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## Article

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# The costs of socializing with government officials: A new measure of corporate political connections

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## ABSTRACT

We construct a new measure to capture corporate political connections, which is based on the amount a corporation spends on socializing with government officials. We examine the validity of this measure using the exogenous turnover of top local officials and find that firms increase their political networking expenditures when top local officials are replaced. Compared to state-owned enterprises (SOEs), non-state-owned enterprises (non-SOEs) react more aggressively to changes in local officials, which implies that non-SOEs have stronger incentives to build political connections with officials through social intercourse. We also find that firms located in regions with low levels of marketization react more aggressively to the turnover of local politicians. In addition, we find a positive effect of corporate political socializing expenditures on corporate performance and valuation, which suggests that political connections built through social intercourse benefit corporations.

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## 1. Introduction

Due to the lack of comprehensive formal legal and governance mechanisms, remarkably effective alternative mechanisms have developed in China (Allen et al., 2005). Political connections are one such mechanism and they play an important role in the Chinese economic regime. Most previous studies of corporate political connections have used the presence or absence of state ownership or the political background of top executives

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to identify firms' connections. In fact, connections between corporations and the government can be built via other channels and it is meaningful to identify other important corporate strategies for building political connections.

Networking with government officials is a common corporate political strategy in the relationship-based Chinese regime. Unlike ownership-based or board member political experience-based political connections, the strategy of socializing with government officials is implemented through various social activities that are part of daily business practices and it is thus hard to capture explicitly. Although the political strategy of social intercourse has been discussed in previous studies, there is little empirical research that systematically identifies it. One exception is [Luo and Ying \(2012\)](#) who use a particular social activity, company visits of officials, to identify corporate political connections. In this study, we try to comprehensively capture corporate political connections built through social intercourse by measuring corporations' expenditures on political networking. We use evidence from a previous survey to construct a variable for measuring corporate expenditures on networking with government officials.

[Zhang and Zhang \(2005\)](#) surveyed hundreds of Chinese entrepreneurs and found that firms socialize with government officials in a number of ways including inviting them for a company visit, sponsoring overseas travel, offering gifts, holding banquets, and so on. Based on their research, we use the accounting items that are most commonly used to reimburse such expenditures to construct a measure of political networking expenditures. One of the contributions of this study is determining the validity of this measure using the exogenous turnover of top local officials. We find that firms increase their expenditures for socializing with government officials when local politicians are replaced. This suggests that our measure effectively captures firms' expenditures on political social intercourse.

We further find that non-SOEs react more aggressively than SOEs when local politicians are replaced and that firms located in regions with a low level of marketization react more aggressively to the turnover of top local officials. We also use our new measure of political connections to examine the economic consequences of political networking expenditures. Consistent with previous studies (see among others, [Fisman, 2001](#); [Johnson and Mitton, 2003](#); [Faccio, 2006](#)), we find that corporate political socializing expenditures have a positive effect on corporate performance and valuation, which suggests that the political connections built through social intercourse benefit corporations.

Our study makes the following contributions to the literature. First, we construct a new measure to capture corporate political connections, namely political socializing expenditures. Second, socializing with officials is a common corporate political strategy that has rarely been mentioned in previous empirical studies, perhaps because of the difficulty in quantifying political socializing. This study quantifies corporate political socializing by measuring corresponding expenditures and testing the validity of this measure by using the exogenous turnover of top local officials. Third, there are few empirical studies of the firm-level effect of the turnover of government officials in China and this study sheds some light on this research area.

The rest of this paper is structured as follows. Section 2 discusses the related literature and hypotheses. Section 3 describes the sample selection and data. Section 4 provides the research design and empirical results. In Section 5 we present our conclusions.

## 2. Literature review and hypotheses

Corporate political connections play an important role around the world (see among others, [Fisman, 2001](#); [Faccio, 2006](#); [Faccio et al., 2006](#); [Adhikari et al., 2006](#); [Niessen and Ruenzi, 2010](#); [Chen et al., 2010](#)). In Chinese studies, corporate political connections are generally correlated with the type of ownership (SOE vs. non-SOE) or the political experience of top executives (e.g. [Hu, 2006](#); [Yu and Pan, 2008](#)). US studies have documented a variety of strategies used by firms to make political connections, such as adding politicians to the board of directors (e.g. [Goldman et al., 2008, 2009](#)), making significant political campaign contributions (e.g., [Cooper et al., 2010](#); [Claessens et al., 2008](#)), or incurring significant lobbying expenditures (e.g., [Hill et al., 2009](#); [Chen et al., 2009](#)).

Unlike the US, lobbying does not publicly exist in China. However, Chinese firms can seek preferential treatment through their private networking channels. [Zhang and Zhang \(2005\)](#) surveyed hundreds of entrepreneurs in Wenzhou City and Suzhou Province and found that firms build political networks by socializing with

government officials. Generally, firms interact with government officials by inviting them for a company visit, holding a banquet, sponsoring the officials' travel abroad, offering gifts, and so on.

Following Cai et al. (2011) and Zhang and Zhang (2005), we select the following accounting items as the most commonly used to reimburse the expenses related to the above-mentioned activities, i.e. travel expenses, entertainment expenses, overseas training expenses, conference expenses, social expenses and clerical expenses. Although not all of these expenses will be directly related to political socializing, Cai et al. (2011) show that entertainment and travel expenses increase firm value, which suggests that this kind of expenditure is related to political connections. In this study, we try to capture socializing-based political connections by measuring political networking expenditures.

