Birds of a Feather Sing together: Politically Connected

Director Clustering and Its Impact on Firm Performance

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Abstract

The economic effects of firm's political ties have attracted increasing scholarly attention in recent years. Different from prior research, this paper investigate the impact of political ties on firm performance for the lens of politically connected directors (PCD) clustering, which is a pervasive phenomenon in emerging economies but is ignored by academic researchers. This phenomenon enables us to build up a unified theoretical framework that considers the asset effect and liability effect of political ties at the same time. We hypothesize and find that there is a curvilinear relationship between firm performance and PCD clustering. Additionally, we find that there are many factors that affect PCD clustering. For instance, PCD clustering may reflect firms' historical burden, the industry needs, the bargaining power of the largest shareholders, as well as CEOs' preference.

Contents

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1. Introduction

The economic effects of firm's political connections have attracted increasing scholarly attention in recent years (Masters and Keim, 1985; Shleifer and Vishny, 1998; Fisman, 2001; Johnson and Mitton, 2003; Asim and Atif, 2005; Bonardi, Hillman and Keim, 2005; Hillman, 2005; Faccio, 2006; Faccio and Parsley 2007; Fan et al., 2007; Goldman et al., 2008; Lester et al, 2008; Goldman et al, 2009; Chen et al., 2011). Yet, despite the widespread debate, there is little systemic analysis on the impact of political ties on firm performance, which leads to theoretically ambiguous arguments, as well as conflicting empirical evidences (Hillman, 2005; Fan et al., 2007; Faccio, 2006; Peng and Luo, 2000).

There is an abundance of arguments, especially from the resource dependence perspective, on how firms with political connections can benefit from such a relationship (Bonardi, Hillman and Keim, 2005; Hillman, 2005; Chen et al., 2011). First, political connections may reduce the risk of expropriation by government agencies when the protection of property rights is weak (Chen et al., 2011). Second, close ties to the governments help businesses to overcome market failures and avoid ideological discrimination when the market is underdeveloped (Li et al., 2008). Third, firms with political connections may receive a substantial competitive advantage or preferential treatment, such as more likely being bailed out by the government (Faccio

et al., 2005), greater access to lucrative government contracts (Goldman et al, 2008), limiting competitors to enter the market (Benmelech and Moskowitz, 2007), and preferential access to credit (Khwaja and Mian, 2005).

However, there are also reasons why political connectedness can negatively impact a firm. Researchers have argued that caution is needed in making inferences about the benefits of political ties (Faccio, 2010). First, ties may split pies. Politicians may expropriate shareholder wealth for political considerations such as wealth distribution and excess employment (Shleifer and Vishny, 1998). Second, an excess of political intervention may lead to inefficient resource allocation and inferior strategic formulation (Shleifer and Vishny, 1994). Third, ties may lead to inefficiency. The goals pursued by the politically-oriented selected managers are not necessarily in line with profit or value maximization (Fan et al., 2007; Boubakri et al., 2008).

These mixed theoretical arguments and empirical findings suggest that it may be useful to explore the contingent relationships between political ties and firm performance. A tight and simple link between political ties and firm performance is inaccurate and misleading. In this paper, following the basic idea of Siegel (2007) that political ties can be either assets or liabilities, I decompose political ties into two components: political assets component (the positive component), and political liabilities component (the negative component). Then, I argue that the net impact of political ties on firm performance depends on which component dominates the other. Firms' valuation will be enhanced only when the marginal benefits of political ties outweigh their marginal benefits. In other words, if the assets component dominates

the liabilities component, the net effect is positive; if the liabilities component dominates the assets component, the net effect is negative. Therefore, the crux is to find the contingent conditions under which the two components can be distinguished and evaluated.

From the dynamic perspective of external environmental conditions, Siegel (2007) found that changes in political regimes can lead to positive cascades of favor exchange as well as negative cascades of discrimination, resource exclusion, and even expropriation. Enlightened by Siegel (2007) but different from him, in this paper, I consider the balance of asset effect and liability effect from the perspective of organizational internal structure, which can be a good indicator to distinguish the asset effect and liability effect of political ties. The influence of organizational structure on individual's attitudes and organizational performance has widely been recognized (Dalton et al., 1980; Hull, 1967). For instance, organizational structure is a major determinant of the activities of the people within it (Dalton et al., 1980). Similarly, Hull (1967) highlighted the importance of organizational structure by arguing that structure is the setting in which power is exercised, decisions are made, and the organization's activities are carried out. However, as to the research of political ties, prior research has largely neglected how organizational structure affect the net effect of political ties, and the boundary conditions of the established patterns of association between political ties and firm performance (positive or negative relationship) have not yet been investigated.

Hopefully to fill in the research gap, we investigate the impact of a special kind of

explicit political ties, namely, the ties of politically connected directors (PCDs), on the performance of firms that went public in the Chinese stock market during the period from 2002 to 2004. The time surrounding the initial public offering is a particularly rich setting for studying board issues because it is a time of significant change in the firm's governance. Examination of IPO firms may offer potential for more insightful analysis of corporate governance effects since corporate governance of the firm at listing is likely clearer than at any point in the firm's history (Filatotchev and Wright, 2005).

Different from prior research that only considers the existence of political ties and its impact, I focus on the phenomenon of PCD clustering on the board, which is pervasive in emerging economies but is ignored by academic researchers. In this paper, PCD clustering means that there are at least two PCDs on the board, and the level of PCDs clustering is measured by the proportion of PCDs on the board. Previous studies have far ignored PCD clustering. Why the phenomenon of PCD clustering attracts so little attention? One possible reason is that PCDs clustering is very rare in developed economies. For example, in Hillman's (2005) U.S. sample, the mean number of PCDs on the board is only 0.31. However, in my Chinese sample, the mean number of politically connected directors on the board is 1.92. What's more, the proportions of PCDs on the boards vary greatly, ranging from zero to 78 percent. Thus, studying Chinese firms can provide evidence about the effects of PCD clustering that is impossible to detect from the U.S. context. To the best of my knowledge, this is the first paper focusing on this phenomenon and its impact on firm performance. Another

possible reason is that researchers are more likely to use the dichotomous division as a simplification. In order to analyze PCD clustering, we need the background information of all directors. Therefore, the data collecting of PCD clustering is more time-consuming than that of the dichotomous division.

Like political regimes switching, PCD clustering provides us good lens to investigate the asset effect and liability effect of political ties. Most of the extant research literatures apply a dichotomous division (Hillman, 2005; Fan et al., 2007; Faccio, 2006; Boubakri et al., 2008): firms are simply divided into two categories (firms with political ties and firms without political ties). There is no doubt that this dichotomy has its merits. However, this simplicity can cause problems if the reality is beyond the premise. I will demonstrate that this assumption is not valid and can lead to erroneous conclusions, especially in China context. It's obvious that this dichotomy has a debatable premise, namely, the net effect of political ties being consistent across firms (either positive or negative, and cannot be both). But, if political ties have both positive effect and negative effect, and the net effect varies across firms, this dichotomy may be misleading. The ties that bind may also turn into ties that blind. The method of PCD clustering enables the intensity (or the level of involvement) of political ties to be measured instead of simply having an indication of its presence. Therefore, PCD clustering will overcome the shortcomings of the dichotomous division, and make it feasible to investigate the non-linear relationship between political ties and firm performance.

In this paper, I propose that PCD clustering are functions of firm characteristics.

What's more, the key claim is that the relationship between firm performance and PCDs clustering is non-linear. It may be that beyond a certain threshold, additional PCD clustering compromise its asset effect. The theoretical underpinning for the claim is that social ties have both asset component and liability component and the net effect of social ties on firm performance depends on different conditions. Social capital may not be the panacea it was once believed to be, and there are situations in which it has negative consequences (Johnson and Ross, 2009).

