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Political capital and CEO entrenchment: Evidence from CEO turnover in Chinese non-SOEs^{*}

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Abstract

Previous theoretical and empirical studies suggest that CEOs' political connections are valuable to firms. We examine whether such connections become entrenched if the expected political capital fails to materialize and the firm lacks other types of political power. Using a sample of listed non-SOEs in China, we show that politically connected CEOs have a lower probability of turnover and cause a weaker turnover-performance sensitivity than non-politically connected CEOs. Further analyses show that these turnover patterns are not consistent with alternative explanations, such as superior managerial ability, being a member of controlling families or being promoted from the inside. The turnover patterns are less pronounced in firms with alternative political power, such as connected boards or being vital to the local economy. Following the turnover of politically connected CEOs, firm performance does not necessarily undergo significant improvement. Our results call for new theories that comprehend the real effects of political connections.

JEL classifications: G32, G34, G38

Keywords: Political connection, CEO turnover sensitivity, performance, financing costs.

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1. Introduction

A large strand of literature demonstrates that political connections are valuable to corporations. Theoretically, Shleifer and Vishny (1994) model that politicians cater to interest groups because the public is disorganized and the favourable treatment from the politicians is particularly beneficial for privately controlled firms. Crony capitalism also suggests that political leaders use their power to create rents for their families' and relatives' businesses. Empirical evidence supporting these predictions prevails both in the US and other countries (e.g., Agrawal and Knoeber 2001, Krozner and Stratmann 1998, Goldman, Rocholl, and So 2009, Cooper, Gulen, and Ovtchinnikov 2010, Fisman, 2001, Hellman, Jones and Kaufmann 2000, Johnson and Mitton 2002, Faccio 2006). For example, using an event study approach, Fisman (2001) and Faccio (2006) show that political connections are positively associated with firm value, which Faccio, Masulis, and McConnell (2006) and Claessens, Feijen, and Laeven (2008) suggest arises from preferred access to credit, regulatory favours, and government financial assistance. Few studies, however, explore the potential negative effect of political connections on corporate governance. Among these, Chaney, Faccio, and Parsley (2011) document that accounting quality is lower in politically connected firms than in non-connected firms. Our study proposes a different perspective from previous literature about the effects of political connections by showing how the political connections of CEOs have a deleterious effect on the managerial monitoring mechanism.¹

Focusing on forced CEO turnover, an important corporate governance event in disciplining managers and enhancing efficiency (Huson, Parrino, and Starks 2001), we provide evidence that political connections may reduce the effectiveness of the managerial monitoring mechanism. The literature on managerial turnover shows that forced turnover is negatively associated with firm performance (Warner, Watts, and Wruck, 1988, Weisbach, 1988) and followed by an improvement in performance (Huson, Malatesta, and Parrino, 2004; Evans et al., 2014). However, through dual positions, managerial ownership, connection with controlling owners, or takeover provisions, CEOs can reduce the probability of being replaced (Chen et al., 2013; Dikolli et al., 2014).

We document that the reduction in the probability of politically connected CEOs being replaced in Chinese non-SOEs is associated with an increase in their entrenchment, and weakens disciplinary mechanisms through CEOs' credible threat of withdrawal of benefits or potential retaliation, which is not applicable to non-politically connected CEOs. Although the forced turnover of a CEO who connects the firm to resources for government financing and regulatory favours may risk the continued availability of such resources, the politically connected CEO should be replaced if he or she is destroying more value by underperforming than he or she is creating. Nevertheless, resentment arising from the firing process may trigger a revenge motive, which can be especially detrimental in countries where legislative decisions are often made according to officials' subjective preferences. Hence, firms are likely to fire politically connected CEOs only when deterioration in firm performance is more severe than the loss of value caused by a credible threat of withdrawal of benefits, or retaliation by the fired CEO, or when they have an alternative political connection – that is alternative political capital input or safeguards that protect them from the withdrawal of benefits or retaliation. This argument also suggests that, as

¹ With few exceptions, the literature on the downside of political interference in corporations focuses on a political economy view of state ownership that posits expropriation as the motivation for government control over corporations (e.g., Fan, Wong, and Zhang 2007).

in all rational games, credible threats are not acted upon in equilibrium: no firm fires politically connected CEOs in the absence of alternative political power. This argument further suggests that there is no significant improvement of post-turnover performance for firms that lack alternative political capital. Therefore, although unobservable, the retaliation will be reflected by a weak recovery of post-turnover performance in the absence of alternative safeguards.

This premise of entrenchment due to political capital is consistent with the view that political connections are valuable. They in fact come from the same source – the political ability to mobilize resources to boost firm performance, everything else being equal. Rather, these entrenchments suggest that in the case of severe managerial inefficiency, firms face a tradeoff between losing the political benefits and improvement in managerial efficiency. The forced turnover of politically connected CEOs can therefore have interesting but previously undocumented implications. Identifying these implications can help us to better understand the influence of political connections, and complement existing research on the benefits they confer.

To the extent that loss of political power is more likely as a result of firing politically connected CEOs than non-politically connected CEOs, we predict that politically connected CEOs are likely to have longer tenure, a lower rate of forced turnover, and lower sensitivity of turnover to firm performance. We also expect a more severe deterioration in pre-turnover performance and a weaker recovery of post-turnover performance for firms which replace politically connected CEOs, compared with their peers replacing non-connected CEOs. These effects, and in turn the erosion of post-turnover firm performance, should vary across firms depending on whether the firms have alternative political power in place.

It is important for us to distinguish our argument about political entrenchment from alternative explanations for the empirical pattern in the turnover. One could argue that the longer tenure and less frequent turnover are due to the possibility that politically connected CEOs have better managerial ability than non-politically connected CEOs. However, if this alternative is a valid explanation of our main results, it suggests that the cross-sectional variations of patterns in turnover and post-turnover performance do not necessarily relate to firms' political power. Moreover, this alternative also suggests an overall reduction in post-turnover performance rather than an improvement due to the loss of a CEO with stronger managerial ability. One could also suspect that these entrenched CEOs are actually members of the controlling families or internally promoted rather than recruited from the external managerial labour market. The analyses, however, show no strong correlation between CEOs' political status and relationship with controlling family members or whether CEOs are promoted inside the firms, and the influence of CEOs' political power holds for various types of firms. We conduct a set of empirical analyses to draw distinctions and rule out these alternative explanations.

To test our predictions, we need a setting in which political connections can benefit a sufficiently wide range of firms that hiring politically connected CEOs is not an industry-specific phenomenon. We also need the setting to allow us to clearly differentiate CEOs' political connections from firms' political connections. China offers just such a setting. The Chinese government controls the majority of the economy through state ownership, authority to allocate resources, and direct interventions. The weak legal and institutional environment, together with the government's dominant role in allocating resources, imbues political connections with great economic value. Hence, given the financial rationing and various entry barriers faced by the private sector, it is common for privately controlled firms (non-SOEs) to build political connections, by hiring ex-politicians as CEOs or board members or by investing in political positions for major shareholders, in order to improve access to credit, regulatory protection, and

government financial assistance.

To empirically test whether political connections can lead CEOs to be entrenched and result in weaker sensitivity of turnover to performance, we choose a sample of non-SOEs from China for the following reasons. Under the current political personnel system in China, the government has the right to appoint, select and dismiss the top executives in SOEs, while in non-SOEs these decisions are usually made by the controlling shareholders, which are non-government entities. In this sense, including a SOE sample may contaminate the results because in SOEs politically connected CEOs are installed by the government, which can discourage the firing of these CEOs. Thus, the distorted turnover pattern for politically connected CEOs may only reflect government intervention in personnel decisions, rather than the fact that political connections can bring benefits to firms and that connected CEOs are likely to be entrenched as a result². Overall, the selection of non-SOEs as the sample can reveal the clear and direct financial implications of political connections.