Leuz and Oberholzer-Gee (2006) find that when the political regime changed in Indonesia (i.e., after Suharto's resignation), the firms once closely connected to Suharto systematically changed their financing strategy from domestic financing to global financing. This result illustrates that the loss of political ties due to the turnover of politicians can change corporate financing strategies. However, few studies have investigated the effect of the turnover of politicians on corporate behavior in China, where corporate behavior is seen as government dominated. As an anecdotal case, Feng Lun, the Chairman of Vantone Holdings, said that "On average, I fly long-haul 180 times a year; two-thirds of these trips are related to the turnover of government officials, because the successors may renege on previous promises or agreements. . ."<sup>1</sup> This implies that the turnover of government officials breaks existing corporate-government connections.

In this study, we test the effect of top local government official turnover on corporate political socializing strategies and predict that corporate expenditures on socializing with officials increase when top local officials are replaced. The following policy risk argument and political connection theory support our view.<sup>2</sup>

The replacement of top local officials may create policy uncertainty (Julio and Yook, 2012). A corporate proposal might be adopted more easily by a policy maker who is part of a well-built network; thus networking reduces policy risk. Local government, as the top administration agency in a municipal region, has the power to allocate resources; thus, firms have incentives to build political connections with local government to get access to valuable resources. An incumbent political tie will be broken when a top local official is replaced; therefore, firms have incentives to socialize with successors to re-build the political tie. Based on this analysis, we predict that expenditures on political socializing will increase when a top local official is replaced. Our first hypothesis is as follows.

**H1.** When turnover of top local officials occurs, corporate expenditures on political networking increase.

Firms with few natural political connections have more incentive to network with government officials. Compared to SOEs, non-SOEs have more incentive to establish political connections. Currently, the property protection regime is relatively weak in China. Non-SOEs that pay more attention to property protection pursue political connections as an alternative protection mechanism (e.g. Bai et al., 2006). In addition, China is a centrally planned system undergoing a slow and uneven transition to a market economy. The government has the power to allocate resources, such as bank loans (see among others, Hu, 2006; Yu and Pan, 2008; Zhang et al., 2010; Lian et al., 2011), access to regulated industries (Luo and Liu, 2009), government subsidies (Chen, 2003; Pan et al., 2009; Yu et al., 2010) and so on. To obtain their preferred resource allocations, non-SOEs have more incentive to establish and maintain political connections. Based on this analysis, we predict that non-SOEs will socialize more aggressively when top local officials change, relative to SOEs. The hypothesis is as follows.

**H2.** Compared to SOEs, non-SOEs' expenditures on political networking will respond more aggressively to top local official turnover.

Previous studies have suggested that firms in poor institutional environments are more motivated to establish political connections. Faccio (2006) shows that corporate political connections are more common in countries with weak legal regimes and severe corruption. Li et al. (2006) find that private entrepreneurs

<sup>1</sup> Quoted from "The Choices of Entrepreneurs in social transition period," Feng Lun, 2013, *Decision Guidance*, March Issue.

<sup>2</sup> In this study, we focus on the political connection perspective.

are more likely to go into politics in regions with strong government intervention and poor financial development. Yu and Pan (2008) and Luo and Zhen (2008) find that political connections are more valuable for the firms in regions with low levels of marketization. Based on the above findings, we examine the effect of the level of regional marketization on corporate political networking expenditures. We use the number of listed firms in a city as a city-level marketization index and predict that corporations will increase political socializing expenditures more aggressively in response to the replacement of top local officials if the level of regional marketization is low. The hypothesis is as follows.

**H3.** The lower the level of regional marketization, the more aggressively corporate political networking expenditures react to the turnover of top local politicians.

### 3. Data and sample

Our sample consists of firms with A-shares listed on either the Shenzhen or the Shanghai Stock Exchanges in the 2006–2010 period. Accounting and corporate governance data are obtained from the China Stock Market and Accounting Research (CSMAR) database. The raw data on corporate expenditures on socializing with government officials are hand-collected from the footnote of annual reports entitled “Cash flow paid relating to other operating activities.”<sup>3</sup> We select the accounting categories that best reflect political networking expenditures, i.e., travel expenses (Chai Lu Fei Yong), entertainment expenses (Ye Wu Zhao Dai Fei Yong), overseas training expenses (Chu Guo Pei Xun Fei), meeting expenses (Hui Yi Fei Yong), social expenses (Jiao Ji Ying Chou Fei Yong) and clerical expenses (Ban Gong Fei Yong). We exclude financial firms and firms that do not disclose any of the above-mentioned expenses in a fiscal year. Panel A of Table 1 summarizes the distribution of the observations by year. It shows that nearly 40% of non-financial listed companies disclose the above-mentioned expense categories in each sample year. Panel B shows the distribution of the observations by industry. The mean of all expenses is as high as 153 million yuan in the construction industry and the mean of the ratio of expenses to sales has the highest value (41.4%) in the manufacturing industry. Panel C shows the distribution of observations by year and the type of ownership. The raw expenses are much higher in the SOE group, but the ratio of expenses to sales is highest in the non-SOE group.

