table 9*>

5. Conclusions

In this study, we propose that, due to its value to privately held firms, a firm's political connection can be instrumental in moderating the adverse impact of market frictions by enhancing the alignment of external investors with insiders. This investor endorsement hypothesis has important implications for corporate finding, investment, and governance. We find that connected firms are more likely to issue equity and invest more, while paying out less in dividends. The market responds more positively to connected firms' equity issuance and investment decisions, but less so to their dividend payout announcements. Investors tend to prefer connected firms to retain earnings and invest. As a more direct evidence of political connection as an investor endorsement device, we find that external investors vote more favorably on managerial proposals in connected firms' annual meetings. We also discuss several alternative explanations for our findings and show evidence that is more consistent with our hypothesis than these alternatives.

Our research contributes to a better understanding of why some firms proactively seek to be politically connected, especially in transition economies like China where the legal system and institutional quality are to be further improved. In particular, we show that firms that are more beleaguered by the adverse impact of market frictions are more likely to hire a politically connected CEO. We thus identify a somewhat interesting interaction between institutional, market quality, and corporate actions. We show that external investors value a firm' political connections despite various risks associated with it (e.g., poor governance and expropriations of free cash flows). This has important implications on corporate governance, on which we call for more future research.

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Table 1 Descriptive analysis

The table presents the results of descriptive analysis of our key variables. Panel A reports the summary statistics of firm characteristics, while panel B presents the results on market reaction to corporate decisions and external shareholders' voting in annual meetings.

Panel A Summary statistics of firm characteristics

	Obs.	MEAN	MEDIAN	MAX	MIN	STDEV
Dependent Variables						
SEODUM (%)	7253	4.69	0.00	100.00	0.00	21.1
SEOSIZE (100 Million RMB, full sample)	7253	0.73	0.00	292.32	0.00	6.03
SEOSIZE (100 Million RMB, SEO sample only)	392	15.76	9.15	292.32	0.85	23.23
SEO RATIO (%, full sample)	7253	2.74	0.00	73.94	0.00	20.06
SEO RATIO (%, SEO sample only)	392	40.83	38.84	73.94	2.17	23.48
CAPEXTA (%)	7253	5.84	4.17	49.92	0.01	5.83
DTE (%)	7253	22.59	13.61	299.59	0.00	31.96
DTE (%, cash dividend sample only)	4471	35.79	26.41	299.59	0.69	33.85
CD_DUMMY	7253	0.65	1.00	1.00	0.00	0.48
SD_DUMMY	7253	0.20	0.00	1.00	0.00	0.40
TD_DUMMY	7253	0.67	1.00	1.00	0.00	0.47
Independent Variables						
PC	7253	0.42	0.00	1.00	0.00	0.49
SIZE (100 Million RMB)	7253	43.99	18.22	6112.95	1.46	29.62
LEV	7253	0.46	0.41	1.38	0.04	0.97
RETAINE	7253	0.73	0.82	12.04	-19.18	1,25
ROA	7253	0.05	0.04	22.01	-8.75	1.18
MANAGER	7253	0.11	0.00	0.82	0.00	0.18
NOCF	7253	-0.19	0.08	41.51	-896.89	21.27
LARGEST	7253	0.34	0.31	0.89	0.08	0.15
WEDGE	7027	0.07	0.04	0.53	0.00	0.09
ATTEND (Number of shareholders)	7253	21.26	9.00	1799.00	3.00	58.14
OUTSIDE	7253	0.16	0.14	0.79	0.03	0.13
INSTITUTIONAL	7253	0.31	0.28	0.84	0.00	0.24
VOLATILITY	7253	1.10	0.43	52.36	0.00	2.44
SR	7253	0.32	0.12	6.66	-0.91	0.71

Panel B Summary statistics of market reactions to announcements of corporate decisions and the extent of disagreement between investors and managers

	Announcements	Obs.	MEAN	MEDIAN	MAX	MIN	STDEV
	SEO (%)	392	0.79	0.00	15.19	-8.57	1.61
CAR (-1, +1)	Dividend initiation or increase (%)	3789	0.12	0.08	21.84	-13.32	3.48
	M&A (%)	4640	2.27	2.25	26.73	-23.30	10.30
REJECTION (%)		7253	1.96	0.00	100.00	0.00	13.86

Table 2 Univariate tests of comparing corporate policies and market reactions to the policies as well as firm characteristics between PC and NPC firms

This table reports the univariate test results of comparing corporate policies (panel A), market reactions to corporate policies and external shareholders' voting in annual meetings (panel B), and firm characteristics (panel C) between PC and NPC firms. T-test column indicates the difference in means and W-test column presents the difference in medians. *, **, and *** indicate significance at the 10%, 5%, and 1% levels, respectively.

