

# Politically connected CEOs, corporate governance, and Post-IPO performance of China's newly partially privatized firms<sup>☆</sup>

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## Abstract

Almost 27% of the CEOs in a sample of 790 newly partially privatized firms in China are former or current government bureaucrats. Firms with politically connected CEOs underperform those without politically connected CEOs by almost 18% based on three-year post-IPO stock returns and have poorer three-year post-IPO earnings growth, sales growth, and change in returns on sales. The negative effect of the CEO's political ties also show up in the first-day stock return. Finally, firms led by politically connected CEOs are more likely to appoint other bureaucrats to the board of directors rather than directors with relevant professional backgrounds.

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## 1. Introduction

A series of papers in the public choice literature argues that rent seeking, extraction, and protection are important objectives of government intervention (see, e.g., Stigler, 1971; Peltzman, 1976; McChesney, 1987; De Soto, 1990; Spiller, 1990; Shleifer and Vishny, 1998). Shleifer and Vishny (1994, 1998) and Hellman, Jones, and Kaufmann (2000) suggest that politicians' intervention in business activities is more severe when institutional constraints are weak. Acemoglu and Johnson (2005) provide cross-country evidence that countries with weaker property rights and limited protection against expropriation by politicians and the country's elite have substantially lower income per capita and investment rates, and less developed stock markets.

This paper examines the role of government intervention in China's newly partially privatized firms. Because property rights in China remain weak and the product and capital markets are far from liberalized, theory predicts a strong negative relation between government intervention and the performance and governance quality of firms.

Indeed, China's share issue privatization results stand in sharp contrast to the experience in other economies, almost all of which document performance improvement.<sup>1</sup> To understand the performance and governance problems of China's partial privatization scheme, this study examines (1) the effect of government influence on a firm's long-term, post-IPO stock returns and accounting performance; (2) whether and when post-IPO stock market performance reflects the effects, if any, of government influence; and (3) how governance and board composition are related to government intervention.

We use the CEO's political connection, defined as serving as a current or former government bureaucrat—that is, a current or former officer of the central or local governments or the military—as a proxy for government intervention in the firm. Because the Chinese government possesses the right to appoint the CEO of a listed company, the CEO's political affiliation provides a suitable proxy for government influence. Our detailed database of CEOs and directors of 790 companies that went public in China between 1993 and 2001 (nearly 73% of all IPOs) shows that almost 27% of CEOs were politically connected. After controlling for other factors that influence firm performance, we find that long-term post-IPO stock returns are significantly worse when a firm's CEO is politically connected. This difference in stock return performance is noticeable soon after the initial listing and becomes statistically significant around 40 days after the new issue. The accounting performance of a firm run by a politically connected CEO is also consistently worse than that of an otherwise similar firm.

After controlling for other influencing factors, we also find that IPO initial (first day) returns are negatively related to the CEO's political connections, which suggests that China's IPO investors anticipate the negative effects of government intervention and hence lower the prices they are willing to pay for these stocks. The evidence also suggests that politically unconnected firms underprice their IPO shares more than do politically connected firms, which serves as a signal to investors that the firms will be less subject to

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<sup>1</sup>See, for example, Megginson, Nash, and Randenborgh (1994), Boubakri and Cosset (1998), D'Souza and Megginson (1999), Megginson, Nash, and Schwartz (2000), and Dewenter and Malatesta (2001). A few survey articles summarize vast evidence of the positive performance effect of privatization. These include Megginson and Netter (2001) who cover the world, Djankov and Murrell (2002) on transition economies, and Chong and Lopez-De-Silanes (2002) on Latin America.

intervention by bureaucrats. This result corroborates prior research findings that IPO firms in market-oriented economies tend to underprice more than do those in interventionist economies (Perotti, 1995; Jones, Megginson, Nash, and Netter, 1999).

The boards of our sample firms have almost no directors who represent public stock investors. Also, when a CEO is politically connected, the board has more bureaucrats and fewer professionals, and the directors are on average older and less likely to be women.

Taken together, our findings suggest that China's partial privatizations and ongoing government intervention (as reflected in the political connections of the firms' CEOs) are not conducive to shareholder value maximization. The high involvement of bureaucrats and the low participation of professionals in management and directorships along with the poor post-IPO performance are perhaps not surprising results of China's share issue privatization scheme.

This paper is related to several other strands of literature. First, it considers the governance and performance consequences when a substantial ownership block is non-transferable (Alchian, 1965; Jensen and Meckling, 1979; Karpoff and Rice, 1989). Second, it provides additional evidence on the effects of government ownership on post-privatization performance (Kole and Mulherin, 1997; Boubakri, Cosset, and Guedhami, 2005; D'Souza, Megginson, and Nash, 2005; Gupta, 2005). Third, it extends the literature on government intervention and rent seeking. Our evidence that bureaucrats seek rents from firms complements several recent studies that focus on political connections and rent seeking (Agrawal and Knoeber, 2001; Hadlock, Lee, and Parrino, 2002; Helland and Sykuta, 2004; Faccio, 2006).

The remainder of the paper proceeds as follows. Section 2 discusses the institutional background in China and develops the hypotheses. Section 3 introduces our data and sample. Section 4 analyzes long-term post-IPO performance and its relation with the CEO's political ties. Section 5 addresses the effects of the CEO's political connections on short-term post-IPO stock returns and IPO pricing. Section 6 considers the association between the firms' board structures and the CEO's political connections. Section 7 concludes the paper.

## 2. Institutional background and hypotheses

During the economic reforms of the 1980s, the Chinese government launched a program that decentralized managerial decision rights of state-owned enterprises (SOEs) from the central government down to the local firm level. This decentralization was motivated by the central government's desire to promote markets and to gradually phase out its central planning function. In the 1990s, the government allowed SOEs to be partially privatized by issuing a minority allocation of shares to individual investors, who could trade their shares freely in newly developed stock markets set up in Shenzhen and Shanghai in 1990 and 1991, respectively. For ideological reasons, this partial privatization process, which was officially called *corporatization*, prohibited the government from selling its controlling stake in the firms. Therefore, unlike in most other countries where share issue privatizations are through secondary or mixed primary-secondary offerings, the Chinese privatizations were primary offerings that did not involve subsequent secondary offerings. Most of our sample firms did not actively engage in secondary offerings, nor did some of the firms' rights offering activities significantly dilute state ownership. We repeat our analysis on the sample excluding 58 firms that made secondary offerings subsequent to

their IPOs, and find that our results are generally unaffected by the exclusion. Subsequent to primary offerings, government-owned shares can occasionally be transferred in blocks among state-owned firms. However, free trading of these shares in the secondary markets was strictly prohibited during our sample period.

In association with the corporatization process in the 1990s, the central government further decentralized its power by specifying the exact decision rights assigned to the SOE level, involving a total of 14 rights mainly related to operating decisions and the use of retained funds (Qian, 1995). While largely granting operating decision rights to SOE managers, the government retained ultimate decision rights concerning mergers and acquisitions and the disposal of shares and assets of these listed firms, as well as decision rights on the appointment of CEOs.

### 2.1. Hypotheses about post-IPO performance

It is not difficult to forecast that, with this institutional background, the non-transferability of state-owned shares/assets would create thorny incentive problems among both government officials and firm managers. Under these conditions, the governance of the firms would likely be weak and firm value would likely be dissipated, due fundamentally to the lack of a free market that would release the firms from state ownership.<sup>2</sup> Moreover, conflicts of interest between shareholders and bureaucrats overseeing the firm, with the latter likely pursuing social objectives or private gains at the firm's expense, would further decrease firm value (Shleifer and Vishny, 1994, 1998).

We assume that an interventionist government is more likely to endorse a bureaucrat's appointment as CEO of a newly listing company. A first test of whether a politically connected CEO and his or her affiliated government pursue objectives that run counter to corporate productivity is to determine if the appointment is associated with poor long-term firm performance. If the government tends to extract rents from the firm, the appointment of a politically connected CEO would negatively affect post-IPO stock returns and accounting performance, all else equal.