Province-level and city-level top official turnover data are hand-collected from People Web<sup>4</sup> and local government websites. To account for the lag effect of official turnover, we collect the turnover data from 2005 to 2009. The sample covers 31 provinces (including provincial-level cities and autonomous regions) and hundreds of cities (including deputy provincial-level cities, prefecture-level cities, autonomous prefectures, municipal districts and cities administrated by a province). Generally, the top officials in a province are the provincial governor and the provincial secretary of the municipal Party committee. The top officials in a city are the mayor and the secretary of the municipal Party committee.

Panel A of Table 2 shows the number and proportion of firms in the sample (i.e., all non-financial listed firms that provide the necessary data on expenditures) and in the general population (i.e., all non-financial listed firms) that experience province-level top official turnover by year. The percentage of sample firms that experience official turnover is 34.21%, which is very close to the proportion in the general population (34.65%). In each year, the proportion of turnovers in the sample is similar to the one in the general population. These statistics illustrate that on average, approximately 30% of listed firms experience province-level top official turnover. Therefore understanding the effect of official turnover on firms is of great practical significance. Furthermore, in each year the proportion of firms in the sample that experience turnover is similar to the proportion of firms in the general population that experience turnover, suggesting that our sample does not have any selection bias problems. As there are 31 provinces in China, we further collect data on city-level top official turnover to provide more data and to analyze the turnover effect more accurately.

Panel B of Table 2 reports the number and proportion of firms that experience the turnover of city-level top officials in the sample group and in the general population by year. For each year, about 35 percent of the

<sup>3</sup> Since 2009, many firms have disclosed detailed items of management expenses in footnotes. These could be an alternative data resource to the footnote item “cash flow paid relating to other operating activities.”

<sup>4</sup> Website: <http://www.people.com.cn/>.

Table 1  
Sample distribution.

Year	Number of all non-financial listed firms (1)	Number of sample firms that disclose expenses <sup>a</sup> (2)			Percentage = (2)/(1) (%)			
<i>Panel A: Sample selection</i>								
2006	1314			476	36.23			
2007	1395			493	35.34			
2008	1508			725	48.08			
2009	1559			763	48.94			
2010	1666			735	44.12			
Total	7442			3192	42.89			
Industry		Observations	Mean	Min	Max	Expenses/Sales		
<i>Panel B: Expenses by industry (in units of ten thousand)</i>								
Mining and Quarrying		86	6300.161	198.576	46248.580	0.006		
Communication and Culture		17	1960.368	181.919	6310.508	0.057		
Electricity, Gas, and Water		143	1939.411	81.846	14765.130	0.010		
Real Estate		92	1269.452	57.620	4725.063	0.032		
Construction		64	15336.820	487.888	231571.100	0.010		
Transport, Storage		137	4060.865	96.139	70783.670	0.014		
Farming, Forestry, and Animal Husbandry and Fishery		77	1799.931	144.481	9065.108	0.014		
Wholesale and Retail Trade		201	2605.560	77.547	25770.000	0.008		
Community Service		83	1400.274	59.523	26885.760	0.032		
Information Technology		217	3279.027	36.078	34452.060	0.051		
Manufacturing		1999	2489.368	21.707	55500.000	0.414		
Other		76	1550.808	64.254	8154.706	0.036		
Total		3192	2848.168	21.707	231571.100	0.035		
	Non-SOEs	SOEs						
Year	Observations	Mean	Min	Max	Observations	Mean	Min	Max
<i>Panel C: Expenses by type of ownership (in units of ten thousand)</i>								
2006	154	1468.71	37.332	21,690	322	2164.585	44.0653	21733.58
2007	170	1782.174	49.0553	24,960	323	2733.266	21.7072	55,500
2008	279	1855.704	57.6206	35,320	446	3464.782	59.8487	153,500
2009	374	2412.249	36.0783	39139.11	389	3632.104	73.6892	183516.9
2010	356	2773.168	59.5237	46248.58	379	4266.515	47.2840	231571.1
Total	1333	2,200	36	46,000	1859	3,300	22	230,000
	Non-SOEs				SOEs			
Year	Observations		Mean		Observations			Mean
<i>Panel D: Ratio of expenses to sales by type of ownership</i>								
2006	154		0.027		322			0.0211
2007	170		0.0315		323			0.014
2008	279		0.0308		446			0.015
2009	374		0.0293		389			0.015
2010	356		0.147		379			0.014
Total	1333		0.061		1859			0.015

<sup>a</sup> The observations in the sample are the firm-year observations that disclose expense data and the other data used as control variables.

sample companies experience the replacement of top officials. This is very close to the percentage of non-financial A share-listed companies, namely 36 percent, that experience such replacement in the same period, implying that our sample does not have any selection bias issues.

In a given year, the top official turnover variable is province- or city- fixed. In addition to the above firm-year statistic, Table 2 summarizes the distribution of top official turnover (TOT) events by province and city. Panel C of Table 2 shows that all of the 31 provinces are included in our sample and that there are sample companies in every province in which replacement of top officials occurs. In 2007, the number of provinces experiencing top official turnover is extremely high, because the 17th National Congress of the Communist Party of China occurred in that year, and lead to many changes. Except for 2007, the turnover of top officials is evenly distributed throughout the sample period.



Table 2

Top local official turnover.