Panel A Corporate policy

	NPC firms		PC firms		Difference Tests	
	Mean	*Median*	*Mean*	*Median*	*T-test*	*W-test*
SEODUM (%)	3.94	0.00	5.68	0.00	1.74***	-
SEOSIZE (100M RMB, full sample)	0.29	0.00	1.34	0.00	1.04***	-
SEOSIZE (100M RMB, SEO sample only)	7.39	0.61	23.53	16.50	16.14***	9.11***
SEO RATIO (%, full sample)	2.15	0.00	3.56	0.00	1.41***	-
SEO RATIO (%, SEO sample only)	38.54	35.36	43.63	42.14	-5.10**	-6.78*
CAPEXTA (%)	5.30	4.09	6.53	4.32	1.23***	0.23**
DTE (%, full sample)	24.06	14.44	20.54	12.38	-3.53***	-2.06***
DTE (%, cash dividend sample only)	39.53	27.07	29.70	25.73	-9.83***	-1.34**
CD_DUMMY	0.67	1.00	0.62	1.00	-0.05***	-
SD_DUMMY	0.21	0.00	0.19	0.00	-0.02***	-
TD_DUMMY	0.69	1.00	0.64	1.00	-0.05***	-

Panel B Market reactions to announcements of corporate policies and shareholder voting

	Announcements	**NPC firms**		**PC firms**		**Difference Tests**	
		Mean	Median	Mean	Median	T-test	W-test
CAR (-1, +1)	SEO (%)	0.03	0.00	2.57**	0.28***	2.54***	0.28**
	M&A (%)	1.97***	1.99***	2.64***	2.74***	0.70**	0.71**
	Dividend initiation and increase (%)	0.09	-0.03	-0.44***	-0.14***	-0.53***	-0.11*
REJECTION (%)		2.55***	0.00	1.15***	0.00	-1.40***	-

Panel C Firm characteristics

	NPC firms		PC firms		Difference Tests	
	Mean	*Median*	*Mean*	*Median*	*T-test*	*W-test*
SIZE (100M RMB)	40.46	17.96	48.84	18.84	8.38***	0.89*
LEV	0.46	0.40	0.46	0.42	0.00	0.02
RETAINE	0.72	0.82	0.74	0.83	0.02	0.01
ROA	0.04	0.04	0.06	0.04	0.02	0.02
NOCF	-0.12	0.07	-0.29	0.08	-0.17	0.01
Q	2.83	1.85	2.59	1.81	-0.16	-0.04
MANAGER	0.13	0.00	0.09	0.00	-0.04***	0.00
LARGEST	0.33	0.31	0.34	0.31	0.01***	0.00
WEDGE	0.06	0.02	0.08	0.06	0.02***	0.04***
ATTEND	20.39	9	22.46	10	2.07*	1**

OUTSIDE	0.16	0.14	0.15	0.13	-0.01*	-0.01
INSTITUTIONAL	0.30	0.27	0.33	0.31	0.03***	0.04***
VOLATILITY	1.01	0.41	1.22	0.46	0.21***	0.05***
SR	0.32	0.13	0.31	0.11	-0.01	-0.02

Table 3 The effect of PC on corporate decisions

Panel A The effect of PC on SEOs

This panel presents the regression results on the effect of PC on seasoned equity offerings. Dependent variables, indicated on top of each column, are an indicator of SEO (SEODUM), SEO size in natural logarithm (LN(SEOSIZE)), and SEO size scaled by market capitalization (SEO RATIO). Definitions of all independent variables are reported in Appendix A. Standard errors are clustered at firm level. p-values are displayed in brackets. *, **, and *** indicate significance at the 10%, 5%, and 1% levels, respectively.

