Political Tie Heterogeneity and the Impact of Adverse Shocks on Firm Value

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ABSTRACT   Past research has recognized the contingent value of corporate political ties but largely neglects their heterogeneity. Drawing on the political embeddedness perspective and literature on emerging economy political institutions, we develop hypotheses regarding how political networks comprising managerial and government ownership ties may have different valuation effects in the face of adverse political shocks. Examining stock market responses to an unanticipated, high-profile political event in China, we find a negative valuation effect of managerial ties to municipal government, but an insignificant effect of government ownership ties. Further, companies combining managerial and ownership ties experienced less post-shock reduction in market value than those holding only managerial political ties. These findings shed light on the values of different configurations of corporate political ties and inform firms of potential ways to manage ubiquitous political hazards in emerging economies.

Keywords: China, emerging economies, network embeddedness, political risk, political tie, tie heterogeneity

INTRODUCTION

Corporate political ties encompass a wide range of individual and institutional linkages between firms and public authorities (Okhmatovskiy, 2010; Sun et al., 2012). There is broad consensus in the literature that these ties can translate into higher profitability and market valuation (e.g., Hillman, 2005; Hillman et al., 1999). Yet prior research has also documented a darker side whereby politically connected firms suffer a substantial loss of firm value upon political shocks that cause a sudden removal of the power bases to which these ties were initially attached (e.g., Fisman, 2001; Siegel, 2007). Given such contingency of corporate political ties, an important and theoretically intriguing question has so far received little scrutiny: Are all politically connected firms equally vulnerable to adverse shocks?

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This question is of particular relevance to firms operating in emerging markets. On ₃₁ the one hand, political ties may confer substantial returns to focal firms: Firms need ₃₂ political connections to guard against government extortions and obtain financial and ₃₃ regulatory resources at the government's disposal (Fang et al., 2015; Shi et al., 2014; ₃₄ Wright et al., 2005; Xu and Meyer, 2013). On the other hand, emerging economies are ₃₅ characterized by considerable sociopolitical pluralism and volatility, such that a variety ₃₆ of interest groups and factions compete for political and economic benefits (Henisz and ₃₇ Zelner, 2010; Kozhikode and Li, 2012). When erratic political rivalry leads opponents ₃₈ to dominate the political process, firms linked with the incumbent political group are at ₃₉ considerable risk of suffering from 'negative cascades of discrimination, resource exclu- ₄₀ sion, and even expropriation and sabotage' (Siegel, 2007, p. 625). ₄₁

We address this risk-return duality by contending that not all politically connected ₄₂ firms are equally vulnerable to adverse political shocks, for they are typically embedded ₄₃ in a variety of ties to political actors and institutions. We draw on the political embedd- ₄₄ edness perspective (Michelson, 2007; Okhmatovskiy, 2010; Sun et al., 2010a) to show ₄₅ that, in the presence of political hazards in emerging economies, different types and ₄₆ combinations of political ties vary in their vulnerability and resilience to negative shocks, ₄₇ which generate different valuation impacts for focal firms. This variance stems in turn ₄₈ from distinct exchange processes and mechanisms underlying different political tie ₄₉ compositions. Specifically, we develop and test hypotheses delineating how specific com- ₅₀ positions of political ties are associated with different valuation impacts arising from ₅₁ exogenous political events. ₅₂

Most previous literature focused on a single type of dyadic ties between firms and gov- ₅₃ ernments. These ties range from personal-level linkages (Hillman et al., 1999; Peng and ₅₄ Luo, 2000) to organizational-level connections such as government ownership ties ₅₅ (Inoue et al., 2013; Li et al., 2009). We operationalize the personal-level investigation by ₅₆ focusing on managerial political ties involving political agents serving on top manage- ₅₇ ment teams (TMTs) and corporate boards. Comparatively less attention has been paid ₅₈ to the organizational linkages to political institutions. If firms are embedded in a particu- ₅₉ lar political network, interorganizational connections can develop in the form of minor- ₆₀ ity ownership stakes to state-owned enterprises (SOEs) or government agencies. These ₆₁ business-government ties may be deliberately created by government investment in pri- ₆₂ vate businesses or stem from residual government shareholdings after privatization ₆₃ (Inoue et al., 2013; Sun et al., 2010b; Vaaler and Schrage, 2009; Xu et al., 2014). No ₆₄ matter whether the formation of such ties is of a strategic nature or not, we know little ₆₅ about if and how adverse shocks affect firms holding government ownership ties ₆₆ (Pérez-Nordtvedt et al., 2014). ₆₇

Finally, there is emerging evidence that firms may hold a portfolio of personal and ₆₈ organizational ties with political groups (e.g., Dieleman and Boddewyn, 2012; Zhu and ₆₉ Chung, 2014). However, literature explicitly studying the differences and interplay ₇₀ between managerial political ties and organizational ties through government ownership ₇₁ is lacking. As elaborated below, these two types of ties are not synonymous, in that the ₇₂ underlying mechanism regulating the exchange relations between firms and political ₇₃ actors (i.e., managerial political ties) is different from those between firms and political ₇₄ institutions (i.e., government ownership ties). As such, it remains unclear whether ₇₅

personal connections and organizational linkages to the same political network function as complements or substitutes. An adverse political shock offers an important setting to disentangle the differences and examine the interplay between the two types of political ties.

We study political tie heterogeneity through an event study of China's most significant political shock in the 2000s, the arrest of the top Communist Party official in Shanghai on 24 September 2006, which signified a sudden crackdown on the Shanghai-based political clique from the Chinese central government. Identifying all manager/board-level and ownership-level ties to the Shanghai municipal government, we investigate how different configurations of political ties impact the market value of Shanghai-based publicly traded companies. Our choice of a negative event yields insights not offered by conventional longitudinal analysis: The identification of a pivotal political event helps provide a more focused and contextualized analysis of the value of political ties in association with unexpected reversals of political fortunes. It complements longitudinal datasets which often lack such contextual and network-level specificity.

Our study makes two primary theoretical contributions. First, we add to general embeddedness research that calls for more multilevel studies to disentangle personal-level and organizational-level relationships (Kilduff and Brass, 2010; Zaheer et al., 2010) from the angle of political embeddedness. Rather than examining different types of ties in isolation, we account for the varying valuation impacts of different configurations of political ties. We offer a fine-grained analysis of how political network structure affects firm value in the face of political shocks in emerging markets, a context where institutional constraints on political actors are lacking. We elucidate the different exchange logics underlying personal-level and organizational-level political ties and achieve more nuanced understanding of how firms may address the risk-return duality of political ties in emerging economies.

Second, our study enriches understanding of political resources and capabilities embedded in corporate political ties. Given that possessing political resources embedded in a single type of political ties is insufficient to sustain competitive advantage (Bonardi, 2011; Sun et al., 2011a), firms may need a bundle of political ties that offer different types of resources and capabilities to navigate the complex political environment (Holburn and Zelner, 2010). Advancing the concept of political tie heterogeneity, we contribute to literature on corporate political resources (Dahan, 2005; Frynas et al., 2006; Oliver and Holzinger, 2008) by addressing the need to further theorize and empirically examine the roles of different types of political resources and capabilities in shaping corporate outcomes.

THEORY AND HYPOTHESES

Political Embeddedness and Political Tie Heterogeneity

Firms are embedded in networks of exchange relationships with other organizational actors to access requisite resources (Granovetter, 1985; Pfeffer and Salancik, 1978/2003). These interorganizational exchanges are not merely governed by arms-length transactions, but occur in the context of social relationships nurturing trust, commitment and

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reciprocity. Hence, social embeddedness characterizes the ways in which prior relations 118
among actors both facilitate and constrain subsequent interorganizational exchanges 119
(Barden and Mitchell, 2007). We treat political embeddedness as involving business- 120
government exchange relationships realized by a multitude of individual and institutional 121
ties to the state and its actors (Michelson, 2007; Okhmatovskiy, 2010; Sun et al., 2010a). 122

Interorganizational networks can be an important source of rent (Dyer and Singh, 123
1998; Gulati et al., 2000). That is, rent-generating resources may span firm boundaries 124
and be embedded in network ties. This is consistent with research conceptualizing the 125
resources acquired by a firm through its ties to government bodies and politicians as 126
'political resources' or 'political capabilities' (Dahan, 2005; Frynas et al., 2006; Holburn 127
and Zelner, 2010). Political ties confer legitimacy, information, and financial and regula- 128
tory resources to focal firms (Hillman et al., 2004). The use of relational political strategy 129
is 'akin to the development of social capital that is embedded in a continued exchange 130
relationship between parties' (Hillman and Hitt, 1999, p. 829). 131

