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Are Political Connections a Blessing or a Curse? Evidence from CEO Turnover in China

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ABSTRACT

Manuscript Type: Empirical
Research Question/Issue: This paper investigates the issue of forced CEO turnover in China and summarizes the economic consequences of political connections within the framework of corporate governance.
Research Findings/Insights: Using a large sample of listed firms in China from 2005 to 2008, we find that politically connected CEOs are less likely to be fired and that the sensitivity of forced turnover to firm performance is weaker for connected CEOs than for their non-connected peers. This suggests that CEOs in a transition economy tend to use their political resources for their own good. We also find a significantly positive relationship between the political connections of retained CEOs and future firm performance only when firm profitability is below the industry median. These findings suggest that the value of political connections is contingent on a firm's operating performance, and that the benefits of political connections may outweigh their costs when firms do not meet their profitability targets.
Theoretical/Academic Implications: This study is the first to examine how the political ties of CEOs relate to their forced turnover. It integrates agency theory with resource dependence theory and contributes to the ongoing debate on the role of political connections in emerging markets. It also takes a step toward reconciling the mixed evidence for the effects of political connections on firm performance by demonstrating a sharp difference between firms under different operating statuses.
Practitioner/Policy Implications: This study offers insights to policy makers who are interested in improving corporate governance in transitional economies such as China, where CEOs have close connections with the government. It also provides a deep perspective for the boards in politically connected firms, allowing them to deal with the relationship between top management and the government in a healthy way.

Keywords: Corporate Governance, Business-Government Relations, CEO Succession Policy, Emerging Market Economy

INTRODUCTION

There is a large body of literature on the impact of political connections on firm performance and market value. According to the resource dependence theory developed by Pfeiffer and Salancik (1978), political connections can help firms to obtain key resources, cope with various external uncertainties, and thereby increase firm value. Consistent with this view, Hillman (2005) finds that firms in heavily regulated industries have more former politicians on their boards than those in less-regulated industries, and thus have better accounting performance. However, the agency theory proposed by Jensen and Meckling (1976) argues that connected CEOs may utilize political resources for their own interests rather than the interests of shareholders. This raises the further question of whether a CEO's political connections are related to the principal-agent conflict and thus the quality of corporate governance, which has received little attention in the recent academic literature.

In this paper, we try to fill this gap by investigating the influence of political connections on forced CEO turnover, a key determinant of corporate governance. Shleifer and Vishny (1989) argue that CEOs can retain their positions by making manager-specific investments to stop outside investors from replacing them. According to this argument, political connections can be regarded as a type of manager-specific investment and thus lower the risk of forced turnover faced by connected CEOs. In particular, when a CEO's leadership is threatened by poor performance, the possibility of being replaced severely affects his or her personal reputation, career prospects, future wealth and so on

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(Morck, Yeung, & Yu, 2000; Stulz, 1988). In this situation, the political networks established by a CEO may become a personal umbrella and reduce the possibility of being dismissed due to poor performance. Furthermore, as CEOs' political connections help firms to gain better access to key resources controlled by the government, firm performance is less important when assessing the ability of politically connected CEOs, which would weaken turnover-performance sensitivity. Based on this supposition, we hypothesize that politically connected CEOs are less likely to be fired and that the relationship between forced turnover and poor performance is weaker for politically connected CEOs than for their non-connected peers.

Although political connections may affect normal selection mechanisms and interfere with the board's ability to discipline poorly performing managers, well-connected CEOs provide their firms with competitive advantages by keeping them in close touch with the government (Claessens, Feijen, & Laeven, 2008). When firm profitability is negative or below the industry median, politically connected CEOs face great pressure to meet their performance targets, which may prompt them to initiate their political connections. This suggests that the value of political connections may depend on firm operating performance. Hence, another fundamental question arises: what is the effect of retained CEOs' political connections on future firm performance? Are these effects significantly different between firms with different operating statuses?

In our study, we take China as an ideal setting in which to explore these issues for the following reasons. First, political connections are commonplace in China and have great influence on firm behavior. As a transition economy, China has a weak legal system to protect the rights of private investors (Allen, Qian, & Qian, 2005). In these circumstances, political connections become an important substitute for formal institutional structures (Li, Meng, Wang, & Zhou, 2008), and listed firms tend to appoint candidates who possess rich political connections (Fan, Wong, & Zhang, 2007; Xu & Zhou, 2008). In this respect, China provides a natural laboratory to study the nexus between business and politics and helps us develop a deeper understanding of the various economic consequences of political ties. Second, during China's process of economic liberalization, the political system has been highly decentralized, with various levels of the government having autonomous policymaking powers within their jurisdictions. The case of China therefore offers useful variation in the type of political connections that can be exploited to identify the relationships of interest.

Following a detailed analysis of the curriculum vitae of CEOs, we identify two categories (political experience and political identity) and construct a composite index to measure both the existence and the closeness of these connections. We find that politically connected CEOs are less likely to be fired and that the relationship between forced turnover and poor performance is weaker for these CEOs than for their non-connected counterparts. The results remain robust to a series of control variables and to various specifications of firm performance and political connections. Overall, these findings show that political connections may weaken the board's monitoring strength and undermine the quality of corporate governance.

We also investigate the effect of political connections of retained CEOs on future firm performance. After controlling for other factors affecting firm performance, we find that the accounting-based performance of firms with connected CEOs is better than that of those without. However, this positive effect is more pronounced in underperforming firms. Specifically, we find a significantly positive relationship between future firm performance and political connections only when current firm profitability is below the industry median. These results indicate that the value of political connections is contingent on actual firm performance and is stronger when firms fail to meet their performance targets.

Our findings contribute to the literature in several ways. First, we provide evidence to the ongoing debate on the exact role of political connections in transitional economies. According to Faccio (2006), connected firms are more prevalent in countries with weak legal systems and high levels of corruption. Li et al. (2008) also argue that political connections add additional value by bridging over the imperfect institutional structures of these countries. However, political connections are not a CEO's birthright, but rather a return on investment. When faced with the risk of being replaced, connected CEOs may use their political ties to reduce the risk of replacement. To the best of our knowledge, this study is the first to examine how CEOs' political ties relate to their forced turnover. Our evidence strongly suggests that political ties have an adverse effect on forced CEO turnover by reducing turnover-performance sensitivity. This expands our understanding of the role of political connections in the framework of corporate governance. Second, we provide additional evidence from China and take a further step toward reconciling the mixed evidence on the effects of political connections on firm performance. In previous studies, political ties have been documented to have both positive effects (e.g., Goldman, Rocholl, & So, 2009; Li et al., 2008) and negative effects (e.g., Faccio, 2010; Fan et al., 2007). Our analysis reveals that these effects are subject to a firm's financial performance by demonstrating a sharp difference between firms with different operating statuses.