In a functioning capital market, the long-term negative effects of government intervention in the form of a politically connected CEO should be factored into a firm's stock prices shortly after its stock is offered to the public. Likewise, the anticipated negative effects of government intervention should lower the willingness of investors to pay high prices for the new shares. The government could lower the offering price to boost demand for the new shares, making the net effect of the politically connected CEO on initial returns unclear. But this scenario is unlikely because the limited supplied IPO shares in China are almost always oversubscribed. Therefore the marginal lower demand for the new shares due to the government intervention would not be a concern in the government's IPO pricing decisions. On the other hand, prior studies have shown that a non-interventionist government will underprice IPO shares to signal to investors its credible

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<sup>2</sup>Alchian (1965), Jensen and Meckling (1979); Karpoff and Rice (1989) provide analyses on the effects of non-transferable property rights on organizations and incentives. When assets/shares are non-transferable, the firms cannot sell off its assets and/or controlling stakes to buyers who potentially can run the firms more productively. The prohibition against trading the shares also renders two governance mechanisms, incentive compensation contracts and corporate control, impractical. This problem is exacerbated by the absence of a large secondary owner who benefits from additional firm productivity by serving as a high-power monitor (Shleifer and Vishny, 1986).

intention of relinquishing control of the firm (see, e.g., Perotti, 1995; Jones, Megginson, Nash, and Netter, 1999). Under this scenario, the CEO's political ties (a proxy for government intervention) should be associated with smaller IPO underpricing (lower initial returns). Consistent with this signaling hypothesis, there should also be a significant difference in the long-term post-IPO performance among privatized firms on the basis of the CEO's political ties, as predicted earlier.

## 2.2. Hypotheses about board structures

The structure of a board of directors reveals information about the quality of the firm's management and the extent of checks and balances on managerial decisions. The degree of professionalism and monitoring required by a firm is likely determined by the institutional environment to which the firm adapts (Hermalin and Weisbach, 2003). We argue that the property regulations in China's privatization scheme led to boards characterized by strong bureaucratic influence, weak governance, and low professionalism. Specifically, we expect that firms with government-appointed, politically connected CEOs have more directors with political ties and fewer directors with business experience or professional backgrounds, mainly because politically connected CEOs need allies on the board to reinforce their policies and objectives. Non-political professionals, or directors representing investors' interests, might obstruct the politicians' objectives.

## 3. Data and sample

We manually collected CEO and board data from the IPO prospectuses of newly listed A-share companies on the Shanghai Stock Exchange and the Shenzhen Stock Exchange from 1993 to 2001.<sup>3</sup> For each company, we obtained a profile of the CEO and each of the other directors from the "Profile of Directors and Senior Managers" section of the company's prospectus. In addition to the CEO's (director's) name, the profile typically contains information on age, gender, education, professional background, and employment history. From the profile, we traced the CEO's (director's) political connections by examining whether he or she was currently or formerly an officer of either the central government, a local government, or the military. From the director's profile and the "Company History," "Background of Founding Investors," and/or "Background of Large Shareholders" sections of the company's prospectus, we further identified each director's current or former business experience outside the business group to which the newly listed company belongs.

We obtained CEO and board data for 790 IPO firms during the 1993–2001 period, representing 73% of the total number of IPO firms in China over that period and covering 7255 CEOs and directors. In addition to the CEO/board data, we obtained IPO-year ownership data from the Shenzhen Genius Information Technology Company database; stock return and financial data from the China Stock Market and Accounting Research (CSMAR) database; and China's regional economic data from China Economic Information Network Data Co., Ltd.

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<sup>3</sup>During the sample period, A-shares were traded by domestic investors, versus other classes of shares such as B- or H-shares that were traded by foreign investors. Starting in 2001, domestic investors were allowed to trade B-shares.

Table 1 provides a description of the sample. Panel A demonstrates that the IPO firms in our sample are unevenly distributed across the sample period, which largely reflects the overall IPO pattern in China. The sample coverage improves over time, reflecting improved public disclosure of company information, especially after 1997. Panel B breaks down the sample by industry sector. Of the 790 firms, 48 firms are in the natural resources sector, 499 are in the manufacturing sector, 116 are in the services and trade sector, 63 are in the public utilities sector, 18 are in the finance and real estate sector, and 46 are classified as conglomerates operating in multiple sectors. The sample captures more than 65% of all IPO firms in each of the sectors, with the exception of the finance and real estate sector (43%).

Table 1 also reports that almost 27% of the sample firms appointed politically connected CEOs who were current or former government bureaucrats or military officers. This suggests that the government maintains direct influence on a significant portion of firms through its CEO appointments. There is no particular pattern in the percentage of politically connected CEOs on a year-by-year basis, but there is a cross-industry variation in the appointment of politically connected CEOs. The highest percentage of politically connected CEOs occurs in the natural resources sector (40%), followed by the public utilities sector (32%), the services and trade sector (28%), the manufacturing sector (26%), conglomerates (24%), and the finance and real estate sector (6%).

Table 1  
The sample

This table presents information on the sample of newly partially privatized firms in China that went public during 1993–2001. Columns 1 and 2 report the number of firms and the percentage of the total initial public offering (IPO) population. Columns 3 and 4 report numbers on the subsample of firms led by politically connected CEOs. Panel A reports the sample by year of IPO. Panel B reports the sample by industry sector.

	Total sample Number	% of the total IPO population by year/ sector	Firms with politically connected CEOs Number	% of the total sample by year/sector
<i>Panel A: By year</i>				
1993	59	47.58	9	15.25
1994	64	58.18	16	25.00
1995	12	50.00	3	25.00
1996	132	65.02	46	34.85
1997	172	83.50	46	26.74
1998	88	83.02	32	36.36
1999	80	81.63	21	26.25
2000	117	85.40	29	24.79
2001	66	83.54	9	13.64
<i>Panel B: By industry sector</i>				
Natural resources	48	78.69	19	39.58
Manufacturing	499	74.92	128	25.65
Services and trade	116	75.82	32	27.59
Public utilities	63	67.02	20	31.75
Finance & real estate	18	42.86	1	5.56
Conglomerate	46	64.79	11	23.91
Total	790	72.68	211	26.71



#### 4. Politically connected CEOs and long-term firm performance

We employ several stock- and accounting-based measures to evaluate the post-IPO performance of the Chinese companies in our sample. The stock performance measures are the one-, two-, and three-year post-IPO cumulative abnormal market-adjusted stock returns (CARs), calculated on the basis of monthly stock returns starting from the first month after the IPO date. We use the equally weighted market index of both the Shanghai and Shenzhen stock exchanges for adjustments in all our analyses, but our regression results remain qualitatively similar with value-weighted indexes.

We also use three accounting performance measures: sales growth, earnings growth, and the change in return on sales (ROS). We calculate ROS as net income divided by sales. We do not use return on book assets or return on book equity because Chinese share issue privatizations are primary offerings that increase the asset base of the firms substantially after the IPOs, creating a downward bias on performance measures based on equity or assets.<sup>4</sup> Prior research on share issue privatization performance typically compares accounting performance changes a few years before and a few years after privatization (Megginson, Nash, and Randenborgh, 1994; Boubakri and Cosset, 1998; D'Souza and Megginson, 1999; Sun and Tong, 2003). Consistent with the literature, we use the pre-IPO accounting figures of a firm as a benchmark to evaluate the firm's post-IPO performance. We compute the change in ROS by subtracting the average ROS in the three years immediately prior to the IPO from the average of the three years of annual ROS after the IPO. The earnings (sales) growth measure is the percentage change in the average level of earnings (sales) over the three years immediately prior to the IPO to the three years after the IPO.

Note that we have omitted accounting numbers in the IPO year, because those accounting data tend to be heavily manipulated. In addition, if the CEO of a firm was politically connected prior to its IPO, we would not expect a change in its accounting return measures after the firm went public. We would have to exclude such firms from the sample in our accounting return analysis. However, we cannot discard these firms from the sample due to the lack of information on the political connections of the pre-IPO CEOs. This biases against finding a relation between political connections and accounting returns. Due to missing pre-IPO data, the number of observations in the change in ROS and earnings growth statistics is 774, while it is 782 in the sales growth statistics. The pre-IPO sales and earnings data are missing for eight firms and the pre-IPO earnings data are missing for another eight firms. We also winsorize the top and bottom 5% of each of the accounting return variables to exclude the effect of outliers.

##### 4.1. Between-group mean and median tests

Fig. 1 shows that the average CAR of newly listed firms in China not only fails to increase but actually deteriorates by almost 17% over the three years subsequent to their IPOs. Fig. 2 plots the mean CARs of newly listed companies in China sorted by whether or not their CEOs are politically connected. The mean CAR of the group of firms run by politically connected CEOs exhibits a steep decline of 30% over the three years subsequent to the IPOs, while the mean CAR of the second group of firms exhibits a much smaller

<sup>4</sup>We thank the referee for pointing out that ROS is not subject to this bias.