Using a panel of CEO turnover data for Chinese listed non-SOEs, we classify CEOs as politically connected if they currently hold or previously held any official government position. We employ three empirical strategies to identify our proposition that political connections reduce forced turnovers and distort monitoring mechanisms. First, to mitigate the concern that firms with a worse performance may be more likely to hire politically connected CEOs or that any variation in turnover patterns is driven by other firm characteristics, we employ the propensity score matching approach to construct the empirical sample. We find that politically connected CEOs are associated with fewer turnovers and lower turnover-performance sensitivity in the matched sample, in which the treatment and control samples have similar firm performance, firm characteristic measures, and likelihood of hiring politically connected CEOs.

We next assess how the above relations vary in the presence of firms' alternative political power. We propose that alternative political power comprises such factors as having politically connected board members or controlling shareholders and whether the firm is vital to the local economy. We find that the above patterns maintain only for firms without other political power in place, which makes the marginal cost of losing CEOs' political capital higher or the threat of retaliation by politically connected CEOs credible. Non-SOEs that actually remove politically connected CEOs are found to have at least one alternative form of political power in place, e.g., a connected replacement CEO.

In the third analysis, we examine the implications of political connections for pre- and post-turnover performance. We find that the deterioration in performance before a forced turnover is much worse for firms with politically connected CEOs than for those with non-politically connected CEOs. Furthermore, the forced turnover of politically connected CEOs is associated with less performance improvement than that of non-politically connected CEOs.

Furthermore, we also conduct subsample regression analysis to directly rule out the suspicion that our results might be driven by CEOs' ability, their controlling family membership or their being promoted from inside firms. Specifically, we divide our full sample into two groups of CEOs with high versus lower ability, two groups of CEOs with family connections versus those without, and two groups of CEOs promoted from inside versus those recruited from outside. We find that the influence of political connections on forced turnover and the turnover-performance relationship holds for all subsamples. This robustness indicates that our results are not driven by CEOs' ability, their personal relationship with firms' controlling families or whether CEOs are promoted from inside the firms.

² We thank the reviewer for pointing out this issue.

In sum, our empirical findings reveal that firms with politically connected CEOs have lower turnover, weaker turnover-performance sensitivity, worse pre-turnover performance, and less post-turnover performance improvement than those with non-politically connected CEOs. Moreover, these empirical regularities do not stem from the endogenous selection of political connections, CEO's ability, CEO family member status, or internal promotion, but rather reflect possible entrenchment due to CEOs' political power. Overall, these results demonstrate a dual role for political connections: a valuable form of capital for firms and an adverse effect on managerial monitoring mechanisms, and suggest that for corporate political connections to be efficiently value-increasing, firms strategically need to have some alternative form of political power in place so that they are not induced by a particular political connection to retain managers who were hired for their political connections but who fail to leverage their political capital and demonstrate low performance. Nevertheless, it is essential to further develop the Chinese legal system and strengthen external governance, so that firms will have less incentive to seek rents from the government through political connections.

Our study on the roles of CEOs' political connections is applicable to other economies, as political connection in corporations is a common phenomenon around the world, including the US and the UK (Faccio, 2006). Moreover, the findings provide new insights for the literature on managerial discipline. Extant analyses of CEO entrenchment consider shareholder protections associated with the institutional environment and corporate governance structures. Our results, based on forced CEO turnover, suggest that CEO characteristics, such as political connections, are another important source of entrenchment. Further, our findings suggest that severing a reciprocal (political) relationship can be extremely inefficient for the party with disadvantaged bargaining power, and thus safeguard devices essentially ensure that such relationships function in a mutually beneficial manner.

The remainder of the paper is structured as follows. Section 2 describes the institutional background, together with our hypotheses. Section 3 summarizes the data and discusses the methodology. Section 4 reports the empirical results, including those for various robustness tests, and discusses caveats in interpreting the results. Section 5 concludes the paper.

2. Institutional background and hypotheses

2.1 Background

Because the government controls most of the economic resources in China, private firms have strong incentives to establish political connections, as such connections can improve access to credit and reduce borrowing costs (Khwaja and Mian, 2005, Li, Meng, Wang, and Zhou, 2008). At the same time, many government officials are willing to exchange low-salary civil service posts and the fierce competition of political careers for highly paid top management positions. Indeed, during the late 1990s and early 2000s, waves of government officials gave up their political careers and accepted managerial positions in private firms, especially in privately controlled firms that are publicly listed.

While some ex-politician managers leverage their political capital to generate value for shareholders, some fail to do so. Such failure may be due to low ability or an agenda that differs from maximization of firm value, in which case it may be desirable to fire the underperforming CEO. However, firing these CEOs may be costly: on the one hand, firms may lose the benefits associated with the CEO's political connection; on the other hand, there is a credible risk that the

politically connected CEO could threaten to penalize the firm in retaliation for being fired. For example, a common form of retaliation is to make a false charge against the controlling shareholder of the firm through connections in the legal/policy department. Such news negatively impacts the firm's stock price and supplier/customer relations, resulting in economic losses and in extreme cases loss of control over the firm. Hence, firms are not likely to fire politically connected CEOs in the absence of alternative political power.

2.2 Hypotheses

Existing literature has well documented the incentives of firms to stay closely connected with the governments, especially for privately controlled firms (Faccio et al., 2006; Wu et al., 2012). According to the resource-based view, firms are likely to connect with the governments in order to be treated favourably. One of the common methods used is to hire CEOs with previous political experience, and the benefits associated with executives' political connections have also been recognized extensively (Faccio, 2010). We argue that these benefits of political connections might also bring with them an adverse impact on the effectiveness of firm governance. Because political connections can bring a unique resource which is less likely to be substituted, CEOs with political connections are likely to become entrenched in their positions and thus be less likely to be monitored by controlling shareholders. Based on our discussion, these CEOs are thus less likely to be replaced, even when they achieve poor performance. Given the complexity of dealing with politicians and the sometimes devastating consequences of losing or disagreeing with them, we expect patterns of forced turnover to differ between politically connected and non-connected CEOs. Specifically, we expect that politically connected CEOs are associated with empirical regularities, such as a lower likelihood of forced turnover and lower turnover-performance sensitivity. Therefore, we form our first hypothesis:

H1: CEOs with political connections face a lower probability of turnover and cause a weaker relationship between turnover and firm performance.

Our previous discussion is based on the assumption that distorted turnover patterns are due to the benefits associated with political connections, and as politically connected CEOs can bring these benefits they thus become entrenched. However, being connected with governments through CEOs' previous working experience is not the only way recognized by existing studies. Firms can also connect with governments through other members on their boards or their largest shareholders (Chen et al., 2011). Thus, we argue that politically connected CEOs are less likely to become entrenched if the firms also have alternative connections with governments which can guarantee favourable treatment by governments. Therefore, we have the following hypothesis:

H2: The distorted turnover patterns caused by politically connected CEOs become less significant in firms with alternative political connections.