The remainder of the paper is organized as follows. The next section discusses the related research and develops our hypotheses. We go on to describe the research context and design, and then report and analyze the empirical results. A final section provides conclusions.

RELATED RESEARCH AND HYPOTHESIS DEVELOPMENT

In transition economies, the government controls a wide range of financial and regulatory resources either through its power of planning or through its full control over state-owned enterprises (McMillan, 1997; Nee, 1992). The economy also lacks a sound legal system for property rights protection and contract enforcement (Johnson, McMillan, & Woodruff, 2002; McMillan & Woodruff, 1999). It is commonplace that firms in these economies make extensive use of political resources, not only to avoid multiform government extortions such as arbitrary fees and charges, but also to gain access to key resources offered by politicians. Such benefits

include easier access to loans from state-owned bank, more favorable tax treatment, more flexible budget constraints, more relaxed market entry regulation, greater chance of government bailout in case of default and so on (Boubakri, Guedhami, Mishra, & Saffar, 2010; Claessens et al., 2008; Faccio, 2010; Francis, Hasan, & Sun, 2009; Mobarak & Purbasari, 2006; Oliver & Rui, 2006). Consequently, firms have great motivation to retain politically connected CEOs to maintain good relations with the government and gain competitive advantages from the political ties.

The literature also suggests that, apart from firm performance, sociopolitical forces relating to incumbents can affect the normal selection mechanism significantly (Cannella & Lubatkin, 1993; Fredrickson, Hambrick, & Baumrin, 1988; Shen & Cannella, 2002). This implies that CEOs' political ties may protect them from being replaced. Consistent with this argument, Shleifer and Vishny (1989) point out that CEOs' political connections can be regarded as a type of manager-specific investment that makes the incumbents difficult to be dismissed. That is to say, CEOs may counter disciplinary forces by making political ties valuable to firms and costly to replace. Hence, all other things being equal, CEOs with richer political resources are less likely to be replaced than their non-connected peers. To gain insight into the outcomes of political connections in a transition economy, we propose the following hypothesis:

Hypothesis 1. In a transition economy, CEOs with political ties are less likely to be replaced than those without.

Despite the various reasons for forced CEO turnover, prior corporate governance research is concerned mainly with the question of whether or not forced turnover is closely related to firm performance. An extensive body of literature suggests that a necessary criterion of good corporate governance is the ability to identify and replace incompetent managers (e.g., DeFond & Hung, 2004; Gibson, 2003; Macey, 1997). In other words, when corporate governance functions well, incompetent CEOs are more likely to be fired. However, agency theory suggests that CEOs can take advantage of their political resources to prevent themselves being dismissed in times of distress. Cannella and Lubatkin (1993), for example, show that managers use sociopolitical forces to shirk responsibility for poor performance.

Especially in transition countries where formal institutions are not routinely enforced and state structures lack authority, managers draw on an extensive network of business-government relations to obtain plan-allocated goods and resources. Moreover, close networks with the government also help firms fight against weak property rights and arbitrary enforcement of business regulations (Aidis & Adachi, 2007; Li et al., 2008). As a result, the political background of CEOs may help them reduce the risk of being fired since the political ties that they own can potentially provide their firms with great benefits. To put it another way, in firms using political ties to seek a favorable regulatory environment and resources, the political background of CEOs can carry more weight than the firm's financial performance when determining their dismissal.

In addition, compared to non-connected firms, connected firms display some weak governance characteristics (e.g., Berkman, Cole, & Fu, 2010; Boubakri, Cosset, & Saffar, 2008; Fan et al., 2007). Based on an emerging market environment, Shleifer and Vishny (1994) assert that when channeling resources toward favored firms, politicians will also interfere in corporate activity and business decisions. This suggests that political ties may influence the mechanisms of internal corporate governance. As an illustration, Fan et al. (2007) find that firms led by politically connected CEOs are more likely to have boards populated by other bureaucrats with less professional backgrounds. This demonstrates a poor quality of corporate governance in these firms and implies a negative effect of political connections on turnover-performance sensitivity. In light of the foregoing discussion suggesting the role of CEOs' political connections in their forced turnover due to poor performance, we propose the following hypothesis:

Hypothesis 2. In a transition economy, CEOs with political ties are less likely to be replaced due to poor performance than those without.

In transition economies, the uncertainty in policy-making and the weak institutional characteristics bring substantial transaction costs for the firms (Williamson, 1991). They create and strengthen the incentives to develop informal institutions including government-business relationships to comply with the current rules and enhance the efficiency of formal institutions. Consequently, business organizations tend to engage in political behaviors to internalize these costs and influence the policy process in ways favorable to them. This implies the additional value of political ties for firms in transition countries. Faccio (2006), for example, finds that the benefits obtained from political connections are especially noticeable in countries with high levels of corruption and weak legal systems.

Although several studies find that government relationships may harm firm performance (e.g., Boubakri et al., 2008; Chaney, Faccio, & Parsley, 2011; Fan et al., 2007), a growing body of literature documents the positive association between political connections and firm performance (e.g., Faccio, 2006; Faccio & Parsley, 2009; Fisman, 2001; Johnson & Mitton, 2003; Ramalho, 2007). Keeping connected CEOs in office is an expedient way for a firm to maintain close ties with the government, which is a significant motivation for firms to retain CEOs with political ties. For this reason, the value of retained CEOs can be proved when their political ties bring access to scarce resources that could further improve firm performance.