This paper try to answer the following three questions: how pervasive are PCD clustering in China? In which firms are PCD clustering more likely to be observed? How does PCD clustering affect firm performance?

This study contributes in two important ways. First, we pay attention to a new phenomenon that is common in China but rare in U.S. To the best of my knowledge, this is the first study to document systematically a specific phenomenon (PCD clustering) and its impact on firm performance. Through the lens of PCD clustering, we show that political ties have both asset component and liability component. Extant research has seldom considered the two components in a unified framework. Second, we advance the corporate governance literature by describing how specific kinds of directors, board structure and composition are related to firm characteristics. Specifically, PCDs and PCD clustering may have historical causes, ownership structure or bargaining power causes, CEO preference causes, and the industry-needs causes. Finally, we provide empirical support for our conceptual framework using a sample of 232 IPOs in China during the period of 2002-2004.

The remainder of this paper is organized as follows. Section 2 provides a brief literature review. Section 3 develops the theoretical framework and hypotheses. Section 4 presents the empirical analysis and results. Section 5 concludes.

2. Literature review

This paper aims to investigate the relationship between political ties and firm performance through the lens of board of directors. Therefore, this study relates to two main strands of the literature. The first strand studies how board of directors affects firm performance, in particular, how board attributes and directors' characteristics affect firm performance. The second strand studies how social ties, especially political ties, affect firm performance. In this section, we will give a brief literature review.

2.1 Board of directors and firm performance

The influence of board of directors on firm performance has been extensively discussed. As summarized by Hillman and Dalziel (2003), boards of directors affect firm performance commonly through two distinct conduits. First, from an agency theory perspective, boards can improve firm performance by effective monitoring. However, agency theory has put a great emphasis on board control tasks, thinking little of value creation and value distribution. Second, from a resource dependence theory perspective, boards can act as providers of resources such as advice and counsel, links to other organizations. Firm performance will be improved if boards have more board capital (including both human capital and relational capital) and the firm can effectively take advantage of the board capital. Corporate boards are

composed of experts, who bring valuable expertise and potentially important connections to the firm (Fama and Jensen, 1983).Additionally, from an institutional theory perspective, boards can convey the message to outsiders that whether the firm is acting in a proper manner. In order to survive, firms need to conform to what is socially appropriate and acceptable (Zucker, 1982). Therefore, boards serve to legitimate the firm. It is widely acknowledged that no single theory can explain the complex patterns of links between board of directors and firm performance (Jackling and Johl, 2009). For instance, Yermack (1996) has combined agency theory and resource dependence theory together and argue that firm performance depends on the quality of monitoring and decision-making by the board of directors.

A great wealth of literature has investigated the impact of board of directors on firm performance. The characteristics of board include board size, board independence, CEO-Chair duality, board diversity, and specific directors.

2.1.1 Board size

Some researchers claim that small board is desired. Their arguments are mainly based on the agency theory or from decision making perspective. Borrowing insight from organizational behavior research, Jensen (1993) posits that 'as groups increase in size they become less effective because the coordination and process problems overwhelm the advantages from having more people to draw on'. In the same token, Lipton and Lorch (1992) argue that larger boards could be less effective than smaller boards because of coordination problems and free-riding. Yermack (1996) presented evidence that firms with a smaller board have higher market valuation, verifying that small

boards are more effective. .

Nowhere is not in dispute. However, researchers in the resource dependence strand strike back and assert that larger boards are better. The basic underpinning is that larger boards may serve as a signal that the firm has access to a wider range of critical environmental resources (Pfeffer and Salancik, 1978). Larger boards potentially bring more experience and knowledge and offer better advice (Dalton et al., 1999). Coles et al. (2008) find that firm performance increases in board size in complex firms. Core et al. (1999) stand in the midpoint of agency theory and resource dependence theory, and argue that there may a nonlinear relationship between board size and firm performance. They think that it may be that beyond a certain threshold, additional directorships compromise directors' effectiveness (Core et al., 1999).

2.1.2 Board independence

It is widely acknowledged that independence improve the quality of monitoring. In order to reduce interest conflicts, Jensen (1993) suggest that CEO should be the only insider on the board of directors, because insider-dominated board could be a device for management entrenchment. Baysinger and Butler (1985) find evidence that firms perform better if boards include more outsiders. The reason behind is that boards dominated by outsiders are more likely to behave in shareholders' interest. Rosenstein et al. (1990) find evidence that the appointment of outside directors is related to positive market reaction. Faleye (2007) find that classified boards will reduce board independence and hinder the effectiveness of corporate governance, hurting the firm's ability to create value for its shareholders.

Nonetheless, board independence could also do bad things. For example, powerful

boards can be disastrous for a company. The Coca-Cola board was criticized for

having intervened too much in executive decision making, vetoing important strategic

decisions (Holmstrom, 2005). Bhagat and Black (2001) suggest that "inside and

affiliated directors play valuable roles that may be lost in a single-minded drive for

greater board independence". Maug (1997) shows that it is not optimal for firms with

high information asymmetry to invite monitoring from independent directors because

it is costly for the firms to transfer firm specific information to outsiders.

Contextualizing the argument in specific condition, Coles et al. (2008) suggest that

insiders are more valuable if firms have specific knowledge, such as R&D-intensive

firms. Thus, such firms should have a higher fraction of insiders on the board.

Adams and Ferreira (2007) and Raheja (2005) model board structure and generally

suggest that the number of outsiders decreases in the cost of monitoring. Similarly,

Linck et al.(2008) empirically find that firms with high growth opportunities, high

R&D expenditures, and high stock return volatility are associated with smaller and

less independent boards. The reason is that the monitoring cost is relatively high to

their counterparts. Faleye et al. (2011) find that the improvement in monitoring

quality comes at the significant cost of weaker strategic advising and greater

managerial myopia. Firm value results suggest that the negative advising effects

outweigh the benefits of improved monitoring, especially when acquisitions or

corporate innovation are significant value drivers or the firm's operations are complex.

As to the diverse national institutional settings, Augulera et al. (2008) argue that

board independence will have a positive influence on the effectiveness of corporate governance in the U.S. firm, but a potentially negative influence in the U.K. firm.

2.1.3 CEO-Chair duality

Agency theory is strongly against CEO-Chair duality. The board will be unable to effectively monitor managers if board duality exists (Jensen and Fama, 1983). Pi and Timme (1993) find that board controlled by CEO is likely to lack independence and vigilance, resulting in poor firm performance.

Stewardship theory recognizes the non-financial motives for managers. These motives include achievement and recognition, intrinsic satisfaction of successful performance. As a result, board duality will have positive performance effects because duality empowers the CEO and stimulates to achieve. Additionally, board duality will builds trust and empowerment and permits clearcut leadship for strategy formulation and implementation (Muth and Donaldson, 1998).From a contingent perspective, Boyd (1995) has argued that board duality will be more helpful under conditions of resource scarcity and environment dynamism. Empirically, Peng et al. (2007) offer strong support for stewardship theory and find that board duality can enhance Chinese firms' performance.

2.1.4 Particular types of directors

A small literature that is closer to this study is on particular types of directors. These particular types of directors include banks, venture capitalists, politically-connected directors, CEO-directors (directors who are themselves CEOs of other firms), and stakeholder representatives on board.