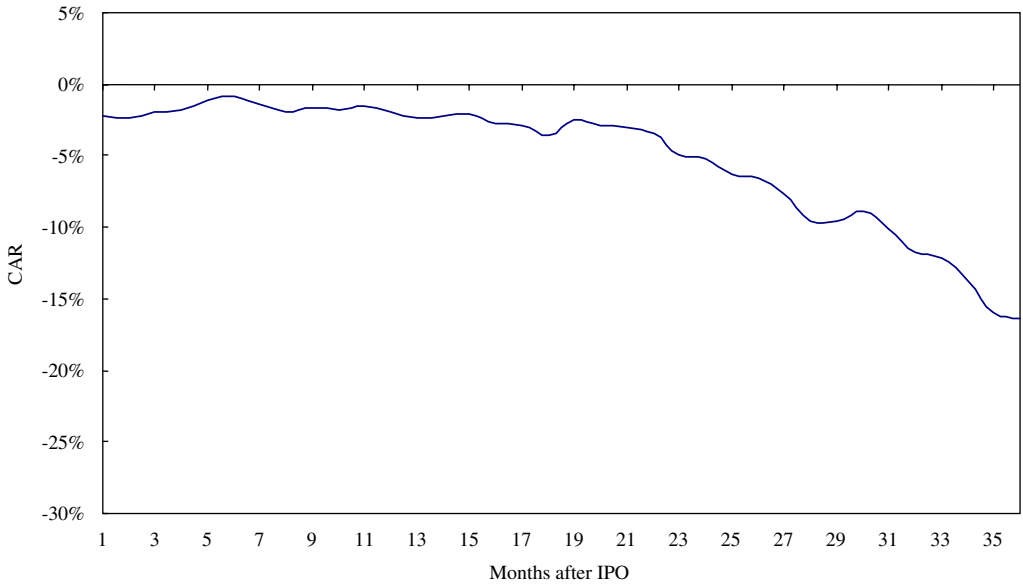


Fig. 1. Mean post-IPO cumulative market-adjusted compound stock returns (CARs) from one to 36 months after the initial trading month of 790 partially privatized firms in China that went public during 1993–2001.

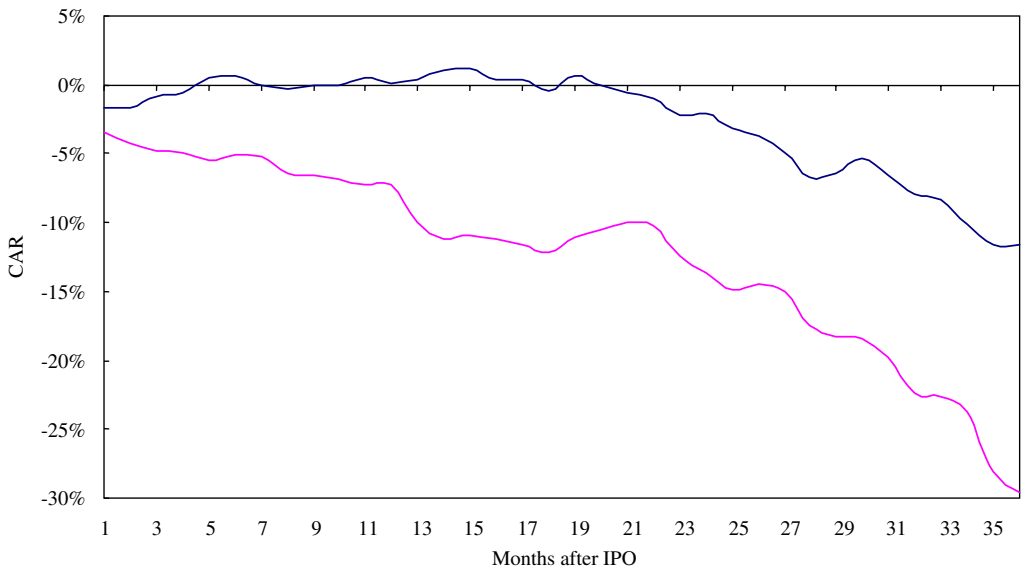


Fig. 2. Mean post-IPO cumulative market-adjusted compound stock returns (CARs) from one to 36 months after the initial trading month of 790 partially privatized firms in China that went public during 1993–2001, sorted by whether their CEOs are current or former government bureaucrats.

drop of 12% over the same period. From this comparison, the overall decline in stock performance of the newly privatized firms (as shown in Fig. 1) seems to be largely attributable to the set of firms that are subject to more direct intervention by bureaucrats.



Table 2 reports the mean and median values of the stock-based and accounting-based performance measures for the full sample and for subsamples sorted by whether or not the CEO is politically connected. Consistent with Figs. 1 and 2, the mean and median CARs decrease significantly over time. In each of the three post-IPO years, the mean and median CARs of firms with politically connected CEOs are statistically significantly lower than those without politically connected CEOs, indicating that the market is able to distinguish between the two groups of firms within the first year after the IPO. Moreover, the magnitude of the difference in the CARs between the two groups grows larger each year, suggesting that over the years the market gradually learns more about the negative effects of government intervention.

As for the accounting-based measures, the post-IPO sales and earnings growth measures are quite substantial, averaging 106% for sales and 89% for earnings relative to the pre-IPO period. However, the mean (median) change in the three-year average ROS of the full sample is  $-4.23\%$  ( $-1.88\%$ ), which corroborates the post-IPO decline in stock values. The decline in accounting performance of the IPO firms in China is consistent with data reported by Aharony, Lee, and Wong (2000) and Sun and Tong (2003). Moreover, our between-group comparison shows that firms led by politically connected CEOs experience more substantial drops in ROS and slower sales and earnings growth than do their politically unconnected counterparts.

#### 4.2. Regressions

We next perform regression analyses to examine the effects of the CEO's political connections on post-IPO firm performance. Table 3 presents the results of our ordinary least squares (OLS) regressions using the one-, two-, and three-year CARs as dependent variables. On the right-hand side of the regressions, we include a dummy variable equal to one if the CEO is politically connected. We also include a few control variables: the fraction of common shares held by the largest shareholder (typically a government), the market-to-book equity ratio, the debt-to-sales ratio, the log of total assets, and the regulated industry dummy variable. We again winsorize the top and bottom 5% of the variables for both dependent and independent variables in the model. The ownership variable controls for the possibility that a politician's rent-seeking incentives depend on the controlling shareholder's ownership stake in the firm.

Consistent with the univariate results reported in Table 2, the multivariate regression results show that firms with politically connected CEOs experience a more statistically significant stock performance decline after the IPO. We also calculate annual CARs and run the regressions on the pooled post-IPO annual data adjusting for clustering effects (Peterson, 2005). The estimated coefficient of the CEO's political connections is  $-0.055$  with a  $t$ -statistic of 2.84. The magnitudes of the differences in CAR between these two subsamples are similar to the univariate results even after controlling for firm-specific factors that could affect post-IPO stock return performance. The results show that firms with politically connected CEOs underperform those without politically connected CEOs by 7% one year after the IPO, 10% two years after the IPO, and 15% three years after the IPO.

Table 4 presents the results of OLS regressions that analyze the effects of politically connected CEOs on post-IPO accounting performance changes. The dependent variables are sales growth, earnings growth, and the change in ROS. The independent variables are the dummy variable for a politically connected CEO, the fraction of common shares held by the largest shareholder, the market-to-book equity ratio, the debt-to-sales ratio, the log

Table 2  
Mean and median statistics of post-IPO performance measures

This table presents the mean and median values of stocks and accounting performance measures of Chinese firms that were partially privatized through IPOs during 1993–2001. The table also reports the statistics for two subsamples of firms sorted by whether or not their CEOs were politically connected. The stock performance measures are the cumulative market-adjusted stock returns (CARs) accumulated for 12, 24, and 36 months starting from one month after the IPO month. Monthly stock returns are used for calculating the CARs measures. Market returns are the equally weighted returns for all common stocks traded on the Shenzhen and Shanghai Stock Exchanges. In total, 790 firms are used for computing the CARs. The accounting return measures are the change in return on sales (ROS), sales growth, and earnings growth. The change in ROS is measured as the difference between the average annual ROS of the three years after the IPO and that of the three years before the IPO year. The sales (earnings) growth variables are the growth rates of sales (earnings) from the average annual sales (earnings) of the three years before the IPO year to that after the IPO year. Due to missing values, 774 observations are used for calculating the statistics of the change in ROS and earnings growth, while 782 observations are used for the sales growth measure. Test statistics for the differences in means and medians are provided. \*\*\*, \*\*, and \* denote significance at the 1%, 5%, and 10% level, respectively.