Var.	*SEODUM*	*LN(SEOSIZE)*	*SEO RATIO(%)*
PC	0.02***	0.50***	1.47***
	(0.00)	(0.00)	(0.00)
LNSIZE	0.01***	0.20***	-0.76***
	(0.00)	(0.00)	(0.01)
LEV	-0.00	-0.20***	-0.65***
	(0.88)	(0.00)	(0.01)
RETAINE	-0.01***	-0.14***	-2.10***
	(0.00)	(0.00)	(0.00)
ROA	0.00	-0.02	-0.23
	(0.97)	(0.59)	(0.23)
NOCF	-0.00	-0.00	0.00
	(0.95)	(0.85)	(0.77)
Q	0.00	0.02**	0.12***
	(0.46)	(0.02)	(0.00)
MANAGER	0.08***	1.60***	-0.31
	(0.00)	(0.00)	(0.85)
LARGEST	0.00	0.15	3.58**
	(0.82)	(0.69)	(0.04)
INSTITUTIONAL	0.03**	0.58**	-0.70
	(0.02)	(0.04)	(0.59)
VOLATILITY	-0.00	-0.03	0.11
	(0.19)	(0.28)	(0.35)
Const	-0.19***	-4.38***	15.72**
	(0.00)	(0.00)	(0.01)
Industry		INCLUDED in all columns	
Year		INCLUDED in all columns	
N	7253	7253	7253
adj. R2	0.185	0.189	0.105

Panel B The effect of PC on investment

This panel presents the regression results on the effect of PC on corporate capital expenditure. The dependent variable is CAPEXTA, which is corporate capital expenditure as a percentage of total assets. Definitions of independent variables are reported in Appendix. Standard errors are clustered at firm level. p-values are displayed in brackets. *, **, and *** indicate significance at the 10%, 5%, and 1% levels, respectively.

Var.	*CAPEXTA (%)*	
PC	1.05***	0.26*
	(0.00)	(0.08)
Q	0.02**	0.02**
	(0.02)	(0.04)
PC*Q		0.07**
		(0.02)
LNSIZE	0.69***	0.73***
	(0.00)	(0.00)
LEV	-0.09	-0.09
	(0.17)	(0.18)
RETAINE	0.02	0.02
	(0.59)	(0.60)
ROA	-0.07	-0.18**
	(0.17)	(0.01)
NOCF	0.00	0.01*
	(0.30)	(0.09)
MANAGER	4.48***	4.41***
	(0.00)	(0.00)
LARGEST	0.94**	1.01**
	(0.04)	(0.03)
INSTITUTIONAL	2.15***	0.02***
	(0.00)	(0.00)
VOLATILITY	-0.13***	-0.13***
	(0.00)	(0.00)
Const	-8.91***	-9.35***
	(0.00)	(0.00)
Industry	INCLUDED in both columns	
Year	INCLUDED in both columns	
N	7253	7253
adj. R2	0.122	0.116

Panel C The effect of PC on dividend policy

This panel presents the regression results on the effect of PC on firms' dividend policy. The dependent variable, indicated at the top, is the dummy of cash dividends in Column (1), the ratio of cash dividends to earnings in Column (2), the dummy of stock dividends in Column (3), and the dummy of total dividends in Column (4). Definitions of all independent variables are reported in Appendix A. Standard errors are clustered at firm level. p-values are displayed in brackets. *, **, and *** indicate significance at the 10%, 5%, and 1% levels, respectively.