Particular types of directors attract academic attention because they can play particular roles in resource provision or corporate governance. For instance, Dooley (1969) observes that an industrial company whose board is occupied by a banker can obtain capital at favorable rates. Guner et al. (2008) argue that increasing financial expertise on boards may not benefit shareholders if conflicting interests exist. The empirical evidence indicates that after commercial bankers join boards, external funding increases and investment-cash flow sensitivity decreases. However, the increased financing flows to firms with good credit but poor investment opportunities. Similarly, investment bankers on boards are associated with larger bond issues but worse acquisitions. As to venture capitalists, Baker and Gompers (2003) find that a high-reputation venture capitalist on the board leads to a more powerful board, even after the venture capitalist exits his investment. Fich et.al., (2006) suggest that firms with busy boards, those in which a majority of outside directors hold three or more directorships, are associated with weak corporate governance. These firms exhibit lower market-to-book ratios, weaker profitability, and lower sensitivity of CEO turnover to firm performance. For directors who are themselves CEOs of other firms, Westphal and Zajac (1997) caution that social exchange and generalized norms of reciprocity are more likely to develop among CEO-directors and CEOs. They empirically find that CEO-directors typically support fellow CEOs by impeding increased board control over management. For stakeholder directors, Luoma and Goodstein (1999) argue that stakeholder representation promotes procedural fairness by providing a means of ensuring that stakeholder considerations are more directly

represented in corporation decision making.

Even though these studies mentioned above are related to this paper, a marked feature
of these studies is that they didn't investigate the clustering effect of particular types
of directors.

2.2 Political ties and firm performance

Doe political ties contribute to firm performance? Frankly speaking, this is a
controversial and inclusive question. Two views are directly at odds with each other.
On one hand, firms with political connections could have better firm performance
than firms without. It is possible that political connections give those firms more
rent-seeking advantages, which lead to their better business performance. Faccio et al.
(2005) show one direct way in which connections create value by demonstrating that
politically connected firms are more likely to be bailed out by the government.
Goldman, Rocholl, and So (2008) provide evidence that government officials can
influence the allocation of lucrative government contracts toward the connected
company. Faccio and Parsley (2007) present indirect evidence that companies located
in a politician's hometown decrease in value upon the announcement of the
politician's unexpected death. Similarly, Benmelech and Moskowitz (2007) find
evidence that usury laws were used by incumbents with political power to limit their
competitors' ability to enter the market. Furthermore, political connections create
value by generating future benefits to the firm (Goldman et al., 2009). From another
perspective, CEO's political incentives for promotion may have a positive effect on
firm performance (Cao et al., 2010). Cao et al. (2010) argue that CEO's political

career concerns not only provide strong incentives but indirectly align CEOs' interests with those of shareholders. Thus, the competitive political arena acts as an informal incentive mechanism for CEOs, one that mitigates the weak corporate governance in emerging market such as China (Cao et al., 2010). Research on Chinese business finds that personal ties with officials help the company achieve more institutional supports to mitigate challenges arising from market uncertainty (Peng and Luo, 2000; Xin and Pearce, 1996).

On the other hand, there is also a wealth of literature indicating that political ties may lead to poor firm performance. Shleifer and Vishny (1994) explain that political control of firms leads to a less efficient resource allocation than managerial control. Government-owned firms are thought to forgo maximum profit in the search for social and political objectives such as wealth distribution and employment. Shleifer and Vishny (1998) argue that governments may expropriate shareholder wealth from public firms for political considerations. Corrupt government bureaucrats enrich themselves by misappropriating funds from these firms or by demanding lavish perks. The expropriation may be facilitated by the presence of politician directors on boards. Additionally, a special case of firms with political ties is public enterprises. They are highly inefficient, and their inefficiency is the result of political pressures from the politicians who control them. Faccio (2010) find that political-connected firms are poor performers. What's more, companies connected through the weakest relationships have the highest market valuation. In China context, Fan et al. (2008) also find that firms with politically connected CEOs are related to poor firm

performance. Public choice theory calls particular attention to the self-interested

behavior of bureaucrats who seek to maximize their own budgets (Niskanen, 1971).

Politicians give priority to securing political support in order to increase their chances

for staying in power (Buchanan et al., 1980). For instance, politicians may take

advantage of firm resources to fulfill individuals' political capital. Researchers found

that politician may make inefficient oversea M&A (merger and acquisition) to attract

political attention and in turn enhance their political capital (Huang, Wong, and Zhang,

2008).

3.   Theoretical Framework and Hypotheses

A growing body of corporate governance literature has investigated the relationship

between firm's political ties and firm performance, yet there is relatively little

research on PCD clustering, especially the determinant of PCD clustering and its

impact on firm performance. There is no general equilibrium theory of board structure

(Linck et al., 2008), so we need to consider PCD clustering from different

perspectives and use multiple theories. In this section, several theories are presented

to explain the variation of PCD clustering across firms and the effect of PCD

clustering on firm performance.

3.1 The Path Dependence Theory and PCD clustering

Path dependence has been offered as an analytical perspective for economics and

organization management (Swell, 1996; Liebowitz and Margolis, 1995; Yoshikawa

and Rasheed, 2009). The basic idea of path dependence is "history matters". For

instance, Sewell (1996) suggests that path dependence means that what happened

earlier will affect the possible outcomes of a sequence of events occurring later. At the firm level, path dependence means that the initial condition and path taken affect the following choice.

Path dependence has been widely adopted to analyze the heterogeneity of corporate governance. For example, Yoshikawa and Rasheed (2009) argue that path dependence is one of the major impediments that stands in the way of the convergence of corporate governance. Bebchuk and Roe (1999) use the term 'structrue-driven path dependence' and argue that prior ownership structure has a direct effect on subsequent ownership structure.

As an important corporate governance mechanism, boards of directors also have the historical heredity. Tolbert and Zucker (1983) suggest that the boards tend to reflect the historical era in which they originate, since organizations generally adopt and retain the form that is predominant at that time. Similarly, Lynall et al. (2003) argue that there exists path dependence within the context of boards. What' more, the path-dependent nature of board composition implies that boards may vary in their ability to meet the needs of the current firm situation, depending on when they were initially formed.

From the historical perspective, the most striking difference among the listed firms in China is their background. Some are partially privatized state owned enterprises (SOEs) affiliated to the central government, and some partially privatized state owned enterprises (SOEs) affiliated to the local governments, and the others are privately-founded firms. For example, privately-founded firms and firms carved from

SOE have different history. In China, most listed firms are carve-outs or spin-offs

from large SOEs, and they still share personnel functions, capital, and assets with

their parents (Deng et al., 2006). Because of the path dependence, a firm's board

structure at any point in time depends partly on the structure it had before.

Consequently, when firms have different backgrounds and history, these differences

might persist at later points in time even they become public listing firms. By

applying path dependence theory, we can get the clues that the difference in

background will lead to the difference in PCD clustering.

Compared to privately-founded firms, there are two possible reasons that partially

privatized state owned enterprises (SOE) have higher level of PCD clustering. First,

partially privatized SOEs have easier access to political resources, compared to their

privately-founded counterparts, so it's more convenient for partially privatized SOEs

to appoint directors who are politically connected. Board composition will reflect the

social networks of the principal stakeholders (Lynall et al., 2003).

Second, former PCDs will continue to occupy the board. If initial pattern provide one

group of players with relatively more wealth and power, this group would have a

better chance to have corporate rules that it favors down the road (Bebchuk and Roe,

1999). Levi (1997) has argued that the entrenchments of certain institutional

arrangements obstruct an easy reversal of the initial choice. Positional advantages of

vested interest groups will be one of the important impediments to changes and

reform that may potentially invade the vested interest group. In China context, Peng

(2004) has provided evidence that older, more established firms usually have

well-entrenched structures supported by vested interest, and initially may not be interested in introducing new governance practices. Moving toward to boards of directors, Chen et al. (2008) find that when firms first list, the senior management and board of directors are often the incumbents from before listing and they owe their appointments to political patronage, seniority, and service to the Chinese Communist Party. The incumbent managers have established relations with the initial controlling shareholder and they often become entrenched and complacent.