Interorganizational relationships are necessarily multilevel (Barden and Mitchell, 132
2007; Brass et al., 2004). 'Nodal multiplexity' of interorganizational ties suggests varia- 133
tion in the content and nature of relational experiences between organizations and the 134
individuals that compose them (Barden and Mitchell, 2007). Specifically, exchange rela- 135
tionships arise at both the personal and the organizational levels. Despite the overlap of 136
the two levels of embeddedness, current research calls for more multilevel studies that 137
can isolate and compare the separate mechanisms governing personal and organiza- 138
tional ties respectively (Zaheer et al., 2010, p. 74). As such, understanding which 139
exchange ties or what combinations of these ties matter when represents a crucial start- 140
ing point for a general theory of network tie heterogeneity. 141

We aim to contribute conceptually by developing the idea of political tie heterogene- 142
ity at both personal and organizational levels of business-government exchanges, which 143
hitherto has attracted little attention. At the personal level, corporate executives and 144
political agents (e.g., politicians and bureaucrats) can exploit and develop reciprocal ties, 145
which lead to formal linkages such as political actors sitting on the board/taking man- 146
agement positions and business people appointed to political positions. 147

At the organizational level, interorganizational ties are concerned with long-term 148
cooperative relationships between organizations where each party retains its operational 149
autonomy, examples being business groups, joint ventures, and strategic alliances (Brass 150
et al., 2004). Viewed through this lens, firms and political institutions can have exchange 151
relationships via ownership linkages. For example, government may hold residual stakes 152
in privatized firms for strategic reasons (Vaaler and Schrage, 2009); alternatively, gov- 153
ernment can invest in private businesses through business entities under its control (e.g., 154
SOEs) to further collaboration with the private sector (Doh et al., 2004; Inoue et al., 155
2013). In addition, whereas majority state ownership will lead to loss of operational 156
autonomy for focal firms, business-government networks can operate through minority 157
government stakes in focal firms (Inoue et al., 2013; Okhmatovskiy, 2010; Vaaler and 158
Schrage, 2009; Wang et al., 2012). Thus, we regard only minority shareholdings held 159
by political institutions and/or SOEs as representing government ownership ties. 160

While the two types of embedded ties may be complementary, the distinction 161
between the two cannot be neglected: Personal-level embeddedness involves the 162

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exchange of particularistic favours between economic and political agents, so that 163
organizations can obtain requisite resources from political actors whose personal as well 164
as organizational interests have been advanced by the social elite networks. Further, 165
these business-government exchanges are susceptible to departures of politically- 166
connected executives and board members, which may cause the termination of political 167
ties and the dilution of political resources (Sun et al., 2012, p. 77). Organizational 168
embeddedness, on the other hand, emphasizes the alignment of strategic goals between 169
firms and political institutions, so that the state awards focal firms critical resources in 170
exchange for firms' accommodation and support of the state's strategic objectives (Luo, 171
2001), which may or may not be congruent with those of the business and political 172
agents. In what follows, we demonstrate how the distinct exchange logics governing the 173
two types of political ties can yield different impacts on firm value resulting from adverse 174
political shocks in emerging economies. 175

Political Shocks under Weak Institutions   176

The preceding account suggests a positive association between political ties and firm 177
value: Both personal connections to prevailing political actors and organizational link- 178
ages to political regimes help create a virtuous circle of favour and resource exchanges, 179
translating into higher firm value through preferential regulatory policies (e.g., Bonardi 180
et al., 2006; Fang et al., 2015) and financial resources (Inoue et al., 2013). Nevertheless, 181
firm value generated via political connections may be lost overnight through exogenous 182
shocks in the political environment. Such unexpected changes can quickly turn political 183
assets associated with the incumbent sociopolitical network into liabilities, as the per- 184
formance of connected firms in emerging economies may vary dramatically depending 185
on the fortunes of their backers (Fisman, 2001; Siegel, 2007). 186

Despite recognition of such risk-return duality, we lack an explication of how political 187
shocks may arise from interactions among the heterogeneity of political actors within 188
individual firms' networks. That is, while shocks may be exogenous to a focal firm, they 189
are oftentimes endogenous to the institutional environment where the firm resides. 190
Therefore, firms need to develop deeper understanding about the nature of the shocks 191
by treating the political actors as a collection of heterogeneous interest groups. Different 192
sociopolitical groups and political parties compete for control of different branches of 193
the state, especially in the weak institutional environment of emerging economies 194
(Holburn and Zelner, 2010). Hence it is important to examine interactions among gov- 195
ernment agencies that may represent different interest groups. 196

While sociopolitical pluralism is present in developed economies, emerging market 197
political institutions experience a key institutional weakness: a lack of institutional checks 198
and balances that effectively constrain the discretion and opportunism of interest groups 199
in power (Henisz and Zelner, 2010). Consequently, incumbent political interest groups 200
both provide sizeable preferential treatment to firms with which they connect and can 201
enforce dramatic discriminatory or wealth-redistribution policies against businesses con- 202
nected to the disadvantaged groups. The value of corporate ties to a cohesive political 203
group in power is vulnerable to shocks with the potential of shaking or even eradicating 204

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the network's power base. These shocks include unexpected election results, forced 205
removal of a regime from office, and arrest and conviction of powerful politicians.   206

Below we examine how a negative shock would differentially affect firms holding vari- 207
ous types and combinations of political ties. This heterogeneity stems from the objectives 208
of actors making up the tie and from different exchange logics underlying the tie. 209
We develop hypotheses regarding the valuation effects by assessing and comparing the 210
vulnerability and resilience of the ties to adverse shocks. While various configurations of 211
political ties can create firm value under political stability, they will provide different sig- 212
nals to investors under conditions of adverse shocks. That is, the more resilient (or less 213
vulnerable) a certain type or combination of political ties is to an adverse shock, the 214
smaller the loss of market value for a focal firm post shock.   215

Managerial Political Ties   216

TMTs and boards of directors have long been central to dealing with organizational 217
interdependence (Pfeffer and Salancik, 1978/2003). In the case of business-government 218
relationships, managerial political ties provide opportunities for networking with power- 219
ful political actors, organizational legitimacy, information about the political process, 220
and regulatory/financial resources controlled by political institutions and actors (Lester 221
et al., 2008; Peng and Luo, 2000). On the other hand, developing managerial political 222
ties entails considerable resource investment in relationship building and maintenance 223
and obligations to reciprocate favours (Park and Luo, 2001). Further, the value of inves- 224
ting in nonmarket activities has a limit, beyond which the investment may jeopardize a 225
firm's market activities (Bonardi, 2008). However, prior literature suggests that the bene- 226
fits of managerial political ties tend to outweigh the costs (Hillman, 2005).   227

According to the political embeddedness perspective, long-term relationships between 228
the two parties are not governed by arm's length transactions in which each seeks only 229
to maximize short-term benefits. Whether they enter into the relationships for instru- 230
mental purposes or not, the subsequent interpersonal networking allows trust and 231
mutual indebtedness to develop beyond the original impetus for the relationships 232
(Das and Teng, 2002; Keig et al., 2015). For both personal and organizational benefits, 233
corporate executives can develop dense reciprocal relationships with incumbent political 234
groups holding important government positions. In short, managerial political ties high- 235
light enormous interpersonal attachments that result from ongoing business-government 236
exchanges (Park and Luo, 2001).   237

When an unexpected shock destroys the power base of the sociopolitical network, the 238
dense social relationships and interpersonal attachments will cease to create value for 239
focal firms. Executives connected to the crumbling political network would suffer 'guilt 240
by association', which refers to the economic or social punishment of a group or an 241
organization for its prior relationships with illegitimate or disadvantaged individuals and 242
social groups (Labianca and Brass, 2006). That is, managerial social capital accumulated 243
before the shock turns into 'social liabilities'.   244

Being personally involved with the old camp makes it difficult for a firm to prove its 245
innocence and reconstitute the broken political ties in the near term. New political 246
actors will seek to distance themselves from firms with 'undesirable' individuals 247

connected to the past, as they attempt to send a public signal that the new political 248
group is different from the previous one. Moreover, if the new political forces wish to 249
extract rents from these firms and use them as sociopolitical instruments, the new players 250
may treat those closely connected with their political opponents as a significant hin- 251
drance (Smith, 2009). Consequently, these firms will likely lose the protective shield and 252
preferential treatment associated with the ousted group. 253

Finally, in a quest for their own legitimacy, incoming political actors may resort to 254
overt discrimination against these firms. This adverse effect can be exacerbated by the 255
lack of institutional checks and balances on the discretion of political leaders. Paucity of 256
political and legal constraints makes it easy for politicians to punish these firms, so long 257
as they have adequate socioemotional and/or economic motives. Thus, the stronger the 258
firm's personal-level linkages to the ousted group, the more susceptible the firm will 259
likely be to the potential negative effect: 260

Hypothesis 1: In the face of adverse shocks on a corporate political network, the 261
stronger the managerial ties to this network, the greater the loss of firm value. 262
263

