

# Princelings: Exploring a Special Type of Political Connection in Chinese Listed Firms in Their Operating Performance and Profit Distribution

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**11/23/2018**

## **Abstract**

In this paper we identify a new type of political connection, referred to as “princelings”, who are the descendants of prominent and influential senior communist officials in the People’s Republic of China. Relative to unconnected firms, “princelings” connected firms (PLGs) experience higher selling expenses than unconnected firms, but they still earn better operating profits. Moreover, PLGs pay lower cash dividend, and stockpile disproportionately larger retained earnings. We find that such behaviour is not due to either investment or precautionary motives. Overall, our findings suggest that princelings appear to add value to connected firms.

**Key words:** Political connection; Operating performance; Cash dividends; Retained earnings; China

**JEL codes:** G32 G35 G38

# 1. Introduction

This paper studies a popular new type of political connection among Chinese listed firms called “princelings”. These are younger generations of former national (or party) leaders who take up important positions in Chinese companies. According to our hand-collected sample, during the period of study from 1992 to 2011, a substantial proportion of approximately 15% of all A-listed Chinese firms have made such a connection.

The princelings political connection has many unique features. These politically related youngsters are not active in business activities; yet they appear to have some association by birth in gaining access to society’s economic and financial resources. Hence, a princeling’s decision to join a company enables the use of their personal power to make it more profitable. This study provides empirical evidence to describe their distinctive attributes with respect to operating business activities and profit distribution actions.

This study first analyses whether princeling-connected firms (PLGs) have greater operating performance and growth opportunities than matching firms. Net cash flow from operating activities divided by total assets (NOC), return on assets (ROA) and net income (NI) are used to measure operating performance, and the change ratio on sales proxies for growth. Using OLS regressions, this study finds that all the measurable variables are significantly positively related to these political connections. This finding that PLGs outperform their counterparts in business activities, is consistent with the view that political connections improve Chinese family firm’s operating performance (C. J. Chen, Li, Su, and Sun, 2011; Xu, Xu, and Yuan, 2013).

The second test investigates whether the princeling connections generate additional costs relative to non-connected matching firms. The results reveal that PLGs experience relatively greater selling expenses. This finding is consistent with prior research suggesting that to build and maintain political ties; connected firms in China incur greater expenditures on social activities and entertainment (Liang and Chen, 2012).

The last set of tests focus on how PLGs allocate profits among investors at the profit sharing stage. This study finds that PLGs stockpile disproportionately larger retained

earnings but pay lower cash dividends, compared to unconnected firms. An examination of the components of retained earnings to net incomes reveals that, PLGs have higher average changes in retained earnings than unconnected firms by 3.8%. However PLGs pay 4.27% lower cash dividends than unconnected firms by 4.27%. Further evidence reveals that such behaviour in PLGs is not due to either investment or precautionary motives.

The regression results are further substantiated by directly observing the movement of proxy variables in time charts. From these charts it is observed that the difference in performance between connected and unconnected firms starts from about 2001 when China became a member of the World Trade Organization and the Chinese economy began to develop rapidly. Therefore, the collective results of the tests and time trends support the conclusion that political connections lead firms to perform differently from their counterparts.

The results in this paper are important in several ways. First, an examination of the financial statements of listed firms belonging to families and associates of revolutionary leaders in China reveals that they vary systematically from other public firms. To the best of our knowledge, no previous research has examined firms with connections to political elites in China. Second, we document that although the princeling connections come at a cost in terms of higher selling expenses, they appear to provide a net benefit to their firms in terms of greater profitability. Third, using an agency theoretic perspective, this study sheds light on how listed Chinese firms with a princelings type to political connection allocate profits. This integrated approach indicates that politically connected firms pay lower dividends and stockpile greater retained earnings that are not used for investment or precautionary motives. Fourth, compared to prior international studies in the area, this study examines a longer period of time and focuses on a single country, which allows for cleaner interpretation of the results. Importantly, these contributions are beneficial with respect to insights regarding firm performance, and are highly relevant to Chinese stock market investors.

This paper proceeds as follows. Section 2 reviews the literature and develops hypotheses. Section 3 describes the data and reports empirical results. Section 4 presents time trend analysis. Section 5 concludes.

## **2. Literature review and hypothesis development**

### **2.1. Operating hypothesis**

In the Chinese setting, the effect of political connections is profound. China maintains a government-oriented economy, in which politicians and bureaucrats have a strong influence over resource allocation. A strong relationship with politicians makes PLGs more likely to gain key inputs controlled by the government, and is pivotal to firms' survival and sustainable growth. These key resources include business operation licenses, bank loans, land, and eligibility for favourable but discretionary government policies such as tax benefits and the waiver of "extra-legal" fees ((Brandt and Li, 2003; Cull and Xu, 2005; Li, Meng, Wang, and Zhou, 2008). The economic environment in China is characterised by weak investor protection, poor enforcement of property rights, and a high level of corruption (Allen, Qian, and Qian, 2005), so private firms seek to establish strong political connections in order to navigate the highly politicised environment (C. J. Chen et al., 2011; Li, Meng, and Zhang, 2006) .

This is known to be advantageous. Several studies show a phenomenon called "propping up" in state-owned firms, in which the government injects favourable assets without interfering with the rest of the operation (X. Chen, Lee, and Li, 2003; Jian and Wong, 2006; Liu and Lu, 2007; Peng, Wei, and Yang, 2011). "Propping" provides firms with a guarantee in the case of financial distress, which can be leveraged by political connectivity since these connections help firms access preferential treatment. Based on the above arguments, political connections in China may have a positive effect on firms' performance. For example, using survey data on privately owned enterprises in 2002, Li, Meng, and Qian (2008) find that good political connections and status make private entrepreneurs more likely to obtain preferential treatment, hence improving firms' profitability. Cheung, Jing, Lu, Rau, & Stouraitis (2009) find that central government connections improve shareholder value via related party transactions with public firms during the period of 2001-2002 in the Chinese stock market.

Given that political connections are key in the Chinese business environment, this paper explores the impact of princelings political connections on listed firm's operating performance and profit distribution. Extant studies on the Chinese market define political

connections differently. Usually, they use state ownership or local politicians on the board to measure political ties. Instead, the political connection defined in this study defines is the connection with families or associates of revolutionary leaders of the Communist Party of China (CPC). This has not been examined previously. The political connections defined in this study distinguish the firms' ability to extract value from such relationships, and may reveal that those firms without strong political connections lack the benefits enjoyed by PLGs. Therefore, the operations of firms selected by the princelings may be more prosperous with respect to operating profits. Accordingly, higher operating performance and better growth an opportunity by PLGs is posited in Hypothesis 1.