Var.	CD_DUMMY	DTE(%)	SD_DUMMY	TD_DUMMY
PC	-0.03***	-2.40***	-0.01	-0.03***
	(0.01)	(0.00)	(0.22)	(0.01)
WEDGE	-0.00***	-0.15***	-0.00**	-0.00***
	(0.00)	(0.00)	(0.05)	(0.00)
LNSIZE	0.13***	1.88***	0.01	0.13***
	(0.00)	(0.00)	(0.12)	(0.00)
LEV	-0.02***	-0.93**	-0.01**	-0.02***
	(0.00)	(0.02)	(0.02)	(0.00)
RETAINE	-0.01***	-2.19***	0.00	-0.01***
	(0.00)	(0.00)	(0.99)	(0.00)
ROA	0.00	0.13	-0.00	0.00
	(0.40)	(0.66)	(0.73)	(0.44)
NOCF	-0.00	-0.00	0.00	-0.00
	(0.85)	(0.87)	(0.81)	(0.83)
Q	0.00***	0.01	0.00	0.00***
	(0.00)	(0.81)	(0.19)	(0.00)
MANAGER	0.70***	21.84***	0.52***	0.72***
	(0.00)	(0.00)	(0.00)	(0.00)
LARGEST	0.06*	6.70**	-0.00	0.06
	(0.09)	(0.02)	(0.98)	(0.13)
INSTITUTIONAL	0.49***	18.20***	0.37***	0.49***
	(0.00)	(0.00)	(0.00)	(0.00)
VOLATILITY	-0.02***	-0.84***	-0.01***	-0.02***
	(0.00)	(0.00)	(0.00)	(0.00)
Industry		INCLUDED in all columns		
Year		INCLUDED in all columns		
Const	-2.39***	-26.89***	-0.07	-2.32***
	(0.00)	(0.01)	(0.55)	(0.00)
N	7026	7027	7026	7026
adj. R2	0.215	0.065	0.071	0.211

Table 4 The effect of PC on corporate decisions in industries/regions with different levels of government interventions

Panel A Industries with different levels of government interventions

This panel reports the effect of PC on corporate decisions in two groups of firms that are classified based on their industries with different levels of government interventions: policy-affected industry and less policy-affected industry. An industry is defined as a policy-affected industry if it falls into the 10th, 11th, and 12th five-year plan issued by the Chinese central government during the period 2001-2005, 2006-2010, and 2011-2015, respectively. All control variables in Table 3 are also included in respective regressions but not tabulated. Standard errors are clustered at firm level. p-values are displayed in brackets. *, **, and *** indicate significance at the 10%, 5%, and 1% levels, respectively.

Panel A1. The effect of PC on SEO decisions in policy-affected industry and less policy-affected industry

Var.	*SEODUM*	*SEOSIZE*	*SEO RATIO*	*SEODUM*	*SEOSIZE*	*SEO RATIO*
	POLICY-AFFECTED INDUSRIES			LESS POLICY-AFFECTED INDSUSTRIES		
PC	0.06***	0.48***	1.79**	0.00	0.08	0.36
	(0.00)	(0.00)	(0.01)	(0.55)	(0.61)	(0.55)
Control variables, industry and year dummies	INCLUDED in all columns					
obs.	3957	3957	3957	3296	3296	3296
adj. R2	0.190	0.180	0.125	0.191	0.192	0.086

Panel A2. The effect of PC on investment in policy-affected industry and less policy-affected industry

Var.	*CAPEXTA (%)*	*CAPEXTA (%)*
	POLICY-AFFECTED INDUSRIES	LESS POLICY-AFFECTED INDSUSTRIES
PC	1.11***	0.17
	(0.00)	(0.31)
Control variables, industry and year dummies	INCLUDED in both columns	
obs.	3957	3296
Adj.R2	0.079	0.159

Panel A3. The effect of PC on dividend decisions in policy-affected industry and less policy-affected industry

Var.	CD_DUMMY	DTE (%)	SD_DUMMY	TD_DUMMY	CD_DUMMY	DTE (%)	SD_DUMMY	TD_DUMMY
	POLICY-AFFECTED INDUSRIES				LESS POLICY-AFFECTED INDSUSTRIES			
PC	-0.04***	-3.33***	-0.01	-0.04***	-0.01	-0.75	-0.01	-0.01
	(0.00)	(0.00)	(0.29)	(0.01)	(0.66)	(0.46)	(0.46)	(0.61)
Control variables, industry and year dummies	INCLUDED in all columns							
obs.	3835	3836	3835	3835	3191	3190	3191	3191
Adj.R2	0.220	0.060	0.080	0.219	0.235	0.115	0.062	0.226