Government Ownership Ties 264

Under political stability, the presence of minority government stakes can send a signal to 265
investors about the focal company's access to crucial resources at the government's dis- 266
posal. With respect to residual government stakes in privatized companies, continued 267
government involvement can assure private investors of state support for the firm 268
(Vaaler and Schrage, 2009). When it comes to state investment in *de novo* projects, the 269
government can serve as a 'venture capitalist' supplying long-term equity finance and 270
legitimacy/reputation to attract further business partners and resource inflows (Inoue 271
et al., 2013). 272

In the face of a negative political shock, we expect firms with government ownership 273
ties, linked via minority government shareholdings, to suffer much less, if any, from 274
'guilt by association' and thereby to experience insignificant discriminatory activities 275
from the incoming political group. This is because the underlying mechanism regulating 276
business-government interaction is different from that relating to managerial political 277
ties. Specifically, firms connected though ownership ties tend to accommodate economic 278
and social objectives of political institutions in return for scarce resources and policy 279
favours (Luo, 2001; Sun et al., 2010a). 280

While interpersonal interactions are present in the development and functioning of 281
government ownership ties (Park and Luo, 2001), this process will *ceteris paribus* generate 282
fewer interpersonal attachments and socioemotional elements characteristic of manage- 283
rial political ties. On the other hand, the strength and durability of interorganizational 284
ties hinge upon the degree of resource interdependence between the two parties and the 285
availability of alternative partners (Pfeffer and Salancik, 1978/2003; Westphal et al., 286
2006). That is, ownership ties will remain instrumentally valuable to incoming elites if 287
these firms remain well-functioning and can help achieve their financial and sociopoliti- 288
cal goals. It is therefore unlikely that new political actors conduct self-cannibalization by 289
excessively punishing them. 290

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Finally, ownership ties may be harder to terminate than managerial ties (Calomiris ₂₉₁
et al., 2010). Feasible alternatives are not always easy to find, and the financial and institu- ₂₉₂
tional constraints of quickly dissolving existing ownership ties serve to maintain the interor- ₂₉₃
ganizational linkages. Overall, the above arguments lead to the following hypothesis: ₂₉₄

   Hypothesis 2: In the face of adverse shocks on a corporate political network, govern- ₂₉₅
   ment ownership ties to this network through the holding of minority ownership ₂₉₆
   stakes in focal firms will have a negligible effect on firm value. ₂₉₇

₂₉₈

Interaction of Managerial Political Ties and Government Ownership Ties ₂₉₉

So far we treated managerial and ownership ties separately. Under political stability, the ₃₀₀
elite group in power also controls government agencies, so there can be considerable ₃₀₁
overlap between personal and organizational exchanges between firms and the state. ₃₀₂
This is particularly the case for firms simultaneously holding managerial and ownership ₃₀₃
ties to the prevailing political regime. The interplay of the two types of political ties is ₃₀₄
important but has been neglected by prior research. ₃₀₅

   The social embeddedness literature suggests that multiple ties between two parties can ₃₀₆
strengthen dyadic reciprocation and symbiotic interdependences (Barden and Mitchell, ₃₀₇
2007). In the context of business-government exchanges, managerial/board networking ₃₀₈
with political actors can further enhance the benefits offered from ownership linkages to ₃₀₉
political institutions. They can reinforce each other to facilitate greater and speedier flow ₃₁₀
of regulatory and financial resources to focal firms (Park and Luo, 2001). This comple- ₃₁₁
mentary effect is especially salient in emerging economies, where government agencies ₃₁₂
are easily captured by political interest groups to further the latter's agendas. ₃₁₃

   On the other hand, as sociopolitical embeddedness involves both opportunities for ₃₁₄
and constraints on organizations, the combination of the two types of ties can also give ₃₁₅
rise to additional costs to focal companies. Our earlier discussion implies that ownership ₃₁₆
ties will on balance be beneficial when the government acts as a minority shareholder. ₃₁₇
The addition of politically-connected boards and TMTs may mean political forces have ₃₁₈
a greater say in the corporate governance process. As a result, the greater bargaining ₃₁₉
power of political agents vis-à-vis private shareholders can facilitate excessive appropria- ₃₂₀
tion of firm surplus, thus resulting in extra loss of firm value. In sum, there are both ben- ₃₂₁
efits and costs of combining the two types of political ties, but extant literature is silent ₃₂₂
on when the benefits will outweigh the costs or vice versa. We add greater specificity to ₃₂₃
this issue by examining how this political tie configuration will impact firm value in the ₃₂₄
context of adverse political shocks. ₃₂₅

   When a shock shakes the incumbent elite power bases to which the focal firms are ₃₂₆
attached, the original overlap between personal ties and organizational ties will disap- ₃₂₇
pear. While managerial linkages to the ousted political group have been effectively ter- ₃₂₈
minated, firms' ownership linkages to political institutions are inherited by the incoming ₃₂₉
political group. In this context, although guilt by personal association can invite subse- ₃₃₀
quent discrimination against focal firms from the new political forces, its severity can be ₃₃₁
mitigated by the minority ownership stakes held by government agencies and SOEs. ₃₃₂

That is, the instrumental value of ownership stakes makes new elite groups hesitant to terminate resource exchanges between the two parties and self-cannibalize the focal companies. Thus, compared to firms connected only through managerial ties, ownership ties to state organizations can serve as a buffer against the 'social liabilities' associated with personal connections by helping reconstitute the broken business-government linkages after adverse shocks. Hence:

> *Hypothesis 3*: In the face of adverse shocks on a corporate political network, government ownership ties to this network through the holding of minority ownership stakes in focal firms will positively moderate the negative association between managerial political ties and firm value.

EMPIRICAL SETTING

Political connections have salient geographical origins (Faccio and Parsley, 2009; Siegel, 2007), and focusing on local political ties reduces extraneous variation arising from connections to other political networks. Our empirical setting is Shanghai, the most developed city in Mainland China. The local political economy in Shanghai makes the event an ideal context. While there is a high cross-regional rotation of local government officials in China, Shanghai remained an exception. Typical of the vast majority of Shanghai government officials, Chen Liangyu spent his entire public-sector career in Shanghai, starting from a state-owned factory manager before becoming a senior official in the municipal government in the 1990s, and then municipal Party secretary, the city's first-in-charge, and a member of China's ruling Communist Party Politburo since 2002.

Political factionalism is a defining feature of Chinese politics (Shih, 2008). Chen was widely believed to be a key member of the Shanghai-based political clique[1] in the Chinese Communist Party, an informal group of officials rising to prominence under the patronage of Jiang Zemin, China's former leader, who was once mayor and Party secretary of the city and cultivated it as his power base. According to the *Wall Street Journal* (2007), this cohesive local clique facilitated the emergence of what was known as 'Shanghai Inc.': 'giant construction projects got funded from public coffers; choice assets moved out of state hands in elaborate transactions; and plum contracts went to the well-connected'.

However, President Hu Jintao and Premier Wen Jiaobao, the successors of Jiang, had few prior Shanghai links but competing relationships with members of the clique. The purge of Chen by the central government, consequently, represented a big blow not only to his close friends, but to the *whole* political network in Shanghai. Representing China's biggest political shakeup in the 2000s, 'Mr Chen's dismissal is being widely interpreted as Hu Jintao strengthening his position both within the party and the country as a whole'. (*BBC News*, 2006)

T1   A detailed timeline of this political event is shown in Table I. On Monday, 25 September 25 2006, the state media announced the dismissal and detention of Chen in Beijing the day before, on the ground of his involvement in the Shanghai pension scandal. It was reported that at least RMB 3.2 billion ($427 million), or about one third of

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Table I. The timeline of the Shanghai pension scandal

Time	Events
17 July 2006	(1) Zhu Junyi, Head of the Labor and Social Security Bureau in the Shanghai Municipal Government detained for investigating the misuse of the city pension fund
	(2) Zhang Rongkun, Board Chairman of Fuxi Investment Holdings Corporation detained by police. It was revealed that a large amount of the city's pension fund had been illicitly funnelled to this private holding company for its investment in real estate and infrastructure projects in Shanghai
8 August 2006	Han Guozhang, Deputy CEO of Shanghai Electric Group Co. Ltd. detained for questioning. Zhang Rongkun was the company's vice board chairman and Fuxi Investment Holdings became the second largest shareholder of this public company during its privatization process in 2004. It was revealed that the funds (RMB 0.96 billion) used to acquire the company stakes originated largely from the city's pension fund
14 August 2006	Wang Chengming, Board Chairman and CEO of Shanghai Electric Group Co. Ltd. detained in relation to the pension fund scandal
24 August 2006	Qin Yu, Governor of Baoshan District in Shanghai detained for interrogation. He was Chen's former secretary and widely believed to be Chen's protégé
23 September 2006	Chen and other Shanghai city officials watched the Shanghai Golden Grand Prix, an international track and field game, in the evening. This is the last time Chen exposed himself to the public before his ouster
24 September 2006	Chen was informed to attend the Politburo meeting in Beijing, where he was detained for corruption charges and removed from all the official posts
25 September 2006	The news was released by Xinhua News, the official media in China
28 September 2006	(1) Sun Luyi, Vice-Secretary-General of Shanghai Communist Party Committee, was detained for interrogation
	(2) Wang Chengming and a CEO of a local SOE (a close friend of Chen's) officially removed from their posts
11 April 2008	Chen sentenced to 18 years in prison on charges of financial fraud, abuse of power, and accepting bribery