*Hypothesis 1: Firms connected to princelings outperform unconnected firms in terms of operating performance and growth opportunities.*

**Variables:** *Profitability:* Net cash flow from operating activities deflated by total assets (NOC); and Net income deflated by total assets (ROA).

*Growth opportunities:* Annual sales growth rate (GROWTH).

Shlerifer and Vishny (1994) develop a general equilibrium model of the relationship between firms and politicians and notes there is a price between firms and politicians. The model has implications for the behaviour of both politicians and related firms. In order to build and maintain political ties, connected firms have a desire to reward their supporters by "gift-giving". The benefits of "gift-giving" can be either pecuniary or non-pecuniary, such as entertainments, luxury houses, cars and famous paintings. Such miscellaneous expenditure should ultimately be reflected in the cost of sales. According to Liang and Chen (2012), an indirect way to examine such operational tunnelling is to trace selling expenses as a percentage of total assets. This indirect approach is motivated by the Chinese cultural practice that business deals are normally conducted through social/entertainment activities. The most common type of entertainment is to enjoy an expensive meal with associates at a nice restaurant. In practice, Chinese firms often use the "Selling expenses" account to cover these expenditures. Therefore, we infer that the selling expense is higher in PLGs.

*Hypothesis 2: PLGs have higher selling expenses*

**Variables:** Selling expenses deflated by total revenues (SEXP).

## **2.2. Distribution hypothesis**

A recent study on the Chinese market by Qian, Pan, & Yeung (2011) shows that expropriation of minority shareholders by insiders is far more severe in politically connected firms when the aim of political ties is to ensure access to bank financing. Based on cross-country studies by Chaney, Faccio, & Parsely (2011) and Chen, Ding, & Kim (2010), they argue that political connections are a reflection of a firm's agency problems and governance quality. From a corporate governance perspective, political connections may intensify dominant shareholders' incentives to expropriate minority shareholders' wealth, as political connections shield related firms from market punishment for insider misconduct. In addition, political connections can increase information asymmetry arising from the separation of ownership and control (Chen et al., 2011). In a nutshell, one can conclude that the existence of preferential access to bank loans, together with the existence of less sensitivity to market penalties and close relations with politicians provide controlling owners with incentives and opportunities to extract private control benefits.

The degree of the expropriation could possibly be influenced by adequate corporate governance and the market punishment mechanism on the dominant owners. In an agency context, La Porta, Lopez – de – Silanes, Shleifer, & Vishny (LLSV) (2000a) state that investors have a preference for cash dividends (bird in the hand argument) over retained earnings (bird in the bush), because the latter might never materialize as future dividends. In their "outcome model", firms in countries with better investor protection pay higher dividends than in countries with poor protection, given the same investment opportunities and growth prospects. As investor protection is quite poor in China, this suggests that dividend payments should be lower than in other countries. Accordingly, if PLGs are more likely to expropriate through profit distributions, then they will pay cash dividends as low as possible and hence retain as much excessive earnings as possible.

Under agency cost theory, unless a firm's profits are paid out as dividends, corporate insiders may divert cash flow for personal use or pursue unprofitable investment projects. Dividend payouts can be seen as a means to reduce the free cash flow that insiders can

use at their own discretion (M. Jensen and Meckling, 1976; M. C. Jensen, 1986; Lang and Litzenberger, 1989). Hypothesis 1 of this study posits that PLGs have better operating performance, thereby implying they do not commit tunnelling through operations. Motivated by the agency theory, we propose that through lower payment of dividends. PLGs have more opportunities to appropriate firm resources for the private benefit of insiders. Firstly, in an environment with poor investor protection, controlling owners can effectively determine how profits are allocated among shareholders and hence are capable of using these earnings for their private benefit. According to Bradford, Chen, and Zhu (2013) and Lee and Xiao (2002), as a result of the institutional background and especially due to highly concentrated ownership in Chinese listed firms, minority shareholders have less power to force management or controlling shareholders to implement dividend policies. Recent empirical papers suggest that dividend policies might be used by the controlling shareholders to engage in tunnelling, due to the differential pricing for tradable and non-tradable shares during the IPO stage (D. Chen, Jian, and Xu, 2009; Zhang, 2008). As a result, controlling shareholders may prefer to stockpile the excess earnings rather than pay dividends to individual investors. Therefore, this paper posits hypothesis as follows.

*Hypothesis 3: Princelings-connected firms are more likely to maintain higher retained earnings and pay lower cash dividends than unconnected firms.*

**Variables:** *Distribution:* Total cash dividends deflated by total assets (DIV); and Retained earnings deflated by total assets (RETAIN).

### **3. Data and empirical results**

#### **3.1. Sample**

This paper considers a firm to be connected to a princeling if at least one of its shareholders or one of its top officers (CEO, president, vice-president, chairman, secretary, or independent directors) is a member, or associate of revolutionary leaders, of the Communist Party of China (CPC). We manually collect details of PLG firms between 1993 and 2011 from IPO prospectuses, journals, and financial websites.



The final sample consists of 381 PLGs listed on the Shanghai and Shenzhen stock exchanges. We then match these connected firms with non-connected firms. First, a potential match is any firm from the same industry but not identified as politically connected. Next, the unconnected matching firm is chosen as the one with the nearest listing year and the same normal trading status as the connected firm. This matching procedure is done without duplications, to reduce bias.

This sample excludes financial companies due to their unique financial structure, regulatory requirements, and accounting standards. Therefore, the final sample includes 8387 firm-year observations, covering the period from 1993 to 2011. Data from the three financial statements; balance sheet, income statement, and cash flow statement (direct) are accessed from the CSMAR database. Cash flow statement data is only available since 1998 when the Chinese accounting system first required listed firms to disclose both the direct and indirect cash flows.