Panel B Geographic regions with different levels of government interventions

The table reports the effect of PC on corporate decisions in two groups of firms that are classified based on their geographic regions with different levels of government interventions. According to the regional government intervention development index (GIID) of Chinese provinces provided by Fan et al., (2009), the eastern regions, which include: Beijing, Tianjin, Hebei, Liaoning, Shanghai, Jiangsu, Zhejiang, Fujian, Shandong, Guangdong and Hainan, have less government interventions, while other regions including Shanxi, Jilin, Heilongjiang, Anhui, Jiangxi, Henan, Hubei, Hunan, Inner Mongolia, Guangxi, Sichuan, Chongqing, Guizhou, Yunnan, Shaanxi, Gansu, Qinghai, Ningxia, Xinjiang and Tibet have more government interventions. All control variables in Table 3 are also included in respective regressions but not tabulated. Standard errors are clustered at firm level. p-values are displayed in brackets. *, **, and *** indicate significance at the 10%, 5%, and 1% levels, respectively.

Panel B1. The effect of PC on SEO decisions in policy affected regions with more or less government interventions

Var.	SEODUM	LN(SEOSIZE)	SEO RATIO	SEODUM	LN(SEOSIZE)	SEO RATIO
	POLICY-AFFECTED REGIONS			LESS POLICY-AFFECTED REGIONS		
PC	0.04***	0.40**	2.47**	0.01	0.11	0.28
	(0.00)	(0.02)	(0.02)	(0.33)	(0.36)	(0.59)
Control variables, industry and year dummies	INCLUDED in all columns					
obs.	2054	2054	2054	5199	5199	5199
R2/Pseudo R2	0.179	0.175	0.073	0.185	0.187	0.131

Panel B2. The effect of PC on investment decisions in policy affected regions with more or less government interventions

Var.	CPEXTA(%)	
	POLICY-AFFECTED REGIONS	LESS POLICY-AFFECTED REGIONS
PC	0.52**	0.17
	(0.03)	(0.23)
Control variables, industry and year dummies	INCLUDED in both columns	
obs.	2054	5199
Adj.R2	0.120	0.134

Control variables, industry and year dummies   INCLUDED in all columns

POLICY-AFFECTED REGIONS   LESS POLICY-AFFECTED REGIONS

Panel B3. The effect of PC on dividend decisions in policy affected regions with more or less government interventions

Var.	CD_DUMMY	DTE (%)	SD_DUMMY	TD_DUMMY	CD_DUMMY	DTE (%)	SD_DUMMY	TD_DUMMY
	POLICY-AFFECTED REGIONS				LESS POLICY-AFFECTED REGIONS			
PC	-0.12***	-5.42***	-0.04**	-0.11***	-0.01	-0.68	-0.01	-0.01
	(0.00)	(0.00)	(0.01)	(0.00)	(0.40)	(0.42)	(0.22)	(0.41)
Control variables, industry and year dummies	INCLUDED in all columns							
obs.	1984	1985	1984	1984	5042	5042	5042	5042
Adj.R2	0.308	0.176	0.058	0.305	0.185	0.049	0.074	0.182

Table 5 The effect of PC on market reactions to corporate decisions

This table presents the regression results on the effect of PC on market reactions to announcements of SEOs, M&As, and dividend policies. The dependent variable, indicated at the top, is the three-day (-1, 1) cumulative abnormal returns around the announcements, respectively. All independent variables are defined in Appendix. Standard errors are clustered at firm level. p -values are displayed in brackets. *, **, and *** indicate significance at the 10%, 5%, and 1% levels, respectively.