	All non-financial listed firms			Sample firms			
Year	Observations (1)	PTOT (2)	Percentage = (2)/(1) (%)	Observations (3)	PTOT (4)	Percentage = (4)/(3) (%)	
Panel A: Province-level top official turnover (PTOT) by firm-year							
2005	1314	303	23.06	476	95	19.96	
2006	1395	694	49.75	493	248	50.30	
2007	1508	1126	74.67	725	515	71.03	
2008	1559	59	3.78	763	39	5.11	
2009	1666	397	23.83	735	195	26.53	
Total	7442	2579	34.65	3192	1092	34.21	
	All non-financial listed firms			Sample firms			
Year	Observations (1)	PTOT (2)	Percentage = (2)/(1) (%)	Observations (3)	PTOT (4)	Percentage = (4)/(3) (%)	
Panel B: City-level top official turnover (CTOT) by firm-year							
2005	1314	356	27.09	476	134	28.15	
2006	1395	557	39.93	493	194	39.35	
2007	1508	524	34.75	725	259	35.72	
2008	1559	544	34.89	763	272	35.65	
2009	1666	584	35.05	735	227	30.88	
Total	7442	2565	34.47	3192	1080	33.83	
# Provinces			# Provinces that experience PTOT				
Year	# provinces covered by all non-financial firms (1)	# provinces covered by sample firms (2)	Percentage = (2)/(1) (%)	# provinces that experience PTOT covered by all non-financial firms (3)	# provinces that experience PTOT covered by sample firms (4)	Percentage of provinces that experience PTOT in all non-financial firms = (3)/(1) (%)	Percentage of provinces that experience PTOT in sample firms = (4)/(2) (%)
Panel C: Province-level top official turnover (PTOT) by province							
2005	31	31	100	6	6	19.35	19.35
2006	31	31	100	12	12	38.71	38.71
2007	31	31	100	22	22	70.97	70.97
2008	31	31	100	7	7	22.58	22.58
2009	31	31	100	7	7	22.58	22.58
Total	31	31	100	31	31	100.00	100.00
# Cities			# Cities that experience CTOT				
Year	# cities covered by all non-financial firms (1)	# cities covered by sample firms (2)	Percentage = (2)/(1) (%)	# cities that experience CTOT covered by all non-financial firms (3)	# cities that experience CTOT covered by sample firms (4)	Percentage of cities that experience CTOT in all non-financial firms = (3)/(1)	Percentage of cities experienced CTOT in sample firms = (4)/(2) (%)
Panel D: City-level top official turnover (CTOT) by city							
2005	273	169	61.90	68	42	24.91%	24.85
2006	280	171	61.07	155	87	55.36%	50.88
2007	284	206	72.54	84	62	29.58%	30.10
2008	284	209	73.59	140	100	49.30%	47.85
2009	288	215	74.65	64	43	22.22%	20.00
Total	297	246	82.83	281	206	94.61%	83.74

Panel D of Table 2 shows that the sample covers about 70 percent of the cities that have non-financial listed companies. Although our sample is limited by insufficient data disclosure, a very large percentage of cities are included in the sample. In addition, the proportion of cities that experience top official turnover in the sample is very similar to the proportion of non-financial listed firms on a year-by-year basis, which suggests our sample does not have any sample selection bias problems. Each year nearly 40 percent of the cities experience top official replacement, confirming the need to analyze the effects of this common event.

Table 3  
Variable definitions.

<i>Dependent variables</i>	
<i>AbLnExpense</i>	Measures corporate political networking expenditures; equals the residual value of model 1
<i>Variables of interest</i>	
<i>PTO</i>	PTO equals 1 if top officials of the province-level region where firm <i>i</i> is located are replaced in year $t - 1$ , and 0 otherwise
<i>CTO</i>	CTO equals 1 if top officials of the city-level region where firm <i>i</i> is located are replaced in year $t - 1$ , and 0 otherwise
<i>NUM</i>	The number of listed firms in a city
<i>NUM_1</i>	Ranked variable. NUM_1 equals 10 if the number of listed firms in a city is in the top 10%; NUM_1 equals 9 if the number of listed firms in a city is in the top 10% to top 20%, etc. NUM_1 equals 1 if the number of listed firms in a city is in the bottom 10%
<i>CTO * SOE</i>	Interaction of CTO and SOE
<i>CTO * NUM</i>	Interaction of CTO and NUM
<i>CTO * NUM_1</i>	Interaction of CTO and NUM_1
<i>Control variables</i>	
<i>Size</i>	Natural log of total assets
<i>SOE</i>	State-owned enterprise dummy; SOE equals 1 if the firm is a state-owned enterprise, and 0 otherwise
<i>Lsh</i>	The shareholding percentage of the largest shareholder
<i>ROA</i>	Return on Assets, which equals Net Income divided by Average Total Assets
<i>Leverage</i>	Total liabilities/total assets
<i>MB</i>	Market-to-Book, which is the market value of equity divided by the book value of equity
<i>Msh</i>	Manager shareholding percentage, which equals the managers' shareholding divided by liquid shares
<i>BoardSize</i>	Number of directors on the board
<i>LnComp</i>	Natural log form of top management's top 3 compensation amounts
<i>Revenue</i>	Natural log of total sales
<i>InDir</i>	InDir equals 1 if the proportion of independent directors on the board is more than or equal to 1/3, and 0 otherwise
<i>RegionLevel</i>	<i>RegionLevel</i> equals 2 if the company is located in Beijing, Shanghai, Guangzhou, or Shenzhen; <i>RegionLevel</i> equals 1 if the company is located in other provincial capital cities, deputy province cities, or sub-provincial cities; and 0 otherwise
<i>FirmAge</i>	Age of the firm
<i>Industry</i>	Industry dummies, which equal 1 if the observation belongs to each particular industry, and 0 otherwise
<i>Year</i>	Year dummies, which equal 1 if the observation belongs to a particular year, and 0 otherwise

## 4. Research design

### 4.1. Variable definitions

Variable definitions are provided in Table 3. The key variables of interest are political networking expenditures (*AbLnExpense*) and top local official turnover by province (*PTO*) and city (*CTO*).