Table 1 provides a description of the sample. Panel A indicates the IPO year of sample PLGs over the sample period 1992 to 2011. This largely mirrors the overall pattern of IPOs in China. Two decades ago there were only 40 newly listed stocks, but by 1997 the number increased rapidly to 209 in 1997. PLGs are unevenly distributed across the sample period, with the number of connected firms increasing from 1992 to 1996, but then remain around 20 until 2005, when it fell to 2. In 2005, there were only 15 newly listed stocks with the abnormally low level of IPO activity reflecting the impact of several regulatory actions that restricted the flow of IPOs to the market<sup>1</sup>. The Chinese stock market had undergone substantial changes in 2005, one of which was the NTS (non-tradable share) reform which gradually makes all non-tradable shares become tradable. Before 2005, the Chinese government still partially controlled share issue privatisation (SIP) firms, impacting the market's development and expansion (People's Daily, June 28, 2005). A consequence of the NTS split-share structuring reform was a reduction in IPOs. Therefore, the sample period is divided into two phases: 1992 to 2004; and 2005 onwards.

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<sup>1</sup> From time to time, market observers have identified some problems with China's IPO system, such as underpricing caused by fixed P-E ratios or issuance quotas. To overcome these problems the CRSC has issued many corresponding reforms. One such freeze was implemented in 2005, lasting from May 2005 to June 2006.

Panel B reports the pattern of cross-industry variation among PLGs. The Industrial category has the highest percentage of PLGs (57.74%), followed by Conglomerates (23.62%), Public Utilities (7.61%), Commerce (6.56%), and Properties (4.46%). Moreover, Panel C breaks down the subsamples of Industrial firms. Of the total 57.74% that are Industrial firms, food, medicine and chemical accounts for nearly 15.49%; this figure is followed by electrical manufacturing and transportation & power, which account for 13.39% and 12.34%, respectively.

### **3.2. Univariate analysis**

Table 2 provides the results for all of the tested variables. The top and bottom 1% of each variable are winsorized to minimise the effect of outliers. The summary statistics report the mean and median explanatory variables for all years in Panel A (1993-2011), the sub-period 1993-2001 in panel B, and 2002-2011 in panel D. In total, there are 7537 firm-year observations.

The variables in each panel are grouped according to the three tested hypotheses. For the first hypothesis, the explanatory variables measure accounting performance (NOC&ROA) and growth opportunities (GROWTH). Panel A shows that connected firms have 1.6% (1.1%) higher mean (median) returns (ROA) and 5.0% (4.2%) higher mean (median) sales growth (GROWTH) than unconnected firms. Moreover, connected firms have higher mean (median) net operating cash flow (NOC) than unconnected firms, by 1.5% (1.5%). The differences in the mean (median) values between connected and unconnected firms are mostly statistically significant at the 1% level. In addition, connected firms have 7.6% (9.1%) significantly (at the 1% level) greater cash received from sales and goods (OCTA) than unconnected firms in terms.

Panel A of the table also shows the descriptive statistics for variables that proxy for selling expenses in Hypothesis 2. The mean (median) of “Selling expenses” for connected firms is higher than for unconnected firms, with a difference of 0.8% (0.24%). Both the differences between the two groups are positive, at a significance level of 1%. The immediate comparison of “Selling expenses” supports Hypothesis 2.

The last group within Panel A reports the statistics for variables used to test Hypothesis 3. At first glance, it can be seen that cash dividends relative to total assets are similar between the two groups. However, when comparing retained earnings, the difference between the connected and non-connected firms is found to be disproportionately high (7.5% versus 4.6% in mean value). These initial findings are consistent with the suggestion that larger retained earnings may give connected firms opportunities for potential extraction of private benefits.

To interpret the observed difference in retained earnings, this study also investigates the possibility of two other explanations; investment motivation, and precautionary motivation. We would expect to see more investment in fixed assets if funds were retained for reinvestment, or higher cash/cash equivalents if a precautionary motive is true. To test these two explanations this study uses the ratio of net fixed assets to total assets (CAPEX) as the proxy for investment motives, and the ratio of cash & cash equivalents to total assets (CASH)<sup>2</sup> as the proxy for precautionary motives. Interestingly, the difference between the groups for the mean (median) of net fixed assets (CAPEX) is negative (at the 10% or 5% significance level in mean or median). By contrast, PLGs hold more cash & cash equivalents (CASH) compared to unconnected firms, by 0.8%. This finding is consistent with either a precautionary motive or opportunities for private extraction incentives rather than investment reasons. Although it is hard to disentangle these two competing incentives between private benefit extraction and precautionary reasons, this study presents a more comprehensive analysis below to add insight into an agency cost explanation for firm retention of earnings.

Comparing the two sub-periods illustrated in Panels B and C, there are two aspects that deserve comment. First, it can be seen that both the mean (median) of each variable for testing Hypothesis 1 increases over the period from 2000 to 2011. This finding is consistent with the overall growth in China's economy after the entry to the WTO at the end of 2001. Second, compared to the full sample period reported in Panel A, Panel B shows that the differences in means for each variable during the period of 1993-1999 are fairly small and insignificant. In contrast, Panel C show a quite similar pattern to that

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<sup>2</sup> The literature puts forward several reasons to explain the incentives of firms to keep cash. For example, Jensen (1986) and Stulz (1990) argue excessive cash holding leads to agency conflicts. While Boubakri, El Ghoul, and Saffar (2013) show PLGs hold more cash than non-connected firms to meet political agendas. This is supportive of our expropriation incentives through retained excessive earnings by PLGs.

reported in Panel A. This evidence suggests that connected firms perform differently since 2001, the year China first became a member of the WTO. Hence, the major operating differences between princelings and the matching firms started in the later period after 2001. This is consistent with the conclusion drawn from the observed difference in retained earnings (Figure 1.C). The precautionary motive (reflected by higher cash reserves) or expropriation opportunities are again supported in this period; and the investment motivation is not supported.

Overall, the between-group T-test results are supportive of the systematic operating superiority of PLGs relative to their matching firms in terms of revenue and profitability. Considering the distribution of these profits, the univariate comparisons of dividend payments, retained earnings, and surplus reserves reveal a major difference in the retained earnings but not in the level of dividends paid. These findings warrant further investigation in the next section to provide an explanation.

### **3.3. Multivariate analysis**

The univariate tests provide preliminary support for our hypotheses, and this section extends the analysis to a multivariate framework. Unreported analysis finds the correlation coefficients between the explanatory variables are small, so multicollinearity is unlikely to affect our results. Both firm and year fixed-effects are included in the panel data regressions to control for the possibility that unobserved firm- and year-specific attributes may affect the results.