3. Data

3.1 Sample

Our sample starts with all listed non-SOEs trading on the main boards of both the Shanghai

Stock Exchange (SHSE) and the Shenzhen Stock Exchange (SZSE) between 2002 and 2010. The sample period begins in 2002 because of the change in accounting and audit standards for publicly listed firms in China commencing in 2001. Most tests are based on the full sample. However, in a few tests that require three post-turnover years to measure performance changes, we truncate the turnover observations for 2007. In addition, we delete firms flagged ST or *ST, designating special treatment due to irregularities in their financial statements and negative profits for two or three consecutive years. We also delete financial firms because of their industry uniqueness and firms with incomplete information on the key variables used in the analysis. Our final sample consists of 2,616 firm-year observations for 475 listed non-SOEs.

We manually collect data on CEOs' career paths and political backgrounds by searching firms' annual reports, their press releases, and online news resources. Combining this information with demographic data for CEOs in the Chinese Stock and Market Accounting Research (CSMAR) database, we compile CEO profiles that include age, gender, education, experience, and professional/political background. We define a CEO as politically connected if that individual currently is or previously was: (1) a central government official, (2) a local government official, (3) a military officer, (4) a member of the standing committee of the National People's Congress (NPC), and/or (5) a member of the Chinese People's Political Consultative Conference (CPPCC).

We identify 637 CEO turnovers among the sample period, which amount to 24.35% of the firm-year observations. The reasons for 379 of these turnovers are clearly stated in the CSMAR database and include retirement, contract expiration, resignation, completion of active duties, health, personal reasons, change in controlling shareholder, arrest or being under investigation, educational advancement, and corporate governance reform that requires the CEO to give up a dual role. We classify these turnovers as normal with one exception: if the CEO is under the age of 60 and retirement is the reason for departure, we classify the turnover as forced.

For the remaining 258 (= 637 - 379) turnovers not given a reason, we trace the departing CEOs' destinations and identify 91 cases in which the turnover is unlikely to be forced: giving up a dual role of CEO and board chair in response to regulation (28 cases), and promotion (43 CEOs became chair or vice chair of the board and 20 CEOs accepted managerial positions in the parent company); we treat these scenarios as normal turnovers. Having exhausted the reasons and information sources for CEO departure and recognizing that firms are unlikely to publicly disgrace CEOs subject to forced turnover, we classify the remaining 167 cases as forced turnovers³. These include demotions (52 CEOs accepted less prestigious positions within the firm, and 17 CEOs left for positions in unlisted or smaller firms), dismissal (23 cases), and replacement during tenure under unusual circumstances but without any traceable information on destination (75 cases). In the final turnover sample, 470 were normal turnovers (73.78% of the 637) and 167 were forced turnovers (26.22%). The reasons for CEO departures and their corresponding frequencies are summarized in Table 1.

Table 1: Reasons for CEO turnover

This table reports the number and frequency of CEO turnovers in our sample between 2002 and 2010.

Reasons for turnover	Number of observations	Frequency (%)
1. Normal turnover	470	73.78
Retirement	3	0.47
Contract expiration	116	18.21

³ Of these forced turnovers, 25 occurred in the first year. We exclude these cases from the performance and turnover-performance sensitivity analysis because it is hard to measure performance over such a short period.

Change in controlling shareholder	7	1.10
Resignation	165	25.90
Health	22	3.45
Personal reasons	35	5.49
Corporate governance reform	15	2.35
Legal dispute	3	0.47
Completion of active duties	11	1.73
Becoming government officials	0	0.00
Promoted to chairman or vice-chairman	43	6.75
Executive position at the parent company	20	3.14
Remaining as chairman or vice-chairman	28	4.40
Going abroad	2	0.31
2. Forced turnover	167	26.22
New position ranked lower than CEO	52	8.16
CEO position at an unlisted, smaller firm	17	2.67
Dismissed	23	3.61
No information available from any source	75	11.77
Total number of observations	637	100

Because any classification based on publicly disclosed information is probably imperfect, in our robustness tests we conduct several reclassifications to ensure that our results are not sensitive to the classification procedure used. First, because resignation (165 cases) and personal reasons (35 cases) are often face-saving reasons given for dismissal (Firth, Fung, and Rui 2006), we reclassify them as forced turnovers. Second, as internal demotions are not the same as dismissal (52 cases), we exclude these cases from forced turnovers. Finally, although we exhausted all information sources, some CEO departures occur with no traceable reason or destination (75 cases). Because these CEOs may not necessarily have been forced to leave, we exclude them from forced turnovers. The empirical results presented below, if not specified, are based on the classification in Table 1.

3.2 Model

Consistent with previous studies, we set up the following model for empirical analysis:

$$Turnover_{it} = \alpha_0 + \alpha_1 Political_{it} + \alpha_2 Performance_{it} + \alpha_3 Political_{it} * Performance_{it} + Controls + Year + Firm + \varepsilon \quad (1)$$

In the above equation, the dependent variable is a dummy variable that equals 1 if forced turnover occurred in the firm-year. *Political* is a dummy variable, equal to 1 for politically connected CEOs and 0 otherwise. *Performance* is the measure of firm performance, and we use ROA, ROS and annual stock returns as the proxies for firm performance which are entered into the equation separately. To capture the effect of a CEO's political connections on turnover-performance sensitivity, we include an interaction term between *Political* and performance measures in the explanatory variables. The control variables include firm size, leverage, CEO age, CEO tenure, CEO duality, board size, independent director ratio and managerial ownership, following existing studies (Chang and Wong, 2009). The regression also controls for firm and year fixed effects. In computing the statistical significance of the estimation, we cluster standard errors by firm both here and in all other regressions in this paper. Definitions of all variables used in this study are summarized in Table 2.

Table 2. Definition of variables

Variable Name	Definition
Firm size	Log of firm total assets
Political	A dummy variable equal to 1 for politically connected CEOs and 0 otherwise.
Leverage (%)	Total debt / Total assets
ROA (%)	Net income / Total assets
ROS (%)	Net income / Sales
Stock return	Annual stock returns
CEO turnover (%)	A dummy variable equal to 1 if the CEO turnover occurs in the current year and 0 otherwise
CEO forced turnover (%)	A dummy variable equal to 1 if the CEO forced turnover occurs in the current year and 0 otherwise.
CEO tenure (year)	The number of years that CEOs have been in their managerial positions
CEO age (year)	The age of the incumbent CEOs
CEO duality	A dummy variable equal to 1 if the CEO is also the Chairman of the board
Board size	Log of total number of directors on the board
Board independence	The proportion of independent directors on the board

3.3 Methodology

In addition to our concern over empirical identification, and whether the results are driven by political entrenchment or alternative explanations, another concern in using a reduced-form approach is the potential for endogeneity. In this context, our concern over endogeneity is whether the decision to hire a politically connected CEO is related to firm performance.

To address these issues, we first employ the propensity score matching approach. We begin by estimating each firm's propensity to hire a politically connected CEO using firm, board, and industry characteristics in the full panel data. Then, for each firm in the treatment sample (i.e., firms with politically connected CEOs), we identify a control firm with the same (or most similar) propensity score that does not hire a politically connected CEO. As a result, the likelihood of hiring a politically connected CEO is the same in the treatment and control samples, but their firm, board, and industry characteristics might differ. The empirical patterns for the turnover of politically connected CEOs in this matched sample are therefore free from selection bias.

Next, we examine how our results vary cross-sectionally with political power aside from the CEO's political connections. For our sample, we proxy for these alternative political connections using (1) the political connections of the firm's controlling shareholders or board members and (2) the importance of the firm to the local economy, as measured by the firm's size and sales in the industry. First, we identify the political connections of controlling shareholders and board members in the same way as we did for CEOs. Second, as the non-SOEs will be more favoured by the governments if they are vital to the local economy, we also identify this status as alternative political power. A non-SOE is identified as vital to the local economy if (1) its assets are more than 50 million RMB and sales are more than 200 million RMB for eastern regions, or (2) its assets are more than 30 million RMB and sales are more than 100 million RMB for central regions, or (3) its assets are more than 20 million RMB and sales are more than 50 million RMB for western regions⁴.