Source: The authors' collection of archival data and media reports.

the city's pension fund, had been illegally diverted to politically-connected firms and 375
obscure private holding companies for investment in real estate and infrastructure proj- 376
ects (such as the companies mentioned in Table I).[2] 377

Although the pension scandal had emerged earlier when some businessmen and 378
lower-level Shanghai officials were arrested, this event was largely unexpected by the 379
public: Misuse of public funds was not uncommon in China, thus hardly justifying the 380
arrest of a ruling Politburo member (Sun et al., 2011b). In effect, the scandal has been 381
exploited by the central government to achieve a 'partial regime change': Our study of 382
media reports and archival data suggests that no less than 30 senior government officials 383
and SOE executives were dismissed, demoted, or arrested because of this scandal. 384

Case Illustrations 385

Anecdotal evidence in the Shanghai corporate sector suggests that politically connected 386
firms were not equally vulnerable to this shock. As noted in Table I, the Shanghai 387

Electric Group Co. Ltd. was directly involved in the pension scandal, as three of its sen- 388
ior executives – Wang Chengming, Han Guozhang, and Zhang Rongkun – were Chen's 389
close friends and actively engaged in the fund diversion activities. Despite the fact that 390
they were jailed after the event, the listed company did not suffer political retaliation as 391
government ownership stakes provide a crucial buffer against the shock. Inspection of its 392
financial reports reveals that it did not experience reduction in bank financing from the 393
state-controlled banking system after the shock. 394

In contrast, another politically connected company – Shanghai Hainiao Development 395
Co. Ltd. – was much less fortunate. A Shanghai-based property developer, the firm was 396
controlled by Zhou Zhengyi, a business tycoon closely connected to Chen and his fam- 397
AQ2   ily. His real estate business received tremendous support from the municipal govern- 398
ment in supplying plots in the city's central locations. The downfall of Chen, however, 399
led to the collapse of Zhou's business empire. He was sentenced to 16 years in prison 400
and his company was no longer able to obtain any land supply from the local govern- 401
ment. Post hoc analysis of its annual reports finds plummeting profitability and external 402
financing after 2006. Although various factors can account for the tale of the two firms, 403
one crucial difference was the presence or absence of government ownership linkages. 404
While the Shanghai government held ownership stakes in the former company, Zhou 405
did not develop ownership ties to local government agencies, which might have been 406
able to buffer this adverse shock. 407

DATA AND VARIABLES 408

In June 2006, 162 companies were headquartered in Shanghai and listed on the Chi- 409
nese stock market, including stock exchanges in Hong Kong, Shanghai, and Shenzhen. 410
Stock price, accounting, and ownership data for these firms were obtained from the Chi- 411
nese Stock Market and Accounting Research (CSMAR) database. After deleting firms 412
without necessary data to calculate cumulative abnormal returns (CARs), we have 154 413
firms for our empirical analysis. 414

Dependent Variables 415

The event study approach can largely obviate the endogeneity problem as studies using 416
adverse shocks as 'quasi-experiments'[3] can obtain a reasonably clean measure of the 417
valuation effects of political ties. The resulting changes in market-adjusted stock returns 418
can serve as an estimate of the *lost value* of various types of ties (Fisman, 2001). As a nega- 419
tive shock damages the power base of the prior network to which firms are attached, dif- 420
ferent tie configurations will exhibit varying degrees of resilience to potential retaliation 421
by the rival network, which should be manifested through investor responses. 422

Standard event study methodology (McWilliams and Siegel, 1997) is used to estimate 423
companies' cumulative abnormal returns (CARs). We first run the following market 424
model for daily returns: $R_{it} = \alpha + \beta_i R_{mt} + \varepsilon_{it}$, where R_{it} is the rate of return for stock i at 425
time t, and R_{mt} is the rate of return on the market portfolio m at time t. The estimated 426
intercept and coefficient prior to the unanticipated event are applied to calculate the 427
abnormal return $[AR_{it} = R_{it} - (\hat{\alpha} + \hat{\beta} R_{mt})]$ for each company. 428

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Regarding the choice of event windows, we treat 25 September 2006 (Monday) as 429
day 0, when the arrest of Chen in Beijing on 24 September was released to the public. 430
Information leakage before 24 September is of minor concern since the purge was kept 431
strictly confidential. For example, Chen made high-profile media exposure on the eve- 432
ning of 23 September – watching the Shanghai Golden Grand Prix, an international 433
track and field game hosted in Shanghai, with other senior municipal officials (see Table 434
I). As such, we follow Faccio and Parsley (2009) by using event windows starting from 435
trading day -1 (22 September 2006) to allow for potential pre-event leakage in calculat- 436
ing the CARs. Event windows starting from day 0 also yield very similar results. 437

Further, we agree with Faccio and Parsley (2009) that there is no reason to extend 438
event windows further prior to such a sudden event. This is not least because of the con- 439
founding information released on day -2 (21 September), when the media reported 440
that Chen accompanied national government leaders in receiving foreign delegates in 441
Shanghai on the same day. Without hindsight, this information would have suggested to 442
investors that Chen was politically safe, at least in the near term. 443

With respect to the ending days of the event windows, a very long event window is 444
hard to justify because of potential confounding effects (McWilliams and Siegel, 1997). 445
Meanwhile, we allow for moderate post-event drift in this context: First, short-window 446
event studies may produce biased inferences from highly complex, infrequent events 447
(Oler et al., 2008). The media in China is strictly state-controlled so that most relevant 448
information and political implications of this event cannot be openly discussed. 449
Therefore domestic investors need more time to digest its delicate nature. Second, as 450
shown in Table I, some of Chen's associates were arrested on 28 September (day $+3$). 451
This information served to reinforce investor belief that the event was targeted at the 452
whole local political network in Shanghai. Consequently, CARs of each company over 453
the event windows $(-1, 2)$ and $(-1, 3) - \mathrm{CAR}_i\,(-1, 2)$ and $\mathrm{CAR}_i\,(-1, 3)$ – are obtained 454
through aggregation of AR_i for each day. 455

Independent Variables   456

Managerial political ties. We manually collected career information on 2577 TMT/board 457
members in the 154 firms, comprising all those for whom information was disclosed in 458
their companies' annual reports and other archival sources. They included board direc- 459
tors, senior executives without board membership, and members of companies' supervi- 460
sory boards. Consistent with previous literature (Faccio, 2006; Hillman et al., 1999; 461
Sun et al., 2011b), a firm is deemed connected to the Shanghai-based political network 462
if at least one TMT/board member had been a former government official[4] or was 463
currently a member in legislative bodies in Shanghai. This specification captures all per- 464
sonal links to the political network that can be identified and verified by investors. 465
We use a binary variable PERSON_TIE to denote personal connections to the local 466
network. It equals 1 if a company had former official(s) from the Shanghai government 467
or current member(s) in municipal legislative bodies as TMT/board member(s) at the 468
time of the event, 0 otherwise. 469

To capture the strength of personal-level political ties, we developed a new firm-level 470
index measuring the degree of a firm's proximity to the local political power. Building 471

on Kim and colleagues' (2012) political alignment index, our firm-level index is con- 472
structed by accounting for two important dimensions of a firm's political connectedness. 473
First, a firm will have a closer local political connection if its TMT/board member(s) 474
had a higher political status/rank in the local state authority. Second, the connection 475
will be stronger if the connected person holds a more important position with greater 476
decision-making power in the company. Specifically, we created the index as below: 477

$$\text{PERSON\_INDEX} = (1/2) * Gov\_Rank + (1/2) * Company\_Position$$

where *Gov_Rank* is valued in accordance with the seniority of the highest government 478
post that a company's TMT/board member once had. We followed the official ranks of 479
the Chinese bureaucracy to divide the connected people into three groups: For compa- 480
nies whose connected executives once had a position below the division level,[5] we 481
assigned a value of 1 to *Gov_Rank*. Moving up the hierarchy is the division (*chu*) level offi- 482
cials who play a significant, albeit operational, role in government's management of 483
business affairs, so a value of 2 is assigned to *Gov_Rank* for firms in this category. Since 484
top positions in the Shanghai government are at the ministry (*bu* in Chinese) level and 485
bureau (*ju* or *si*) level, *Gov_Rank* is assigned a value of 3 if the firm has the very top 486
connections.[6] 487