The empirical model used for testing Hypotheses 1 and 2 is as follows:

$$INDICATOR = \alpha + \beta_1 PC + \beta_2 CONTROL + \varepsilon$$

For the testing of operating performance, *INDICATOR* refers to net cash flow, accounting performance (ROA), or growth opportunities (Growth). For the testing of profit distributions, *INDICATOR* refers to dividend payments (DIV) or retained earnings (RETAIN). *PC* is our main variable of interest, indicating whether or not a company belongs to the families or associates of national leaders in China. It is a dummy variable equal to one if the firm is a PLG with connections to the associates and families of revolutionary CPC leaders, and zero otherwise. *CONTROL* refers to a set of firm-level control variables that may affect our main results and includes: leverage (Leverage), size,

market to book ratio of assets (MB), and the percentage ownership of the largest owner (Largest). It also includes a set of variables to control for board characteristics; the number of directors on the board (Board), the number of independent directors (Independent), the average director age (Age), the average score of director education level (Education), and the background of directors (Background).  $\varepsilon$  is an error term.

The focus in this study is on the coefficient  $\beta_1$ , which measures the sensitivity of performance and expropriation to firms' political connectedness.

### **3.3.1. Hypothesis 1: Political connections, operating performance and growth opportunities.**

The dependent variables are operating performance and growth opportunities. The firms' operating performance and profitability are measured as the ratio of net cash flow from operating activities divided by total assets (NOC) and return on assets (ROA). Growth opportunities are proxied by the change ratio in sales (Growth).

The measurement of the control variables is described below. Firm size (Size) is the log of total assets, Leverage is total liabilities divided by total assets, MB is the market to book value of total assets (MB), and Largest is the percentage ownership of the largest shareholder. The ownership variable controls for the possibility that a politician's rent-seeking incentives depend on the controlling shareholders' ownership stake in the firm. In addition, board characteristics are controlled using the following variables; Board is the log of number of board directors, Independent is the percentage of independent directors on the board, Age is the average age of directors on the board, Education is the average education level of directors on the board, and Background is the number of directors who used to work, or are currently working, for universities or research institutions. All definitions are described in Appendix 1.

Table 3 shows the results of the OLS regression on the relation between political connections, and operating performance (models 1-4) and growth opportunities (models 5-6). The multivariate regression results reveal a positive relationship between political connections and firm operating performance or growth opportunities. The coefficient on the dummy variable PC is positive and statistically significant across all specifications, at

the 1% level (except model 2). The effect is also economically significant given the mean differences of 1.6% for NOC, 1.6% for ROA and 5% for GROWTH between the two groups of firms. Regarding the control variables, leverage has a negative effect on firms' operating performance and growth opportunities, whereas both firm size and number of directors have positive explanatory effects.

Consistent with the Hypothesis 1 prediction, the multivariable regression results confirm the univariate results in Table 2 that connected firms outperform the unconnected matched firms in terms of operating performance and growth opportunities. The result is in contrast with a negative and perhaps dominating view in the literature that PLGs underperform their unconnected peers (Sun & Tong, 2003; Fan et al., 2007).

### **3.3.2. Hypothesis 2: political connections and Selling expenses**

This study uses the ratio of selling expenses over total assets/revenues to proxy for political cost. When a firm is politically connected, additional expenditures are necessary to maintain good relationships with government officials. As a consequence, such uses of firm funds should be higher in firms with political connections. In practise, Chinese listed firms often use the account "selling expenses" to cover these. Alternatively, one may argue that an observation of higher expenses in connected firms could be for tax minimisation motives. Therefore, models 1 and 2 in Table 4 include the control variable of tax payments (Tax).

Model 1 shows that the ratio of selling expenses over total assets is positively related to political connections, with significance at the 1% level. But after controlling for governance variables in model 2, it becomes insignificant. Moreover, it is possible that the higher selling expenses in politically connected firms could alternatively be explained by their higher total revenues rather than representing extraordinary expenditures on politicians. To rule out this concern, the ratio of selling expenses over total revenues is used, and the results are given in models 3 and 4. The coefficients on the main interest variable PC in models 3 and 4 are 0.3% and 0.1%, respectively. The former is significant at the 10% level, but the latter is insignificant. Collectively, the results of the two tests presented in models 1 to 3 in Table 4 are consistent with the view that the positive relationship between political PC and SEXP suggests the use of selling expenses as a

mechanism to establish or maintain political ties; however, after controlling for corporate governance issues the relationship disappears.

### **3.3.3. Hypothesis 3: Political connections and profit allocations**

So far, the results in Table 3 suggest that political connections increase a firm's profitability. A natural question is whether or not political connections influence the distribution of a firm's earnings. Low payment of dividends may allow insiders better opportunities for expropriation, so the third hypothesis predicts that connected firms are more likely to retain larger earnings during profit allocations.

Model 1 in Table 5 shows that the coefficient on PLGs is significantly negative at the 10% level for cash dividend payments (DIV) at the 10% level, while model 2 shows that the coefficient on PLGs is significantly positive at the 1% level for retained earnings (RETAIN). These findings are consistent with the explanation that connected firms prefer to retain earnings rather than pay out cash dividends. This increases the possibility that the earnings retained are available to be expropriated by insiders. However, the higher retention of earnings by PLGs could also be explained by two other sound economic incentives; investment, and precautionary motives.

The investment motivation is based on pecking order theory. Internal funding is cheaper than issuing dividends and floating new securities (Easterbrook, 1984) because of informational asymmetries between insiders and external investors (Myers and Majluf, 1984). Hence, firms tend to prefer using internal funds (such as retained earnings) to finance profitable investment opportunities. Accordingly, PLGs may accumulate excessive earnings in order to reduce transaction costs associated with external financing in imperfect capital markets. The second possibility concerns precautionary reasons. That is, firms' retention of excess operating cash flow can be a deliberate choice for precautionary motivations. According to this view, firms' accumulation of earnings is more or less automatic, because having sufficient retained earnings can provide a cushion for unanticipated events, such as a global crisis.