⁴ http://baike.baidu.com/link?url=5A2rFdiHpZJ1PvXQy-E3srMVNYTZ9c8sLM6fz1wb7uLFfXd00J5X62GmIH2UarlOCvWSZz5Nkb02YZaoD4-yB_

Since these measures together cover more than 90% of the sample, we conduct cross-sectional comparisons based on each indicator separately. Note, however, that this approach obfuscates the results because it categorizes some firms with political power as being without. In addition, firms that do not have political power can hire politically connected replacements or make peace with departing CEOs through large payoffs; while our data identify the former, the latter are unobservable, which again works against our results. If a reduction in turnover is not due to entrenchment but instead the superior managerial ability of ex-bureaucrats, we should not observe that the cross-sectional pattern depends on firms' political power.

Moreover, we examine pre- and post-turnover performance over a seven-year horizon. Specifically, we document the time-series dynamics of firm performance both prior to and after the forced turnovers and examine the changes for each subset of firms. To capture performance, we use (1) return on assets (ROA), defined as the ratio of net income to the book value of total assets, (2) return on sales (ROS), defined as the ratio of net income to total sales, and (3) annual stock returns. If a reduction in turnover is not due to entrenchment but instead a remedy for firm myopia, we should observe stronger post-turnover performance improvements for politically connected CEOs rather than the patterns hypothesized above.

In addition to the above indirect identification approaches, we also conduct direct tests to exclude alternative explanations for the documented turnover patterns, such as CEOs' superior ability, CEO's personal relationship with firms' controlling families or internally promoted CEOs. We estimate the relationship between forced turnover and CEOs' political connections, and CEO performance during the tenure in subsamples grouped by the following methods: First, whether CEOs' ability is above or below the median level; secondly, whether the CEO is a member of the controlling family or not; and thirdly, whether the CEO is promoted internally or hired from the external managerial labor market. If CEOs' ability, family member status, or insider CEOs, drive the forced turnover pattern, we should observe that the influence of political connection on the turnover-performance relationship disappears in firms in which CEOs have higher ability, family members are CEOs, and firms with insider CEOs.

We recognize that it might also seem desirable to find evidence of removal of benefits⁵ or retaliation following actual departure of politically connected CEOs and to compare such responses across firm types. Such an analysis, however, would be contradictory and the evidence false.

3.4 Summary statistics

We report summary statistics for CEO characteristics, firm characteristics, and board composition in Table 3 to validate our sample construction. Consistent with the previous findings of frequent CEO departures in China, we find that on average CEO tenure is quite short at about 2.83 years.⁶ Looking at the firm subsamples, CEOs in politically connected firms are older and

⁵ Fisman (2002) indirectly supports this notion of losing benefits by documenting a negative stock market reaction to firms in which the health of the associated politician declines.

⁶ For example, the average CEO turnover rate in our sample is 21.04%, implying that more than one-fifth of the CEOs were replaced during the sample period. This figure is not only higher than that reported by Huson, Malatesta et al. (2004) for US firms (9.3%) but also that provided by Kang and Shivdasani (1995) for Japanese firms (12.88%). It is close, however, to the 25.51% and 24% documented by Firth et al. (2002) and Kato and Long (2006), respectively, for Chinese listed firms during the period 1995 to 2001. On the other hand, the tenure measure has a downward bias for CEOs still in the CEO position because of the required cut-off at the end of the sample period. In regressions below, however, we find that this bias, rather than driving results, works against us.

have longer tenure than their non-politically connected counterparts. In addition, there are significantly fewer forced turnovers in firms with politically connected CEOs than in those with non-connected CEOs, and politically connected CEOs' tenure is longer.

We further find that, in sharp contrast to the US, CEO-board chair duality is common in China despite the Chinese Security Regulatory Committee's (CSRC) 2004 ruling that the two roles must be separated: in practice, 10% of CEOs continue to serve simultaneously as board chairs. Chinese firms also tend to have larger boards with a lower independence ratio than US firms. These differences are consistent across firm types. Firm characteristics, in contrast, differ dramatically across subgroups of Chinese firms. Politically connected firms are typically smaller, have higher leverage, and have worse performance than non-politically connected firms.⁷

Overall, the summary statistics in Table 3 suggest that CEO discipline in the form of forced turnover is most rigid in private firms with non-politically connected CEOs. Politically connected CEOs, on the other hand, are less likely to be fired and are likely to have longer tenure.

Table 3: Summary statistics for firm, CEO, and board of director characteristics

In this table, we report the panel means (medians) of firm characteristics for the full sample, for firms with and without politically connected CEOs between 2002 and 2010 in columns 1 to 3. Columns 4 and 5 report the mean difference and median difference. Variables are defined as in Table 2.

Variables	Full sample	(a). With PC CEOs	(b). Without PC CEOs	(a) - (b) [t-value]	(a) - (b) [wilcoxon value]
Firm size (in millions)	2,770 (1,510)	2,260 (1,340)	3,030 (1,600)	-770*** (-4.90)	-260*** (-3.84)
Leverage (%)	51.81 (51.71)	53.07 (52.82)	51.15 (51.08)	1.91* (1.85)	1.74** (2.52)
ROA (%)	2.34 (2.70)	2.23 (2.09)	2.58 (2.95)	-0.35 (-1.03)	-0.86 (-1.53)
ROS (%)	4.85 (4.95)	3.48 (4.07)	5.59 (5.41)	-2.11*** (-2.82)	-1.34*** (-2.64)
Stock return	45.63 (0.16)	35.61 (-6.59)	50.80 (7.49)	-15.19*** (-3.20)	-14.08*** (-3.53)
CEO turnover (%)	24.35 (0)	23.01 (0)	25.05 (0)	-2.04** (-1.98)	-0.00*** (-5.19)
CEO forced turnover (%)	6.38 (0)	3.93 (0)	7.65 (0)	-3.72*** (-4.31)	-0.00*** (-5.00)
CEO tenure (year)	2.83 (2.19)	2.93 (2.5)	2.77 (2)	0.16* (1.83)	0.5*** (2.93)
CEO age (year)	42.87 (44)	45.03 (46)	41.76 (43)	3.27*** (7.18)	3*** (9.43)
CEO duality	0.10 (0)	0.11 (0)	0.09 (0)	0.02* (1.78)	0.00 (0.28)
Board size (# of members)	8.21 (9)	8.45 (9)	8.09 (9)	0.36*** (3.59)	0 (1.12)
# of independent directors	3.17 (3)	3.14 (3)	3.18 (3)	-0.04 (-1.19)	0.00 (0.78)
Observations	2616	891	1725		

⁷ We note that the lower performance of private firms with politically connected CEOs compared to non-connected CEOs is not inconsistent with previous findings that political connections create value. Prior evidence is based on individual firms' market reaction to news, for example, about the decline in a politician's health (Fisman 2002) or the establishment of a new connection (Faccio 2006). The performance numbers here, in contrast, are simple summary statistics that describe the data; they do not control for determinants of performance nor do they consider the selection issue that poorly performing firms are more likely to seek political connections. The numbers here, therefore, are not a measure of value creation.

4. Empirical results

Whereas forced turnover is purportedly related to poor performance and thus is a disciplinary mechanism, normal turnovers due to retirement, health problems, promotion, and so forth, are likely to be unrelated to the firm's corporate governance. Hence, given our aim is to shed light on the effect of political connections on firm governance, the analyses below focus on forced CEO turnovers.