The second part of the index – *Company_Position* – concerns the company decision- 488
making power held by the politically connected. Again we divide the connected people 489
into three categories: *Company_Position* is assigned a value of 1 if the politically connected 490
person does not have board membership. That is, s/he was an executive in charge of 491
operational/functional aspects of the business or sitting on its supervisory board. While 492
Chinese regulations mandate the establishment of two-tier boards in all listed compa- 493
nies, Chinese supervisory boards normally play a symbolic role. *Company_Position* equals 494
2 if the politically connected person acted as an independent director. Imitating the 495
Anglo-American corporate governance system, the Chinese regulatory authority man- 496
dates the appointment of independent directors and grants them considerable power in 497
corporate governance, such as chairing board sub-committees and ratifying major busi- 498
ness transactions. Finally, *Company_Position* equals 3 if the politically connected was an 499
executive board director, i.e., a corporate insider. In other words, connections are 500
expected to generate more impacts when held by people with greater decision rights 501
within a firm. 502

Government ownership ties. Based on prior literature (Inoue et al., 2013; Vaaler and 503
Schrage, 2009), we measure the strength of political ownership ties by using a continuous 504
variable SHG_SHARE, which is the percentage of minority equity stakes held by Shang- 505
hai government agencies via their SOEs. Since the early 2000s, most Chinese govern- 506
ment agencies have tended to hold ownership stakes in the downstream listed companies 507
through their SOEs. We have confirmed from our data analysis that this is indeed the 508
case: Government agencies do not act as immediate shareholders of the Shanghai-based 509
publicly traded corporations. As listed companies in China are required to disclose their 510
ten largest shareholders, we manually identify if minority stakeholders were local SOEs 511
in each company. This was accomplished by careful study of archival information and 512
by assistance from equity analysts with deep knowledge of these companies. 513

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Government minority stakes are found in 81 sample companies. Tracing the origin of   514
these stakes by checking the companies' IPO prospectuses and merger and acquisition   515
records confirms that both residual government stakes and original government invest- 516
ment existed in these firms.   517

Control Variables   518

De facto Shanghai SOEs. If a Shanghai-based SOE holds a majority equity stake in a   519
downstream listed firm, we treat the listed company as a *de facto* SOE affiliated to the   520
local government. A dummy variable SH_SOE takes the value of 1 if the Shanghai gov-   521
ernment owns more than 50 per cent of the listed company's total shares outstanding   522
via its SOE(s), 0 otherwise. We find 28 companies in this category.   523

Central government control and connections. Since the event implies a crackdown on the local   524
political clique, a firm's personal and ownership ties to central government need to be   525
controlled for. We use CEN_CONTROL to denote firms controlled by central govern-   526
ment agencies. This equals 1 if a company disclosed that a central SOE was its largest   527
shareholder, 0 otherwise. Similarly, we use CEN_PERSON to denote firms that had   528
personal connections to central government agencies, equaling 1 if a company had for-   529
mer central government official(s) being TMT/board member(s) at the time of the   530
event, 0 otherwise.   531

Other control variables. SIZE is the natural logarithm of sales revenues in 2005. AGE is   532
the number of years since incorporation in China. ROA is return on assets in 2005. P/B   533
Ratio is the ratio of a firm's market value to its book value at year-end 2005. INDUS-   534
TRY is the standard dummy variables controlling for industry-specific effects. MAR-   535
KET TYPE is a dummy variable controlling for the specific stock exchange on which a   536
company was traded.   537

Testing a Null Hypothesis   538

Testing the null form hypothesis 2 entails a power analysis that has been applied in   539
behavioural sciences (Cohen, 1988, 1990, 1992) and management research (Lane et al.,   540
1998; Peng, 2004). It is well known that failure to find a statistically significant estimated   541
coefficient does not warrant the conclusion that the null hypothesis is true. However, as   542
pointed out by Cohen (1990), the null can be 'accepted' if the hypothesized effect is   543
found to be of no more than negligible or trivial size by virtue of a power analysis.   544

Thus, this analysis begs the question of when the effect size can be treated as 'nontri-   545
vial' in testing a null. Cohen (1992) proposed operational definitions of large, medium,   546
and small effect sizes. In view of our event study context involving observations from   547
outside investors, we find it suitable to adopt a medium effect size, which 'represents an   548
effect likely to be visible to the naked eye of a careful observer' (p. 156). Following Table   549
I in Cohen (1992) and Lane et al. (1998), we consider an effect to be trivial if the result-   550
ant R^2 from our power analysis is smaller than 0.13, the medium effect size.   551

To proceed with the power analysis, we further set the significance level α (the type I   552
error risk) to be equal to 0.05 or 0.01 and the power of the test to be 0.8 (so the type II   553
error risk $\beta = 0.2$), which are 'a convention proposed for general use' (Cohen, 1992, p.   554
156). Finally, the power analysis needs to determine the sample size necessary to attain   555

Table II. Cumulative abnormal returns (CARs) in Shanghai-based publicly listed companies

	Full sample (n = 154)		Companies connected to local political networks (n = 127)		Companies lacking local political embeddedness (n = 27)	
Event window	CAR	t-statistic	CAR	t-statistic	CAR	t-statistic
−1, 1	0.005	1.235	−0.001	−0.173	0.033**	2.429
−1, 2	0.002	0.473	−0.005	−1.155	0.034***	2.643
−1, 3	−0.007	−1.474	−0.014***	−2.838	0.024*	1.624
−1, 4	−0.015***	−2.964	−0.021***	−4.217	0.016	1.139
0, 1	0.004	1.119	−0.000	−0.036	0.024**	2.477
0, 2	−0.000	−0.073	−0.006*	−1.627	0.026***	2.736
0, 3	−0.009**	−2.220	−0.014***	−3.269	0.016	1.497
0, 4	−0.017***	−3.962	−0.022***	−4.913	0.009	0.862

Notes: *, **, and *** denote significance levels at 10%, 5%, and 1% respectively.

T2 the above power for the specified α and β. Referring to Table II in Cohen (1992), we note that our sample size (n = 154) is larger than all the minimum sample sizes required to test our null hypothesis. Hence, our null hypothesis will receive empirical support if the effect size is found to be greater than the R^2 in association with the medium effect size, given the specified α and β and the large-enough sample size.

RESULTS

Stock market responses are shown in Table II. For the full sample, the sign and the significance of the CARs are very sensitive to the event window chosen, with no consistent result emerging. The table also presents a classification of sample firms into two broad categories: Those with personal connections to and/or equity stakes held by the local political authority and those without. Clearly, the stock market on average discounted the politically-embedded group with a significant decline in CARs ranging from 1.4 per cent to 2.2 per cent over the event windows ending on day $+3$ or $+4$, when the purge of other Shanghai officials became publicly known. These results are greater than the percentage losses reported in some previous studies of negative events (e.g., Fisman (2001, −0.95 per cent) and Faccio and Parsley (2009, −1.7 per cent)).

Using CAR $(-1, 4)$ as a case to illustrate the monetary value of the negative impact, the market-adjusted loss of 2.1 per cent for the 127 politically connected companies is equivalent to a reduction of 10.59 billion RMB ($1.33 billion) in these companies' market value over these six trading days, which accounts for about 1 per cent of Shanghai's GDP in 2006. The magnitude of this shock is more substantial in proportional terms than estimates in some prior studies: Jayachandran (2006) reports that the loss of market capitalization in US companies previously making donations to the Republican Party amounted to $76.9 billion, or 0.76 per cent of US GDP in 2001, when Senator Jeffords' unexpected defection from the Republican Party tipped the control of the US Senate to

the Democrats. More dramatically, a recent study of the impact of the rise of the Nazis 581
in Germany suggests that the market value appreciation enjoyed by companies con- 582
nected with the Nazi movement in early 1933 amounted to 0.71 per cent of German 583
GDP in the same year (Ferguson and Voth, 2008). 584

T3   Table III presents descriptive statistics and pair-wise correlations among the variables 585
used in subsequent regressions, with several noteworthy features. First, the mean of the 586
binary variable PERSON_TIE is 68.8 per cent, indicating that a majority of sample 587
firms maintained personal connections to the local political authority. The mean of 588
SHG_SHARE is 11.5 per cent, suggesting that the Shanghai government held substan- 589
tial but non-controlling stakes in 81 of our 154 sample companies. Second, while the 590
negative correlation between CARs and SHG_SHARE is not significant, both PER- 591
SON_TIE and PERSON_INDEX are negatively correlated with CARs at 1 per cent 592
or 5 per cent significance levels. Third, both CEN_CONTROL and CEN_PERSON 593
exhibit strong negative correlations with various measures of local political ties (i.e., 594
SHG_SHARE and PERSON_TIE). This suggests that both central and local political 595
ties cluster around different groups of companies, so that few companies simultaneously 596
develop personal and/or ownership ties to both local and central authorities. Finally, 597
the variance inflation factors (VIFs) of all the explanatory variables are smaller than 2.5, 598
far below the conventional cut-off level, suggesting that multicollinearity is not a concern 599
in the empirical analysis. 600