To mitigate the first consideration with respect to investment motives, models 3 and 4 in Table 5 re-run the model 2 regression by adding the ratio of net fixed assets over total assets (CAPEX) as a proxy for investment opportunities and an interaction term

CAPEX\*PC. In both models 3 and 4 the coefficients of fixed asset investment (CAPEX) are significantly negative. The negative relationship between fixed assets and retained earnings is not supportive of an investment motivation. The coefficients on PC in models 3 and 4 remain positive and significant at the 1% level, supporting the notion that PLGs retain more of their earnings.

To mitigate the second concern with respect to precautionary motives, we control for precautionary motives in Table 5 by adding the ratio of cash & cash equivalents over total assets (CASH) in model 5 and by further including the interaction term, CASH\*PC, in model 6. The coefficients on CASH are significantly positive in both models 5 and 6, consistent with the precautionary motive, although the interaction term CASH\*PC is not significant. Nevertheless, with precautionary motives controlled, a positive relation remains between PC and retained earnings in model 5 (1% level of significance).

Overall, the results reported in Table 5 are consistent with the proposition in Hypothesis 3 that firms with princeling connections maintain greater retained earnings and lower cash dividends. Further, the evidence suggests that the stockpiling of resources is not for investment or precautionary motives.

### 3.3.4. Unsolved Puzzle in Retained earnings

To shed further light on the distribution of profits, this section directly tests components of retained earnings by PLGs by decomposing the distributable profit process using the following accounting equations:

$$\text{Distributable profits} = \text{Net income} + \text{Retained earnings}_{T_0} - \Delta \text{Surplus reserves} \quad (1)$$

$$\text{Retained earnings}_{T_1} = \text{Distributable profits} - \text{Cash dividends} \quad (2)$$

Substituting equation (1) in equation (2), we get equation (3):

$$\Delta \text{Retained earnings} = \text{Net income} - \Delta \text{Surplus Reserves} - \text{Cash dividends} \quad (3)$$

Any adjustment for changes to retained earnings allowed by accounting regulations must also added this into the equation. Thus, we express it as:

$$\Delta \text{Retained earnings} = \text{Net income} - \Delta \text{Surplus reserves} - \text{Cash dividends} + \text{Adjustment} \quad (4)$$



As shown in Table 6, over the whole time period of 1994-2011, on average, a connected PLG firm earns 1.80 times more net income (NI) than an unconnected firm, being RMB 234.92 million and RMB 130.87 million, respectively. Nevertheless, the relative difference in retained earnings ( $\Delta RE$ ) is even greater. The mean  $\Delta RE$  in connected firms of RMB 132.45 million is 1.92 times more than that of unconnected firms.

Table 6 also analyses the distribution ratios relative to NI. Relative to a 100% level of NI, an average PLG pays 32.88% as dividends while a typical unconnected firm pays dividends at a rate of 37.15%. The net difference between the two groups is 4.27%. As for retained earnings, an average connected firm keeps 56.38% of NI while the matched firm retains 52.58%; the 3.80% net difference.

The above results provide a more detailed picture of lower dividends and greater retained earnings in PLGs. An average politically connected firm produces more net income, and pays a lower proportion of this out as dividends, leaving a higher proportion in retained earnings. According to the balance sheet, the higher accumulated retained earnings in PLGs could be reflected in asset accounts growing larger than non-PLGs, liability accounts declining faster than the matched firms, or a reduction in other equity accounts. To answer this question, we further investigate asset accounts and liability accounts between PLGs and non-PLGs through time trend analysis in section 4.

#### **4. Time trend analysis**

One drawback of this study is that we do not know the date on which each firm's PLG connection started and/or ended. This drawback potentially biases against finding significant differences between the PLG sample and the non-PLG matched firms, because it is possible that the princeling-connection for any given firm did not persist through-out the entire sample period. Therefore it is likely that the actual differences between PLGs and matched firms are stronger than is reflected in our results. A further issue is that, we cannot test the causality between the princeling connection and higher profitability. The question remains whether the higher observed profitability of PLGs arises after the initiation of the PLG connection, or whether princelings deliberately choose to be affiliated with more profitable firms.

Nevertheless, we can shed some light on this by observing the time line of political connections. Economic expansion in China started after the beginning of the current century. In the first of our sample period (1994 to 1999), the difference of net income between PLGs and non-PLGs is -0.21% (Table 6). Yet, the difference in net income in the second period (2006-2011) is 19.16% (Table 6). This difference supports the notion that PLGs outperform non-PLG through operating performance after they are selected by princelings. The sharp increase supports the idea that princeling connection has introduced some new value into the connected firms.

Prior research particularly emphasises endogeneity issues in OLS regressions because it is not possible to infer causality from the results reported (see Faccio et al., 2010). In other words, the potential concern for the regression is that political connections may not be exogenous. Some unobserved determinants may explain the differences between connected firms and their counterparts. Hence, the causality problem can make the results of OLS regression biased and inconsistent.

This study attempts to resolve endogeneity concerns by looking into the time trends in the changes of accounting performance. Specifically, it covers a sufficiently long time horizon from 1993 to 2011 to provide us with a greater variety of information reflecting the dramatic changes that have taken place in firms with political connections. For example, firms may be more likely to seek political connections when they lack management or production efficiencies, but gain their competitive edge through political connections or outright bribery. In this scenario, political connections would lead to differences in firm performances before and after the establishment of political ties. If so, we could then find time trend changes in accounting performance for connected firms. Alternatively, it could be that these types of firms tend to seek strong political ties because they are more successful in business operations (more competitive). In this case, rent seekers are also efficient firms who are likely to invest in political relations because they are affordable. If so, the political connection is an expected risk with no economic outcome and, as such, it may be that no changes are observed in accounting performance by connected firms across time, relative to the matching firms. Therefore, to examine the consequences of political cronyism, this time approach is cleaner than running regressions.

Figure 1 compares the average ratios of total revenue (A), net cash flow from operating activities (B), net income (C), and selling expenses (D) standardized by total assets.

Before 2000, all figures show similar average ratios for both groups. In contrast, reviewing the time path from about 2000 onwards, the ratios for PLGs are generally higher than unconnected firms, with the gaps consistently sustained from 2001. The systematic differences in operating performance between PLGs and the matching unconnected firms in operating performance are consistent with a view that the superior performance of PLGs is the result of political connections. This is consistent with the first hypothesis regarding better growth opportunities and operating performance. Instead of paying higher dividends, PLGs keep a disproportionately higher level of retained earnings.