4.1 *Political connections and turnover-performance sensitivity using the matched sample*

In this section we begin by examining the turnover-performance relationship using regression analysis. Originally, we are expected to use the full sample for the empirical regression analysis. However, in the spirit of Boubakri et al. (2012) and Guedhami et al. (2014), we employ propensity score matching approach to mitigate the concern that variations in the turnover-performance relationship are driven by other firm characteristics rather than political connections. Taking firms that hire politically connected CEOs as our treatment sample, we construct a control sample by analyzing the propensity score for selecting politically connected CEOs for each firm and then matching each firm in the treatment sample to a firm with a non-politically connected CEO. The matching criterion is that the potential matching firm has the same propensity score for CEOs' political connections or, when no such match exists, the closest one with no more than a 2% deviation in propensity score; otherwise, the firm is dropped from the matching process. In particular, we obtain the propensity score for CEO political connections by regressing *Political* against a set of variables, including firm size, firm age, board size, leverage, book-to-market ratio, following Chen et al. (2011), Boubakri et al. (2012) and Guedhami et al. (2014). To validate our sample construction using propensity score matching approach, we conduct univariate tests to compare firm and CEO characteristics between the treatment sample and the control sample. The unreported results suggest that firm characteristics are not significantly different between these two samples, while CEO characteristics show some difference. Nonetheless, we still control for these variables in the regression. This procedure reduces 891 firm-year observations with politically connected CEOs to 608 pairs of firms in which the treatment and control pair have the same (or a closely similar) propensity to hire politically connected CEOs. We then analyze the impact of actual political connections on CEO turnover in this matched sample. We have also conducted the regression analysis using the original full sample and the general results are quite similar. To save space, we do not report the results using the full sample but they are available on request.

In Panel A of Table 4, we perform logit analysis of the determinants of forced CEO turnover using the matched sample. While the first stage matching procedure uses historical performance, in the second stage regression, we are interested in the change of performance during CEO tenure, in the spirit of Chang and Wong (2009). The purpose here is to see whether an equal decline in performance leads to a difference in the likelihood of firing politically connected CEOs, compared to non-connected CEOs. This approach, in addition to propensity matching, mitigates the concern that selection per se may lead to turnover-performance insensitivity for politically connected CEOs. The regression results in the matched samples confirm the negative impact of political connections on managerial turnover. In particular, we find that the coefficient of *Political* is negative and statistically significant at the 1% level (t-value is -7.88), indicating that CEOs' political connections reduce the turnover rate by 35%. We also observe that the

coefficient of $\Delta ROA * Political$ is positive and statistically significant at the 1% level, indicating that CEOs' political connections weaken the negative turnover-performance relationship.

In Panel B of Table 4, we conduct robustness tests using alternative categories of forced turnovers. In particular, the regressions use the same specifications as in Panel A, but the dependent variable is replaced by (1) CEO departures due to personal reasons or resignations, (2) CEO departures excluding cases with non-traceable reasons for departure or destinations, and (3) CEO departures excluding internal demotions. As the results show, the effects of political connections on forced turnover and turnover-performance sensitivity are robust to these alternative categories of forced turnover.

In sum, the evidence from the regression analysis supports our hypothesis that firms are more tolerant of deterioration in performance during a politically connected CEO's tenure. CEOs with political connections are less likely to be fired, and forced turnover decisions are less sensitive to firm performance. These empirical relations are robust to firms' endogenous choice to build political connections and to the definition of forced turnovers.

Table 4: Political connections and turnover-performance sensitivity using a matched sample

This table reports the regression results using the matched sample. The treatment sample includes firms with politically connected CEOs and the control sample includes firms with non-politically connected firms. Panel A reports regression results using the standard definition of forced turnover in the study, and Panel B reports results using alternative definitions of forced turnover where the control variables are also included in each regression. Variables are defined as in Table 2. Standard errors are clustered at the firm level. *, **, and *** indicate significance at the 10%, 5%, and 1% levels, respectively.

Panel A: Dependent variable is Turnover, which is equal to 1 if forced turnover occurs and 0 otherwise			
	(1)	(2)	(3)
Constant	-5.87**(-2.04)	-3.35(-1.18)	-3.07(-1.06)
Political	-0.35***(-7.88)	-0.31***(-7.03)	-0.32***(-7.06)
ΔROA	-0.99***(-3.41)		
$\Delta ROA * Political$	0.52***(-2.74)		
ΔROS		-0.42***(-2.58)	
$\Delta ROS * Political$		0.38**(-2.44)	
$\Delta Stock\ returns$			-0.15**(-2.00)
$\Delta Stock\ returns * Political$			0.05*(1.68)
Firm size (log assets)	0.13(1.00)	0.02(0.15)	0.03(0.24)
CEO age	0.27(1.49)	0.23(1.36)	0.20(1.12)
CEO tenure	-1.56***(-12.45)	-1.55***(-12.42)	-1.55***(-12.65)
Board size	0.25(0.55)	0.24(0.55)	0.28(0.63)
Board independence	0.20(0.24)	0.19(0.25)	0.23(0.28)
Leverage	-0.41(-0.64)	0.55(1.01)	0.68(1.37)
CEO duality	-0.05(-0.17)	-0.02(-0.08)	-0.04(-0.02)
Managerial ownership	-1.39(-0.36)	-2.93(-0.70)	-3.05(-0.75)
Year fixed effects	Included	Included	Included
Firm fixed effects	Included	Included	Included
Pseudo R ²	0.31	0.29	0.29
Observations	1,216	1,216	1,216
Panel B: Robust tests using alternative definitions of forced turnover			
(i). Forced turnover includes resignations and personal reasons cases			
Political	-0.34***(-7.34)	-0.30***(-6.71)	-0.10***(-4.79)
$\Delta ROA * Political$	0.19*(1.75)		
$\Delta ROS * Political$		0.25**(-2.27)	
$\Delta Stock\ returns * Political$			0.12*(1.64)
Pseudo R ²	0.29	0.28	0.32
Observations	1,216	1,216	1,216

(ii) Forced turnover excludes departing CEOs without traceable reasons or destinations			
Political	-0.32***(-5.94)	-0.28***(-5.41)	-0.28***(-5.17)
$\Delta ROA * \text{Political}$	0.20*(1.69)		
$\Delta ROS * \text{Political}$		0.34**(2.09)	
$\Delta \text{Stock returns} * \text{Political}$			0.34**(2.11)
Pseudo R^2	0.25	0.24	0.24
Observations	1,216	1,216	1,216
(iii) Forced turnover excludes internal demotions			
Political	-0.28***(-6.68)	-0.24***(-5.90)	-0.25***(-5.69)
$\Delta ROA * \text{Political}$	0.58**(2.04)		
$\Delta ROS * \text{Political}$		0.32*** (2.56)	
$\Delta \text{Stock returns} * \text{Political}$			0.28*** (2.62)
Pseudo R^2	0.24	0.23	0.23
Observations	1,216	1,216	1,216

4.2 Cross-sectional implications of safeguards

Having illustrated the negative impact of political connections on CEO turnover, we now distinguish this explanation from alternatives by examining the cross-sectional impact of firms' political power. Departure of a politically connected CEO may possibly cause a threat of retaliation. Such a threat is not credible, however, if the firm has other political connections, which in effect serve as substitute political capital or a safeguard from retaliation. We therefore investigate the occurrence of forced turnover and examine how the above empirical patterns differ across firm types according to firms' alternative political power.