Var.	CAR (-1, +1)%		
	SEO	M&A	Dividend Initial and Increase
PC	6.92***	0.79**	-0.32***
	(0.00)	(0.01)	(0.01)
LN(SEOSIZE)	-0.98*		
	(0.07)		
SEOTYPE	-2.22***		
	(0.01)		
M&A SIZE		-1.22	
		(0.32)	
M&A LOCATION		0.80***	
		(0.01)	
M&A RPT		0.26	
		(0.52)	
M&A CASH		-0.25	
		(0.74)	
M&A HORIZONTAL		-0.12	
		(0.70)	
LNSIZE	-2.88***	-0.02	0.08
	(0.00)	(0.92)	(0.43)
LEV	4.53	0.29	-0.12
	(0.11)	(0.56)	(0.78)
RETAINE	0.73**	0.73*	-0.01
	(0.04)	(0.07)	(0.69)
ROA	22.67**	-0.08	-0.58
	(0.01)	(0.73)	(0.71)
NOCF	0.58	-0.06	0.58*
	(0.62)	(0.24)	(0.05)
Q	-0.51***	0.06	-0.02
	(0.00)	(0.44)	(0.65)
MANAGER	-0.86	2.16*	-0.41
	(0.80)	(0.08)	(0.34)
LARGEST	-2.21	0.99	-0.01
	(0.54)	(0.37)	(0.97)
WEDGE	-0.03	0.02	-0.00
	(0.65)	(0.41)	(0.61)
SR	-1.12	0.38	0.06
	(0.39)	(0.19)	(0.61)
INSTITUTIONAL	0.00	0.95	-0.01
	(0.92)	(0.28)	(0.13)
VOLATILITY	0.32	0.10	-0.03
	(0.24)	(0.14)	(0.30)
Const	38.68**	0.34	-1.32
	(0.02)	(0.94)	(0.51)
Industry		INCLUDED	
Year		INCLUDED	
obs.	392	4640	3798
adj. R2	0.091	0.001	0.023

Table 6 The effect of PC on external investors' voting in the annual shareholder meeting

This table reports the results of analysing how shareholders' voting on corporate decisions proposed by management in annual meeting is affected by PC. The dependent variable, REJECTION, is a dummy variable that equals 1 if at least one of the corporate policies proposed by management are rejected in the annual shareholder meeting and 0 otherwise. Definitions of other independent variables are reported in Appendix A. p-values are displayed in brackets. *, **, and *** indicate significance at the 10%, 5%, and 1% levels, respectively.

Var.	REJECTION
PC	-0.01***
	(0.01)
ATTEND	0.00**
	(0.02)
OUTSIDE	0.07***
	(0.00)
LNSIZE	-0.01***
	(0.00)
LEV	0.03***
	(0.00)
RETAINE	0.00
	(0.90)
ROA	-0.00
	(0.44)
NOCF	0.00
	(0.16)
Q	-0.00
	(0.21)
MANAGER	-0.05***
	(0.00)
LARGEST	0.00
	(0.65)
WEDGE	0.00
	(0.87)
INSTITUTIONAL	-0.00**
	(0.02)
VOLATILITY	0.00**
	(0.01)
Const	0.25***
	(0.00)
Industry	INCLUDED
YEAR	INCLUDED
obs.	7026
adj. R2	0.081

Table 7 An unconnected firm's decision to hire a PC CEO

This table presents the regression results on the determinants of having a PC CEO in the sample of unconnected firms. The dependent variable, *PC*, is a dummy variable that equals one if the firm hires a PC CEO in the year and zero otherwise. Definitions of all independent variables are reported in Appendix A. Standard errors are clustered at firm level. p-values are displayed in brackets. *, **, and *** indicate significance at the 10%, 5%, and 1% levels, respectively.

Var.	*PC*
INSTITUTIONAL	-0.02***
	(0.00)
VOLATILITY	0.00**
	(0.02)
WEDGE	0.01***
	(0.00)
POLICY AFFECTED INDUSTRY	0.02*
	(0.06)
POLICY AFFECTED REGION	0.02**
	(0.04)
LNSIZE	0.00
	(0.72)
LEV	-0.00
	(0.94)
LARGEST	-0.02
	(0.50)
MANAGER	-0.07**
	(0.02)
Q	-0.00
	(0.60)
ROA	0.00
	(0.82)
Const	-0.03
	(0.76)
Industry	INCLUDED
Year	INCLUDED
obs.	4720
adj. R2	0.039

Table 8 The impact of PC around the anti-corruption campaign

This Table presents the regression results on the effect of PC on corporate policies (Panel A) and market reactions to those policies as well as shareholder voting (Panel B) around the anti-corruption campaign. *ANTI* is an indicator for years after 2012 when the anti-corruption campaign started. Definitions of all other independent variables are reported in Appendix. Standard errors are clustered at firm level. p-values are displayed in brackets. *, **, and *** indicate significance at the 10%, 5%, and 1% levels, respectively.