We use the residual of model (1) as the measure of corporate political networking expenditures (*AbLnExpense*). Basically, the above-mentioned expenses can be divided into three parts: normal firm operating expenditures, management perks and political socializing expenditures. However, it is difficult to separate political networking expenditures from managers' perks and the measurement power of the variable is reduced if management perks are excluded from the expenses.<sup>5</sup> Therefore, we retain management perks but control for the variables that influence normal operating expenditures in model (1) and control for the factors that affect management perks in the follow-up main regressions to diminish the potential for measurement noise.

We use model (1) to predict the residual (*AbLnExpense*) by industry.

$$LnExpense = \gamma_0 + \gamma_1 Size + \gamma_2 Revenue + \gamma_3 RegionLevel + \varepsilon \quad (1)$$

<sup>5</sup> For instance, corporate executives may treat government officials to a dinner. This activity may have the characteristics of both a management perk and political socializing. Thus, the power of our political socializing expenditure measure will be reduced if we comprehensively eliminate the factors related to management perks in model (1).



Table 4  
Descriptive statistics.

	<i>N</i>	Mean	Median	Min	Max	s.d.
<i>Panel A Descriptive statistics of continuous variables</i>						
<i>AbLnExpense</i>	3192	0.09	0.09	−2.81	3.08	0.95
<i>Size</i>	3192	21.49	21.39	17.12	26.69	1.20
<i>ROA</i>	3192	0.04	0.03	−1.72	2.06	0.10
<i>MB</i>	3192	2.03	1.57	0.54	43.85	1.79
<i>Leverage</i>	3192	0.57	0.50	0.01	61.34	1.40
<i>Lsh</i>	3192	35.96	34.50	3.64	83.74	14.98
<i>Msh</i>	3192	0.11	0.00	0.00	5.14	0.44
<i>LnComp</i>	3192	13.64	13.66	10.82	16.50	0.79
<i>BoardSize</i>	3192	9.25	9.00	4.00	18.00	1.81
<i>NUM</i>	3192	20.51	13.00	1.00	130.00	24.99
<i>FirmAge</i>	3192	8.38	9.00	0.00	20.00	4.63
	<i>N</i>	Value = 0	% for 0 (%)		Value = 1	% for 1 (%)
<i>Panel B Descriptive statistics of discrete variables</i>						
<i>PTO</i>	3192	2100	65.79		1092	34.21
<i>CTO</i>	3192	2112	66.17		1080	33.83
<i>SOE</i>	3192	1333	41.76		1859	58.24

where *Size* is the log value of total assets, *Revenue* is the log value of sales, and *RegionLevel* is the level of regional development. For detailed variable definitions please refer to Table 3.

We construct the province-level and city-level top official turnover variables, *PTO* and *CTO*, respectively. Considering the lag effect of turnover, *PTO* and *CTO* capture the turnover event in year  $t - 1$ .

#### 4.2. Descriptive statistics

Table 4 Panels A and B provide the descriptive statistics of the continuous and discrete variables in the regressions. The mean of *AbLnExpense* is 0.09 and the proportion of sample firms that experience province-level and city-level top official turnover is 34.21% and 33.83%, respectively. The percentage of SOEs in the sample is nearly 60% and the mean of the largest shareholder ownership is 35.96%. The largest number of listed firms in one city is 130, but approximately 21 is the average number of firms in a city.

#### 4.3. Multivariate analysis

To test whether corporations increase political networking expenditures when the top local officials change, we construct the following model:

$$AbLnExpense = \beta_0 + \beta_1 TurnOver + \beta_2 SOE + \beta_3 Lsh + \beta_4 Msh + \beta_5 BoardSize + \beta_6 LnComp + \beta_7 Size + \beta_8 ROA + \beta_9 MB + \beta_{10} Leverage + \beta_{11} FirmAge + \beta_{12} RegionLevel + Industry + Year + \varepsilon \quad (2)$$

where *AbLnExpense* is corporate political networking expenditure measured by the residual of model (1) and *TurnOver* represents *PTO* and/or *CTO*. The other control variables are defined in Table 3.

We chose an exogenous event, specifically top local official turnover, to test the validity of our corporate political socializing measure. As it is a validity test of our measure of political networking expenditure, we expect a significant positive  $\beta_1$  in regression (2).

Previous studies use expense items as a proxy for management perks (Chen et al., 2005; Gul et al., 2011). Although there is no theoretical link between management perks and official turnover, we control for the factors that affect management perks in model (2). The main results are shown in Table 5. We report robust *t*-statistics based on standard errors adjusted for clustering at the firm level. In the first column, we put *PTO* in the regression and do not find a significant result. The results for *CTO* in the regression are shown in column (3). The significant positive coefficient of *CTO* means that the turnover of city-level top officials increases corporate expenditures on political networking. If both *PTO* and *CTO* are included in the regression

Table 5  
Results of validity test (H1).