More importantly, according to resource dependency theory, a firm's competitive advantage is based on its possession of key resources that are difficult or costly for other firms to obtain. Previous studies have provided evidence that connected CEOs can help their firms obtain valuable resources and support from the government (e.g., Faccio, 2010; Goldman et al., 2009). In comparison to developed countries, the benefits of political connections in transitional countries are much more prevalent, such as preferential access to external finance (e.g., Claessens et al., 2008 for Brazil; Cull and Xu, 2005 for China; Johnson & Mitton, 2003, Khwaja and Mian, 2005 for Pakistan), reduction in taxes or fees (Adhikari, Derashid, & Zhang, 2006 for China; Faccio, 2010 for the emerging markets) and so on. Thus we expect the political ties of retained CEOs to bring firms more

benefits than costs and eventually enhance firm performance. Accordingly, we propose the following hypothesis:

Hypothesis 3. In a transition economy, future firm performance is positively related to political connections of the retained CEOs.

Finally, we examine whether the influence of political connections on future firm performance varies with a firm's operational performance. To do so, we divide firms into two categories: underperforming firms with operational profit below the industry median, and outperforming firms with operational profit above the industry median. When a firm's profitability is negative or below the industry median, the retained CEO may face greater pressure from shareholders and the board. He or she will therefore make greater efforts to improve firm performance. For example, based on the behavioral theory of organizational search, Shen and Lin (2009) find that when firms miss the performance target, they tend to change their current routines and have greater motivation to search for alternatives, thus leaving their CEOs at greater risk of being fired. Chang and Wong (2009) also report a negative relationship between forced CEO turnover and firm performance in firms incurring financial losses but not in those making profits, indicating that CEOs in underperforming firms are under great pressure to keep their positions and have a personal incentive to improve financial performance. Consequently, the retained CEOs tend to use their political resources, if they have any, to improve firm profitability, suggesting that the value of political connections will be more manifest when firms do not meet performance targets.

At the same time, the government tends to help underperforming connected firms through the provision of fiscal subsidies and/or low-cost loans. Politicians as stakeholders may also give a helping hand for fear of losing rent-seeking profits. For example, Faccio, Masulis, and McConnell (2006) illustrate that, when confronting economic distress, politically connected firms are more likely to be bailed out than their non-connected peers. Thus, we expect that the benefits associated with political connections may outweigh the costs when a firm is failing to meet performance targets. We test this prediction with the following hypothesis:

Hypothesis 4. The positive relationship between future firm performance and political connections is stronger when firm profitability is below the industry median rather than above it.

RESEARCH DESIGN

Research Context

As a transitional economy, China provides an ideal natural setting for our study. On the one hand, despite the massive waves of privatization in the last two decades in China, the government continues to exert substantial control over the economy. For example, the majority of Chinese listed firms are controlled by state shareholders who retain their dominant position through the ownership of about two-thirds of total equity (Sun & Tong, 2003). On the other hand, the economic environment in China can be characterized as poorly enforced property rights. MacNeil (2002) calculates an index score of 2 for China based on the index of investor protection developed by La Porta, Lopez-De-Silanes, Shleifer, and Vishny (1999), and compares it with the world average of 3 and the world maximum of 6. Li et al. (2008) point out that to overcome these market and state failures and avoid ideological discrimination, cultivating political connections is an important strategy for Chinese firms. Hence, to shield firms from external market uncertainties and to circumvent the problems associated with the weak institutional environment, managers are keen to develop a rich network of political ties, which in turn embeds their economic behavior more deeply in a complex social network (Allen et al., 2005; Xin & Pearce, 1996).

For example, Fan et al. (2007) find that almost 27 percent of the CEOs in their sample of 790 partially privatized firms in China have political connections, defined as being a former or current government bureaucrat. Xu and Zhou (2008) also report that in their sample firms (137 companies registered in Shanghai), 64 percent have at least one board member with career experience in the Shanghai government. In our sample, 17.70 percent of CEOs and more than 20 percent of the remaining board members have government experience, and over 80 percent of the sample firms have at least one politically connected director (discussed in greater detail in the next section).

The Chinese term *guanxi* vividly expresses this reality. As a central idea in Chinese society, it describes the informal mechanisms of exchange and cooperation between individuals or organizations, of which political connections are the most important. As Luo (2007), and Chua, Morris, and Ingram (2009) point out, *guanxi* is a key factor in successful business and an important source of professional advancement in China. It has taken the place of individual capability as the fundamental element in career success. Considering the similar stylized characteristics in other transitional countries and the universal phenomenon of business-government relations in firms, we take China as our sample to address the aforementioned issues in this study.

Sample Construction and Data Sources

We start with a sample of A-share companies listed on the Shanghai and Shenzhen Stock Exchanges in China over the period 2005–2008. Data for CEO turnover, financial information and corporate governance-related variables such as stock ownership are collected from the Chinese Stock Market and Accounting Research database (CSMAR), which compiles information from listed firms' annual, semi-annual and quarterly reports.

The financial reports of Chinese listed companies and the CSMAR database did not collect CEOs' curriculum vitae until 2004. Considering our analysis requires CEOs' personal information for the previous year to gauge their political connections, this study covers the four-year period from 2005 to 2008. We exclude banks, financial institutions, and insurance companies, as well as any observations with missing values in the variables included in our analysis. The resulting sample comprises 5,403 firm-year observa-

tions of 1,546 firms over a four-year period. To investigate the relationship between the retained CEOs' political connections and future firm performance, we exclude firms that underwent turnover in the fiscal year. Previous studies show that a firm's performance improves following a change in top management (e.g., Denis & Denis, 1995; Fee & Hadlock, 2004; Huson, Malatesta, & Parrino, 2004). Therefore, the exclusion of these observations may control for the possible effect of CEO turnover on future firm performance. We also exclude firms with missing firm-specific financial data. The resulting sample includes 4,253 firm-year observations of 1,511 firms from 2005 to 2008.

The CSMAR provides detailed personal information on CEOs, including age, sex, education, professional background and work experience. We supplement CSMAR by hand-collecting data from various resources. We traced most CEOs' political connections through their work experience. For a few CEOs with no specific records in the CSMAR database, we obtained their curricula vitae from http://finance.sina.com.cn. If a CEO's details were still unclear or incomplete, then we visited his or her firm's homepage for more information. If this procedure was unsuccessful, we searched http://www.google.com.hk and http://www.baidu.com using the name of the CEO and the firm as key words.