Panel A The effect of PC on corporate policies around the anti-corruption campaign

Var.	(1) SEODUM	(2) LN(SEOSIZE)	(3) SEO RATIO	(4) CAPEXTA(%)	(5) CD_DUMMY	(6) DTE(%)	(7) SD_DUMMY
PC	0.02***	0.55***	3.26***	0.78***	-0.09***	-4.78***	-0.01
	(0.01)	(0.00)	(0.00)	(0.00)	(0.00)	(0.00)	(0.71)
ANTI	-0.01	-0.22	2.52*	-2.13***	0.00	-3.49	-0.11***
	(0.40)	(0.49)	(0.10)	(0.00)	(0.88)	(0.15)	(0.00)
PC*ANTI	-0.03***	-0.65***	-4.14***	-0.54**	0.04**	3.45**	-0.01
	(0.01)	(0.00)	(0.00)	(0.03)	(0.03)	(0.03)	(0.47)
Control variables				INCLUDED in all columns			
Industry				INCLUDED in all columns			
Year				INCLUDED in all columns			
Const	-0.18***	-4.38***	18.69***	-6.73***	-2.28***	-22.23**	-0.09
	(0.00)	(0.00)	(0.00)	(0.00)	(0.00)	(0.02)	(0.43)
obs.	7253	7253	7253	7253	7026	7026	7026
adj. R^2	0.184	0.185	0.104	0.116	0.218	0.064	0.071

Panel B The effect PC on market reactions to corporate policies and shareholder voting around the anti-corruption campaign

Var.	(1) CAR_SEO(-1,+1)%	(2) CAR_M&A(-1,+1)%	(3) CAR_DIV(-1,+1)%	(4) REJECTION
PC	5.11***	1.65***	-0.83***	-0.01***
	(0.00)	(0.00)	(0.00)	(0.01)
ANTI	1.12	-0.80	-1.91***	-0.02**
	(0.91)	(0.48)	(0.00)	(0.04)
PC*ANTI	-2.03**	-1.46**	0.84***	0.01**
	(0.03)	(0.03)	(0.00)	(0.03)
Control Variables		INCLUDED in all columns		
Industry and year dummies		INCLUDED in all columns		
Const	0.72	0.44	-1.89	0.32***
	(0.96)	(0.92)	(0.31)	(0.00)
obs.	392	4651	3906	7252
adj. R2	0.035	0.002	0.024	0.099

Table 9 The effect of born PC

This table presents the regression results on the effect of a firm's born PC on corporate policies and market reactions to them as well as shareholder voting. A firm's born PC, *BORNPC*, is defined as dummy that equals one if the founding Chairman/CEO of the firm acquires the PC status before the firm is founded and zero otherwise. Definitions of all other independent variables are reported in Appendix A. Standard errors are clustered at firm level. p-values are displayed in brackets. *, **, and *** indicate significance at the 10%, 5%, and 1% levels, respectively.

Panel A: The effect of born PC on corporate policies

Var.	*SEODUM*	*LN(SEOSIZE)*	*SEO RATIO*	*CAPEXTA(%)*	*CD_DUMMY*	*DTE(%)*	*SD_DUMMY*
BORNPC	0.03***	0.42***	2.29***	0.63***	-0.06***	-2.48**	-0.01
	(0.00)	(0.01)	(0.00)	(0.00)	(0.00)	(0.03)	(0.32)
Const	-0.13*	-2.71*	28.74***	-8.23***	-2.36***	-25.69**	-0.14
	(0.08)	(0.08)	(0.00)	(0.00)	(0.00)	(0.02)	(0.29)
Control variables				INCLUDED in all columns			
Industry				INCLUDED in all columns			
Year				INCLUDED in all columns			
obs.	5108	5108	5108	5108	5107	5108	5107
Adj.R2	0.188	0.188	0.109	0.100	0.228	0.066	0.067

Panel B The effect of born PC on market reactions to corporate policies and shareholder voting

	CAR_SEO(-1,+1)%	*CAR_DIV(-1,+1)%*	*CAR_MA(-1,+1)%*	*REJECTION*
Var.				
BORNPC	2.58**	-0.58***	-1.27***	-0.01***
	(0.02)	(0.00)	(0.01)	(0.01)
Control variables		INCLUDED in all columns		
Industry		INCLUDED in all columns		
Year		INCLUDED in all columns		
Const	32.42*	-3.42	4.58	0.31***
	(0.06)	(0.20)	(0.26)	(0.00)
obs.	280	2696	4850	4939
Adj.R2	0.006	0.017	0.002	0.100

Appendix: Definition of variables

This table provides detailed definitions for main regression variables used in the paper. Definition of other variables will be introduced when used.