Additionally, prior research has suggested that the central government and local governments have divergent interests in SOEs that are affiliated with them (Bai et al., 2006; Cheung et al., 2008; Chen et al., 2009). For example, local governments may have fewer resources than the central government to perform a social role, resulting in their search for alternative sources of revenue (Cheung et al., 2008). Listed firms in China pay out dividends when the local governments have cash-flow problems (Lawrence, 1999). Chen et al. (2009) also suggests that distinctions should be made among SOEs affiliated to the central government and those affiliated to local governments because SOEs affiliated to local governments face stricter monitoring and supervision. From the perspective of related party transactions, Cheung et al. (2008) find that benefits are concentrated in firms controlled by the central government while expropriation is concentrated in firms controlled by local governments. They attribute these results to the fact that local governments have more freedom to expropriate. Local governments, in most cases, appoint the management of listed firms (Liu and Lu, 2007).

Based on the discussion above, we state out the hypotheses as follows.

Hypothesis 1a: Firms that carved from SOEs affiliated to local governments will have a greater degree of PCD clustering than other firms.

Hypothesis 1b: Firms that carved from SOEs affiliated to central government will have a greater degree of PCD clustering than other firms.

3.2 Bargaining power and PCD clustering

From the bargaining power perspective, firms can be depicted as complex political systems with agents organized in coalitions, and some of them further organized into sub-coalitions. Goal conflicts are solved through political bargaining rather than through objective alignment by economic incentives (Cyert and March, 1963). Power is defined as the capacity of individual actors to exert their will (Finkelstein, 1992). Similarly, power means one social actor have the capability of overcoming resistance in achieving a desired outcome (Pfeffer, 1981). Finkelstein (1992) present four dimensions of power measuring, namely: structure power that comes from formal organizational structure and hierarchical authority, ownership power that comes from the ownership, expert power that comes from the ability to deal with environment contingencies and contribute to organizational success, and prestige power that comes from personal prestige or status.

Governance structures should be viewed as arising from bargaining power rather than as precursors to bargaining power (Coff, 1999). The bargaining power theory suggests that the arrangements are determined by negotiation between individual actors involved (Arino and Torre, 1998). The eventual distribution of ownership and control

will be attributed to the relative bargaining power possessed by individual actors (Lee et al., 1998). A governance structure that favors stockholders is a manifestation of their bargaining power rather than a tool used to grant bargaining power in the first place. By applying the analytical framework of bargaining power theory, Mak and Li (2001) find that firms with high managerial ownership tend to have low proportion of outside directors. They also find that firms with higher outside blockholder ownership are more likely to employ the dual leadership structure (different people hold the chairman of the board and CEO positions). Analyzing a sample of French IPO firms, Roosenboom (2005) find that board composition reflects the relative bargaining power of stakeholders. Specially, owner-managers tend to entrench and capture the board. The fraction of independent directors declines if the owner-manager is more powerful. Venture capitalists will help to prevent the reduction in the proportion of independent directors in the board. Powerful managers may structure their boards in ways that are more advantageous to themselves. Linck et al. (2008) find that high managerial ownership is associated with smaller and less independent boards.

Does bargaining power affect PCDs clustering? By conducting a benefit-cost analysis, I will show that the relative bargaining power which derives from ownership may have an impact on PCDs clustering. In this study, I focus on the relative bargaining power of the largest shareholders. Power is a context-specific concept and can only be understood in a particular context (Emerson, 1962). In this study, the context is shareholders that have different ownership percentages and board composition which are determined by the negotiation of shareholders. Hence, ownership power is the

measure of bargaining power. This argument is consistent with Salancik and Preffer (1980) who aregue that ownership represents a source of power that can be used to either support or oppose managers, and Grossman et al. (1986) who define ownership as the power to exercise control and delegate this control to the board of directors. Zald (1969) has found that a top manager with significant shareholdings will be more powerful than a manager without the ownership.

Why does bargaining power affect PCD clustering? Typically, listed firms have many shareholders, and the incentives to seek and establish political connections may vary cross shareholders. The largest shareholder with overwhelming bargaining will have strong motivation to establish political ties and improve PCD clustering. First, political ties means rent seeking. When the largest shareholder has overwhelming bargaining power, he can keep the private benefits arising from political ties to himself because rent appropriation is a function of bargaining power. Therefore, the largest shareholder who has overwhelming bargaining power has strong motivation to establish political ties. Second, overwhelming bargaining power of the largest shareholders is more suitable to breed political ties. The overwhelming bargaining power of the largest shareholder will lead to a centralized power structure. On one hand, centralized power structure may increase the homogeneity of interest, and homogeneity will help achieve consensus on rent seeking activities. On the other hand, centralized power structure will reduce exchange and transfer of important information, resulting in lower probability of information leakage to outsiders. Chen et al. (2011) provide evidence that corporate political connections are positively

correlated with the proportion of shares owned by the controlling owner.

For the reasons discussed above, we can expect that the bargaining power of the largest shareholder will positively affect the degree of PCD clustering. Hence,

Hypothesis 2: The degree of PCD clustering is positively associated with the bargaining power of the largest shareholder.

3.3 Regulated industries and PCD clustering

Apart from the path dependence and bargaining power, the differences between industries may also have great impact on PCD clustering. A board's composition reflects the firm's external dependencies (Preffer, 1972). Hillman et al. (2000) empirically support this hypothesis. They find that board composition changes parallel the changing resource dependence needs of the firms. With the process of undergoing deregulation, the airline firms have more business experts and less former government officials on the boards. Since after deregulation, many competitive strategic actions become available to firm, and experts can provide expertise and advice concerning strategic actions and options. From the benefit-cost analysis framework, Grier et al. (1994) indicate that both the costs and benefits of political activity vary across industries. Hillman (2005) found that politician directors are more valuable to firms in more heavily regulated industries.

Government regulation differs among industries, deriving from idiosyncratic paths of decentralization between industries and also from governmental needs for controlling strategically vital industries (Luo, 2003). For firms in heavily regulated industries, political ties are established to meet the needs of survival and development. Forming

linkages with the government takes on increased importance for firms in more heavily regulated industries. Grier et al. (1994) suggests that industries with greater potential benefits from government assistance will contribute systematically more. Firms are most likely engage in political activity when the government significantly affects their business (Bonardi, Hillman and Keim, 2005). Industrial regulation highlights firms' dependence on regulators (Luo, 2003). In regulated industries, firms need improved relationship with the government to create a more favorable environment in which they benefit from rapid information exchange. Pfeffer and Salancik (1978) indicate that firms operating within highly regulated industries have a context that reinforces accountability to public concerns and heightens the importance of maintaining legitimacy. It was reported by Lianhe Zaobao that more than fifty government officials (former and current) serve on ZiJin Mining, the country's largest gold miner. Additionally, regulated industries have more interactions with the government, which may reduce the costs of establishing political ties. Firms in regulated industries may use personal ties with officials more extensively, which then results in a stronger link between networking and regulation (Luo, 2003).

Based on the arguments above, we come up with the hypothesis,

Hypothesis 3: Firms in regulated industries will have a greater degree of PCD clustering than firms in non-regulated industries.

3.4 PCD Clustering and Firm Performance

Last but not the least, we develop a hypothesis about the relationship between PCDs clustering and firm performance. Political ties do not necessary lead to higher level of

firm performance. Just as we mentioned in the introduction part, a complete theory of the political ties and firm performance must consider both the asset effect and liability effect. The net effect depends on how much of rents created by political ties are appropriated by shareholders, and how much of costs are incurred to establish and maintain political ties, as well as how much negative externality that political ties induce.