We perform multivariate regressions investigating the relationship of firm-level CAR 601
$(-1, 2)$ and CAR $(-1, 3)$ to the composition of local political ties, with results shown in 602
T4   Table IV. Models (1) and (5) only contain control variables. The positive effect of 603
CEN_CONTROL aside, no other variables show significant effects on CARs. 604

Regressions in the remaining models concern the valuation effects of different types 605
and compositions of local political ties. Strongly supporting Hypothesis 1, the marginal 606
effect on CARs of managerial ties to the Shanghai-based political network is significantly 607
negative. When we use the continuous measurement of personal political ties, consistent 608
supportive results are present in models (2) and (6): Noting that a firm's PERSON_IN- 609
DEX is zero if it was not connected to the local government through personal connec- 610
tions, a one-unit increase in a firm's political proximity to the local regime would lead to 611
about a 0.8 per cent discount in CAR $(-1, 2)$ $(p < 0.05)$. 612

Regarding the marginal valuation effect of SHG_SHARE, the estimated coefficients 613
in models (2) and (6) are statistically insignificant, implying that the valuation effect of 614
government ownership ties is insignificantly different from zero following the shock. 615
This is a necessary but insufficient condition to 'accept' the null form hypothesis 2. In 616
models (3), (4), (7), and (8), we test Hypothesis 3 regarding interactions between manage- 617
rial ties and ownership ties. Irrespective of using binary or continuous measures of man- 618
agerial political ties, regression results offer unambiguous support for this hypothesis. 619
That is, government ownership ties play a significant moderating role of buffering 620
against the negative shocks on companies having managerial connections to the local 621
political network. 622

T5   Table V presents the results of the power analysis testing the null hypothesis 2. In 623
models (9), (10), (13), and (14), we regress CAR $(-1, 2)$ and CAR $(-1, 3)$ simply on the 624
measures of the two key independent variables. While the managerial political ties are 625

Table III. Descriptive statistics and Pearson correlation coefficients

	Mean	SD	1	2	3	4	5	6	7	8	9	10	11	VIF
1 CAR(−1,2)	0.002	0.053	1											
2 CAR(−1,3)	−0.007	0.060	0.949	1										
3 AGE	11.305	4.051	−0.070	−0.149	1									2.47
4 ROA	0.032	0.083	−0.288	−0.255	−0.153	1								1.58
5 SIZE	21.060	1.689	−0.106	−0.043	−0.235	0.331	1							1.65
6 P/B Ratio	3.150	4.383	−0.092	−0.121	0.063	−0.087	−0.155	1						1.49
7 CEN_CONTROL	0.234	0.424	0.144	0.142	−0.266	0.079	0.124	−0.132	1					1.87
8 CEN_PERSON	0.260	0.440	0.064	0.045	−0.008	−0.032	0.103	−0.033	0.373	1				1.39
9 SH_SOE	0.182	0.384	−0.092	−0.065	−0.094	0.158	0.149	0.060	−0.221	−0.164	1			1.88
10 SHG_SHARE	0.115	0.159	−0.036	−0.028	0.134	−0.052	0.034	−0.060	−0.333	−0.199	−0.340	1		1.89
11 PERSON_TIE	0.688	0.464	−0.213	−0.159	0.075	0.188	0.168	−0.049	−0.258	−0.305	0.245	0.284	1	1.58
12 PERSON_INDEX	1.795	1.264	−0.216	−0.155	0.060	0.161	0.197	−0.051	−0.264	−0.286	0.277	0.286	0.959	1.60

Notes: Correlations with absolute values greater than 0.155 are significant at 5% level. (N = 154).

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Table IV.　Regressions of CARs on political tie compositions

	CAR (−1, 2)				CAR (−1, 3)			
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
INTERCEPT	−0.036(−0.492)	−0.034(−0.468)	−0.016(−0.215)	−0.018(−0.243)	−0.088(−1.206)	−0.086(−1.190)	−0.066(−0.914)	−0.068(−0.942)
AGE	0.001(0.815)	0.001(1.063)	0.001(0.877)	0.001(0.852)	0.000(0.353)	0.001(0.546)	0.000(0.333)	0.000(0.325)
ROA	−0.091*(−1.689)	−0.074(−1.380)	−0.080(−1.513)	−0.074(−1.371)	−0.083(−1.580)	−0.070(−1.326)	−0.077(−1.479)	−0.070(−1.335)
SIZE	−0.002(−0.829)	−0.001(−0.477)	−0.002(−0.716)	−0.002(−0.800)	−0.001(−0.280)	−0.000(−0.006)	−0.001(−0.271)	−0.001(−0.333)
P/B Ratio	−0.000(−0.415)	−0.001(−0.564)	−0.001(−0.521)	−0.000(−0.457)	−0.001(−0.619)	−0.001(−0.728)	−0.001(−0.684)	−0.001(−0.636)
CEN_CONTROL	0.021**(1.984)	0.020*(1.723)	0.018(1.618)	0.019*(1.687)	0.021**(2.000)	0.020*(1.779)	0.019*(1.667)	0.020*(1.740)
CEN_PERSON	−0.004(−0.408)	−0.008(−0.817)	−0.007(−0.699)	−0.007(−0.710)	−0.005(−0.593)	−0.009(−0.899)	−0.007(−0.771)	−0.007(−0.796)
SH_SOE	0.001(0.138)	0.007(0.543)	0.014(1.078)	0.012(0.899)	0.002(0.153)	0.006(0.506)	0.014(1.113)	0.012(0.960)
PERSON_TIE			−0.012***(−2.917)	−0.029***(−2.674)				
PERSON_INDEX		−0.008**(−2.096)				−0.006*(−1.685)	−0.011***(−2.706)	−0.027***(−2.524)
SHG_SHARE		0.012(0.393)	−0.081(−1.517)	−0.078(−1.401)		0.012(0.383)	−0.091*(−1.744)	−0.086(−1.579)
SHG_SHARE*PERSON_TIE			0.049**(2.124)	0.122*(1.895)				
SHG_SHARE*PERSON_INDEX							0.054**(2.394)	0.134**(2.126)
R^2	0.390	0.411	0.431	0.425	0.549	0.559	0.578	0.574
F statistics	3.62***	3.57***	3.70***	3.61***	6.89***	6.49***	6.69***	6.59***

Notes: N = 154. *t*-statistics are reported in parentheses, with *, **, and *** mark significance at the 10%, 5%, and 1% levels respectively (two-tailed tests). All regressions shown in the table have controlled for firms' two-digit industry affiliation and stock exchanges where they were traded.

Table V. Power analysis testing the null hypothesis of government ownership ties

	CAR $(-1, 2)$				CAR $(-1, 3)$			
	(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)
INTERCEPT	0.018**	0.018**	0.013	0.014	0.006	0.007	−0.001	0.000
	(2.400)	(2.405)	(1.274)	(1.342)	(0.684)	(0.767)	(−0.091)	(0.027)
SHG_SHARE	0.009	0.009	0.021	0.019	0.007	0.007	0.025	0.024
	(0.342)	(0.323)	(0.629)	(0.562)	(0.218)	(0.224)	(0.632)	(0.612)
PERSON_INDEX	−0.009***		−0.009**		−0.008*		−0.007	
	(−2.704)		(−2.301)		(−1.915)		(−1.641)	
PERSON_TIE		−0.025***		−0.024**		−0.021**		−0.020*
		(−2.664)		(−2.273)		(−1.961)		(−1.701)
CEN_CONTROL			0.015	0.015			0.020	0.020
			(1.295)	(1.291)			(1.481)	(1.480)
CEN_PERSON			−0.003	−0.004			−0.005	−0.005
			(−0.318)	(−0.381)			(−0.384)	(−0.443)
SH_SOE			0.002	−0.000			0.004	0.003
			(0.118)	(−0.000)			(0.257)	(0.201)
R^2	0.047	0.046	0.059	0.058	0.024	0.026	0.039	0.040

Notes: N = 154. *t*-statistics are reported in parentheses, with *, **, and *** mark significance at the 10%, 5%, and 1% levels respectively (two-tailed tests).

negatively correlated with the CARs, there is again no statistical association between government ownership ties and the CARs. Moreover, the corresponding R^2s are much smaller than the medium size threshold − 0.13, so we can conclude that hypothesis 2 can be accepted with the power of the test greater than 0.8 and the risk of type II error smaller than 0.2. In the rest of the models in Table V, we add more control variables regarding other political linkages. Again, the results remain very similar, offering consistent support for hypothesis 2.