Performance measure	Mean				Median			
	Total sample	CEO is politically connected	CEO is not politically connected	Difference in mean	Total sample	CEO is politically connected	CEO is not politically connected	Difference in median
CAR 1 year after IPO	-1.89*	-7.31	0.07	-7.38***	-7.64***	-14.08	-4.77	-9.31***
CAR 2 years after IPO	-5.14***	-13.64	-2.04	-11.6***	-13.21***	-18.86	-11.03	-7.83***
CAR 3 years after IPO	-16.57***	-29.62	-11.81	-17.81***	-20.62***	-30.13	-17.92	-12.21***
Change in ROS	-4.23***	-5.34	-3.83	-1.51*	-1.88***	-1.98	-1.80	-0.18
Growth in sales	105.7***	85.9	113	-27.1***	70.9***	54.5	77.3	-22.8***
Growth in earnings	88.9***	66.9	97.0	-30.1**	55.6***	38.8	62.4	-23.6**

Table 3

Regression results of the effects of politically connected CEOs on the post-IPO stock performance of newly partially privatized firms in China

The dependent variable reported in this table is stock performance, measured alternately as the cumulative market-adjusted stock returns (CARs) accumulated for 12, 24, and 36 months, starting from one month after the IPO month. Monthly stock returns are used for calculating the CARs measures. Market returns are the equally weighted returns for all common stocks traded on the Shenzhen and Shanghai Stock Exchanges. The independent variables, measured upon the IPO year, include a dummy variable equal to one if the CEO is politically connected (zero otherwise), the percentage ownership of the largest owner, the market-to-book equity ratio, the leverage ratio measured as total debt over sales, the natural log of total assets, and a dummy variable equal to one if the firm is in a heavily regulated sector (natural resources, public utilities, or finance and real estate). The regressions utilize the ordinary least squares method. Absolute values of robust *t*-statistics are in parentheses. \*\*\*, \*\*, and \* denote significance at the 1%, 5%, and 10% level, respectively.

	CAR 1 year after IPO	CAR 2 years after IPO	CAR 3 years after IPO
CEO is politically connected	−0.069 (2.87)***	−0.099 (2.73)***	−0.153 (3.40)***
Largest shareholder's ownership %	−0.000 (0.14)	−0.000 (0.08)	0.001 (1.07)
Market-to-book of equity	0.109 (10.05)***	0.089 (5.21)***	0.032 (1.59)
Leverage	0.012 (0.73)	0.002 (0.07)	−0.054 (1.72)*
Log of total assets	0.049 (2.86)***	−0.049 (1.86)*	−0.133 (3.96)***
Regulated industry	0.095 (2.90)***	0.132 (2.69)***	0.196 (3.41)***
Constant	−1.330 (3.59)***	0.760 (1.35)	2.633 (3.62)***
Observations	790	790	790
Adjusted $R^2$	0.18	0.11	0.09

of total assets, and a regulated industry dummy variable. The top and bottom 5% extreme values are winsorized for the dependent and independent variables in the model.

The regression results show that firms with politically connected CEOs experience deteriorating accounting performance subsequent to their IPOs, regardless of whether performance is measured by sales growth, earnings growth, or the change in ROS. The difference in the accounting variable is around −1.6% for the change in ROS, −21% for sales growth and −24% for earnings growth. These results are consistent with the univariate results reported in Table 2.<sup>5</sup>

<sup>5</sup>We alternatively perform random and fixed-effect regressions based on firm-year panel data for the sample firms from three years before to three years after their IPOs, excluding the IPO years. The dependent variables are accounting performance levels (ROS, log sales level, and log net income level). In addition to our other independent variables, we include a post-IPO dummy variable equal to one if an observation is from the post-IPO period and an interaction term for the CEO's political connection dummy variable and the post-IPO dummy variable. We find that the estimated coefficients of the post-IPO dummy variable are significantly negative, suggesting declined accounting performance after the firms' IPOs. Moreover, the coefficients of the interaction term are negative and significant in the ROS and sales regressions, suggesting that politically connected CEOs have a further negative effect on post-IPO accounting performance. These results are not reported in a table but are available upon request.

Table 4

Regression results of the effects of politically connected CEOs on the post-IPO accounting performance of newly partially privatized firms in China

The dependent variable in this table is, alternately, change in ROS, sales growth, and earnings growth. The change in ROS variable is measured as the difference between the average annual ROS of the three years after the IPO and that of the three years before the IPO. The sales (earnings) growth variables are the growth rates of sales (earnings) from the average annual sales (earnings) of the three years before the IPO year to that of the three years after the IPO year. The independent variables, measured upon the IPO year, include a dummy variable equal to one if the CEO is politically connected (zero otherwise), the percentage ownership of the largest owner, the market-to-book equity ratio, the leverage ratio measured as total debt over sales, the natural log of total assets, and a dummy variable equal to one if the firm is in a heavily regulated sector (natural resources, public utilities, or finance and real estate). The regressions utilize the ordinary least squares method. Absolute values of robust *t*-statistics are in parentheses. \*\*\*, \*\*, and \* denote significance at the 1%, 5%, and 10% level, respectively.

	Change in ROS	Growth in sales	Growth in earnings
CEO is politically connected	-0.016 (1.94)*	-0.208 (2.35)**	-0.238 (1.89)*
Largest shareholder's ownership %	0.000 (2.30)**	-0.004 (1.98)**	-0.001 (0.55)
Leverage	-0.037 (6.87)***	0.041 (0.57)	-0.209 (2.51)**
Market-to-book of equity	-0.000 (0.11)	0.306 (7.41)***	0.297 (5.97)***
Log of total assets	0.001 (0.10)	0.123 (1.96)*	-0.070 (0.79)
Regulated industry	0.017 (1.60)	0.212 (1.62)	0.716 (4.49)***
Constant	-0.052 (0.42)	-1.809 (1.33)	1.493 (0.79)
Observations	774	782	774
Adjusted <i>R</i> <sup>2</sup>	0.08	0.12	0.19

To examine if our results are driven by earnings reversals resulting from earnings manipulation during the year of the IPO (Aharony, Lee, and Wong, 2000), we repeat the earnings growth regression reported in Table 4 using operating earnings, which are less subject to manipulation, rather than net earnings in the calculation of ROS and earnings growth. The coefficient of the CEO's political connections remains significantly negative, suggesting that our results are unlikely to be driven by pre-IPO accounting manipulations.

In summary, the regression results in Tables 3 and 4 suggest that partially privatized firms in China generally have poorer stock returns and accounting performance when their CEOs are politically connected through their former or current government or military positions.

#### 4.3. Robustness tests

We are concerned about potential endogeneity issues in the relations between post-IPO performance and the CEO's political connections. A firm's performance and its CEO's political status could both be affected by the firm's local institutional conditions, creating a spurious relation between them. Specifically, regions with poor economic conditions or

facing severe unemployment or fiscal problems could have poorly performing firms, creating stronger incentives on the part of local governments to intervene by appointing bureaucrats to run the firms. Moreover, a firm performing poorly prior to its IPO might be likely to recruit a politically connected CEO to facilitate its new share issuance, and then continue to perform poorly after the IPO.

To investigate this endogeneity concern, we re-run the three-year CAR regressions (as in Table 3) on subsamples alternately stratified by firm and regional institutional factors to examine whether the predicted relations persist in the subsample regressions. We partition the sample by the sample median value of (1) local (provincial) GDP per capita, (2) local fiscal deficit levels, (3) local unemployment rates, and (4) firm return on sales (ROS). The values of each of the regional and firm ROS variables corresponding to an IPO firm are calculated as three-year average values during the three years prior to the firm's IPO. Endogeneity would be a concern if we did not find the relation between the CAR and the CEO's political ties in both of the subsamples.

Table 5 reports the results of the subsample regressions. Firms with politically connected CEOs are associated with significantly negative post-IPO CARs regardless of whether they are from regions with high or low GDP per capita, healthy or poor fiscal conditions, or high or low employment rates, or whether they have high or low ROS. The sub-sample regression results corroborate the results in Table 3, providing support for the argument that the negative relations between firms' political ties and their post-IPO stock return performance are robust to potential endogeneity.

#### 4.3.1. Types of connections

We use the CEO's affiliation with the government as an indication of political intervention. A government can be the central government, a local government that governs the geographic region within which the firm is located, or a local government outside the firm's geographic region. The ability to intervene might be stronger for the central government or a local government governing the firm's business region, and weaker for a local government that does not have direct jurisdiction over the firm.

To examine whether the effects of political connections are concentrated in one or two specific types of political links, we repeat the three regressions in Table 3 with separate political connection variables based on the following: a CEO connected with the central government, a CEO connected with a local government that governs the firm's region, and a CEO connected with a local government without direct jurisdiction over the firm. The regression results in Table 6 show that the estimated coefficients of all three types of political connection are negative. The coefficients of a CEO with central government or local government connections are both negative and statistically significant in the one-, two-, and three-year CAR regressions. The effects of the CEO's connections with local governments without direct jurisdiction over the firm are less robust: they are negative and statistically significant in the one-year CAR regression, but insignificant in the two- and three-year CAR regressions.

Overall, the analysis of the specific types of political connection suggests that these measures reasonably capture the effects of government intervention in publicly traded firms. Even though our measures do not capture all possible channels of political connections, we still find that they have important effects on post-IPO performance.