From the resource dependence perspective, researchers emphasize the benefits deriving from political ties. However, Coff (1999) has suggested that the resource-based view can become a significant tool for predicting firm performance if it simultaneously explores how rent is generated and how it is appropriated. He has argued that performance is an outcome of a two-stage game. Rent generation is the first stage, and rent appropriation is the second stage. We cannot predict firm performance if our theory only speaks to the first stage.

We build up our hypothesis in two steps. In the first step, we will theoretically argue that the marginal benefit of PCD clustering is a decreasing function of PCD clustering, and the marginal cost of PCD clustering is an increasing function of PCD clustering. In the second step, the hypothesis is set up.

Why the marginal benefit of PCD clustering is a decreasing function of PCD clustering? Generally, there are two possible reasons, namely, resource homogenization and responsibility shuffling. In economic literature, the law of diminishing marginal return is widely accepted. The basic idea is that adding more of one factor of production, while holding all others constant, will yield a lower per-unit

return. A direct result of PCD clustering is the overlap of political resources. In China,

PCDs obtain their political capital from the same ruling party (the Chinese

Communist Party) and the same government led by the ruling party, the same source

will result in homogenization of political capital. Therefore, the more the PCDs on the

board, the less the marginal benefit.

Another potential result of PCD clustering is responsibility shuffling among PCDs. A

famous Chinese proverb goes that 'One monk fetches water to drink, two monks carry

water to drink, when three monks are together, they have no water to drink' or 'One

boy is a boy, two boys half a boy, three boys no boy.' When several PCDs all have

the channel to help the firm acquiring resources, responsibility shuffling may occur.

The more PCDs that help, the less work they do. Why this would happen? This

happens because that more substitutability leads to lower valuation. Burt (1997) found

that promotions and compensation depend on the extent to which individuals control

unique ties to key resources. Individuals' behavior will be less priced if others can do

the same work. This externality caused by other PCDs will reduce individual's

inclination to provide political resource.

There are several reasons that the marginal cost of PCD clustering rises with an

increase in PCD clustering. First, PCD clustering may facilitate rent appropriation.

Coff (1999) has argued that if actors have strong bargaining profiles, the rent may not

appear in performance measures because they can use the bargaining power to

appropriate the rent. For PCDs, their bargaining power will increase as PCD

clustering increases. Furthermore, Rent appropriation is a function of stakeholders'

power (Hickson et al., 1971; Pfeffer, 1982). As a result, PCDs clustering may enhance

the power of PCDs as a whole and facilitate rent appropriation.

Marginal Benefit

PCD clustering

Marginal Cost

PCD clustering

Marginal effect

PCD clustering

Net effect
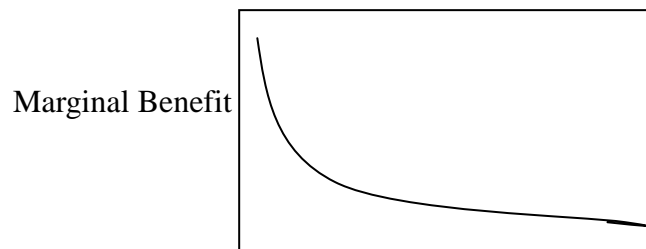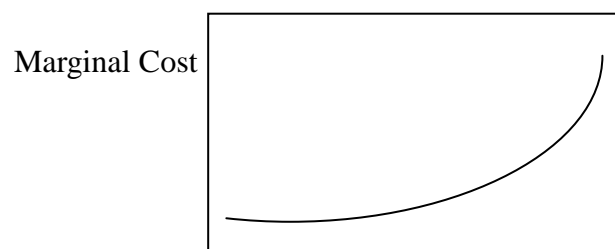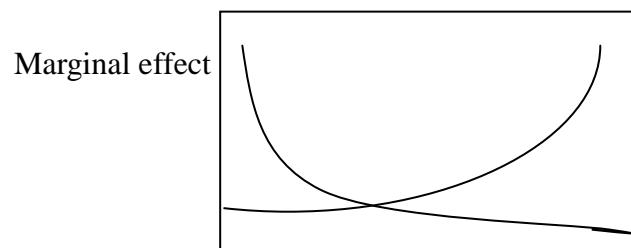
PCD clustering

Second, governance quality will decrease as PCDs clustering increases. PCD

clustering could potentially weaken the governance role of other directors who have

no political ties, making the board less effective. A direct result of PCDs is

centralization in authority and decision-making power. In an Empirical test on

26

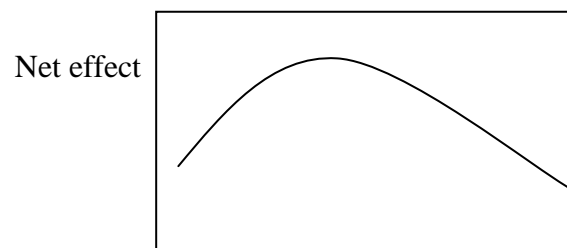Chinese firms, Chang and Wong (2004) find that PCDs are not effective in performing their monitoring role.

Third, PCD clustering has the potential of groupthink. The homogeneity of members' social background and ideology will hinder viewpoints outside the comfort zone of consensus thinking (Esser, 1998). A variety of motives for this may exist such as a desire to avoid being seen as foolish, or a desire to avoid embarrassing or angering other members of the group (Heller, 1983). Groupthink may cause groups to make hasty, irrational decisions, where individual doubts are set aside, for fear of upsetting the group's balance (Hart, 1991). Therefore, if the board is PCDs dominated, groupthink may occur and decision making will consider more from the political perspective.

Fourth, PCD dominated board may have a Crowd-out Effect on professionalism. Fan et al. (2007) find that when the board has more bureaucrats, firms are associated with low professionalism: the firm has fewer directors with experience in accounting, finance, or law. Drach et al. (2001) investigate the impact of team functional diversity on information exchange and innovation. They find that functional diversity prompts information exchange, and information exchange, in turn, positively affect team innovation. Earley and Mosakowski (2000) empirically find that subgroups negatively affect team performance. Obviously, as the degree of PCD clustering, functional diversity of boards will decrease and subgroups will form.

Integrating the decreasing marginal benefit of PCD clustering and increasing marginal cost of PCDs clustering, we may logically postulate an inverted U-shaped relationship

between firm performance and PCD clustering. Hence,

Hypothesis 4: Firm performance has an inverted U shape relationship with increased PCD clustering.

4. Empirical analysis

4.1 Sample

Our sample frame includes 232 listed firms that went to public on the Shanghai Stock Exchange and the Shenzhen Stock Exchange during period from 2002-2004. In order to smooth out annual fluctuations, we obtain three year data which includes 696 observations after excluding (1) cases without sufficient information about the background of the board of directors, (2) observations with missing values for other variables, and (3) financial institutions. Data on the board of directors were collected from the IPO prospectuses of newly listed A-share companies on the Shanghai Stock Exchange and the Shenzhen Stock Exchange. Additionally, we rechecked the information by using the search engine Baidu Baike (http://baike.baidu.com) and get more information about their background.

4.2 Measures and statistics

We define politically connected directors as those who are/were current and former government officials, as well as members of the People Congress (PC) or members of the Chinese People's Political Consultative Conference (CPPCC). There are several reasons we adopt this definition.