Classification of Forced CEO Turnover

Any person holding the formal title of either General Manager or Chief Executive is identified as a CEO. During our sample period, there are a total of 2,356 CEOs and 1,134 cases identified as having CEO changes in the 5,403 firm-year observations. If a firm underwent two or more turnovers in the fiscal year, then only the first turnover is counted. The average annual turnover rate for CEOs is 20.99 percent, substantially higher than the worldwide average reported by DeFond and Hung (2004) and Lel and Miller (2008), which are 14.80 percent for 33 countries and 16.30 percent for 47 countries, respectively. The CSMAR provides 12 reasons for top management turnover: (1) change of job, (2) retirement, (3) contract expiration, (4) change in controlling shareholders, (5) resignation, (6) dismissal, (7) health, (8) personal reasons, (9) corporate governance reform, (10) legal disputes, (11) completion of acting duties, and (12) no reason given. Panel A in Table 1 illustrates the distribution of the different reasons for a CEO to leave the top management team. In the full sample, change of job, resignation, and contract expiration are the three most commonly stated reasons, accounting for 37.93 percent, 21.56 percent, and 14.42 percent, respectively.

There is no public information available to distinguish forced turnovers from voluntary ones. Even when the stated reason is "change of job," turnover can be either forced or voluntary, not to mention "resignation," a wise choice of CEOs before being dismissed (Firth, Fung, & Rui, 2006). To effectively identify forced turnovers, we create a binary variable called *CW CEO turnover* using the Chang and Wong (2009) algorithm. First, we classify changes in CEOs due to retirement, health, change in controlling shareholders, corporate governance reform, and legal disputes as voluntary departures (58 turnovers accounting for 5.11 percent). For the remaining seven reasons (1,076 turnovers accounting for 94.89 percent), we identify the destinations of the departing managers, which may be grouped into the following categories: (1) remaining as board chairman or vice chairman; (2) promoted to board chairman or vice chairman; (3) CEO position taken up at another listed firm or parent firm; (4) new important government position; (5) new position ranked lower than CEO position; (6) new position at an unlisted, smaller firm; (7) others (including imprisonment, prosecution, study abroad and unemployment); and (8) information unavailable. Since it is unlikely that there would be no information available if a departing CEO took up a position better than his or her previous role, we define reasons (1)–(4) as indicators that the new job is better than the previous one, and reasons (5)–(8) as indicators that the new job is worse than the previous one.

As suggested by Chang and Wong (2009), turnover is highly likely to be voluntary if the new job is better, while forced if the new job is less desirable than the old one. Therefore, turnovers caused by reasons (1)–(4) are classified as voluntary, otherwise as forced. Panel B of Table 1 reports the results in detail. Our final sample contains 702 forced turnover cases, accounting for 61.90 percent of all turnovers, which is higher than the rates reported by Chang and Wong (2009) for Chinese firms during the period 1995–2001 (30.98 percent). Three reasons may explain the differences. First and foremost, in Chang and Wong's (2009) study, 27.89 percent of the turnovers giving the same reasons as ours are regarded as voluntary, which is much higher than the voluntary departures in our study (only 5.11 percent). Second, the sample in their study comprises only state-owned firms in which the departing CEOs could find another higher post in other government bodies or state-owned firms, which lowers the percentage of forced turnovers. In our study, the sample includes both state-owned and private firms. In private firms, it is difficult for the departing CEOs to find higher positions in government bodies or other state-owned firms, which indirectly increases the percentage of forced turnovers. Additionally, following Chang and Wong (2009), we treat a turnover as forced if there is no information available about the destinations of departing CEOs. In our study, such cases account for 34.67 percent of all cases, higher than the ratio of 28.46 percent in Chang and Wong's (2009) study.

The rate of forced CEO turnover during our sample period is high in comparison to the studies carried out by Kang and Shivdasani (1995) on Japanese firms (24.14 percent) and Denis and Denis (1995) and Huson, Parrino, and Starks (2001) on US firms (13.3 percent and 18.1 percent, respectively). Consistent with our findings, Firth et al. (2006) also report a high rate of forced turnover among top management in China. In their sample, 47 percent of turnovers are regarded as forced, and this percentage would have been higher if they had reclassified resignations as forced turnovers. As a transition economy, China has adopted a succession of reforms seeking to move state-owned enterprises toward a market orientation (Ralston, Jane, Terpstra, Wang, & Egri, 2006). During this period, the scale of transactions in the control of listed companies in China has expanded year by year, and short-term renewable contracts have replaced life-long positions (Tenev, Zhang, & Brefort, 2002). If firms

TABLE 1
Statistics on CEO Turnover in China's Listed Firms

	Number	Percentage of sample
Panel A: Stated reasons for CEO turnover		
1. Change of job	468	37.93
2. Retirement	16	1.30
3. Contract expiration	178	14.42
4. Change in controlling shareholders	8	.65
5. Resignation	266	21.56
6. Dismissal	23	1.86
7. Health	23	1.86
8. Personal reasons	52	4.21
9. Corporate governance reform	9	.73
10. Legal disputes	2	.16
11. Completion of acting duties	37	3.00
12. No reason given	52	4.21
Total	1,134	100.00
Panel B: Destinations of departing CEOs		
1. Remaining as board chairman or vice chairman	151	14.03
2. Promoted to board chairman or vice chairman	103	9.57
3. CEO position taken up at another listed firm or parent firm	84	7.81
4. New position at an important government organization	36	3.35
5. New position ranked lower than CEO position	251	23.33
6. New position at an unlisted, smaller firm	25	2.32
7. Others (imprisonment, prosecuted, studying abroad and unemployed)	53	4.93
8. Information unavailable	373	34.67
Total	1,076	100.00

Panel A reports the reasons for CEO turnovers as stated in the financial reports issued during the 2005–2008 period. Panel B reports the destinations of departing CEOs for which the stated reasons for turnovers fall into the categories of change of job, contract expiration, resignation, dismissal, personal reasons, completion of acting duties, and no reason given.

are poorly managed in the short term, then companies face a high risk of being merged or acquired, which leads to a greater frequency of CEO turnover and a higher percentage of forced turnovers.