As mentioned in section 3.3.3, PLGs accumulated higher retained earnings should be mirror reaction in increasing asset accounts, declining liability accounts, or reducing other equity accounts. Figure 1 compares the mean ratio of current assets (E), current liabilities (F) and share capital (G) standardized by total assets. We observe that PLGs have higher current assets and lower total current liabilities than non-PLGs after 2001, which is again consistent with the time pattern in ROA (C). Moreover, the share capital in both PLGs and matching firms declined during sample time period from 1993-2011. However, PLGs' share capital declines faster than unconnected firms after 2001, which can potentially explain where the higher retained earnings accumulated by PLGs is going. For example, one potential explanation is that PLGs are repurchasing shares in order to prop up share prices, which in turn rewards investors with capital gains. In summary, Figure 1.E-G show the mirror image of higher retained earnings in PLGs.

## 5. Conclusions

This paper investigates Chinese listed firms with a special type of political connection, namely princelings, who are the descendants of prominent and influential senior Communist officials in the People's Republic of China. This study empirically investigates the predicted qualities of the princeling politically connected firms. By comparing PLGs with the industry-matched sample firms, this study produces strong evidence of a strong positive relation between political connections and measures of operating performance as well as growth opportunities. Even though PLGs show higher

selling expenses than unconnected firms, they have greater profitability. This finding suggests that PLGs are more prosperous compared to their counterparts, which means that the princeling connection is valuable.

Second, this study examines how PLGs distribute profits. Consistent with LLSV (2000), this paper finds that PLGs pay lower cash dividends and thereby keep disproportionately larger retained earnings that are not used either for investing opportunities or precautionary reasons. To better understand the motivations behind the accumulation of retained earnings, this study analyses the components of retained earnings during profit allocations and finds that PLGs have higher changes in retained earnings but lower change in cash dividends than unconnected firms<sup>3</sup>. Nevertheless, none of the evidence reported here is consistent with expropriation of funds by PLG insiders.

As it is not possible to infer any causality from the results reported from the OLS regression, this study also investigates the time trend of the main variables used to test the hypotheses in this paper. The systematic patterns observed from the time trends are supportive of the notion that political connections affect firms' operating activities and profit allocations. The timing of changes in performance among connected firms is also important. PLGs systematically perform differently from unconnected firms effective from 2000, when China experienced rapid economic growth as a member of the World Trade Organization.

One question that this study is unable to resolve concerns the mechanism behind the documented large portion of retained earnings in Chinese listed firms. Given the sheer scale of this study, it is suspected that the answer to this question is rather extensive and complex. What can be stated is that princelings type political connections appear valuable, but it is not clear why PLGs stockpile retained earnings. We hope this study could trigger further analyses to investigate the source of our documented effects and better explain the value effects to outside investors.

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<sup>3</sup>These findings are still informative as they are supportive of the argument that Chinese PLGs tend to pay lower dividends on average.

## APPENDIX

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### Appendix 1: Variable Definition

This appendix table provides definitions of the variables employed in this paper.

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Variable	Definition
PC	Dummy variable equal to 1 if the firm is politically connected and 0 otherwise.
<i>Hypothesis1</i>	
OCTA	Cash received from sales of goods divided by total assets
OCPTA	Cash paid for goods and services divided by total assets
NOC	Net cash flow from operating activities divided by total assets
TURNOVER	Total sales divided by total assets
COGS	Total operating expenses divided by total assets
ROA	Net income divided by total assets
GROWTH	Total revenue growth rate, $(\text{Total revenue}_{t1} - \text{Total revenue}_{t0}) / \text{Total revenue}_{t0}$
<i>Hypothesis2</i>	
SEXP	Selling expenses divided by total assets
<i>Hypothesis3</i>	
DIV	Total cash divided by total assets
RETAIN	Retained earnings divided by total assets
CAPEX	Total net fixed assets divided by total assets
CASH	Total cash and cash equivalents divided by total assets
<i>Control variables</i>	
Size	Natural logarithm of total assets
Leverage	Total liabilities divided by total assets
MB	Market to book ratio of assets
Largest	The percentage ownership of largest shareholder
Board	The logarithm of total number of directors on the board
Independent	Ratio of independent directors to total number of directors
Age	The average age of directors on the board
Education	The average of the education level of the directors (ranges from 0-4)
Background	Directors who used to work or are currently working for universities or research institutions.

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**Table1. The sample**

Panel A: By year			
listing Year	No. of connected firm's IPO	Total No. of A-share's IPO	% of total A-share IPOs
1992	5	40	12.5%
1993	13	129	10.1%
1994	18	107	16.8%
1995	6	28	21.4%
1996	34	206	16.5%
1997	39	209	18.7%
1998	24	104	23.1%
1999	16	96	16.7%
2000	27	131	20.6%
2001	15	75	20.0%
2002	16	71	22.5%
2003	21	67	31.3%
2004	21	100	21.0%
2005	2	15	13.3%
2006	14	66	21.2%
2007	25	126	19.8%
2008	12	77	15.6%
2009	21	99	21.2%
2010	27	349	7.7%
2011	20	282	7.1%
2012	5	155	3.2%
total	381	2532	15.0%
Panel B: By industry classification A		% of total connected firms	
Public utility	29	7.61	
Properties	17	4.46	
Conglomerates	90	23.62	
Industrials	220	57.74	
Commerce	25	6.56	
Total	381	100	
Panel C: (within Industrials)		% of total connected firms	
Food, medicine & chemical	59	15.49	
Electrical manufacturing	51	13.39	
Transportation & power manufacturing	47	12.34	
Metallic manufacturing	25	6.56	
Culture, office & education goods	21	5.51	
Oil, rubber & fibre	17	4.46	
Total	220	57.74	



**Table 2. Descriptive statistics**

OCTA is the ratio of cash received from sales of goods divided by total assets. OCPTA is cash paid for goods and services scaled by total assets. NOC is net cash flow from operating activities scaled by total assets. TURNOVER is total revenues scaled by total assets. COGS is total expenses scaled by total assets. ROA is net income scaled by total assets. GROWTH is the change ratio of total revenues. OREC is net other receivables scaled by total assets. SEXP is selling expenses scaled by total assets. DIV is cash dividends scaled by total assets. RETAIN is retained earnings scaled by total assets. CAPEX is fixed assets scaled by total assets. CASH is cash & cash equivalents scaled by total assets.