Much of the research on politician directors has different definition of politically connected directors. In the US political context, Hillman et al. (2005) define

politically connected directors as directors with political (elected or appointed) experience at the local, state, or national level. Goldman et al. (2008) identify politically connected directors by the criterion of whether he or she at any time in his or her past held a position such as senator, member of the House of Representatives, or member of the administration, or has been a director of an organization such as the Central Intelligence Agency. In China context, Fan et al. (2007) judge a politically connected director by considering whether he or she was currently or formerly an officer of the central government, a local government, or the military. Li, Meng and Zhang (2006) measure political ties by considering whether the entrepreneur has membership of the party, the People Congress (PC), or the Chinese People's Political Consultative Conference (CPPCC). By considering the characteristics of China's political system, we define politically connected directors as those who are/were current and former government officials, as well as members of PC or members of CPPCC. The PC is China's legislature body, and the CPPCC is an advisory body to the party/government in China, somewhat analogous to an advisory legislative upper house (Li et al., 2006). We include members of PC and members of CPPCC in politically connected directors because members of PC/CPPCC have many opportunities to interact with government officials, and government officials also need political support from these two political bodies.

PCD clustering is measured by the ratio of the number of PCDs and board size. We measure firm performance by considering both operating performance and financial market performance. Return on assets (ROA) is used to measure firm operating

performance, and previous work in China has already used and validated this performance measure (Luo, 1995; Luo and Chen, 1997; Tan and Litschert, 1994; Peng and Luo, 2000). Generally, we measure board size by the number of directors on the board. Board duality is a dummy variable which equals to 1 if the chairman and CEO is the same person, 0 otherwise. Board independence is measured by the fraction of independent directors on the board.

Consistent with Fan et al. (2007), a dummy variable equals to one if the firm is in a heavily regulated sector (natural resources, public utilities, and real estate). I differentiate three types of controlling shareholders, namely, the central government (CG), the local government (LG), and private. These distinct types of owners have different objectives and motivations and this will affect how they exercise their control rights over the firms they invest in. A dummy variable for CG takes a value of 1 if the controlling shareholder is the Central State-owned Asset Supervision and Administration Commission (CSASAC) or the SOEs controlled by CSASAC. Another dummy variable for LG takes a value of 1 if the controlling shareholder is the Local State-owned Asset Supervision and Administration Commission (LSASAC) or the SOEs controlled by LSASAC. The type of controlling shareholder takes vale of 0 otherwise. Leverage was measured by debt to assets ratio. Ownership concentration is measured by the percentage of largest shareholder's ownership. In order to consider the bargaining power of the largest shareholder, I add the second, the third, the fourth and the fifth shareholders' ownership percentage together, and bargaining power (BP) equals to:

$$BP = \frac{P_1}{\sum_2^5 P_i}$$

Where P_i is the ownership percentage of the ith shareholder.

Table 1 presents summary statistics of the variables.

4.3 Univariate results

To provide an initial assessment of the hypotheses, I compare PCD clustering and firm performance across various subsamples. Table 2 presents the results. Panel A indicates that firms controlled by local governments have the highest PCD clustering level (21.55%). Firms controlled by private have the lowest PCD clustering level (15.97%), and firms controlled by Central government stand in the middle (18.55%). For the full sample, PCDs clustering level is 18.90%. These results are consistent with Hypothesis 1 that the type of controlling shareholder has an impact on the level of PCD clustering.

Table1 Summary statistics				
	Observation	Mean	Min	Max
Number of PCDs	696	1.918	0	9
PCD clustering	696	0.189	0	0.778
ROA	696	0.049	-0.905	0.3
Ownership concentration	696	0.415	0.061	0.796
Bargaining power	696	6.436	0.257	77.237
Board size	696	10.22	4	19
Board duality	696	0.056	0	1
Board independence	696	0.293	0	1
Politically connected CEO	696	0.103	0	1
Central government	696	0.177	0	1
Local government	696	0.444	0	1
Heavily regulated industries	696	0.147	0	1
Leverage ratio	696	0.411	0.035	1.704

In order to investigate the difference across industries, I categorize firms into two groups, namely, the heavily regulated industries and the less regulated industries.

Panel B indicates that firms in the heavily regulated industries have nearly two times

(1.84) higher level of PCD clustering than firms in the less regulated industries. These

results are consistent with Hypothesis 2 that firms in heavily regulated industries have

higher level of PCD clustering.

Table 2
Univariate results
Panel A reports the variations of PCD clustering based on different controlling shareholders, namely, the central government, the local government, and the Private. Panel B reports the means of PCDs clustering for firms based on whether they are in the heavily regulated industries. Panel C reports the means of PCD clustering for firms based on the bargaining power of the largest shareholders.

Panel A: Does PCD clustering vary across firms controlled by different types of shareholders?					
	obs	mean	Std. Dev.	Min	Max
Central government	123	.1855	.1897	0	.75
Local government	309	.2155	.1992	0	.7778
Private	264	.1597	.1517	0	.5556
All sample	696	.1890	.1824	0	.7778
Panel B: Does PCD clustering vary across industries?					
Heavily regulated industries	102	.3096	.2285	0	.7778
Low relgulated industries	594	.1683	.1647	0	.75
Panel C: Does the largest shareholders bargaining power affect PCD clustering?					
Low bargaining power	348	.1742	.1677	0	.6363
High bargaining power	348	.2038	.1950	0	.7778
Panel D: ROA of firms with different PCD clustering level					
No PCDs	201	.0416	.0852	-.9047	.2494
Low level PCD clustering	165	.0539	.0408	-.1736	.1694
Middle level PCD clustering	165	.0592	.0501	-.0866	.2995
High level PCD clustering	165	.0427	.0679	-.3890	.1860

Then, I provide evidence on the relationship between PCD clustering and the

bargaining power of the largest shareholders. Panel C tells us that greater bargaining

power the largest shareholders have, the higher level of PCD clustering. Averagely,

PCD clustering is nearly 17% higher for the high bargaining power group compared
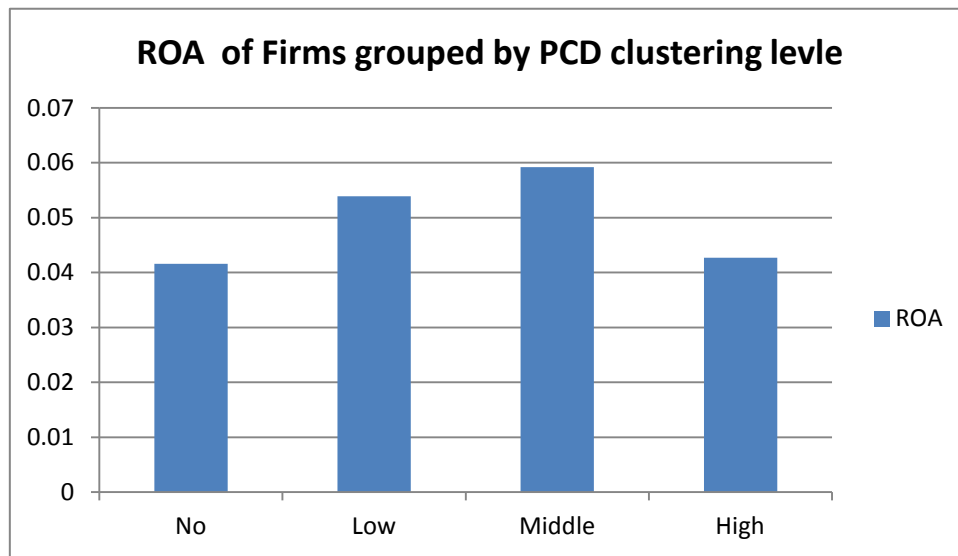
ROA of Firms grouped by PCD clustering levle

Fig. 1. Effect of PCD clustering on ROA. Firms without PCDs are classified as "No PCD clustering group" Firms with PCDs are evenly divided into "Low PCD clustering group", "Middle PCD clustering group", and "High PCD clustering group" according to their PCD clustering level. ROA of the Middle PCD clustering group is the highest. ROA of the Low PCD clustering group ranks the second. The "No PCD clustering group" and the High PCD clustering group perform the worst. This pattern indicates that there is a curvilinear relationship between firm performance and PCD clustering.

with the low bargaining power group. These results are consistent with hypothesis 3.