Table 5

Regression results of the effects of politically connected CEOs on the post-IPO stock performance of newly privatized firms in China using stratified subsamples

This table reports the results of stock performance regressions on subsamples alternately stratified by firm and regional institutional factors. The sample is partitioned alternately by the sample median value of local (provincial) GDP per capita, local fiscal deficit, local unemployment rate, and firm return on sales (ROS). The values of each of the regional and firm ROS variables corresponding to an IPO firm are calculated as the three-year average values for the three years prior to the firm's IPO. The dependent variable is stock performance, measured as the three-year cumulative market-adjusted stock return (CAR). The stock returns are accumulated for 36 months, starting from one month after the IPO month. Monthly stock returns are used for calculating the CARs. Market returns are the equally weighted returns for all common stocks traded on the Shenzhen and Shanghai Stock Exchanges. The independent variables, measured upon the IPO year, include a dummy variable equal to one if the CEO is politically connected (zero otherwise), the percentage ownership of the largest owner, the market-to-book equity ratio, the leverage ratio measured as total debt over sales, the natural log of total assets, and a dummy variable equal to one if the firm is in a heavily regulated sector (natural resources, public utilities, or finance and real estate). The regressions utilize the ordinary least squares method. Absolute values of robust *t*-statistics are in parentheses. \*\*\*, \*\*, and \* denote significance at the 1%, 5%, and 10% level, respectively.

	GDP per capita		Fiscal deficit		Unemployment rate		ROS	
	Low	High	Low	High	Low	High	Low	High
CEO is politically connected	-0.149 (2.30)**	-0.223 (3.60)***	-0.155 (2.35)**	-0.127 (2.06)**	-0.152 (2.15)**	-0.147 (2.55)**	-0.132 (2.17)**	-0.185 (2.72)***
Largest shareholder's ownership %	0.001 (0.66)	0.002 (1.24)	0.002 (1.23)	0.000 (0.18)	-0.001 (0.58)	0.003 (2.13)**	-0.001 (0.46)	0.002 (1.67)*
Market-to-book of equity	0.005 (0.16)	0.068 (2.59)***	-0.001 (0.04)	0.089 (2.82)***	0.025 (0.81)	0.048 (1.68)*	0.003 (0.10)	0.069 (2.19)**
Leverage	-0.091 (1.69)*	-0.037 (0.96)	-0.094 (2.29)**	0.027 (0.57)	-0.083 (1.77)*	-0.030 (0.72)	-0.153 (3.03)***	-0.003 (0.07)
Log of total assets	-0.218 (4.40)**	-0.062 (1.47)	-0.194 (4.27)**	-0.030 (0.58)	-0.139 (2.93)***	-0.127 (2.58)**	-0.217 (4.94)***	-0.069 (1.26)
Regulated industry	0.227 (2.69)***	0.157 (1.94)*	0.407 (4.44)***	-0.036 (0.52)	0.148 (1.60)	0.208 (2.88)***	0.305 (2.51)**	0.144 (2.11)**
Constant	4.530 (4.28)***	1.000 (1.09)	3.729 (3.85)***	0.354 (0.31)	2.953 (2.86)***	2.310 (2.19)**	4.655 (4.84)***	1.044 (0.89)
Observations	389	396	390	395	392	393	391	391
Adjusted R <sup>2</sup>	0.12	0.15	0.10	0.09	0.08	0.10	0.12	0.08

Table 6

Regression results of the effects of different types of political connections of the CEO on the post-IPO stock performance of newly partially privatized firms in China

The dependent variable in this table is stock performance, measured alternately as the cumulative market-adjusted stock return (CAR) cumulated for 12, 24, and 36 months starting from one month after the IPO month. Monthly stock returns are used for calculating the CARs measures. Market returns are the equally weighted returns for all common stocks traded on the Shenzhen and Shanghai Stock Exchanges. The independent variables, measured upon the IPO year, include three dummy variables for political connection that equal one if alternately (1) the CEO is connected with a local government governing the firm's region, (2) the CEO is connected with the central government, and (3) the CEO is connected with a local government outside the firm's geographic region, respectively. Other variables are the percentage ownership of the largest owner, the market-to-book equity ratio, the leverage ratio measured as total debt over sales, the natural log of total assets, and a dummy variable equal to one if the firm is in a heavily regulated sector (natural resources, public utilities, or finance and real estate). The regressions utilize the ordinary least squares method. Absolute values of robust *t*-statistics are in parentheses. \*\*\*, \*\*, and \* denote significance at the 1%, 5%, and 10% level, respectively.

	CAR 1 year after IPO	CAR 2 years after IPO	CAR 3 years after IPO
CEO is connected with a local government of the same region	-0.051 (1.84)*	-0.090 (2.16)**	-0.135 (2.51)**
CEO is connected with the central government	-0.112 (1.65)*	-0.241 (2.35)**	-0.285 (2.16)**
CEO is connected with a local government of a different region	-0.084 (1.97)**	-0.056 (0.87)	-0.136 (1.64)
Largest shareholder's ownership %	-0.000 (0.14)	-0.000 (0.19)	0.001 (1.06)
Market-to-book of equity	0.108 (11.34)***	0.088 (6.07)***	0.031 (1.67)*
Leverage	0.012 (0.74)	0.002 (0.09)	-0.054 (1.73)*
Log of total assets	0.049 (2.91)***	-0.048 (1.91)*	-0.134 (4.13)***
Regulated industry	0.097 (3.16)***	0.138 (2.96)***	0.202 (3.39)***
Constant	-1.315 (3.68)***	0.753 (1.39)	2.641 (3.80)***
Observations	790	790	790
Adjusted $R^2$	0.18	0.11	0.09

## 5. Short-term stock returns

In this section, we investigate how soon after the first public trading day the stock market begins to capture the effects of the political connections of a firm's CEO. First, we examine the daily stock return patterns in the first 60 days of trading, starting from the second day after the IPO. We then focus on the initial (first-day) stock return pattern of the IPO firms.

### 5.1. Short-term CARs

Fig. 3 plots the mean daily CAR of the sample firms from the first day to the 60th day subsequent to the initial trading day. As shown in the figure, the mean CAR drops by



almost 4% within the first 60 days after IPO, excluding the initial day of trading. When we divide the sample based on the CEO's political ties, as shown in Fig. 4, the politically connected firms start to underperform their politically unconnected counterparts around 13–14 days after the IPO. The difference in the mean CAR between the two groups of firms widens over time to about 4.4% by the 60th day. To test whether the short-term CAR difference between the two groups is significant and robust to other influencing factors, we run the same regressions reported in Table 3, but alternately using CARs 20 days, 40 days, and 60 days after the initial trading day as dependent variables. As reported in Table 7, the coefficient on the CEO's connection dummy is negative but insignificant in the 20-day CAR regression, but it is negative and significant in the 40-day CAR regression (10% significance level) and in the 60-day CAR regression (5% significance level). Consistent with Fig. 4, the regression results suggest that the negative impact of the CEO's political connections grows over time, from 0.6% in the first 20 days to 4% by the 60th day. These results indicate that the firms led by politically connected CEOs significantly underperform their politically unconnected counterparts beginning shortly after their IPOs.

## 5.2. IPO initial returns

Table 8 reports mean and median initial stock returns for the full sample as well as for subsamples sorted by the CEO's political ties, measured as the difference between the closing price on the first trading day and offering price, and then divided by the offering price. The mean (median) initial return is 241% (139%) which is extraordinarily large but consistent with prior Chinese IPO studies. Based on almost 700 A-share IPOs during 1992–1997, Chen, Firth, and Kim (2004) report a median initial return of 145%, and for a similar sample during 1993–1998, Chan, Wang, and Wei (2004) report an average initial return of 178%. Panel A of Table 8 shows that the mean (median) initial return of the firms with politically connected CEOs is 208% (126%), smaller than that of the politically

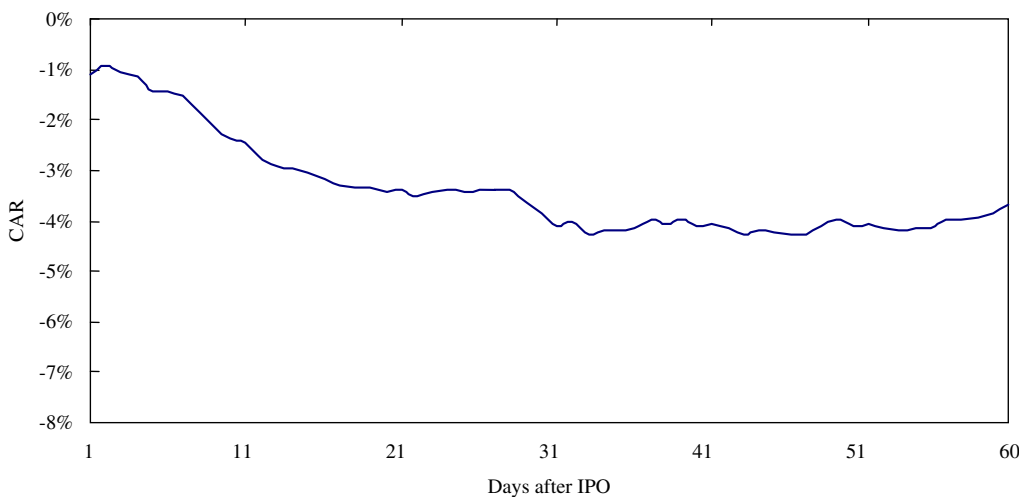


Fig. 3. Mean post-IPO cumulative market-adjusted compound stock returns (CARs) from one to 60 days after the initial trading day of 790 partially privatized firms in China that went public during 1993–2001.