	Mean			Median		
	Connected	Unconnected	Diff	Connected	Unconnected	Diff
Panel A: Whole sample period 1993-2011						
<i>Variables used for testing Hypothesis1</i>						
OCTA	0.732	0.655	0.076***	0.631	0.541	0.091***
OCPTA	0.524	0.496	0.028***	0.402	0.369	0.034***
NOC	0.061	0.046	0.015***	0.057	0.042	0.015***
TURNOVER	0.692	0.649	0.043***	0.599	0.538	0.061***
COGS	0.638	0.622	0.016*	0.536	0.503	0.034***
ROA	0.055	0.039	0.016***	0.051	0.04	0.011***
GROWTH	1.231	1.18	0.050***	1.187	1.145	0.042***
<i>Variables used for testing Hypothesis2</i>						
SEXP	0.047	0.039	0.008***	0.026	0.024	0.002***
<i>Variables used for testing Hypotheses3</i>						
DIV	0.025	0.024	0.001	0.018	0.017	0.001*
RETAIN	0.075	0.046	0.029***	0.074	0.064	0.010***
CAPEX	0.261	0.267	-0.006*	0.23	0.243	-0.013**
CASH	0.183	0.175	0.008***	0.145	0.135	0.010***
Panel B: sub-period 1993-2001						
<i>Variables for testing Hypothesis1</i>						
OCTA	0.577	0.543	0.034	0.482	0.424	0.060***
OCPTA	0.433	0.417	0.016	0.336	0.294	0.042**
NOC	0.037	0.035	0.002	0.035	0.033	0.002
TURNOVER	0.567	0.539	0.028	0.471	0.426	0.045***
COGS	0.519	0.504	0.015	0.425	0.379	0.046*
ROA	0.0502	0.043	0.0071**	0.056	0.051	0.005***
GROWTH	1.179	1.163	0.016	1.125	1.1	0.025
<i>Variables used for testing Hypothesis2</i>						
SEXP	0.031	0.030	0.001	0.019	0.018	0.001
<i>Variables used for testing Hypotheses3</i>						
DIV	0.032	0.029	0.003**	0.025	0.022	0.003**
RETAIN	0.037	0.034	0.003	0.044	0.044	0.000
CAPEX	0.264	0.254	0.01	0.237	0.231	0.006
CASH	0.142	0.142	0.000	0.109	0.111	-0.002
Panel C: sub-period 2002-2011						
<i>Variables used for testing Hypothesis1</i>						
OCTA	0.762	0.681	0.081***	0.663	0.570	0.093***
OCPTA	0.542	0.514	0.028**	0.419	0.390	0.029***
NOC	0.066	0.048	0.018***	0.062	0.045	0.017***

TURNOVER	0.729	0.684	0.045***	0.643	0.585	0.058***
COGS	0.672	0.658	0.014	0.576	0.545	0.031**
ROA	0.056	0.037	0.019***	0.049	0.036	0.013***
GROWTH	1.245	1.185	0.060***	1.201	1.156	0.045***
<i>Variables used for testing Hypothesis2</i>						
SEXP	0.052	0.042	0.010***	0.029	0.025	0.004***
<i>Variables used for testing Hypotheses3</i>						
DIV	0.023	0.022	0.001	0.016	0.015	0.001
RETAIN	0.087	0.049	0.038***	0.088	0.072	0.016***
CAPEX	0.259	0.271	-0.012***	0.228	0.249	-0.021***
CASH	0.195	0.185	0.010***	0.155	0.142	0.013***

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**Table 3. Political connections, operating performance and growth opportunities**

This table presents OLS regression results of the relationship between political connections and firms' operating performance and growth opportunities. NOC is the ratio of net cash flow from operating activities divided by total assets. ROA is net income divided by total assets. GROWTH is the change ratio of sales. A firm is defined as PC when it is politically connected. All other control variables are defined in Appendix A. The P-values are reported in parentheses. Superscripts \*, \*\*, \*\*\* indicates significance at the 90%, 95% or 99% confidence levels, respectively.

Variables	NOC		ROA		GROWTH	
	1	2	3	4	5	6
PC	0.008*** (.0002)	0.008** (.0152)	0.007*** (<.0001)	0.007*** (.0023)	0.041*** <.0001	0.049*** 0.0002
Leverage	-0.057*** <.0001	-0.062*** <.0001	-0.153*** <.0001	-0.149*** <.0001	-0.054*** 0.0025	-0.036 0.2033
Size	0.012*** <.0001	0.007*** <.0001	0.022*** <.0001	0.019*** <.0001	0.056*** <.0001	0.063** 0.0338
Largest	0.000 0.3706	0.000** 0.0104	0.000 0.6716	0.000 0.4873	0.000 0.2346	0.001*** <.0001
MB	0.006 <.0001	0.008*** <.0001	0.011*** <.0001	0.012*** <.0001	0.022*** <.0001	0.034 0.9069
Board		0.025*** 0.0015		0.012** 0.0351		0.004* 0.541
Independent		-0.001 0.9648		-0.000 0.9634		0.054*** <.0001
Age		0.002*** <.0001		-0.000 0.8378		-0.008 0.7756
Education		0.005* 0.0974		0.001 0.6112		-0.003 0.3220
Background		0.002 0.7795		0.005 0.2832		0.025 0.3216
Intercept	-0.189*** <.0001	-0.264*** <.0001	-0.392*** <.0001	-0.362*** <.0001	-0.061*** 0.5044	0.110 0.4335
N	6029	2477	6072	2487	5808	2401
R-squared	0.06	0.11	0.32	0.38	0.04	0.06

**Table 4. Political connection and selling expenses**

This table presents OLS regression results of the relationship between political connections and firms' selling expenses. SEXP is selling expenses divided by total assets/ total sales. All other control variables are defined in Appendix A. The P-values are reported in parentheses. Superscripts \*, \*\*, \*\*\* indicates significance at the 90%, 95% or 99% confidence levels, respectively.