Note that the high rate of forced CEO turnovers does not necessarily reflect the high quality of corporate governance in China. As Denis and Denis (1995) point out, good corporate governance not only involves firing incompetent managers, but also selecting appropriate successors. Testing this, Firth et al. (2006) find no profitability improvement after changes in top management, and thus conclude that the governance structure of Chinese listed firms is ineffective as firms are unable to recruit suitable replacements. They also point out that inadequate laws and weak law enforcement in China limit the rights of top management and thus increase the possibility of dismissal, whereas the strong protection afforded to individuals in the US and Europe makes it costly, and in some cases prohibitively costly, to fire managers.

Definition of Political Connections

It is necessary to identify and define a proper measurement of political connections first when analyzing the impact of such connections (Goldman et al., 2009). Faccio (2006) considers parliament members, ministers, state principals, and anyone closely related to senior officials as the source of political connections, whereas Fan et al. (2007) measure political connections on the basis of managers' past or present political experience or identity. Goldman et al. (2009) see party affiliation (Republicans or Democrats) as a key measurement factor. In China, however, the political background of CEOs is quite diverse. For example, to ensure its absolute control over the financial system and to maintain economic stability, the government directly interferes in the appointment of top managers in state-owned banks. Thus, the CEOs in these banks enjoy the same treatment as government officials. The president or vice-president of a government-regulated business association is usually a retired government leader, and hence these associations usually possess abundant political resources. Additionally, CEOs who have received the title of "model worker" or another government award are also classified as politically connected.

Thus, considering the reality in China, we construct an index to measure the political connections of CEOs based on the two dimensions of political experience and political identity. There are three aspects of a CEO's political experi-

TABLE 2
Statistics on CEOs' Curricula Vitae

	State	Province	City	County	Total
Number from government branches	13	39	80	28	160
Number from state-owned banks	8	30	37	7	82
Number from government-led trade associations	40	16	19	2	77
Number of the NPC/CPPCC members	18	29	29	5	81
Number of government rewards or model workers	54	31	14	0	99
Total	133	145	179	42	499

This table summarizes the CEOs' curricula vitae in the sample firms. NPC and CPPCC refer to the National People's Congress and the National Committee of the Chinese People's Political Consultative Conference in China, respectively. As several CEOs are simultaneously in more than one position, these statistics contain double counting.

ence: whether he or she was from one of the government branches, whether he or she worked for a state-owned bank, and whether he or she had leadership experience in a government-regulated business association. A CEO's political identity is evaluated on the basis of two aspects: whether he or she was a deputy to the National People's Congress (NPC) or the National Committee of the Chinese People's Political Consultative Conference (CPPCC) and whether he or she received the title of "model worker" or any other governmental reward. To each of the five aforementioned aspects, we assign "1" if it is present and "0" otherwise, and obtain an unweighted-sum political connection index by summing these aspects. Table 2 summarizes the distribution of political connections across different administration levels, which are state, province, city, and county governments from high to low. The administrative levels are heavily concentrated on state, province and city. After excluding the duplicate counting of CEOs holding concurrent posts, we find that 417 CEOs have political experience or a political identity, accounting for 17.70 percent of all CEOs (unreported in the table).

Regression Models for Forced CEO Turnover

To examine the impact of political connections on forced CEO turnover, we estimate a series of logistic regression models that take the following form.

$$Probability\,(turnover_{it}) = f(performance_{it-1}, PolCon_{it}, Performance_{it-1} \times PolCon_{it}, Control\ variables_{it}). \quad (1)$$

We use *CW CEO turnover* as the dependent variable, which equals one if the CEO's departure is forced based on Chang and Wong's (2009) algorithm during the fiscal year and zero otherwise. Because noise trading is prevalent and the stock price tends to capitalize on market-level information rather than on firm-specific information in China's stock market (Morck, Yeung, & Yu, 2000), we use accounting-based measures, i.e., the return on assets (*ROA*), to proxy for firm performance. We take a one-year lag to prevent a possible overlap of the replaced CEO's performance with that of the new CEO. To minimize the impacts of outliers, we winsorize *ROA* at the 1st and 99th percentiles. *PolCon* is an unweighted index measuring the political connections enjoyed by CEOs at the beginning of the fiscal year.[1] We also include an interaction term of *Performance* and *PolCon* to test whether the presence of political connections reduces the sensitivity of forced CEO turnover to firm performance.

We include a set of control variables to eliminate possible confounding effects. The first two variables are the CEO duality and tenure. CEOs holding two positions or having a long tenure tend to be more powerful, suggesting a lower risk of being replaced (Shen & Cannella, 2002; Weisbach, 1988). The third is the CEO age, which is used to control for turnover due to retirement. The fourth variable is board size. As Jensen (1993) shows, a more streamlined board can operate more efficiently. The fifth variable is the number of outside directors on the board. Weisbach (1988) finds a stronger relationship between firm performance and CEO turnover when the boards are dominated by outside directors. We also introduce the political connections enjoyed by the remaining board members as a control variable, which may affect the quality of corporate governance and thus the CEO forced turnover suggested by Fan et al. (2007). The political ties of board members are measured in the same way as CEOs' political connections. The seventh variable is ownership concentration, which is used to control for the impact of large shareholders on forced CEO turnover. We also introduce two variables to capture the effect of state ownership. One is the ownership nature of the largest shareholder, and the other is the state share. Kato and Long (2006) find that among firms controlled by the state in China, top managers are less likely to be replaced due to poor performance. Shen and Lin (2009) also find that when a Chinese listed firm's performance is below the target measured by the industry median, senior management in state-controlled firms are more likely to be replaced. The tenth variable is leverage. Jensen (1986) points out that debtors play a role in disciplining managers. The eleventh variable is firm size because prior research shows that managers in larger firms are less likely to be replaced (e.g., Volpin, 2002). Given that non-financial performance may be an important factor in evaluating CEOs' ability, we also introduce employment number and employment growth as control variables. Finally, a series of dummy variables are applied to control for time- and industry-specific

TABLE 3
Description and Measurement of the Control Variables

Variable name	Description and measurement
CEO duality	A binary variable equal to one if the current CEO is also the board chair at the beginning of the fiscal year and zero otherwise
CEO tenure	The total number of years that the current CEO has been in the position at the beginning of the fiscal year
CEO age	A binary variable equal to one if the current CEO is older than 60 at the beginning of the fiscal year and zero otherwise
Board size	The total number of directors on the board at the beginning of the fiscal year
Outside directors	The number of outside directors on the board at the beginning of the fiscal year
Board *PolCon*	The percentage of politically connected directors on the board (excluding the CEO)
Ownership concentration	The Herfindahl index measured as the sum of the squared percentage of shares held by the top 5 shareholders at the beginning of the fiscal year
Ownership nature	A dummy variable equal to one if the firm is under state control at the beginning of the fiscal year and zero otherwise
State shares	The percentage of shares held by state shareholders at the beginning of the fiscal year
Leverage	The ratio of total liabilities to total assets at the beginning of the fiscal year
Firm size	The logarithm of total assets at the beginning of the fiscal year
Employee number	The logarithm of the total number of employees at the beginning of the fiscal year
Employee growth	The growth of total employees at the beginning of the fiscal year

factors.[2] Table 3 provides the description and measurement of the aforementioned control variables.