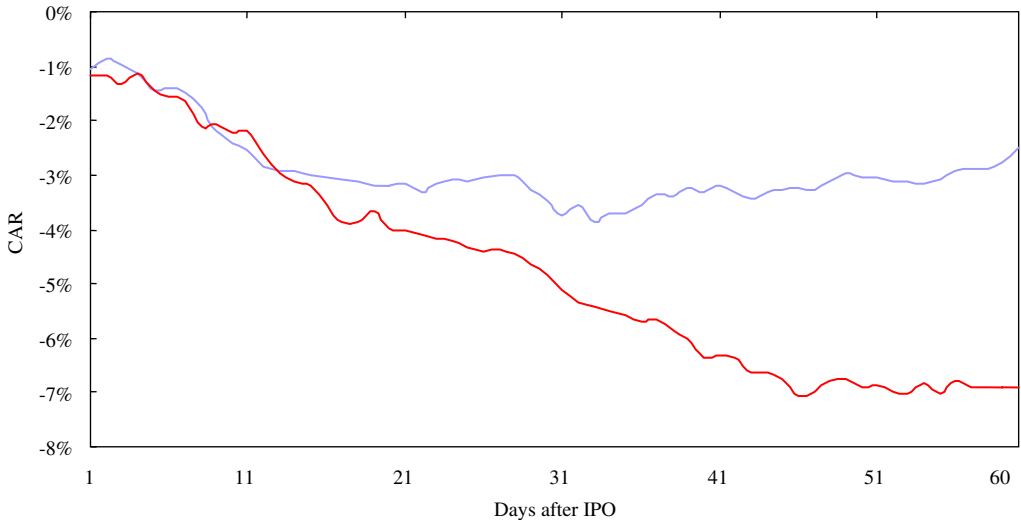


Fig. 4. Mean post-IPO cumulative market-adjusted compound stock returns (CARs) from one to 60 days after the initial trading day of 790 partially privatized firms in China that went public during 1993–2001, sorted by whether their CEOs are current or former government bureaucrats.

unconnected firms, which is 253% (146%). Both the mean and median differences are statistically significant at the 10% level.

Panels B and C of Table 8 indicate that, in most of the years and in most industry sectors, firms with politically connected CEOs show smaller initial returns than firms whose CEOs are free from such political ties. In addition, Panel B shows an overall decline in the IPO initial return over the sample period, while Panel C reports that IPO initial returns are not evenly distributed across industries. Overall, the basic statistics in Table 8 suggest that we should control for time and industry factors in our regression analyses.

We thus perform a regression analysis to investigate the effects of CEO political connections on IPO initial returns, controlling for other firm, industry, and institutional factors in China's IPO markets. The dependent variable in the regression model is the IPO initial stock return. Our key independent variable is the dummy variable for the CEO's political ties. As reported in Table 9, when we include only this independent variable in the regression, its estimated coefficient is negative and significant at the 5% level.

We next include additional control variables, based on prior studies of Chinese IPOs (Su and Fleisher, 1999; Chan, Wang, and Wei, 2004; Chen, Firth, and Kim, 2004). Information asymmetry among the issuer, the underwriter, and investors can lead to underpricing of IPO shares (see, e.g., Baron, 1982; Rock, 1986). We include issue size (the natural logarithm of the number of shares issued) to capture the effects of information asymmetry. Initial returns are expected to be higher from a smaller share issue. As an additional control of information asymmetry, we include the natural logarithm of the number of days between the offering date and the listing date, because information asymmetry tends to be more severe when a longer time elapses

Table 7

Regression results of the effects of politically connected CEOs on the short-term post-IPO stock performance of newly partially privatized firms in China

The dependent variable in this table is stock performance, measured alternately as the cumulative market-adjusted stock return (CAR) accumulated for 20, 40, and 60 days, starting from the second day after the IPO day. Daily stock returns are used for calculating the CARs measures. Market returns are the equally weighted returns for all common stocks traded on the Shenzhen and Shanghai Stock Exchanges. The independent variables, measured upon the IPO year, include a dummy variable equal to one if the CEO is politically connected, the percentage ownership of the largest owner, the market-to-book equity ratio, the leverage ratio measured as total debt over sales, the natural log of total assets, and a dummy variable equal to one if the firm is in a heavily regulated sector (natural resources, public utilities, or finance and real estate). The regressions utilize the ordinary least squares method. Absolute values of robust *t*-statistics are in parentheses. \*\*\*, \*\*, and \* denote significance at the 1%, 5%, and 10% level, respectively.

	CARs 20 days after IPO	CARs 40 days after IPO	CARs 60 days after IPO
CEO is politically connected	−0.006 (0.51)	−0.025 (1.76)*	−0.040 (2.41)**
Largest shareholder's ownership %	−0.001 (3.03)***	−0.001 (2.76)***	−0.000 (1.44)
Market-to-book of equity	0.017 (3.67)***	0.027 (4.91)***	0.034 (5.29)***
Leverage	−0.005 (0.67)	−0.004 (0.38)	−0.004 (0.36)
Log of total assets	0.020 (2.47)**	0.026 (2.64)***	0.025 (2.24)**
Regulated industry	0.019 (1.30)	0.034 (1.90)*	0.040 (1.92)*
Constant	−0.461 (2.76)***	−0.616 (3.08)***	−0.653 (2.81)***
Observations	790	790	790
Adjusted $R^2$	0.05	0.08	0.07

between the offering date and the listing date. China's IPOs are often characterized by long such time lags.

We include the largest shareholder's ownership percentage to control for the effects of non-tradable shares and state control. The ex ante relation between the ownership variable and the initial return is ambiguous. One potential effect of the high concentration of ownership in government hands is that there are too few tradable shares to satisfy market demand, hence causing high initial returns. Another effect could be that investors discount the stock (and hence there are low initial returns) because they anticipate the association between a high concentration of state ownership and low firm productivity. Finally, we include industry and year dummy variables along with a listing location dummy variable, which equals one if a firm is listed on the Shanghai Stock Exchange and zero otherwise.

We report the results of the multiple regression in Table 9. As expected, several control factors influence an IPO's initial returns. When the time lapse between the offering and listing day is longer, and when the issue size is smaller, the initial returns are higher. The estimated coefficient on the largest shareholder's ownership percentage is significantly

Table 8

IPO initial stock returns of China's partially privatized firms

This table reports mean and median statistics of the initial (first-day) stock returns of IPOs of partially privatized firms in China during 1993–2001. It also reports statistics for subsamples distinguished by whether or not the CEO is politically connected. The initial return of an IPO is measured as the difference between the closing stock price on the first trading day and the offering price, and then divided by the offering price. Panel A reports the full sample's initial return statistics. Panels B and C present the statistics by year and by industry sector, respectively. \*\*\*, \*\*, and \* denote level of statistical significance of difference in mean (median) initial returns between the politically connected and unconnected subsamples (1%, 5%, and 10%, respectively).

	CEO is politically connected			CEO is not politically connected			Total sample		
	Mean	Median	Number	Mean	Median	Number	Mean	Median	Number
<i>Panel A</i>									
Initial returns (%)	208*	126***	209	253	146	577	241	139	786
Year	CEO is politically connected			CEO is not politically connected			Total sample		
	Mean	Median	Number	Mean	Median	Number	Mean	Median	Number
<i>Panel B: Initial returns (%) by year</i>									
1993	481	283	9	542	428	50	533	402	59
1994	103**	82**	15	225	155	48	196	144	63
1995	137	64	3	488	198	9	400	134	12
1996	253*	130*	45	382	169	86	338	145	131
1997	252*	130	46	231	146	126	236	139	172
1998	188	111	32	252	136	56	229	131	88
1999	123	78	21	108	100	59	112	91	80
2000	148	131	29	152	142	88	151	141	117
2001	135	111	9	147	133	55	145	130	64
Industry	CEO is politically connected			CEO is not politically connected			Total sample		
	Mean	Median	Number	Mean	Median	Number	Mean	Median	Number
<i>Panel C: Initial returns (%) by industry</i>									
Conglomerate	311	188	11	406	197	35	383	197	46
Finance & real estate	93	93	1	312	199	16	299	185	17
Manufacturing	210	121**	127	223	141	370	220	136	497
Natural resources	186	104	19	228	133	29	211	126	48
Services and trade	207	104	31	310	170	84	282	152	115
Public utilities	162	109	20	274	138	43	238	120	63

negative, suggesting that IPO stock investors discount the value of new issues when the state retains a large non-tradable ownership block.