Variables	SEXP/T.Assets		SEXP/T.Sales	
	1	2	3	4
PC	0.003*** 0.006	0.001 0.9759	0.003* 0.084	0.001 0.6597
Tax	0.784*** <.0001	0.905*** <.0001	0.703*** <.0001	0.823*** <.0001
Leverage	0.006** 0.0239	0.014*** 0.0007	-0.002 0.5496	0.004 0.5716
Size	-0.003*** <.0001	-0.006*** <.0001	-0.011*** <.0001	-0.012*** <.0001
Largest	0.000*** <.0001	0.000*** <.0001	-0.001*** <.0001	-0.001*** <.0001
MB	0.000 0.2107	-0.001* 0.0526	0.001 0.1231	0.001 0.1143
Board		0.001 0.8738		0.002 0.7565
Age		0.000 0.5635		-0.001*** 0.0004
Education		0.011 <.0001		0.004 0.1434
Independent		0.035*** 0.0064		0.027 0.1808
Background		-0.014*** 0.0001		-0.016*** 0.0055
Intercept	0.080*** <.0001	0.104*** <.0001	0.304*** <.0001	0.361*** <.0001
N	5961	2442	5956	2441
R-squared	0.28	0.34	0.13	0.18

**Table 5. Political connections and profits sharing distribution**

This table presents the OLS regression results of the effects of political connections on profits allocations. DIV is total cash dividend payments divided by total assets. RETAIN is retained earnings divided by total assets. CAPEX is net fixed assets divided by total assets. CAPEX\*PC is an interaction term between CAPEX and PC. CASH is cash & cash equivalents divided by total assets. CASH\*PC is an interaction term between CASH and PC. A firm is defined as PC when it is politically connected. All other control variables are defined in Appendix A. The P-values are reported in the parentheses. A superscript \*, \*\*, \*\*\* indicates significance at the 90%, 95% or 99% confidence levels, respectively.

Variables	DIV		RETAIN			
	1	2	3	4	5	6
PC	-0.001*	0.013***	0.013***	0.022***	0.013***	0.006
	0.0844	0.0018	0.0027	0.005	0.0026	0.3988
CAPEX			-0.050***	-0.033*		
			<.0001	0.0593		
CAPEX*PC				-0.033		
				0.1582		
CASH					0.074***	0.057**
					<.0001	0.0058
CASH*PC						0.035
						0.1838
Leverage	-	-0.340	-0.339	-0.339	-0.320	-0.320
	0.033***	<.0001	<.0001	<.0001	<.0001	<.0001
Size	<.0001	0.041	0.041	0.041	0.041	0.041
	0.004***	<.0001	<.0001	<.0001	<.0001	<.0001
Largest	<.0001	0.000	-0.001	-0.001	0.000	-0.001
	0.001***	0.7131	0.9833	0.9537	0.834	0.8853
MB	<.0001	0.009	0.008	0.008	0.007	0.007
	0.003***	<.0001	<.0001	<.0001	<.0001	<.0001
Board	<.0001	0.016	0.019	0.018	0.016	0.016
	0.006***	0.124	0.0671	0.0687	0.1249	0.1245
Age	0.0017	0.001	0.002	0.002	0.001	0.001
	0.001	0.0005	0.0118	0.0052	0.0054	0.0096
Education	0.0005	-0.001*	0.012	0.011	0.011	0.011
	-0.001*	0.0905	0.0012	0.0018	0.0021	0.0014
Independent	0.0905	-0.008	0.030	0.026	0.027	0.024
	-0.008	0.1367	0.2883	0.3518	0.3499	0.3967
Background	0.1367	0.002	-0.017	-0.017	-0.017	-0.017
	0.002	0.1734	0.0391	0.0374	0.0401	0.0401
Intercept	-	-0.805	-0.809	-0.814	-0.828	-0.826
	0.088***	<.0001	<.0001	<.0001	<.0001	<.0001
N	<.0001	2353	2482	2485	2485	2485
R-squared	2353	0.25	0.45	0.46	0.46	0.46

**Table 6. Summary statistics on profit distributions**

This table presents the summary statistics on profit distributions across connectedness. NI is net income attributable to parent owners. DIV is cash dividends.  $\Delta$ SR is the net change in surplus reserves from year t+1 to year t.  $\Delta$ RE is the net change in retained earnings from year t+1 to year t. Adj. is regulation change adjustments from equation (4) in this paper. Panel A gives the value mean value of these variables. Panel B shows the mean percentage to net income attributable to parent owners.

	Panel A Mean Value (In Million)		Panel B Mean/NI			
	Connected	Unconnected	Connected	Unconnected	Diff.	Diff/Connected
<b>Whole period:1994-2011</b>						
NI	234.92	130.87	100.00%	100.00%	0.00%	0.00%
Div	77.23	48.61	32.88%	37.15%	-4.27%	-12.97%
$\Delta$ SR	29.77	18.59	12.67%	14.20%	-1.53%	-12.10%
$\Delta$ RE	132.45	68.81	56.38%	52.58%	3.80%	6.74%
Adj.	2.46	-2.22	1.05%	-1.7%	2.75%	261.78%
<b>Sub-period:1994-1999</b>						
NI	79.96	51.19	100.00%	100.00%	0.00%	0.00%
Div	23.87	14.67	29.85%	28.66%	1.19%	4.00%
$\Delta$ SR	27.12	15.56	33.91%	30.40%	3.52%	10.38%
$\Delta$ RE	12.62	8.18	15.78%	15.99%	-0.21%	-1.31%
Adj.	16.74	13.24	20.94%	25.86%	-4.92%	-23.50%
<b>Sub-period:2000-2005</b>						
NI	88.46	48.87	100.00%	100.00%	0.00%	0.00%
Div	47.88	29.89	54.12%	61.27%	-7.15%	-13.21%
$\Delta$ SR	23.46	16.69	26.52%	34.22%	-7.70%	-29.02%
$\Delta$ RE	29.57	6.96	33.42%	14.26%	19.16%	57.33%
Adj.	-10.20	-3.22	-11.53%	-6.61%	-4.92%	42.68%
<b>Sub-period:2006-2011</b>						
NI	382.76	218.11	100.00%	100.00%	0.00%	0.00%
Div	113.03	73.35	29.53%	33.63%	-4.10%	-13.88%
$\Delta$ SR	35.02	20.97	9.15%	9.61%	-0.46%	-5.07%
$\Delta$ RE	239.35	134.72	62.53%	61.77%	0.76%	1.22%
Adj.	7.59	-6.19	1.98%	-2.84%	4.82%	243.45%

**Figure1. The time trends of operating performance measures of the princelings connected firms (PLGs) and unconnected firms**

These charts plot the differences between PLGs and unconnected firms in the sample period.