Regression Models for Future Firm Performance

To test the effect of the political connections of retained CEOs on future firm performance, we estimate the following regression model:

$$Performance_{it+1} = f(PolCon_{it}, Control\ variables_{it}). \quad (2)$$

Future firm performance is measured by the one-year-ahead rate of return on assets (*ROA*). Following previous research, we include a number of control variables that may influence firm performance. First, we control for a series of corporate governance-related variables, including board size, outside directors, the board's political connections, ownership concentration, ownership nature, and state shares. Second, we control for firm characteristic-related variables, including leverage and firm size. In addition, we control for time and industry effects with dummy variables.

To test Hypothesis 4, we divide the sample into two subsamples based on current firm profitability measured by *ROA*. A listed firm is classified as outperforming if its *ROA* is above the industry median, otherwise it is consigned to the underperformance sample. We separately estimate the coefficients for the full, outperforming, and underperforming samples to test our hypothesis.[3]

Descriptive Statistics

Table 4 provides the descriptive statistics for the key variables in our regression models. In our sample, the average of *ROA* is .02, and the average unweighted-sum political connection index is .18. The average tenure length of a CEO is 3.40 years. Duality is not a common feature for Chinese listed firms, with only 13.1 percent of the CEOs also serving as board chairpersons. The average size of the board of directors is around nine, and the average number of outside directors is around three, which is consistent with the CSRC's mandatory requirement that the proportion of outside directors should be more than one third. The average board's *PolCon* is .22, indicating that over 20 percent of the remaining board members have ties with the government. We also find that over 80 percent of the boards in our sample firms possess at least one connected director (unreported in the table), showing that political connections in China are quite common. The average ownership concentration is .18, showing that shares of listed companies in China often concentrate in the hands of large blockholders. Another remarkable characteristic of the Chinese ownership structure is that the majority of China's listed firms are controlled by state shareholders, which account for 58.5 percent of all listed firms and 27.2 percent of all outstanding shares in our sample.

Table 5 reports the correlation coefficients among the key variables examined in this study. Focusing on our main interest, we see that *CW CEO turnover* is significantly negatively correlated with firm performance measured by *ROA*, with *P*-values less than .01, showing that forced turnover increases rapidly in response to poor performance. *CW CEO turnover* is also significantly negatively correlated with political connections, which suggests that a CEO's political connections decrease the likelihood of his or her dismissal. In addition, the value of the variance inflation factor, with a maximum of 3.76, indicates that there are no extremely high

TABLE 4
Descriptive Statistics

Variables	Mean	Median	Max	Min	STDEV	N
Prior *ROA*	.02	.03	.21	–.50	.09	5,403
CEO *PolCon*	.18	0	5	0	.52	5,403
CEO duality	.13	0	1	0	.34	5,403
CEO tenure	3.40	3	9	1	2.19	5,403
CEO age	.03	0	1	0	.16	5,403
Board size	9.35	9	19	2	1.97	5,403
Outside directors	3.30	3	8	1	.73	5,403
Board *PolCon*	.22	.20	1	0	.19	5,403
Ownership concentration	.18	.15	.76	.01	.12	5,403
Ownership nature	.59	1	1	0	.49	5,403
State shares	.27	.27	.97	0	.24	5,403
Leverage	.55	.52	2.72	.08	.33	5,403
Firm size	21.28	21.20	27.62	12.31	1.14	5,403
Employee number	7.31	7.42	13.05	1.79	1.39	5,403
Employee growth	.09	.01	3.76	–.89	.53	5,403

This table presents descriptive statistics of the variables used in the forced CEO turnover analysis for 5,403 firm-year observations over the period 2005–2008. Prior *ROA* is the prior one-year return on assets. CEO *PolCon* is the unweighted-sum index of political connections measured from six aspects. Other variable definitions are provided in Table 3.

correlations among the independent variables in the regression, suggesting that there is no serious multicollinearity problem in our regression analysis.[4]

EMPIRICAL RESULTS AND ANALYSIS

The Effect of Political Connections on Forced CEO Turnover

Table 6 presents the empirical results of the logistic regressions based on equation (1) with *CW CEO turnover* as the dependent variable. We also include a series of control variables to eliminate other possible effects on forced CEO turnover. Model (1) takes firm performance and political connections as key explanatory variables to test Hypothesis 1. Model (2) introduces the interaction term between firm performance and political connections to test Hypothesis 2. In addition, in our study, CEOs' political connections are measured along the two dimensions of political experience and political identity, where the former mainly reflects the CEOs' horizontal ties with the government and the latter mainly reflects their political position in society. To explore the differences in the effects of these dimensions on CEO forced turnover, we estimate the regression based on equation (1) in Models (3) and (4) for political experience and political identity, respectively.

In Model (1), the estimated coefficient on the performance measure is negative ($t = -4.76$, $p < .01$), showing that poorly performing CEOs in Chinese listed firms have a higher likelihood of forced turnover, which is consistent with previous research (e.g., Kato & Long, 2006; Shen & Lin, 2009). Model 1 also shows that forced CEO turnover is negatively associated with his or her political ties ($t = -6.03$, $p < .01$), consistent with Hypothesis 1 that CEOs with political ties are less likely to be replaced than those without. In Model (2), the coefficient on the interaction term is significantly positive ($t = 2.05$, $p < .05$), suggesting that the presence of political connections reduces the sensitivity of forced CEO turnover to firm performance, which supports Hypothesis 2. In Model (3), the coefficients on *PolCon* and the interaction term are both statistically significant, whereas in Model (4), the coefficient on *PolCon* is significantly negative, and the interaction term is insignificantly positive. These results show that, of the two dimensions of political connections, political experience exerts more influence in weakening the turnover-performance sensitivity.