Variables	Definition
	Dependent variables
SEODUM	A dummy variable that equals one if the firm conducts a seasoned equity offering in a specific year.
LN(SEOSIZE)	Natural logarithm of the gross proceeds from a SEO.
SEO RATIO	SEO size divided by market capitalization as of the end of the previous year.
DTE	Total cash dividend to earnings.
CD_DUMMY	A dummy variable that equals one if a firm pays cash dividend and zero otherwise.
SD_DUMMY	A dummy variable that equals one if a firm pays share dividend and zero otherwise.
TD_DUMMY	A dummy variable that equals one if a firm pays either cash or share dividend and zero otherwise.
CAPEXTA	Total capital expenditure to total assets as of the end of the prior year.
CAR(-1, +1)	Cumulative abnormal return from day -1 to day +1 around the event announcement day. We focus on the announcements of SEOs, dividend initial or increase, and merger and acquisitions (M&As).
REJECTION	A dummy that equals one if any of the policies proposed by management/controlling shareholders is rejected in the annual meeting and zero otherwise.
	Key independent variables
PC	A dummy variable that equals one if the CEO or chairman of the board is currently or was formerly an officer of the government or military, or a deputy of the National/Provincial People's Congress or People's Political Consultative Conference, and zero otherwise.
BORNPC	A dummy that equals one if the founder of the firm acquires the PC status before he/she founds the firm and zero if the firm does not have PC or the PC status is acquired after the firm is founded.
	Other control variables
ANTI	A dummy that equals one for sample years after 2012 (the anti-corruption campaign's starting year) and zero otherwise.
ATTEND	Number of shareholders who attend the annual shareholder meeting.
INSTITUTIONAL	Proportion of shares held by institutional shareholders.
LARGEST	Proportion of shares held by the largest shareholder.
LEV	Total debt to total assets.
LNSIZE	Natural logarithm of total assets.
MANAGER	Proportion of shares held by the CEO.
M&A CASH	A dummy that equals one if the M&A is made by cash payment only and zero if the deal is completed with stock payment or mixed payment of both stock and cash.

M&A HORIZONTAL	A dummy that equals one if the acquirer and the target are in different industries and zero otherwise.
M&A LOCTION	A dummy that equals one if the acquirer and the target are in the same region (governed by the same local (provincial) government).
M&A RPT	A dummy that equals one if the M&A deal is a related party transaction.
M&A SIZE	The deal value to total assets of the acquirer.
NOCF	Net operational cash flow to sales.
OUTSIDE	Share ownership by external shareholders who attend the annual shareholder meeting.
POLICY-AFFECTED INDUSTRIES	A dummy that equals one for policy affected industries and zero otherwise. An industry is defined as policy affected if it falls into a respective government plan during a year.
POLICIY-AFFECTED REGIONS	A dummy that equals one for firms that locate in regions with more government interventions. Following the regional government intervention development index (GIID) developed by Fan, Wang, and Zhu (2009), more government intervened regions include the following provinces and districts: Shanxi, Jilin, Heilongjiang, Anhui, Jiangxi, Henan, Hubei, Hunan, Inner Mongolia, Guangxi, Sichuan, Chongqing, Guizhou, Yunnan, Shaanxi, Gansu, Qinghai, Ningxia, Xinjiang, and Tibet.
Q	Total market value of equity divided by the replacement cost.
RETAINE	Total retained earnings to book value of equity.
ROA	Net profit to total assets.
SEOTYPE	A dummy that equals one if the SEO is a public issuance and zero if it is a private offering.
SR	Annual stock return.
VOLATILITY	Standard deviation of annual net earnings in the last three years.
WEDGE	The difference between control rights and cash flow rights of the controlling shareholder.