Robustness Checks

The portfolio approach. Besides conventional regressions of CARs on firm characteristics, the portfolio approach is also used in the finance literature. A recent survey of event studies (Kothari and Warner, 2007, pp. 19–20) advocates combining the two methods and checking if there is broad consistency so as to enhance the robustness of future event studies. Thus, we employ the portfolio approach to investigate if investors could have reaped significant stock returns by forming certain trading portfolios in line with the configuration of the political ties in our sample. Since the adverse shock is expected to generate a detrimental effect on firms with managerial and/or ownership ties to the Shanghai government, a hypothetical prescient investor should be able to earn significant returns by taking advantage of such information over $(-1, 2)$ and $(-1, 3)$.

Specifically, we construct three equal-weighted portfolios during the event periods: The first is long (buy shares) in companies without personal connections to the Shanghai

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government and short (sell shares) in those with personal ties; the second is long in com- 646
panies whose PERSON_INDEX is higher than or equal to the median (i.e., 2.5), and 647
short in those with no personal ties (i.e., PERSON_INDEX = 0); the third is long in 648
companies without minority ownership stakes held by the Shanghai government 649
(SHG_SHARE), and short in those with minority stakes. To implement the portfolio 650
time-series regressions, we follow Berkman et al. (2010) to specify the following models: 651

$$R(\text{Without } PERSON_{TIE_t}) - R(\text{With } PERSON_{TIE_t})$$
$$= \beta_0 + \beta_1 EVENT + \beta_2 MARKET_{RETURN_t} + \varepsilon_t \quad (1)$$

$$R(\text{Min } PERSON_{INDEX_t}) - R(\text{High } PERSON_{INDEX_t})$$
$$= \beta_0 + \beta_1 EVENT + \beta_2 MARKET_{RETURN_t} + \varepsilon_t \quad (2)$$

$$R(\text{Without } SHG_{SHARE_t}) - R(\text{with } SHG_{SHARE_t})$$
$$= \beta_0 + \beta_1 EVENT + \beta_2 MARKET_{RETURN_t} + \varepsilon_t \quad (3)$$

R(Without PERSON_TIE$_t$) and R(With PERSON_TIE$_t$) are the respective returns for 652
day t on firms without and with personal-level political ties; R(Min PERSON_INDEX$_t$) 653
and R(High PERSON_INDEX$_t$) are respective returns for day t on firms whose PER- 654
SON_INDEX are zero and no smaller than 2.5 in the sample; R(Without SHG_SHARE$_t$) 655
and R(With SHG_SHARE$_t$) are the respective returns for day t on firms without and with 656
government minority stakes. EVENT is a dummy variable equaling $1/n$ for the dates 657
within the event window of n days, and 0 otherwise, where $n = 4$ in the window $(-1, 2)$ 658
and $n = 5$ in the window $(-1, 3)$. MARKET_RETURN$_t$ is the return for day t on the 659
value-weighted market portfolio of firms listed on the Chinese stock exchanges. Each 660
model is estimated over all the 241 trading days in 2006 (i.e., $t = 1, \ldots, 241$). 661

T6 Table VI reports the performances of the three portfolios by showing the estimates of 662
β_1 with different firm samples. Hypothesis 1 receives support in the whole sample: An 663

Table VI. Portfolio performances by different political tie compositions

Portfolios	Without PERSON_TIE vs. With PERSON_TIE	Min PERSON_INDEX vs. High PERSON_INDEX	Without SHG_SHARE vs. With SHG_SHARE
Whole sample (N = 154)			
(−1,2)	0.023*** (3.110)	0.027*** (4.080)	0.013 (1.370)
(−1,3)	0.019 (1.580)	0.022* (1.850)	0.013 (1.210)
Subsample without Shanghai government equity stakes (N = 45)			
(−1,2)	0.049*** (7.940)	0.040** (6.590)	
(−1,3)	0.041** (2.110)	0.030 (1.560)	
Subsample with positive SHG_SHARE (N = 81)			
(−1,2)	0.014 (0.700)	0.011 (0.530)	
(−1,3)	0.020 (0.930)	0.019 (0.830)	

Notes: T = 241. *t*-statistics are reported in parentheses, with *, **, and *** mark significance at the 10%, 5%, and 1% levels respectively (two-tailed tests).

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investor holding the first two portfolios during the event periods would reap positive 664
returns, the statistical significance of which is present in most cases. For example, if an 665
investor had longed the stocks of companies with managerial political ties to the Shang- 666
hai government and meanwhile shorted the stocks without these ties during the event 667
window (-1, 2), s/he could have earned a 2.3 per cent investment return over the four 668
trading days (equivalent to 144 per cent of annualized investment return). Moreover, 669
this positive return could have been increased to 4.9 per cent (equivalent to 295 per cent 670
of annualized return), had s/he concentrated on a subsample without Shanghai govern- 671
ment equity stakes over the same event window. 672

In contrast, investors holding the third portfolio would have failed to reap any signifi- 673
cant returns during the event windows. This is consistent with Hypothesis 2, which sug- 674
gests that trading on the basis of minority ownership stakes is unlikely to yield 675
investment returns. This result also corroborates the support for Hypothesis 2 reported 676
above using the power analysis. 677

In support of Hypothesis 3, the first two portfolios would have failed to generate 678
positive returns if the companies traded had been constrained to those with owner- 679
ship ties to the Shanghai government during the event periods. The estimated coeffi- 680
cients – the investment returns – in the two subsamples are statistically 681
indistinguishable from zero. This suggests that, facing this political shock, minority 682
government ownership plays a significant buffering role for companies holding man- 683
agerial ties to the local political authority. In sum, results of the portfolio approach 684
are consistent with those in the preceding regression analysis and provide further 685
corroborating evidence. 686

Alternative definition of government ownership ties. We also consider the case when Shanghai 687
government agencies held minority stakes but remained the largest shareholders via 688
their SOEs in the listed firms. If we assume that these companies were still under operat- 689
ing control by the largest shareholders, these sample companies may also be classified as 690
de facto Shanghai SOEs. Thus, we narrow down our original definition of government 691
ownership ties to companies where local SOEs did not act as their largest shareholders. 692
Specifically, a binary variable OWN_TIE is equal to 1 if a listed company's largest 693
shareholder is unrelated to the Shanghai government, but one or several Shanghai- 694
based SOEs held ownership blocks in the company, 0 otherwise. Correspondingly, the 695
control variable SH_SOE now takes the value of 1 not only for firms with majority 696
stakes held by Shanghai-based SOEs, but also for those with local SOEs acting as 697
minority largest shareholders. 698

On the basis of this new classification, we re-tested the second and third hypotheses 699
through the conventional regression analysis, the power analysis, and the portfolio 700
approach. All the estimation results are very similar to those reported in Tables (IV–VI). 701
Due to space limit, these results are not reported here but are available upon request. 702

DISCUSSION AND CONCLUSION 703

Prior research on corporate political ties recognizes the general contingency of their 704
value for focal firms, but falls short of examining the heterogeneity of these ties. Emerg- 705
ing economies are characterized by political hazards that are difficult to regulate by 706

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institutional checks and balances. As a result, firms need to develop a deeper under- 707
standing of how different corporate political ties vary in their vulnerability and resilience 708
to negative shocks. To this end, we unpack the exchange process embedded in different 709
types and combinations of political ties. We have developed and tested hypotheses delin- 710
eating how specific compositions of political ties are associated with different valuation 711
impacts arising from the most dramatic political shock in China in the 2000s. 712

Theoretical Implications 713

Students of interorganizational relationships have long called for more in-depth studies 714
to distinguish the respective mechanisms regulating personal-level and organizational- 715
level embeddedness (Barden and Mitchell, 2007; Brass et al., 2004; Zaheer et al., 2010). 716
However, attempts to understand the heterogeneity of corporate political ties and its 717
impacts on corporate outcomes remain virtually absent in the literature. Most political 718
connection research overlooks that firms are typically embedded in a political constella- 719
tion encompassing different levels/dimensions of business-government exchanges. This 720
approach, however, risks theoretical misspecification and misleading empirical findings. 721
By simultaneously examining managerial political ties, government ownership ties, and 722
their interactions, we investigate how nodal multiplexity of corporate political ties influ- 723
ences firm outcomes in the emerging economy context. 724

   The importance of such heterogeneity would be less critical if adverse political shocks 725
did not characterize emerging economies. Under political stability, interpersonal 726
exchanges embedded in managerial political ties and interorganizational exchanges 727
embedded in government ownership ties are oftentimes intertwined and overlapping, as 728
political elites are also in charge of public authorities. It is, however, in the presence of 729
adverse shocks that the criticality of political tie heterogeneity manifests itself for focal 730
firms. 731

   Specifically, the value of managerial political ties can be quickly erased after the shock 732
that damages the local political network. 'Guilt by association' makes it hard to reconsti- 733
tute these broken ties in the near term and may invite unfavourable treatment from rival 734
political groups. In comparison, the exchange of resources and favours involves negligi- 735
ble personal and socioemotional elements at the interorganizational level. Absent allies 736
of political opponents holding executive/board positions, firms with only ownership ties 737
are less susceptible to 'guilt by association' and find it easier to realign themselves with 738
incoming political elites. Furthermore, for focal firms with managerial connections, our 739
study suggests that ownership linkages help alleviate the negative impacts of personal- 740
level liabilities. Thus, a combination of personal and organizational ties to local political 741
authority is instrumental in managing the risk-return duality prevailing in emerging 742
economies. 743