As for the CEO characteristic-related control variables, we find both CEO tenure and age to be positively related to forced turnover and CEO duality to be negatively related. In the case of the governance-related control variables, we find the probability of forced CEO turnover to increase with ownership concentration, state shares, and the number of outside directors and to decrease with board size and board political connections. We also find less probability of forced CEO turnover among companies that are larger, have lower leverage, more employees, higher employee growth, and are under state control.

The Effect of Political Connections on Future Firm Performance

Table 7 presents the empirical results of the ordinary least squares (OLS) regressions based on equation (2) with one-year-ahead *ROA* as the dependent variable. The CEO *PolCon* is the unweighted-sum political connection index. In the

TABLE 5
Correlation of Key Variables

	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16
1 *CW CEO turnover*	1															
2 Prior *ROA*	−.12**	1														
3 CEO *PolCon*	−.10**	−.10**	1													
4 CEO duality	.03*	−.01	.16**	1												
5 CEO tenure	.01	.05**	.02	.14**	1											
6 CEO age	.07**	.04**	.08**	.18**	.14**	1										
7 Board size	−.05**	.11**	.01	−.09**	.03*	.01	1									
8 Outside directors	−.03*	.10**	.01	−.07**	.01	.02	.83**	1								
9 Board *PolCon*	−.04**	.08**	.27**	−.02	−.01	.04**	.06**	.07**	1		−					
10 Ownership concentration	.01	.16**	−.01	−.06**	−.08**	.01	.05**	.04**	−.01	1						
11 Ownership nature	−.05**	.08**	−.08**	−.10**	.09**	.01	.19**	.15**	−.02	.26**	1					
12 State shares	−.02	.08**	−.09**	−.12**	.02	−.00	.18**	.13**	−.04**	.56**	.76**	1				
13 Leverage	.09**	−.45**	−.05**	.01	−.01	−.03†	−.07**	−.05**	−.02†	−.10**	−.11**	−.10**	1			
14 Firm size	−.07**	.23**	.03*	−.10**	.18**	.07**	.28**	.27**	.09**	.26**	.27**	.26**	−.14**	1		
15 Employee number	−.05**	.12 **	.02	.06**	.12**	.04**	.23**	.20**	.03*	.18**	.21**	.21**	−.09**	.26**	1	
16 Employee growth	−.04**	.13 **	.03 *	.00	−.02	.00	.04**	.04**	.01	.08**	.02	.04**	−.06**	.05**	−.12**	1
Variance inflation factor		1.35	1.36	1.11	1.12	1.06	3.30	3.22	1.26	1.76	2.81	3.76	1.27	1.78	1.53	1.15

†p < .10
*p < .05
**p < .01
This table presents the Pearson correlation coefficients of the key variables. *CW CEO turnover* equals one if the CEO's departure is forced (based on Chang & Wong's 2009 algorithm) during the fiscal year and zero otherwise. Prior *ROA* is the prior one-year return on assets. CEO *PolCon* is the unweighted-sum index of CEOs' political connections. The other variable definitions are provided in Table 3.

TABLE 6
Political Connections and Forced CEO Turnover

Model	(1)		(2)		(3)		(4)	
Intercept	.41	(.51)	.33	(.40)	.19	(.24)	.31	(.39)
Prior ROA	–2.11**	(–4.76)	–2.22**	(–4.98)	–2.29**	(–5.13)	–2.24**	(–5.02)
CEO *PolCon*	–.69**	(–6.03)	–.74**	(–6.23)	–.92**	(–5.65)	–.72**	(–3.87)
Prior ROA × CEO *PolCon*			.93*	(2.05)	1.47†	(1.88)	1.09	(1.15)
CEO duality	–.04	(–.35)	–.04	(–.37)	.01	(.12)	–.01	(–.05)
CEO tenure	.03	(1.37)	.02	(1.35)	.02	(1.15)	.03	(1.63)
CEO age	.86**	(4.30)	.86**	(4.28)	.82**	(4.14)	.83**	(4.19)
Board size	–.08*	(–2.38)	–.08*	(–2.34)	–.08*	(–2.34)	–.08*	(–2.41)
Outside directors	.18†	(1.96)	.18†	(1.94)	.18†	(1.95)	.18*	(1.99)
Board *PolCon*	–.10	(–.47)	–.10	(–.49)	–.28	(–1.32)	–.46*	(–2.20)
Ownership concentration	.80*	(2.05)	.77†	(1.96)	.77*	(1.98)	.71†	(1.82)
Ownership nature	–.36**	(–2.93)	–.37**	(–2.97)	–.36**	(–2.92)	–.35**	(–2.83)
State shares	.42	(1.42)	.44	(1.47)	.47	(1.57)	.46	(1.52)
Leverage	.24*	(2.08)	.26*	(2.21)	.28*	(2.37)	.24*	(2.01)
Firm size	–.07†	(–1.70)	–.07	(–1.60)	–.07	(–1.50)	–.08†	(–1.72)
Employee number	–.04	(–1.08)	–.04	(–1.10)	–.04	(–1.34)	–.02	(–.80)
Employee growth	–.17*	(–2.16)	–.17*	(–2.15)	–.18*	(–2.29)	–.17*	(–2.16)
Year dummy	Included		Included		Included		Included	
Industry dummy	Included		Included		Included		Included	
Wald χ^2 (Prob > χ^2)	179.80	(.00)	184.82	(.00)	175.46	(.00)	152.07	(.00)
Pseudo R^2	.036		.037		.035		.031	
No. obs.	5,403		5,403		5,403		5,403	
No. turnovers	702		702		702		702	

†p < .10
*p < .05
**p < .01
This table presents a series of logistic regressions with *CW CEO turnover* (measure of CEO turnover) as the dependent variable. The sample period is from 2005 to 2008. *CW CEO turnover* equals one if the CEO's departure is forced based on Chang and Wong's (2009) algorithm during the fiscal year and zero otherwise. Prior *ROA* is the prior one-year return on assets. CEO *PolCon* is the unweighted-sum index of CEOs' political connections. Specifically, CEO *PolCon* in Models (1) and (2) is an aggregate index equal to the sum of political experience and political identity, and CEO *PolCon* in Models (3) and (4) is the index for political experience and political identity, respectively. The other variable definitions are provided in Table 3. Asymptotic *t*-statistics based on robust standard errors are reported in parentheses.

regression models including political connections and a series of control variables as explanatory variables, we are concerned not only with the possible impact of the retained CEOs' political ties on future firm performance, but also with the possible variation in the impact across different samples. To address these two issues, we run the analysis for the full, outperforming, and underperforming samples. Again, to explore the differences in the effects of the two dimensions of political connections on future firm performance, we estimate the regression based on equation (2) in Models (3) and (4) for political experience and political identity, respectively.