First, with regard to the forced turnover rate, we find that it is lowest in firms that have politically connected CEOs but no alternative political connection. In Panel A of Table 5, we present the forced turnover rate for each subsample of firms grouped by firms' type of political connection and sorted by firm performance. The forced turnover rate is significantly higher (at the 1% level) in the lowest ROA quartile than in the highest ROA quartile for all subsamples except privately controlled firms with politically connected CEOs but no politically connected board or no vital importance to the local economy. However, firms in these two subsamples have the lowest forced turnover rates across all performance quartiles. For example, in the lowest performance quartile, the forced turnover rate is 5.08% for firms without politically connected board members and 5.12% for firms with no vital importance to the local economy. On the other hand, the forced turnover rate increases dramatically to 9.08% and 8.93%, respectively, for firms with politically connected boards and firms that are vitally important to the local economy.

Second, we conduct regression analysis to examine the variations in the influence of political connections on turnover-performance relationship for subsamples with non-SOEs that are vital to local economy or non-SOEs that have politically connected directors or controlling shareholders, and the results are reported in Panels B and C respectively. Consistent with our hypothesis, we find that CEOs' political connections in these firms do not reduce turnover-performance sensitivity significantly, reflected by insignificant coefficients of interaction terms (though the coefficient of $\Delta \text{Stock returns} * \text{Political}$ is significant). These results suggest that once firms have alternative connections with governments, CEOs' political connections do not bring about significant entrenchment for CEOs.

In sum, the empirical analysis in this section yields two messages. First, underperforming politically connected CEOs are removed only from firms that have alternative political power that protects them from potential retaliation, for example, politically connected boards. Second,

the forced turnover rate and the turnover-performance sensitivity for politically connected CEOs are lowest in firms that do not have offsetting political power.

Table 5: Comparison of forced turnover rate in firm performance quartiles across subsamples

This table presents the forced CEO turnover rate by quartiles of firm performance and compares them across various subsamples partitioned by the political power of CEOs and firms. In Panel A, we report the turnover rate; in Panel B, we present logit analysis on the subsample of Non-SOEs that are vitally important to the local economy. In Panel C, we present logit analysis for firms that have politically connected board or shareholders. Control variables in equation (1) are also included in each regression. Standard errors are clustered at the firm level. *, **, and *** indicate significance at the 10%, 5%, and 1% levels, respectively.

	Bottom quartile	Second quartile	Third quartile	Higher quartile	t-test	
<i>Panel A: The rate of forced CEO turnover by performance quartile (%)</i>						
Full sample	11.13	7.20	6.84	2.97	8.16***	(4.02)
(a) Non-politically connected CEOs	18.13	9.73	10.82	4.06	14.07***	(3.07)
(b) Politically connected CEOs	8.03	4.52	0.73	0.00	8.03***	(4.17)
(i) Politically connected board or major shareholder	9.08	4.33	1.78	0.00	9.08***	(4.53)
(ii) Non-politically connected board or major shareholder	5.08	4.79	0.00	0.00	5.08	(1.48)
(iii) Firm is vitally important to local economy	8.93	5.97	1.56	0.00	8.93***	(5.66)
(iv) Firm is not important to local economy	5.12	3.01	0.00	0.00	5.12	(1.16)
<i>Panel B: Subsample: Non-SOEs with politically connected board or shareholders</i>						
	(1)	(2)	(3)			
Political	-0.27***(-5.91)	-0.29***(-6.10)	-0.31***(-6.29)			
ΔROA*Political	0.52(1.62)					
ΔROS*Political		0.33(1.55)				
ΔStock returns*Political			0.13**(1.99)			
Pseudo R ²	0.25	0.29	0.29			
Observations	718	718	718			
<i>Panel C: Subsample: Non-SOEs that are vitally important to the local economy</i>						
	(1)	(2)	(3)			
Political	-0.33***(-6.84)	-0.32***(-6.64)	-0.33***(-6.67)			
ΔROA*Political	0.30(1.20)					
ΔROS*Political		0.31(0.26)				
ΔStock returns*Political			0.27(0.99)			
Pseudo R ²	0.26	0.25	0.24			
Observations	1473	1473	1473			

4.3 Implications of forced turnover for pre- and post-turnover performance

We next consider the implications of forced turnover for firms' pre- and post-turnover performance. In particular, we examine the time series of firm performance from three years before until three years after a forced turnover, the variation in performance dynamics across firm types, and the relation between CEO/firm type and improvement in post-turnover performance.

In Table 6, we report the time series of firm performance for firms with a forced CEO turnover. Several patterns stand out. First, ROA during the three years prior to forced turnover for all firm types is significantly negative, suggesting that poor performance leads to forced

turnover. Second, performance deteriorates more severely for firms with politically connected than firms with non-politically connected CEOs. For example, ROA decreases from year $T-3$ to year T by -4.95% for the former and -2.52% for the latter, where T is the year in which the CEO is replaced. Moreover, in these firms, although turnovers of non-politically connected CEOs are associated with ROA improvement three years later (a significant 3.13%), turnovers of politically connected CEOs on average have no effect on ROA (negative and insignificant).

We next link this difference in performance to firms' political power. We find that although the turnover of politically connected CEOs is generally followed by insignificant performance improvement, ROA improves by 3.78% (significant at the 1% level) during the three years after CEO replacement for those firms with politically connected boards, and by 6.04% (significant at the 1% level) for those firms that are vitally important to the local economy. Moreover, although firms that replace politically connected CEOs underperform those that replace non-connected CEOs by -1.77% in terms of annual ROA during the three years after turnover, this underperformance is more than restored when firms have politically connected boards or are vitally important to the local economy (1.96% and 4.25%, significant at either 5% or 1% level, respectively). The restoration of post-performance improvement due to firms' political power is thus sizable.

Overall, the results in Table 6 suggest that in Chinese non-SOEs, forced CEO turnover is driven by poor performance but not necessarily followed by post-turnover improvement. The cross-sectional difference supports the notion that this inefficiency is associated with the removed CEO's political power and potential retaliation. On the one hand, firms fire underperforming politically connected CEOs only when the marginal benefits of correcting performance outweigh the loss of political benefits and the costs of retaliation. On the other hand, post-turnover performance does not recover significantly as the costs resulting from retaliation will drive the change pattern of firm performance. The retaliation costs for the firms, however, are relatively marginal if a firm maintains a politically connected board or ensures that it is important to the local economy.

Table 6: Change in firm performance around forced CEO turnovers in privately controlled firms

This table reports the change in performance around forced CEO turnovers in our sample firms. The performance measure is industry-adjusted ROA (obtained by subtracting the industry median). The performance changes are measured over a three-year horizon prior to, as well as after, the year of forced turnover. The mean change is presented and compared for the following subgroups of firms: those with non-politically connected CEOs, those with politically connected CEOs, and those with both politically connected CEOs and boards. *, **, and *** indicate significance at the 10%, 5%, and 1% levels, respectively. We do not report the performance changes for forced turnover of politically connected CEOs in firms that do not have a politically connected board because, among the firms that have seven years of firm performance observations, there are only six such cases, which does not allow for meaningful inferences.