Nonetheless, the coefficient of the CEO's political connection dummy variable remains negative and significant at the 10% level. The marginally lower initial return, or smaller underpricing, associated with a politically connected CEO is consistent with the signaling argument that non-interventionist governments underprice IPO shares to signal their credible intention of relinquishing control of the firms. The evidence also suggests that the negative effects of government intervention manifested by the CEO's political ties are reflected in lower initial trading prices for the stock, which depresses the initial returns on the first day of trading.

Table 9

Regression results of the effects of politically connected CEOs on the initial stock returns of partially privatized firms in China

The dependent variable in this table is the initial return measured as the difference between the closing stock price on the first trading day and the offering price, and then divided by the offering price. The independent variables include a dummy variable equal to one if the CEO is politically connected, the natural logarithm of the number of days between the offering and listing date, the percentage ownership of the largest owner, a dummy variable equal to one if the company is listed on the Shanghai Stock Exchange and the natural logarithm of the number of shares issued. Dummy variables that proxy for industry and year effects are also included in the model but are not reported. The regressions utilize the ordinary least squares method. Absolute values of robust *t*-statistics are in parentheses. \*\*\*, \*\*, and \* denote significance at the 1%, 5%, and 10% level, respectively.

	Model (1)	Model (2)
CEO is politically connected	−0.483 (2.11)**	−0.336 (1.67)*
Days between offering and listing date		1.975 (9.22)***
Largest shareholder's ownership %		−0.011 (2.62)***
Listed in Shanghai Stock Exchange		−0.291 (1.38)
Number of shares issued		−1.266 (10.28)***
Constant	2.055 (4.73)***	16.110 (11.47)***
Observations	786	786
Adjusted <i>R</i> <sup>2</sup>	0.13	0.34

## 6. Politically connected CEOs and board structures

In this section we examine the board structures of IPO firms in China, which have not been the subject of analysis in the literature, and how the government's rent extraction incentive might affect the degree of professionalism and the monitoring function of the boards. We construct several variables to capture the governance and the degree of professionalism of the sample firms' boards of directors. The definitions of the board variables are given in Appendix A. Table 10 reports the mean and median values of the board variables for the full sample of 790 firms as well as for subsamples sorted by the CEO's political ties. Appendix B reports the correlation coefficients of the pairs of CEO and board variables. We focus our discussion on the mean values since the mean and median statistics are quite similar. The mean statistics of the full sample reveal that a typical corporate board in China has about nine directors (excluding the CEO), 24% of whom are current or former government bureaucrats and 33% of whom are senior managers of the company.

Forty-three percent of the board members are professional managers. Their backgrounds are in unaffiliated businesses; in accounting, law, or finance; or in academic institutions. Only 24% of the directors have current or previous experience in unaffiliated companies. This number is rather small relative to boards of US firms, which are typically dominated by outside directors with professional qualifications (see, e.g., Hermalin and

Table 10

Characteristics of the boards of directors of the newly partially privatized firms in China

This table reports the mean and median statistics of the board characteristics of 790 newly partially privatized firms that went public in China during 1993–2001. The table also reports the statistics for two subsamples of firms sorted by whether or not their CEOs are politically connected. Director education level is a score ranging between 0 and 4: 4 equals a doctoral degree, 3 a master's degree, 2 a university degree, 1 a junior college degree, and 0 below junior college. The definitions of the other variables are given in Appendix A. Test statistics of the differences in the mean and median are provided. \*\*\*, \*\*, and \* denote levels of statistical significance of the difference in mean and median (1%, 5%, and 10%, respectively).

Board characteristics	Mean				Median			
	Total sample	CEO is politically connected	CEO is not politically connected	Difference between mean	Total sample	CEO is politically connected	CEO is not politically connected	Difference between median
Board size	9.18	9.01	9.25	-0.23	9.00	9.00	9.00	0.00
Percentage of directors who are								
Senior managers	33.03	32.75	33.13	-0.37	30.00	33.33	28.57	4.76
Current or ex-government bureaucrats	23.76	36.22	19.22	17.00***	22.22	36.36	14.29	22.08***
Professionals	43.48	33.89	46.98	-13.09***	37.50	27.27	42.86	-15.58***
With non-affiliated business experience	5.73	5.04	5.98	-0.94	0.00	0.00	0.00	0.00
With accounting, law, or finance background	23.91	20.99	24.98	-3.98***	20.00	16.67	20.00	-3.33***
With academic background	13.84	7.86	16.01	-8.15***	9.09	0.00	9.09	-9.09***
Women	5.89	4.63	6.34	-1.71***	0.00	0.00	0.00	0.00***
Director age	46.98	47.46	46.81	0.65***	46.91	47.63	46.60	1.03***
Director education level	1.62	1.63	1.62	0.01	1.64	1.67	1.62	0.05

Weisbach, 1988; Yermack, 1996). Accountants, lawyers, or directors with prior experience in financial institutions or securities intermediaries constitute only 6% of the board. By contrast, there is a surprisingly large percentage (mean 14%) of directors with academic backgrounds.

The board is young (mean age of 47) and the average education level of the directors, indicated by a score defined in Appendix A, is low (between junior college and college). Compared with boards of US firms, there is a higher percentage (6%) of female directors.<sup>6</sup> Not reported in the table, there was almost no director representing minority shareholders during our sample period, be they institutional or individual investors.

### 6.1. Effects of politically connected CEOs

Table 10 further reports the mean and median values of the board variables for the subsamples distinguished by whether the CEO is/was a bureaucrat. We find that when a CEO is politically connected, it is highly likely that his or her political allies are also on the board. Moreover, CEOs' political connections are associated with low professionalism on boards: the difference in both the mean and median percentage of professionals is significantly smaller for the group of firms led by politically connected CEOs. When a CEO is politically connected, his or her firm has fewer directors with business experience from unaffiliated firms, fewer academicians and women serving as directors, and older directors on average. The firm also has fewer directors with experience in accounting, finance, or law, but the difference is statistically insignificant. The directors' education levels are higher for firms with politically connected CEOs, but the differences are not statistically significant.

In addition to the univariate analysis, we run a set of regressions to examine how board characteristics are affected by the appointment of politically connected CEOs. The dependent variables in these regressions are (1) the number of directors (excluding the CEO) who are politically connected, (2) the number of directors who are senior managers, (3) the number of directors who are professionals, broken down by unaffiliated business experience, accounting, law, or finance background, academic background, (4) director age, (5) the number of female directors, and (6) average education level. The independent variables in each of the regressions are the dummy variable for a politically connected CEO; board size; the ownership percentage of the largest shareholder; ROS; the market-to-book equity ratio; the leverage ratio; the log of total assets; and the regulated industry dummy variable. Because the dependent variables are numbers, the ordinary least squares method would lead to biased and inconsistent estimates. Following Hermalin and Weisbach (1988), Agrawal and Knoeber (2001), and Helland and Sykuta (2004), we estimate a Poisson

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<sup>6</sup>Farrell and Hersch (2001) document that the percentage of women on the board of Fortune 1000 firms was less than 2% from 1990 to 1999. As reported in Appendix 2, female directors are negatively correlated with the presence of politically connected CEO (−10%) and politically connected directors (−12%), while positively correlated with directors possessing business experience from unaffiliated firms (19%) and directors with legal, accounting, or finance expertise (24%). These gender statistics suggest that women are more likely appointed to boards for their specialized expertise than for their managerial or political roles. Similarly, Agrawal and Knoeber (2001) find that female directors do not play a political role in the US



Table 11

Regression results of the relations between board characteristics and CEO political connections

This table presents the results of Poisson regressions of the board structures of 790 newly privatized firms upon their going public in China during 1993–2001. The dependent variable of the regressions reported in columns 1, 2, 3a through 3c, and 6 is the number of directors in the category. Director education level is a score range between 0 and 4: 4 equals a doctoral degree, 3 a master's degree, 2 a university degree, 1 a junior college degree, and 0 below junior college. Director age is the average age of the directors on the board. The independent variables in the regressions include board size measured as the total number of directors on the board, the largest shareholder's ownership percentage, return on sales, leverage measured as total debt divided by sales, log of total assets, and a regulatory industry dummy variable equal to one if the firm is in a heavily regulated sector (natural resources, public utilities, or finance and real estate). Absolute values of z-statistics are in parentheses. \*\*\*, \*\*, and \* denote significance at the 1%, 5%, and 10% level, respectively.