	(1) <i>AbLnExpense</i>	(2) <i>AbLnExpense</i>	(3) <i>AbLnExpense</i>	(4) <i>AbLnExpense</i>
<i>PTO</i>	−0.034 (−1.032)			−0.032 (−0.991)
<i>CTO</i>		0.072** (2.118)	0.063** (2.440)	0.061** (2.301)
<i>SOE</i>	−0.077 (−1.457)		−0.094* (−1.828)	−0.093* (−1.811)
<i>Size</i>	−0.049*** (−2.711)		−0.053*** (−2.910)	−0.053*** (−2.898)
<i>Lsh</i>	−0.003** (−1.973)		−0.003 (−1.634)	−0.003 (−1.632)
<i>ROA</i>	0.308* (1.883)		0.407** (2.519)	0.405** (2.506)
<i>MB</i>	0.085*** (5.665)		0.065*** (4.877)	0.065*** (4.896)
<i>Leverage</i>	−0.027*** (−3.302)		−0.017** (−2.074)	−0.018** (−2.082)
<i>Msh</i>	0.059 (1.271)		0.031 (0.675)	0.031 (0.685)
<i>LnComp</i>	0.263*** (7.745)		0.275*** (8.229)	0.274*** (8.200)
<i>BoardSize</i>	0.012 (0.971)		0.010 (0.892)	0.010 (0.897)
<i>RegionLevel</i>	0.415*** (12.233)		0.399*** (12.114)	0.399*** (12.119)
<i>FirmAge</i>	−0.017*** (−2.797)		−0.012** (−1.977)	−0.012* (−1.941)
<i>Industry</i>	Controlled	Controlled	Controlled	Controlled
<i>Year</i>	Controlled	Controlled	Controlled	Controlled
<i>Constant</i>	−2.635*** (−5.414)	0.087 (0.789)	−2.713*** (−5.611)	−2.693*** (−5.569)
<i>Observations</i>	3192	3192	3192	3192
<i>F</i>	22.088	24.999	24.966	24.109
<i>Adj. R<sup>2</sup></i>	0.259	0.107	0.300	0.300

Robust *t*-statistics are in parentheses.

\*  $p < 0.1$ .

\*\*  $p < 0.05$ .

\*\*\*  $p < 0.01$ .

the results are consistent. In column (2), we regress *AbLnExpense* on *CTO* to show the explanatory power of city top official turnover on corporate political networking expenditure. The coefficient is positive and significant and the adjusted *R*-square is 0.107. The above results confirm the validity of our political networking expenditure measure.

The effect of corporate ownership type has been discussed broadly in China. Compared to SOEs, which have obvious political ties, non-SOEs have more incentives to establish political connections. We predict that non-SOEs react more aggressively when top local officials are replaced. We test the interaction effect of state ownership on the relationship of corporate political networking expenditure to top local official turnover by grouping the firms by ownership type. The results shown in Table 6 are consistent with our prediction. In the non-SOE group, corporate political networking expenditure increases significantly in response to city-level top official turnover, but the result disappears in the SOE group. This suggests that the systematic effect of local official turnover on the increase of corporate political socializing expenditure is dominated by non-SOEs, implying that non-SOEs tend to socialize with officials to create political connections when top officials are replaced. We also use the interaction method to re-check these results, and the results are confirmed.

Table 6  
Results for ownership type (H2).

	(1) SOEs <i>AbLnExpense</i>	(2) Non-SOEs <i>AbLnExpense</i>	(3) Full sample <i>AbLnExpense</i>
<i>PTO</i>	−0.016 (−0.369)	−0.031 (−0.596)	−0.023 (−0.673)
<i>CTO</i>	0.030 (0.859)	0.094** (2.197)	0.078* (1.774)
<i>SOE</i>			−0.073 (−1.264)
<i>CTO * SOE</i>			−0.063* (−1.716)
<i>Size</i>	−0.029 (−1.133)	−0.069*** (−3.087)	−0.048*** (−2.627)
<i>Lsh</i>	−0.005** (−2.295)	−0.001 (−0.252)	−0.004** (−2.224)
<i>ROA</i>	0.519 (1.641)	0.314* (1.766)	0.289* (1.764)
<i>MB</i>	0.136*** (5.511)	0.047*** (3.707)	0.085*** (5.738)
<i>Leverage</i>	0.024 (0.167)	−0.016* (−1.776)	−0.026*** (−3.064)
<i>Msh</i>	−0.583 (−1.527)	0.002 (0.048)	0.300 (1.590)
<i>LnComp</i>	0.296*** (6.725)	0.220*** (4.438)	0.259*** (7.533)
<i>BoardSize</i>	0.015 (1.026)	0.009 (0.420)	0.009 (0.680)
<i>RegionLevel</i>	0.406*** (9.189)	0.413*** (8.662)	0.418*** (12.147)
<i>FirmAge</i>	−0.012 (−1.482)	−0.018* (−1.859)	−0.013** (−2.063)
<i>Industry</i>	Controlled	Controlled	Controlled
<i>Year</i>	Controlled	Controlled	Controlled
<i>Constant</i>	−3.647*** (−5.940)	−1.574** (−2.307)	−2.589*** (−5.458)
<i>Observations</i>	1859	1333	3192
<i>F</i>	13.474	18.201	19.873
<i>Adj. R<sup>2</sup></i>	0.260	0.294	0.246

Robust *t*-statistics are in parentheses.