   In sum, our study integrates the political embeddedness perspective and the literature 744
on emerging economy political institutions to unravel a more nuanced picture of politi- 745
cal tie utilization. In doing so, we extend the conventional perspective adopted in devel- 746
oped economies, which portrays political ties as facilitators of business-government 747
transactions on an implicit political market (Bonardi et al., 2005; Kingsley et al., 2012). 748

This paves the way for more disaggregated, multilevel investigations into the impacts of 749
political embeddedness on firm outcomes across different contexts. 750

Our study also has important implications for existing studies of corporate political 751
activity through the political resources lens. While corporate political ties are a crucial 752
element of firm-specific political resources to generate rents (Dahan, 2005; Frynas et al., 753
2006; Oliver and Holzinger, 2008), prior research largely neglects the heterogeneity of 754
resources that can be supplied by different types and bundles of political ties. We have 755
taken a critical step forward by examining both the direct and interactive effects of two 756
types of political ties. The results reveal that minority government ownership acts as a 757
buffer against the deleterious valuation effect that personal ties can have in the after- 758
math of negative political shocks. 759

Echoing Bonardi's (2011, p. 250) argument that 'future work on political resources 760
needs to be strongly anchored in a theory of how political environments work', our study 761
suggests that the value of heterogeneous political ties is contingent on the dynamics 762
of political fragmentation and volatility in emerging economies. The distinct exchange 763
processes underlying personal and organizational linkages imply different rent- 764
generating mechanisms, which in turn give rise to varying degrees of vulnerability/ 765
resilience to political perturbations. Therefore, our findings highlight the need to further 766
understand the heterogeneity and bundles of political resources by studying the interac- 767
tions between different types and compositions of non-market resources and changing 768
non-market environments. 769

Managerial and Ethical Implications 770

Our study has profound implications for senior executives doing business in emerging 771
economies. Corporate political ties may reflect focal firms' umbilical cords to the state 772
embedded in past institutional legacies or be deliberately created by focal firms to co- 773
opt powerful political forces. In both cases, adroit management of these ties has proved 774
crucial for firms to navigate the challenging business environments. As recent research 775
hints at (Bonardi, 2011; Shi et al., 2014; Sun et al., 2012) and our present study shows, 776
basing corporate political strategy on a single, however high-profile, political tie can be 777
particularly risky. Instead, firms may rely on a portfolio of connections to generate the 778
requisite political resources, which themselves differ in nature and function. 779

Concretely, the prevailing risk-return duality in the non-market environment prompts 780
managers to contemplate strategies of both capturing sizeable government resources 781
and mitigating political risks. While developing personal-based connections with politi- 782
cians can result in significant benefits for focal firms, they have to be balanced by the 783
vulnerability of the ties to adverse political shocks. Government ownership ties, on the 784
other hand, can play an important risk absorption role in buffering firms from these 785
shocks. Therefore, a combination of personal and organizational ties to the incumbent 786
political regime can be beneficial for focal firms, since they can enjoy their managerial 787
connections absent adverse shocks, while relying on organizational ties to reduce the 788
likelihood of falling victim to unpredictable power struggles. 789

Closely related to these managerial implications are the broader ethical ramifications 790
for both indigenous and foreign firms operating in emerging economies. The corporate 791

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political strategy literature has been criticized as being insensitive to business ethics   792
issues, for some practices are ethically questionable and sometimes border on the cor-   793
rupt (den Hond et al., 2014; Mantere et al., 2009). While we do not directly address the   794
effects of different types of political ties on corporate reputation, our analysis does imply   795
that political ties are *not* equally subject to ethical problems.   796

Like all organizations, political institutions have both 'personal faces' represented by   797
individual political actors and 'organizational faces' endorsed by their collective inter-   798
ests. In reality, firms have resource exchanges with political institutions through both of   799
these interfaces. The presence of faces of political elites in focal firms may raise ethical   800
concerns from the public even under political stability. The problem can be more salient   801
in the presence of adverse shocks, when the legitimacy and images of the focal compa-   802
nies are damaged by their association with certain politicians. In view of this risk, our   803
research reminds practitioners of the importance of managing government relations   804
through organizational-level interfaces. Keeping some distance from personal-level   805
agendas but highlighting organizational-level collaboration can at least mitigate possible   806
ethical concerns and contribute to more sustainable business-government exchanges.   807
Hence, development of reciprocal relationships with the state should be anchored more   808
on the alignment of organizational objectives than on particularistic favour exchanges   809
with individual political leaders. In emerging economies, this ethical challenge seems   810
likely to persist while institutional voids remain and vary between different economies as   811
they develop their institutional infrastructures at different rates (Hoskisson et al., 2013).   812

Limitations and Future Research   813

Our study provides a snapshot of how the composition of heterogeneous political ties   814
impact firm value upon a high-profile political shock in the world's largest emerging   815
economy. While we have undertaken a careful analysis of the relevant qualitative infor-   816
mation related to this shock, it is evident that more insights can be generated in future   817
by longitudinal qualitative studies which trace the evolution of how firms develop,   818
exploit, or terminate different types and combinations of political ties both in stable peri-   819
ods and following shocks. Such research will enrich our initial finding and deepen our   820
knowledge about how the underlying mechanisms regulating the various political ties   821
co-evolve with the business and institutional environments.   822

As we are interested in comparing and contrasting interpersonal and interorganiza-   823
tional ties between business and government, we focused on managerial political and   824
government ownership ties because they are salient representations of these broader   825
constructs in the current research context. However, we do not claim that this classifica-   826
tion exhausts the typology of political tie heterogeneity in both personal and organiza-   827
tional dimensions. At the personal level, our measure of managerial ties is appropriate   828
for an event study since it incorporates all the verifiable information that an outside   829
investor can garner about the personal linkages to the local regime that the listed com-   830
panies could have. In other contexts, however, we may need to find ways of identifying   831
more informal linkages between business people and politicians. This is an empirical   832
challenge that future qualitative and survey research can help to tackle.   833

With respect to ownership ties, we acknowledge that some are not strategically created by focal firms but are residual government holdings following privatization. Clearly, basing a nonmarket strategy on government ownership ties may have very limited scope in many circumstances. On the other hand, the *strategic* retention of minority stakes signals that the focal firms are instrumental in helping achieve a regime's financial or policy goals (Vaaler and Schrage, 2009). Hence, firms can exploit such strategic interdependence and manage the residual holdings as a certain type of political resources. That being said, ownership ties are not the only way through which business firms and governments interact at the organizational level. Affiliation to government agencies (Wang et al., 2012), participation in quasi-government industry associations (Jia, 2014), and joint ventures established between multinationals and host-country SOEs (Sun et al., 2010a) are among the various examples of organizational linkages between firms and the state. Future research might usefully examine how different types of these linkages interact with personal level political ties to shape firm outcomes.

Finally, we do not address the feasibility and consequences of a scenario where focal firms simultaneously develop multiple ties to competing political groups. Few companies in our sample had personal and/or ownership ties to both local and central authorities at the same time. However, this does not preclude the presence of 'bets-hedging' ties to rival networks in China and other emerging economies (Dieleman and Boddewyn, 2012; Zhu and Chung, 2014). Future studies can contribute to the political strategy literature by developing datasets focused on achieving a deeper understanding of the formation and performance consequences of different political tie configurations.

In sum, corporate political ties are widespread around the world, but compared to interfirm network embeddedness, we know much less about how the content and structure of political embeddedness shape firm outcomes. By disentangling managerial ties to political actors and ownership ties to political institutions and examining their interactions, we hope our study can open the door to future research that unravels the nuances of corporate political activities through political tie utilization across different institutional contexts.

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NOTES

[1] For more information, please visit http://en.wikipedia.org/wiki/Shanghai_clique.

[2] More information about this scandal can be accessed by visiting the following websites: http://en.wikipedia.org/wiki/Chen_Liangyu and http://en.wikipedia.org/wiki/Shanghai_pension_scandal.

[3] They refer to 'exogenous shocks such as policy changes or other unanticipated events that enable identification of causal effects' (Oxley et al., 2010, p. 384).

[4] The Civil Servant Law of China stipulates that a public servant not hold a concurrent post in any profit-making organization. Consistent with the legal requirement, we did not find any acting Shanghai government officials sitting on the boards or holding executive positions in the sample companies.

[5] This means that these people were low-rank bureaucrats before moving to the business sector.

[6] There are few connections at the ministry level in our sample, so we group the two levels of observations. Bureau-level officials in Shanghai wield enormous power over business activities, such as the approval of land use and investment projects.

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