	Current or former government bureaucrats	Senior managers	Professionals with accounting, law, or finance background	Professionals with non-affiliated business experience	Professionals with academic background	Director education level	Director age	Female directors
	(1)	(2)	(3a)	(3b)	(3c)	(4)	(5)	(6)
CEO is politically connected	0.602 (12.01)***	-0.030 (0.64)	-0.105 (0.88)	-0.029 (0.50)	-0.669 (7.58)***	0.005 (0.22)	0.013 (3.22)***	-0.234 (1.91)*
Board size	0.106 (12.54)***	0.105 (14.72)***	0.118 (7.20)***	0.092 (10.70)***	0.093 (8.42)***	0.096 (29.86)***	0.099 (165.35)***	0.081 (4.72)***
Largest shareholder's ownership %	-0.001 (0.50)	-0.000 (0.50)	-0.003 (1.39)	-0.002 (1.30)	0.003 (1.76)*	0.000 (0.99)	0.000 (0.50)	0.001 (0.55)
ROS	-0.023 (0.45)	0.011 (0.23)	0.011 (0.14)	-0.201 (1.49)	0.114 (2.96)***	0.043 (2.41)**	0.013 (3.43)***	-0.052 (0.36)
Market-to-book value of equity	-0.002 (0.09)	-0.019 (0.99)	0.007 (0.15)	0.021 (0.86)	0.099 (3.63)***	0.003 (0.32)	-0.004 (2.63)***	0.018 (0.39)
Leverage	0.119 (3.25)***	-0.044 (1.24)	0.069 (0.92)	0.076 (1.82)*	0.028 (0.56)	-0.017 (1.10)	0.000 (0.01)	0.031 (0.38)
Log of total assets	0.027 (0.72)	-0.003 (0.09)	-0.115 (1.85)*	-0.137 (3.27)***	0.100 (2.00)**	0.036 (2.46)**	0.007 (2.70)***	-0.134 (1.65)*
Regulated industry	0.154 (2.35)**	-0.115 (1.88)*	0.178 (1.36)	-0.018 (0.26)	0.015 (0.17)	-0.023 (0.88)	-0.014 (2.94)***	-0.015 (0.11)
Constant	-1.039 (1.35)	0.318 (0.47)	1.023 (0.63)	2.509 (2.95)***	-3.117 (3.04)***	0.964 (3.18)***	4.948 (87.74)***	1.445 (0.87)
Observations	790	790	790	790	790	788	790	790
Pseudo R <sup>2</sup>	0.11	0.08	0.06	0.11	0.07	0.17	0.75	0.04

model using the maximum likelihood method. The overall regression results, reported in Table 11, are consistent with the univariate results in Table 10. When CEOs are strongly connected with the government, their firms tend to display weak governance characteristics and low professionalism.

## 7. Conclusion

We have documented a significant presence of politically connected CEOs in publicly listed companies in China. Firms with politically connected CEOs are more likely to have boards populated by current or former government bureaucrats. These boards show low degrees of professionalism, as fewer directors have relevant professional backgrounds. The accounting and stock return performance of the firms run by politically connected CEOs is poor relative to their politically unconnected counterparts. The difference in performance is evident in IPO pricing and in stock returns shortly after the initial trading day. The overall evidence is consistent with the “grabbing hand” argument (Shleifer and Vishny, 1998) that bureaucrats/politicians extract resources from listed SOEs under their control to fulfill objectives that are not consistent with firm value maximization.

Our analysis of China’s newly listed firms reveals that the property rights constraints faced by the firms, namely the non-transferability of state ownership and the right of the government to appoint CEOs, significantly impair firm performance as well as board professionalism and governance. Removing these property rights constraints is a key to the success of future reforms aiming to improve the productivity of the corporate sector. Of course, the usual caveat applies: the results of any single-country study are specific to that country’s conditions.

It is possible that stock markets can play a monitoring role even when the government remains the controlling owner of privatized firms. Prior literature provides mixed evidence. Based on a developing country sample, Boubakri, Cosset, and Guedhami (2005) report that post-privatization firm performance is positively related to the degree to which the government relinquishes control. However, a parallel study of developed countries by D’Souza, Megginson, and Nash (2005) finds that state ownership is associated with reduced employment and increased capital spending after privatization. Kole and Mulherin (1997) examine a sample of US firms with substantial ownership under federal government custody during and after World War II. Consistent with the market monitoring view, they report that the performance of the government-controlled firms is not significantly different from private-sector firms in the same industry. Gupta (2005) finds that partial privatization in India is associated with improvement in firm profitability. Unlike India and the US, China does not have a well-established stock market that pre-dates its partial privatization. Rather, the ensuing agency problems between bureaucrats/politicians and minority shareholders contribute to the general post-IPO underperformance.

However, we believe that the evidence from China is useful to emerging economies around the world that have weak legal systems and weak property rights protection. These countries can learn from the experience of China’s partial privatization that a government’s reluctance to relinquish (or its desire to retain) even only a subset of its property rights with regard to its enterprises can have significantly negative consequences on corporate governance and firm performance.

**Appendix A:**

## Board and director variables

This appendix table provides the definitions of the variables of board of directors employed in this study.

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CEO is politically connected	Dummy variable equal to 1 if the CEO was or is an officer of the central government, local government, or the military, and 0 otherwise.
Board size	The total number of directors on the board in the IPO year.
Politically connected directors	Directors (excluding the CEO) who used to work or are currently working for government agencies, including the central government, local governments, and the military.
Senior manager directors	Directors who are senior managers of the firm in the IPO year.
Directors that are professionals	Directors with accounting, law, or finance backgrounds, directors with experience in unaffiliated firms, or directors with academic backgrounds.
Directors with accounting, law, or finance background	Directors who used to work or are currently working for financial institutions or intermediaries, or who are accountants, lawyers, or auditors.
Directors with experience in unaffiliated firms	Directors who used to work or are currently working for firms unaffiliated with the business group to which the firm belongs. The largest shareholder, parent firm of the largest shareholder, other large shareholders, pre-existing firm prior to the IPO, and subsidiaries of the listed firm are considered as affiliated firms.
Directors with academic background	Directors who used to work or are currently working for universities or research institutions.
Director education level	The average score of the education level of the directors on the board during the IPO. The value of the score ranges between 0 and 4: If a director's education level is below junior college, the value is 0; if junior college, the value is 1; if graduated with bachelor degrees, the value is 2; if graduated with master's degrees the value is 3; and if graduated with doctorate degrees, the value is 4.
Director age	The average age of directors on the board during the IPO.
Female directors	Dummy variable equal to 1 when the director is a female, and zero otherwise.

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**Appendix B:**

Pair-wise correlations of CEO and board characteristics

This table reports the Pearson correlation coefficients between pairs of the variables of CEO and board characteristics. Numbers in parentheses are *p*-values.

	Board size	Number of manager directors	Number of politically connected directors	Number of directors who are professionals	Number of directors with accounting, law, or finance backgrounds	Number of directors with un-affiliated business experience	Number of directors with academic backgrounds	Number of female directors	Director age	Director education level
CEO is politically connected	-0.0387 (0.277)	-0.0253 (0.4779)	0.346 (<.0001)	-0.171 (<.0001)	-0.0536 (0.1325)	-0.0744 (0.0366)	-0.182 (<.0001)	-0.0964 (0.0067)	-0.019 (0.5948)	-0.0248 (0.4878)
Board size		0.521 (<.0001)	0.337 (<.0001)	0.3486 (<.0001)	0.1936 (<.0001)	0.2478 (<.0001)	0.2078 (<.0001)	0.1485 (<.0001)	0.9773 (<.0001)	0.7309 (<.0001)
Number of manager directors			0.1142 (0.0013)	-0.1037 (0.0035)	-0.0427 (0.2301)	-0.0708 (0.0466)	-0.0735 (0.0388)	-0.0533 (0.1344)	0.5094 (<.0001)	0.3134 (<.0001)
Number of politically connected directors				-0.0919 (0.0098)	-0.1264 (0.0004)	-0.0111 (0.7555)	-0.0784 (0.0276)	-0.1237 (0.0005)	0.375 (<.0001)	0.2777 (<.0001)
Number of directors who are professionals					0.4416 (<.0001)	0.7759 (<.0001)	0.5802 (0.2608)	0.2247 (<.0001)	0.3273 (<.0001)	0.4573 (<.0001)
Number of directors with accounting, law, or finance backgrounds						0.2175 (<.0001)	-0.0401 (0.2608)	0.2411 (<.0001)	0.1598 (<.0001)	0.0617 (0.0835)
Number of directors with unaffiliated business experience							0.0382 (0.2839)	0.1943 (<.0001)	0.2189 (<.0001)	0.2197 (<.0001)
Number of directors with academic backgrounds								0.0273 (0.444)	0.2238 (<.0001)	0.5075 (<.0001)
Number of female directors									0.0994 (0.0052)	0.0405 (<.0001)
Director age										0.7498 (<.0001)

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