ROA changes around forced turnovers	$T-(T-3)$	T-average of (T-3, T-1)	$T-(T-1)$	$(T+1)-T$	Average of (T+1, T+3) - T	$(T+3)-T$
(a) Firms with non-politically connected CEOs	-2.52** (-2.53)	-1.96* (-1.88)	-1.75* (-1.68)	1.31 (1.16)	2.16* (1.93)	3.13** (2.03)
(b) Firms with politically connected CEOs	-4.95*** (-4.63)	-4.55*** (-4.55)	-3.91*** (-3.97)	1.06 (1.08)	1.13 (1.62)	1.36 (1.02)
i. With politically connected board or major shareholder	-0.71 (-0.70)	-1.58* (-1.68)	-1.62 (-1.56)	1.80*** (3.21)	2.93*** (5.95)	3.78*** (4.82)
ii. With non-politically connected board or major shareholder	-2.85*** (-4.97)	-2.92*** (-5.82)	-2.64*** (-5.39)	1.05 (0.57)	1.21 (0.66)	1.82 (1.03)

iii. Firm is vitally important to local economy	-1.69*** (-3.73)	-1.74*** (-4.16)	-1.48*** (-3.52)	5.33*** (2.98)	6.89*** (4.42)	6.04*** (3.19)
iv. Firm is not important to local economy	-5.96*** (-3.06)	-6.68*** (-4.36)	-6.94*** (-4.67)	0.83 (0.70)	1.82 (1.00)	1.79 (0.93)
Difference tests (a –b)	2.43** (2.02)	2.59** (1.99)	2.16* (1.83)	0.25 (0.78)	1.03* (1.91)	1.77** (2.17)
Difference tests (i-ii)	2.14** (1.99)	1.34* (1.67)	1.02 (0.77)	0.25 (1.33)	1.72** (1.97)	1.96** (2.03)
Difference tests (iii-iv)	4.27*** (3.24)	4.94*** (3.58)	5.46*** (4.33)	4.50*** (3.37)	5.07*** (3.70)	4.25*** (3.12)

Finally, we investigate the relation between CEO/firm type, forced turnover, and post-turnover performance using regression analysis. To avoid interactions among explanatory variables, we conduct subsample analysis. In all of these regressions, the dependent variable is performance improvement, that is, the change in ROA, ROS, or stock returns. For firms with a forced CEO turnover, the change in performance is given by the difference in ROA/ROS/stock returns between the average of years $T + 1$ to $T + 3$ and year T , where T denotes the year in which the forced turnover occurs. For firms without a forced turnover, employed as a control group, we take the end of the third year of tenure as the hypothetical turnover date and compute the change in performance as above. These regressions therefore require that firms have at least six years of data. The explanatory variables include firm, board, and CEO characteristics, as well as year fixed effects. Standard errors are clustered at the firm level.

The results in Panel A of Table 7 focus on non-SOEs with politically connected CEOs (turnovers and non-turnovers). In this subset, forced turnover of politically connected CEOs is no longer associated with improvements in operating performance (negative and insignificant). Nonetheless, the market perceives the forced turnover as efficiency-enhancing, with a 23% increase in stock returns.

The results in Panel B of Table 7 aim to increase our understanding of the impact of CEOs' political connections on post-forced turnover firm performance. The subsample in this panel comprises non-SOEs (with either politically connected or non-politically connected CEOs) with a forced turnover. Of the 117 non-SOEs with a forced turnover, only 44 have at least six years of observations. In this regression, we include an indicator variable equal to 1 if the CEO being replaced is politically connected and 0 otherwise. The results clearly show that CEO political connections are associated with a negative change in post-turnover performance of -4% for ROA and -6% for stock returns, both significant at either the 10% and 5% levels, respectively.

Ideally, we would also examine the effect of firms' political power when the CEOs are politically connected, but any further partitioning of the 44 observations results in too small a sample size to produce statistically reliable tests. The results in Table 7 do suggest that for non-SOEs, forced turnover of politically connected CEOs brings significantly less performance improvement compared to that of non-connected CEOs and results in an insignificant gain in operating performance but a somewhat positive gain in stock performance. This finding is consistent with our hypothesis regarding the trade-off in the replacement of politically connected CEOs in equilibrium.

Table 7: Post-turnover performance improvement across firm types

In Panel A, we regress the change in firm performance on turnover, firm characteristics, and other governance variables for non-SOEs with politically connected CEOs. We report only the effect of forced CEO turnover and its significance. In Panel B, we regress the change in firm performance on CEOs' political power in the subsample of

non-SOEs that have forced turnovers. The dependent variable is the change in firm performance over the three years after the forced turnover. All other control variables are defined as in Table 2. In computing the t-statistics, the standard errors are clustered at the firm level and reported in parentheses. *, **, and *** indicate significance at the 10%, 5%, and 1% levels, respectively.

	Δ ROA		Δ ROS		Δ Stock returns	
<i>Panel A: Non-SOEs with politically connected CEOs</i>						
Forced turnover	-0.02	(-0.15)	-0.07	(-0.20)	0.23*	(1.68)
Other control variables include firm size; CEO age, tenure, and duality; board size and independence; leverage; managerial ownership; and year fixed effects						
Adjusted R ²	0.02		0.02		0.03	
Observations	242		242		242	
<i>Panel B: Non-SOEs with forced turnovers</i>						
Politically connected CEO	-0.04*	(-1.71)	-0.02	(-1.09)	-0.06*	(-2.01)
Other control variables include firm size; CEO age, tenure, and duality; board size and independence; leverage; managerial ownership; and year fixed effects						
Adjusted R ²	0.10		0.03		0.05	
Observations	44		44		44	

4.4 Alternative explanation

Our main results show that politically connected CEOs are associated with reduced sensitivity of turnover to firm performance. Nevertheless, the observed influence of CEOs' political connections on turnover patterns may be consistent with other explanations, such as superior managerial ability, CEOs being a member of the controlling family or CEOs being promoted from inside the firms. It is possible that such CEOs are less likely to be replaced due to poor performance, which challenges our main argument. In particular, if the reduction in turnover is driven by superior managerial ability, the forced turnover pattern may not necessarily vary with a firm's political power. Similarly, if it is the CEO's personal relationship with the controlling family or insider CEOs that are driving the results, the forced turnover patterns and weakened turnover-performance relationship for politically connected CEOs should differ between firms with and without family CEOs, and between firms with internally promoted CEOs and firms with externally recruited CEOs. Specifically, according to our discussion above, if our main results hold for both subsamples, it indicates that CEO managerial ability, CEO family membership and internal promotion of CEOs do not contribute to the reduced sensitivity of turnover to performance for politically connected CEOs. If these factors are the real reason that leads to reduced sensitivity of turnover to performance, we should observe that the weaker relationship between turnover and performance for politically connected CEOs disappears for the subsample of firms with superior CEOs, family CEOs or internally promoted CEOs.

In this section, we perform subsample regression analysis to rule out these alternative explanations. Empirically, we divide our total sample into firms with CEOs of high versus lower ability, firms having CEOs with family connections versus those without, and firms with internally promoted versus externally recruited CEOs. In particular, we use the principal component analysis (PCA) to construct an index to reflect the managerial ability of each CEO in our sample, using the information of a number of measures for managerial ability which have been mentioned in the existing studies (Rose and Shepard, 1994; Murphy and Zbojnik, 2004; Demerjian et al., 2012; Demerjian et al., 2013)⁸. Then, we divide our total sample based on the median value of this index into firms with CEOs of high versus lower ability.

⁸ These measures include stock returns and ROA during the tenure, CEO compensation and CEO tenure.

In Table 8, we report estimation results on the turnover-performance relationship in these subsamples. In our sample, 33.7% of firm-year observations are from firms with controlling families and 38.8% of these firms have a family member as the CEO. 42% of firms have internally promoted CEOs. As Table 8 shows, the coefficients on the indicator for politically connected CEOs are significantly negative and the coefficients of the indicator for the interaction of performance during the CEO tenure and political connection are significantly positive in all subsamples. These results suggest that the influence of CEOs' political connection on forced turnover pattern and turnover-performance sensitivity is not driven by CEOs' ability, their personal relationship with firms' controlling families or whether they have been internally promoted.