\*  $p < 0.1$ .

\*\*  $p < 0.05$ .

\*\*\*  $p < 0.01$ .

We use the number of listed firms in a city as a city-level marketization index to test whether the level of regional marketization has an interaction effect on the relationship between top local official turnover and corporate political networking expenditures. Previous studies have shown that corporations are more likely to have political connections in regions with weak legal regimes, strong government intervention and lower marketization (Faccio, 2006; Yu and Pan, 2008). Therefore, we predict that corporations located in regions with low levels of marketization will socialize with officials more actively when top officials are replaced. To test this hypothesis, we add the interaction term of the local marketization index (*NUM*) and city-level top official turnover (*CTO*) to the main regression.

The results summarized in Table 7 show that the coefficient of the interaction term of the local marketization index (*NUM*) and city-level top official turnover (*CTO*) is significantly negative, indicating that high levels of marketization diminish the sensitivity of political networking expenditure to top local official turnover. Consistent with previous studies, we thus provide new evidence that political connections are pursued

Table 7  
Results for levels of regional marketization (H3).

	(1) <i>AbLnExpense</i>	(2) <i>AbLnExpense</i>	(3) <i>AbLnExpense</i>
<i>PTO</i>	−0.025 (−0.797)	−0.028 (−0.894)	−0.027 (−0.829)
<i>CTO</i>	0.160*** (2.713)	0.101*** (2.966)	0.068* (1.809)
<i>NUM</i>	0.001 (0.477)		
<i>NUM</i> * <i>CTO</i>	−0.002** (−2.099)		
<i>NUM_1</i>		0.037 (1.395)	
<i>NUM_1</i> * <i>CTO</i>		−0.041* (−1.842)	
<i>MktIndx</i>			0.006 (0.504)
<i>MktIndx</i> * <i>CTO</i>			−0.005 (−0.422)
<i>SOE</i>	−0.101** (−1.966)	−0.103** (−2.006)	−0.091* (−1.712)
<i>Size</i>	−0.035* (−1.774)	−0.036* (−1.818)	−0.053*** (−2.944)
<i>Lsh</i>	−0.003 (−1.646)	−0.003 (−1.629)	−0.003 (−1.532)
<i>ROA</i>	0.432*** (2.644)	0.433*** (2.640)	0.411** (2.537)
<i>MB</i>	0.069*** (4.894)	0.068*** (4.846)	0.063*** (4.817)
<i>Leverage</i>	−0.026 (−1.493)	−0.026 (−1.455)	−0.017* (−1.930)
<i>Msh</i>	0.040 (0.885)	0.044 (0.997)	0.135 (0.741)
<i>LnComp</i>	0.222*** (6.445)	0.225*** (6.508)	0.279*** (8.293)
<i>BoardSize</i>	0.005 (0.461)	0.006 (0.481)	0.009 (0.736)
<i>RegionLevel</i>	0.394*** (9.997)	0.417*** (10.012)	0.403*** (12.138)
<i>FirmAge</i>	−0.011* (−1.856)	−0.011* (−1.891)	−0.011* (−1.726)
<i>Industry</i>	Controlled	Controlled	Controlled
<i>Year</i>	Controlled	Controlled	Controlled
<i>Constant</i>	−2.314*** (−4.717)	−2.262*** (−4.623)	−2.660*** (−5.486)
<i>Observations</i>	3192	3192	3192
<i>F</i>	21.431	21.540	22.462
<i>Adj. R<sup>2</sup></i>	0.295	0.295	0.299

aggressively in regions with lower market orientations. We re-check this result using a ranked variable of the number of city-listed firms (*NUM\_1*) and the result is consistent. However, the result disappears if we use the Fan-Wang marketization index instead of our *NUM* index, perhaps because the Fan-Wang index is a province-level index that does not reflect the variation between cities.

#### 4.4. Additional tests

In the recent years, the value of political connections to corporations has been explored around the world (see, Fisman, 2001; Faccio et al., 2006; Goldman et al., 2009; Wu et al., 2010). Using our new measure of

Table 8  
Economic consequences of political networking expenditures.

	(1) OLS <i>ROA</i>	(2) OLS <i>Tobin's Q</i>
<i>AbLnExpense</i>	0.011*** (5.225)	0.254*** (5.275)
<i>SOE</i>	−0.013*** (−2.903)	−0.080 (−1.228)
<i>Size</i>	0.015*** (7.015)	−0.369*** (−6.519)
<i>Lsh</i>	0.000** (2.135)	−0.005** (−2.224)
<i>MB</i>	0.012*** (2.663)	
<i>Leverage</i>	−0.017*** (−2.820)	0.373*** (7.547)
<i>Msh</i>	0.020*** (5.506)	−0.851*** (−3.466)
<i>RegionLevel</i>	−0.004 (−1.399)	−0.008 (−0.151)
<i>Region</i>	Controlled	Controlled
<i>Industry</i>	Controlled	Controlled
<i>Year</i>	Controlled	Controlled
<i>Constant</i>	−0.279*** (−5.733)	9.872*** (7.946)
<i>Observations</i>	3192	3192
<i>F</i>	13.171	39.035
<i>Adj. R<sup>2</sup></i>	0.143	0.354

Robust *t*-statistics are in parentheses.