Last but not the least, the relationship between firm performance (measured by ROA) and PCD clustering is presented. Firms without PCDs are classified as "No PCD clustering group". Firms with PCDs are evenly divided into "Low PCD clustering group", "Middle PCD clustering group", and "High PCD clustering group" according to their PCD clustering level. Panel D and Figure 1 indicate that ROA of the Middle PCD clustering group is the highest. ROA of the Low PCD clustering group ranks the second. The "No PCD clustering group" and the High PCD clustering group perform the worst. This pattern indicates that there is a curvilinear relationship between firm performance and PCD clustering, which is consistent with Hypothesis 4.

4.4 Multivariate results: Factors affecting PCD clustering

While the results above are generally consistent with the hypotheses, there may be other factors affect PCD clustering and firm performance. Therefore, we need to control for other determinants. There is no literature on what factors affect PCD clustering, so we can only relay on theoretical analysis to find the potential factors. In this section, I extend the analysis to a multivariate setting. The multivariate analysis is conducted by using the ordinary least squares (OLS) method.

Firm size is included as a control variable. The structure of a firm depends on the scope and complexity of its production process (Fama and Jensen, 1983). Larger firms will be more complex. Large firms have a high degree of exposure to the overall social and economic environment (Miles, 1987), and firms' political ties will provide them with more reliable access to external resources that can help them limit exposure (Schuler and Rehbein, 1997). Further, Boone et al. (2007) find that the scope and complexity of a firm can affect the board's composition. Therefore, firm size is controlled during the multivariate analysis.

The level of market development may be an institutional-level antecedent of PCD clustering. North (1990) has argued that the attractiveness of political ties vary across institutional settings, and political opportunities are perceived as more attractive in regions with less effective institution. Hence, market development is included as another control variable. Hence, a variable that reflects market development should be included in the analysis. A significant characteristic of China is that there are significant differences in regional development. So it is reasonable to account for this

factor. Consistent with Chen et al. (2009), we use a comprehensive index compiled by

Fan and Wang (2003) as a proxy for the market development of every province.

Higher score means greater market development. This index has been widely used in

China research to control for regional effects (Chen et al., 2006; Li et al., 2006; Lin,

2009; Wei, 2006; Chen et al., 2009).

CEO could use his power to influence board composition. PCD clustering could be

affected by CEOs' preference. Hermalin and Weisbach (1998) model board

composition as the outcome of a bargaining process between the CEOs and the rest of

the board. The model indicates that CEOs have the tendency to choose friendly boards

and entrench themselves. What' more, birds of a feather sing together. There exists

mutual reciprocity among individuals who belong to the same social category.

Westphal and Zajac (1997) provide evidence that CEO-directors may typically

support fellow CEOs by impeding increased board control over management. By the

same token, PCDs will have higher likelihood to support the politically connected

CEO because they have similar experience, even overlapped social ties. Fan et al.

(2007) found that firms led by politically connected CEOs are more likely to appoint

other bureaucrats to the board of directors rather than directors with relevant

professional background. They argued that politically connected CEOs need allies on

the board to reinforce their policies and objectives. Therefore we can expect that if the

CEO is politically connected, the CEO will use his bargaining power to select more

PCDs on the board. A dummy variable for politically connected CEO takes value of 1

if the CEO is politically connected.

Table 3

What affects PCD clustering?

The dependent variable is PCD clustering. Central government (Local government) is a dummy variable which equal 1 if the firm the controlled by the Central government (Local government). Heavily regulated industry is a dummy variable which equals 1 if the firm is in the heavily regulated industries. High bargaining power is a dummy variable if the ownership percentage of the largest shareholder exceeds the total of the second, the third, the fourth and the fifth largest shareholders. Firm size is the logarithm of total assets. Market development index measures the regional difference. Politically connected CEO is a dummy variable which equals 1 if CEO is politically connected.

Absolute values of t-statistics based on robust standard errors are reported in parentheses, ***, **, and * indicate statistical significance at the 1%, 5%, and 10% levels, respectively.

	Dependent variable: PCD clustering			
Independent variables	Model 1	Model 2	Model 3	Model 4
Central government(CG)		-.0003 (.0186)		-.0365 (.0333)
Local government(LG)		.0309* (.0163)	.0341*** (.0130)	.1138*** (.0266)
Heavily regulated industry		.0983*** (.0191)	.0974*** (.0188)	.0976*** (.0187)
High bargaining power(BP)		-.0327** (.0142)	-.0327** (.0142)	-.0030 (.0203)
CG*BP				.0469 (.0395)
LG*BP				-.1032*** (.0307)
Firm size	.0501*** (.0067)	.0381*** (.0072)	.0379*** (.0071)	.0359*** (.0071)
Market development index	-.0052 (.0034)	-.0021 (.0037)		
Politically connected CEO	.0736*** (.0078)	.0739*** (.0076)	.0737*** (.0076)	.0752*** (.0075)
Constant	-.8429 (.1433)	-.6194 (.1478)	-.6297 (.1464)	-.6084 (.1471)
Number of observations	696	696	696	696
Adjust R^2	17%	21.35%	21.54%	23.14%

Table 2 reports the multivariate results. Contrary to our expectation, the coefficient of

"Central government" is negative, which means that firms controlled by Central

government will have lower level of PCD clustering. However, the result is not significant. Hence, Hypothesis 1a is not supported.

The estimated coefficient of "Local government" is significantly positive in both model 2 ($p<0.1$) and model 4 ($p<0.01$). The parameter estimates indicate that PCD clustering will increase at least 0.03 (model 2 and model 3) if the firms in controlled by the local government. These results are consistent with our hypothesis that firms controlled by local government will have more PCD on their boards.

The estimated coefficient of "Heavily regulated industries" is significantly positive ($p<0.01$) in model 2, model 3, and model 4. What's more, PCD clustering will increase about 0.1 if the firm is in the heavily regulated industries. Hence, Hypothesis 2 is supported.

Contrary to our expectation, the estimated coefficient of "Bargain power (BP)" is negative (Model 2, model 3, and model 4). One possible explanation is that controllers with high bargain power will use their stock ownership to influence the firm decision, instead of using the mechanism of board of directors to guarantee their interest. A firm's board structure may be viewed as a strong indicator of the controlling shareholder's commitment to corporate governance, especially in weaker investor protection countries (Yeh and Woidtke, 2005). If the largest shareholder has high bargaining power from the ownership perspective, he would show his commitment through board composition, expecting to reduce the concerns of investors. Filatotchev and Bishop (2002) find that the IPO firm may strategically select directors to ensure board diversity and the public image. In preparation for the

public scrutiny accompanying an IPO, firms with controlling shareholders with dominant ownership will focus on becoming more 'professional' in compliance with Securities and Exchange Commission (SEC) regulations and the expectations of investment bankers and potential investors (Welbourne & Andrews, 1996, p. 893). In order to find some evidence to support our conjecture, we include the interaction terms (CG*BP, LG*BP) in the regression (model 4). We find that if the firm's controller is local government and its bargaining power is high, the local government will reduce PCDs clustering. If firms has government background, 'less political and more professional' board may provide investors greater confidence in the firm's potential.

In terms of control variables, we find that the coefficients on firm size and "Politically connected CEO" are significantly positive, while market development is negative but not significant.