Table 8: Political connection, performance, and forced turnover in subsamples

We regress forced turnover on firm performance, CEOs' political connections, firm characteristics, governance variables, and year fixed effects. The coefficients and t-statistics of the key explanatory variables are reported in the table. In computing the t-statistics, the standard errors are clustered at the firm level and reported in parentheses. *, **, and *** indicate significance at the 10%, 5%, and 1% levels, respectively.

Dependent variable: The probability of forced turnover						
	Higher managerial ability	Lower managerial ability	With family CEOs	With non-family CEOs	With insider CEOs	With outsider CEOs
Political	-0.18** (-2.15)	-0.56*** (-4.93)	-0.28*** (-4.37)	-0.38*** (-6.85)	-0.31*** (-4.27)	-0.37*** (-6.79)
Δ ROA	-0.23*** (-2.68)	-1.48** (-2.10)	-0.68** (-2.23)	-1.19*** (-6.34)	-0.57** (-2.24)	-1.43*** (-6.70)
Δ ROA*Political	0.42** (2.15)	0.84*** (4.04)	0.32* (1.94)	0.79*** (3.65)	0.26* (1.87)	1.06*** (4.55)
Other control variables are firm size, CEO age, CEO tenure, CEO duality, board size, board independence, managerial ownership, year and firm fixed effect.						
Pseudo R ²	0.36	0.16	0.33	0.27	0.34	0.22
Observations	621	595	256	960	512	704

The key mechanism in our argument, losing benefits, depends on whether the firms have other forms of political power. In particular, the strength of the CEO's political power compared to that of the firm. If this mechanism does indeed drive the relation between CEOs' political connections and turnover, we expect the impact to be concentrated only in firms with weak political power. We can also expect an improvement in post-turnover performance in firms that have other forms of political power. Our previous analysis also confirms our main argument that distorted turnover patterns are driven by the political benefits that politically connected CEOs can bring.

In sum, the findings in this section are consistent with our hypothesis that politically connected CEOs are potentially able to withdraw political benefits after a forced turnover, which leads to managerial entrenchment. We find no evidence that lower forced turnover rate and weaker turnover-performance relationship is driven by CEO's ability, CEO's controlling family status or internally promoted CEOs.

4.5 Robustness and caveats

Our analysis above addresses the selection of politically connected CEOs, robustness to the definition of forced turnover, robustness to alternative measures of performance, and exclusion

of alternative explanations. Another legitimate concern is whether firm performance is an appropriate measure of CEO performance. In other words, what are the benefits that the politically connected CEOs bring to firms which cause firms to be less likely to replace these CEOs? As the literature suggests, the purpose of hiring politically connected CEOs is to increase access to credit with a low cost, regulatory favours, and government financial assistance. To address this concern, we compare bank financing costs, government subsidies and market reactions to the appointment of CEOs in firms with politically connected CEOs versus those with non-connected CEOs. The financing cost is measured as the ratio of interest payment over the book value of the total debt. Government subsidies are measured as the ratio of subsidies received to the total sales and the information on subsidies is obtained from the Footnotes to Financial Statements sub-dataset of the CSMAR database. The market reaction is measured as the market-adjusted cumulative abnormal returns (CARs) around the date of CEO turnover. To calculate CARs, we choose (0, +1) as the event window and (-240, -10) as the estimation window. We observe that firms with politically connected CEOs have lower financing costs, higher government subsidies, and higher cumulative abnormal returns (CARs) than do firms without politically connected CEOs. An untabulated comparison also shows that firms in the top performance quartile have significantly lower financing costs (by at least 559 basis points) than other firms. These results complement our previous argument that politically connected CEOs can bring benefits to firms so that they face low forced turnover and cause a weak turnover-performance relationship.

Table 9: Comparison of benefits brought by politically connected CEOs

We compare the financing costs, government subsidies and market reaction to CEO appointments between firms with politically connected CEOs and non-politically connected CEOs. Financing costs are measured by the ratio of interest payment to total debt. Subsidies are measured as the ratio of subsidies received from the government over the total sales, and the information on subsidies is obtained from the Footnotes to Financial Statements sub-dataset of the CSMAR database. Market reaction is measured by the market-adjusted cumulative abnormal returns (CARs) around the date of CEO appointment, with [-240, -10] as the estimation window and [0, +1] as the event window. *, **, and *** indicate significance at the 10%, 5%, and 1% levels, respectively.

	PC	Non-PC	Difference test
Financing costs	1.75%	2.58%	-0.83%*(-2.32)
Subsidies (million)	53.4	26.2	27.2**(2.03)
Observations	891	1725	
CARs	2.39%	1.13%	1.26*(1.94)
Observations	191	398	

In addition, because it is possible that tunnelling may smudge the translation among financing cost, managerial ability, and performance, one may ask how large this risk is for our results. Most of our results on the turnover-performance relationship are first obtained for homogeneous firm or CEO types and then compared across types. Hence, addressing the tunnelling concern would require a proposition explaining why tunnelling differs within the same type of firm and CEO combination. Such a proposition would also have to explain turnover and post-turnover performance in a way that agrees with the empirical findings.

One important caveat worth highlighting is that one should be careful in drawing inferences from the summary measures of firm performance. In particular, because underperforming firms have strong incentives to build political connections, lower performance in firms with politically connected CEOs than in those with non-connected CEOs does not contradict the view that

political connections are valuable to firms. Rather, the prevalence of political-business ties and the finding that connected boards counter CEO entrenchment, as documented in this paper, suggest that political connections are overall value-adding.

5. Conclusions

In countries with weak investor protection, minority shareholders have limited influence over management. Replacing underperforming CEOs therefore plays a crucial role in corporate governance. At the same time, CEOs in these countries, particularly those in privately controlled firms, are often politically connected as a means of increasing access to credit, as well as to regulatory favours and government financial assistance. Such connections have the potential to negatively impact CEO turnover. In this paper we provide insight into this overlooked issue by demonstrating that a credible threat of withdrawal of benefits or retaliation by politically connected CEOs makes it costly for firms to serve such relationships, even when the CEOs are destroying more firm value than they are creating. In such situations, political capital turns into political entrenchment.

Our evidence, based on a comprehensive dataset on forced CEO turnovers in Chinese listed non-SOEs, supports this argument. We find that a CEO's political connections reduce the likelihood of forced turnover and turnover-performance sensitivity. Such a reduction, however, is mitigated when firms have other forms of political power that serve to protect them from losing benefits or suffering from retaliation. More specifically, although forced turnover of non-politically connected CEOs leads to performance improvement in all firms, forced turnover of politically connected CEOs leads to performance improvement only in firms that are politically advantaged. These cross-sectional variations and the evidence on post-turnover performance distinguish the political entrenchment argument from alternative explanations for turnover patterns, such as superior managerial ability, being a member of controlling families or being promoted internally.

Whereas previous studies identify the value of political connections, this study identifies one of their negative externalities: the potential for political capital to lead to entrenchment when a gap in bargaining power exists between the firm and the CEO. Therefore, safeguard devices are necessary for the reciprocal relationship between firms and governments to function in a mutually beneficial way. Otherwise, it may result in inefficiency for the party with a disadvantaged bargaining position. Our findings suggest a very different perspective from previous studies and call for new theories that comprehend the real effect of political connections.

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