\*  $p < 0.1$ .

\*\*  $p < 0.05$ .

\*\*\*  $p < 0.01$ .

political connections, we examine the economic consequences of the political ties created through social intercourse.

We use return on total assets (*ROAt*) to measure accounting performance in year *t*. In column (1) of Table 8, the coefficient of *AbLnExpense* is significantly positive, indicating that political ties formed through social intercourse could improve firm performance. We also examine the effect of such political ties on firm valuation, which is proxied for by *Tobin's Q*; the result is similar. Consistent with previous studies, we find that political connections obtained through social intercourse can increase corporate value.

We also conduct several robustness tests. First, we exclude all of the observations from 2007 as the 17th National Congress of the Communist Party of China was convened that year and thus the number of provinces that experienced top official turnover is extremely high for that year. Second, we rule out the alternative explanation that increased expenditures may be caused by increased corporate investment after top local officials are replaced. Julio and Yook (2012) find that firms reduce investments during election years. Other researchers have argued that firms may increase investments after politicians are replaced and expenses may increase correspondingly. To test this, we additionally control for corporate investment in our model and the results remain the same. Following Xin et al. (2007), we define investment as the log value of the change in net PP&E, long-term investment, and intangible assets. We do not find a positive relationship between our measure of expenditures on political social intercourse (*AbLnExpense*) and corporate investment; therefore, we rule out the investment explanation.

Third, we use the IV-2SLS method to re-test the relationship between firm performance and corporate political networking expenditures. There may be an endogeneity issue in the analysis of the association between firm performance and corporate political socializing expenditure, as high-performing firms tend to

Table 9  
Results of IV-2SLS regressions.

	(1) 2SLS Second step <i>ROA</i>	First step <i>AbLnExpense</i>	(2) 2SLS Second step <i>Tobin's Q</i>	First step <i>AbLnExpense</i>
<i>AbLnExpense</i>	0.012* (1.896)		0.797* (1.661)	
<i>LnAvgSalary</i>		0.252** (2.034)		0.474*** (2.599)
<i>SOE</i>	−0.009 (−1.455)	−0.105* (−1.869)	−0.002 (−0.016)	−0.140** (−2.565)
<i>Size</i>	0.014*** (4.961)	0.017 (0.986)	−0.364*** (−6.349)	−0.010 (−0.579)
<i>Lsh</i>	0.000* (1.917)	−0.003* (−1.652)	−0.003 (−1.046)	−0.004** (−2.269)
<i>MB</i>	0.010* (1.727)	0.086*** (5.416)		
<i>Leverage</i>	−0.015*** (−3.386)	−0.040*** (−4.077)	0.375*** (7.568)	−0.003 (−0.660)
<i>Msh</i>	0.056** (2.377)	0.086*** (5.416)	−1.036*** (−3.738)	0.316* (1.678)
<i>RegionLevel</i>	−0.011 (−0.774)	0.411*** (9.434)	−0.263 (−1.123)	0.405*** (8.227)
<i>Region</i>	Controlled	Controlled	Controlled	Controlled
<i>Industry</i>	Controlled	Controlled	Controlled	Controlled
<i>Year</i>	Controlled	Controlled	Controlled	Controlled
<i>Constant</i>	−0.093* (−1.988)	−3.071** (−2.429)	9.814*** (7.845)	−4.864** (−2.498)
<i>Observations</i>	3192	3192	3192	3192
<i>F</i>	15.208	20.414	39.439	19.458
<i>Adj. R<sup>2</sup></i>	0.129	0.211	0.341	0.246

Robust *t*-statistics are in parentheses.

\*  $p < 0.1$ .

\*\*  $p < 0.05$ .

\*\*\*  $p < 0.01$ .

have higher socializing expenditures. We choose an instrumental variable for corporate political networking expenditure to diminish the endogeneity problem. The IV we use is the average regional salary. We think that the average regional salary, to a certain extent, reflects regional consumption levels, and that the local corporate social expenses should reflect the local level of consumption. However, there is no theoretical link between firm performance or valuation and average regional salary. The results of the 2SLS are shown in Table 9 and are consistent with the OLS results. They confirm that corporate expenditures on political networking are a new measure of corporate political connections and that increased amounts of political networking increase firm value.

## 5. Conclusions

In this study of corporate political connections, we document that socializing with government officials is a common and important political strategy used by Chinese firms. We capture political connections using a new measure based on corporate socializing expenditures. Several interesting findings emerge from our analysis. First, we test the validity of the new measure using exogenous events, specifically the turnover of top local officials, which results in the breaking of corporate political ties. We find that corporate expenditures on political networking increase significantly when top local officials are replaced and this effect is stronger for non-SOEs, who seek political connections more aggressively. Second, this study shows that firms in regions with low levels of marketization react more aggressively to the turnover of local politicians, which confirms



previous findings that political connections are more important when the institutional environment is poor. We also find that corporate expenditures on socializing with officials have a positive effect on corporate performance and valuation, which suggests that socializing expenditures perform well as a new measure of corporate political connections and confirms the valuation effect of corporate political connections.

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