4.5 Multivariate results: Effect of PCD clustering on firm performance

We now explore the relation between PCD clustering on firm performance. Leverage, board characteristics (board duality, board size, board independence), firm size are included as controlled variables.

The ratio of debt to assets may affect profitability (ROA). In the multivariate regression, we controlled the impact of financial leverage on ROA. Prior research indicates that the political ties of firms can facilitate their access to debt (Khwaja and Mian, 2005). In order to eliminate the effect of PCD clustering on financial leverage, we run regression of the ratio of debt to assets on PCD clustering (the ratio of debt to

assets as dependent variable, PCD clustering as independent variable). Then, the

interaction term of the coefficient of PCD clustering and PCD clustering implies how

much PCD clustering affect the ratio of debt to assets. The difference between the

ratio of debt to assets and the interaction term is the Leverage that we use in the

analysis.

We argue earlier that the asset effect dominates at low PCD clustering levels, but high

PCD clustering is characterized with strong liability effect, so we expect that the

relationship between PCD clustering and firm performance is nonlinear.

| Table 4			
How PCD clustering affects firm performance?			
	Dependent variable: ROA		
Independent variables	Model 1 All sample	Model 2 Heavily regulated	Model 3 Not heavily regulated
PCDC	.0898***	.1174**	.1164***
	(.0312)	(.0586)	(.0373)
PCDC^2	-.2233***	-.2241***	-.2910***
	(.0541)	(.0828)	(.0713)
Leverage	-.2204***	-.1087***	-.2492***
	(.0130)	(.0218)	(.0149)
Board duality	-.0068	-.0374	-.0022
	(.0090)	(.0244)	(.0096)
Board size	-.0018**	-.0086***	-.0008
	(.0009)	(0018)	(.0010)
Board independence	.0154	-.0141	.0170*
	(.0097)	(.0313)	(.0103)
Firm size	.0267***	.0097***	.0336***
	(.0025)	(.0035)	(.0032)
Constant	-.4078	-.0086	-.5531
	(.0521)	(.0724)	(.0655)
Number of observations	696	102	594
Adjust R^2	30.34%	32.35%	32.81%
Absolute values of t-statistics based on robust standard errors are reported in parentheses, ***, **, and * indicate statistical significance at the 1%, 5%, and 10% levels, respectively.			

In the full sample regression (Model 1), the coefficient of PCDC (Politically

connected directors clustering) is positive, and the squared term of PCDC has a

negative coefficient. These results indicate that there is an inverse U-shaped

relationship between PCD clustering and firm performance. In mathematic terms,

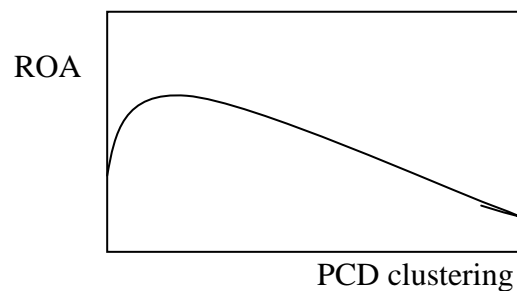ROA reaches the maximum when PCDC equals nearly 20.11%.

Fig. 2 The relationship between PCD clustering and firm performance measured by ROA

ROA

PCD clustering

A. Full sample

ROA

PCD clustering
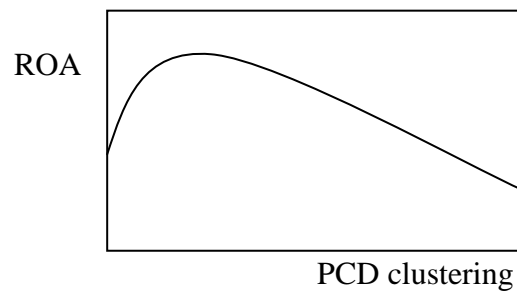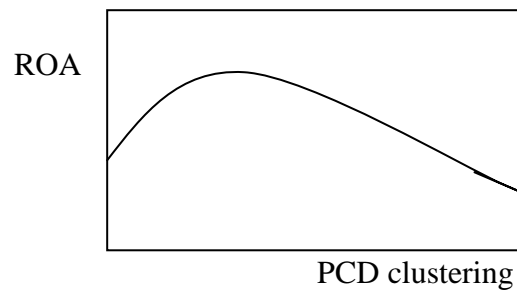
B. The subsample of regulated industries

ROA

PCD clustering

C. The subsample of not-regulated industries

If we divide the full sample into two subsamples (the sample of the heavily regulated

industries, and the sample of not heavily regulated industries), we get similar results.

The only difference is that ROA reaches the maximum when PCDC equals 26.19% in the sample of the heavily regulated industries and 20% in the sample of not heavily regulated industries.

Based on the results in Table 4, we draw draft figures (Fig. 2) to reflect the relationship between ROA and PCD clustering. There are two facts we can find from Fig. 2. On one hand, they have the same pattern. The curve slopes upward until PCD clustering reaches certain threshold value and then slopes slightly downward. On the other hand, the threshold values of PCD clustering vary across samples. Therefore, even though the threshold is not fixed and identical, Hypothesis 4 is supported.

5. Conclusions and further research

This study suggests that the relationship between political ties and firm performance is more complex than it was previously thought to be. Prior studies either merely look at the asset effect (Bonardi, Hillman and Keim, 2005; Faccio et al., 2005; Hillman, 2005; Chen et al., 2011), or just emphasize the liability effect (Shleifer and Vishny, 1994; Fan et al., 2007; Boubakri et al., 2008). We hypothesize and find that there is a curvilinear relationship between firm performance and PCD clustering. Our results are consistent with the notion that political ties may be two-edged swords which have both asset effect and liability effect. This study echoes Siegel (2007) who think that the contingent value of business-government ties has been understudied (Siegel, 2007). We also find that there are many factors that affect PCD clustering. PCD clustering may reflect firms' historical burden, the industry needs, the bargaining power of the largest shareholders, as well as CEOs' preference.

Our findings provide important implications for corporate governance practices, especially in China. For decision makers of firms, during the process of director selection and board construction, they should evaluate individual director under the framework of the whole board rather than in isolation, taking both individual effect and clustering effect into consideration. As to the selection and appointment of PCDs, decision makers should consider not only his/her political capital, but also his/her impact on the power structure of board, resource overlapping of other PCDs, board decision making, as well as his/her impact on rent distribution.

For policy makers, they should formulate guidance for director selection and set constraints towards PCD clustering. In the final analysis, corporate governance mirrors the distribution of power within a society (Yoshikawa and Rasheed, 2009). Hence, a guidance of director selection should reflect the power distribution. A society that has dispersed ownership structure and less government involvement (such as U.S.) emphasizes board independence. As to China, where government has greater influence and ownership concentration is more prominent, a guidance of corporate governance should pay more attention to PCD clustering.

Our findings also indicate that PCD clustering is more likely to occur for firms that controlled by local governments. Therefore, local governments should show more commitment instead of entrenchment by reducing their representative on board, steering boards from politic oriented toward business oriented.

There is no denying that this study has several limitations. First, we only consider the explicit political ties in the corporate governance context. Some implicit political ties

can also function. A natural extension of our study would take care of the implicit ties and compare them with the explicit ties, even investigate how they interact with each other and affect firm performance. Second, this study treat all the PCDs are homogeneous. Lester et al. (2008) indicate that the depth and breadth of the social capital and human capital of former government officials increase their capability to provide resources. Further research can carefully consider the heterogeneity of PCDs. Third, this study adopt the static analysis. Further research can make use of both historical analytic and dynamic analytic methods to find the dynamic changes of PCD clustering, as well as the interaction between PCD clustering and firm performance.

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