THE IMPACT OF MANAGEMENT POLITICAL CONNECTION
ON FIRM PERFORMANCE

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Abstract  
This paper investigates how political connections affect firm performance. Different from prior studies, we enlarge the scope of political connections to include the board of directors in addition to large shareholders and top management. Besides, we also examine connection types, including connections through political parties, members of parliament, and government ministers. Using a sample of Taiwanese-listed firms from years 2005 to 2011, we find that politically-connected firms have lower accounting performance as well as lower market performance. Further analysis indicates that firms have weaker performance when they have higher proportions of directors serving as central government officers or legislative body representatives. The negative association is not affected by the director’s level of professional knowledge and exists both before and after the financial crisis. The results are also consistent across different incentives (including future growth opportunities, financing needs, and tax avoidance) for politically-connected firms.  
Keywords: political connection, firm performance, corporate governance

I. INTRODUCTION  
The incentive for corporations to become politically connected has been recognized among economists for many years (Faccio, 2006). The value of political connections can take various forms, including preferential treatment by government-owned enterprises, lighter taxation, preferential treatment in competition for government contracts, relaxed regulatory oversight of the company in question, and many other forms. From this perspective, the government plays the role of a “helping hand.” On the other hand, however, political connections may help the government and affiliated politicians to extract political benefits at the expense of the wealth maximization of stakeholders in the firm. This view is called a “grabbing hand” of the government (Shleifer & Vishny, 1998). Building upon the two perspectives, this paper examines how political connections affect firm performance.

It has been found that political connections help firms to secure favorable regulatory conditions and access to resources such as bank loans (e.g., Agrawal & Knoeber, 2001; Faccio, 2006). Politically connected firms are also more likely to resort to the courts in business disputes (Li et al.,
It has also been documented that the quality of earnings reported by politically-connected firms is significantly poorer (Chaney et al., 2011). While Goldman et al. (2008) show a positive abnormal stock return following the announcement of the nomination of a politically-connected individual to the board in the U.S., others find that among China’s newly-privatized firms those with political connections underperform their non-connected counterparts (Boubakri et al., 2008; Fan et al., 2007). Although studies have examined the implications of political connections in different countries, limited research in Taiwan investigates whether the marginal benefits of connections outweigh the marginal costs. Since the capital markets development as well as the economic and political environment in Taiwan are distinct from those of other countries, we believe it is important to examine this issue using Taiwanese settings. Given the competing theoretical arguments as well as mixed empirical evidence, we think political connections can either enhance or diminish firm performance.

II. Methodology

Our sample includes publicly-traded companies in Taiwan during fiscal years 2005–2011. In contrast with prior studies, we enlarge the scope of political connections to include the board of directors in addition to large shareholders and top management. More specifically, we adopt two definitions of political connections: (1) POLITICAL_TOPMGT, which follows Faccio (2006) to define a firm as “politicallyconnected” if one of the firm’s large shareholders (at least 10% ownership) or top executives (CEO, president, or vice-president) is a member of parliament, an officer of central government, or is closely related to a politician or party; (2) POLITICAL_BOARD, which defines a firm as “politicallyconnected” if one of the firm’s directors has served positions related to the parliament, central government, or political parties. Both definitions consider past and current connections.

We use two measures of firm performance: Tobin’s Q (TQ) as a measure of market performance and the return on equity (ROE) as a measure of accounting performance. Since these effects of political connections on firm performance may not be contemporary, the two performance measures are computed using the next-year value. After controlling political donations (DONATION), leverage (FR), firm size (SIZE), advertising, and R&D expenditures (ADRD), sales growth (GROWTH), and changes in corporate governance (CGIUP), the main empirical models are as follows:

\[
TQ_{it} = \alpha + \beta \text{POLITICAL\_TOPMGT}_{it}\text{POLITICAL\_BOARD}_{it} + \alpha \text{DONATION}_{it} + \alpha \text{FR}_{it} + \alpha \text{SIZE}_{it} + \alpha \text{ADRD}_{it} + \alpha \text{GROWTH}_{it} + \alpha \text{CGIUP}_{it} + \epsilon_{it}
\]

\[
\text{ROE}_{it} = \beta + \beta \text{POLITICAL\_TOPMGT}_{it}\text{POLITICAL\_BOARD}_{it} + \beta \text{DONATION}_{it} + \beta \text{FR}_{it} + \beta \text{SIZE}_{it} + \beta \text{ADRD}_{it} + \beta \text{GROWTH}_{it} + \beta \text{CGIUP}_{it} + \epsilon_{it}
\]

III. FINDINGS

The main empirical results of this study support the “grabbing hand” argument that politically-connected firms exhibit weaker accounting and market performance. To enrich our analysis as well as ensure the robustness of the results, we perform several additional tests. First, we calculate the number of politically-connected directors as a percentage of the board, and separate the different types of political connections. The results indicate that firms have weaker performance when they have higher proportions of directors serving as central government officers or as legislative body representatives. Second, we test whether the documented association varies with
transitions between ruling parties or with an individual director’s political affiliation. We find that firm performance is negatively related to directors with a KMT affiliation but is not related to directors with a DDP affiliation. In addition, this negative association is moderated when the ruling party switches from KMT to DDP. Third, to resolve the potential endogeneity of political connections, we test our main model using a two-stage instrumental variable approach as well as a difference-in-difference design (DID). The DID design considers the changing status of the board of director’s connections after election of new directors. Regardless of the approach taken, the findings are qualitatively similar. Fourth, we consider firms’ differential incentives of having political connections, including their future growth opportunities, financing needs, and preferences for tax avoidance. We partition the sample based on these incentives and find that the negative association between firm performance and political connections are consistent across subsamples with high and low incentives. Finally, we find that our results exist both before and after the 2008 financial crisis, after removing government-owned enterprises, and that the results are not sensitive to directors’ level of professional knowledge.

IV. Implications

Using Taiwanese sample firms as the context for research, we provide consistent evidence that political connections are negatively associated with firm performance. The findings are informative for capital market participants in making their investment and lending decisions. The results also provide implications for firms’ corporate governance practices. In particular, firms should consider the possible negative impact of political connections when hiring or electing top managers and directors.

However, our findings are subject to several limitations and should be interpreted with some caveats. First, this study does not consider the potential differential effects of industrial life cycles as well as the macroeconomic environment. Second, while we consider firms’ incentives to become politically connected, the analysis may be incomplete. For example, we do not include firms that use political connections to conduct fraud or to avoid regulatory investigations. Third, due to data limitations, our measures of political connections include only those available from public sources. These definitions may not be inclusive, since political connections can also be obtained through friendship and social networks that are difficult to measure.

V. Contribution

We expect our paper to make the following contributions. First, this study augments Jang (2005) who uses an event-study approach to examine market reactions to firms’ appointments of executives who are also legislators. We enlarge the scope of political connections and consider the effect on long-term performance rather than just the announcement effect. Second, this study further analyzes the influences of different types of political connections as well as considers directors’ political affiliations and professional knowledge. Third, we extend prior research that examines firms’ incentives to become politically connected. We test and discover that firms with political connections have weaker performance regardless of their incentives. Finally, our study also contributes to the corporate governance literature. Prior literature generally examines various board and manager
characteristics, focusing on how composition and ownership structures might affect firm performance. However, none of these studies investigate the political ties of the board of directors and top managers. We believe the findings of our study have important implications to capital market participants as well as corporate practices.

Reference