Model 1 shows that the coefficient on *PolCon* is significantly positive (t = 4.01, p < .01) when the full sample is used in the analysis. This result suggests that the close political connections of the retained managers significantly improve future firm performance, which is consistent with Hypothesis 3. However, when the sample is split according to the industry median of *ROA*, the associations between political connections and future firm performance in the two sub-samples are quite different. Specifically, the coefficient on political connections is insignificant (t = 1.05, p > .10) for the sub-sample where the one-year-lagged *ROA* is above the industry median, while significantly positive (t = 2.24, p < .05) for the sub-sample where the one-year-lagged *ROA* is below the industry median. Therefore, the positive relationship between political connections and future firm performance is primarily driven by the sub-sample of underperforming firms. This indicates that the value of political connections shows up particularly when firms are in financial distress. Moreover, both dimensions of the political connection index have significantly positive impacts on firm performance in the whole sample, although political experience plays a more important role in weakening turnover-performance sensitivity than does political identity. Specifically, when firm profitability is below the industry median, the regression coefficients for political experience and political identity are .013 and .006, respectively, significant at the 10 percent level. When firm profitability is above the industry median,

TABLE 7
Political Connections and Future Firm Performance

Model	All samples			Firm profitability above industry median			Firm profitability below industry median		
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
Intercept	−.09** (−3.43)	−.09** (−3.41)	−.09** (−3.36)	−.00 (−.01)	−.00 (−.02)	.00 (.02)	−.15** (−3.63)	−.15** (−3.68)	−.15** (−3.56)
CEO *PolCon*	.01** (4.01)	.01** (3.41)	.01** (2.60)	.00 (1.05)	.01† (1.71)	−.00 (−.51)	.01* (2.24)	.01* (2.29)	.01† (1.89)
CEO duality	−.00 (−.53)	−.00 (−.80)	−.00 (−.67)	.00 (.08)	.00 (.03)	−.00 (−.05)	−.00 (−.23)	−.00 (−.35)	−.00 (−.45)
CEO tenure	.00 (1.36)	.01 (1.50)	.00 (1.26)	.00 (.31)	.00 (.36)	.00 (.31)	.00 (1.36)	.00 (1.51)	.00 (1.28)
CEO age	−.01 (−.66)	−.00 (−.60)	−.00 (−.57)	.01 (.82)	.00 (.81)	.01 (.91)	−.02 (−1.34)	−.02 (−1.33)	−.01 (−1.26)
Board size	.00** (2.69)	.00** (2.73)	.00** (2.69)	.00* (2.03)	.00* (2.07)	.00* (2.05)	.00† (1.93)	.04† (1.93)	.00* (1.97)
Outside directors	−.01† (−1.65)	−.01† (−1.68)	−.01† (−1.65)	−.01** (−2.85)	−.01** (−2.87)	−.01** (−2.86)	−.00 (−.49)	−.00 (−.50)	−.00 (−.52)
Board *PolCon*	.00 (.58)	.01 (.90)	.01 (1.63)	.01† (1.91)	.01† (1.68)	.02* (2.56)	−.01 (−.53)	−.01 (−.55)	.00 (.15)
Ownership concentration	.09** (6.94)	.09** (6.92)	.09** (7.05)	.04** (2.92)	.04** (2.87)	.04** (2.98)	.09** (3.80)	.09** (3.73)	.09** (3.82)
Ownership nature	.00 (.19)	.00 (.18)	.00 (.14)	.00 (.02)	.00 (.05)	.00 (.00)	.01† (1.84)	.01† (1.82)	.01† (1.80)
State shares	−.02† (−1.84)	−.02† (−1.89)	−.02† (−1.89)	−.01 (−.62)	−.01 (−.62)	−.01 (−.67)	−.02 (−1.12)	−.02 (−1.10)	−.02 (−1.15)
Leverage	−.06** (−6.77)	−.06** (−6.81)	−.06** (−6.76)	−.07** (−4.32)	−.07** (−4.32)	−.07** (−4.33)	−.03* (−2.26)	−.03* (−2.30)	−.03* (−2.25)
Firm size	.01** (4.19)	.01** (4.23)	.01** (4.15)	.00* (2.14)	.00* (2.16)	.00* (2.13)	.01** (2.69)	.01** (2.77)	.01** (2.67)
Year dummy	Included	Included	Included	Included	Included	Included	Included	Included	Included
Industry dummy	Included	Included	Included	Included	Included	Included	Included	Included	Included
F value (Prob > *F*)	19.40 (.00)	18.91 (.00)	18.87 (.00)	8.38 (.00)	8.59 (.00)	8.34 (.00)	8.86 (.00)	8.95 (.00)	8.57 (.00)
Adj R^2	.12	.12	.11	.12	.12	.12	.08	.08	.08
No. obs.	4,253	4,253	4,253	2,141	2,141	2,141	2,112	2,112	2,112

†p < .10
*p < .05
**p < .01

This table presents a series of OLS regressions with future firm performance as the dependent variable, which is measured by the one-year-ahead return on assets (*ROA*). The sample period is from 2005 to 2008. CEO *PolCon* is the unweighted-sum index of CEOs' political connections. Specifically, CEO *PolCon* in Model (1), (4), and (7) is an aggregate index equal to the sum of political experience and political identity. CEO *PolCon* in Models (2), (5), and (8) is the index for political experience. CEO *PolCon* in Models (3), (6), and (9) is the index for political identity. The other variable definitions are provided in Table 3. *t*-Statistics based on robust standard errors are reported in parentheses.

although both political experience and political identity have positive impacts on future firm performance, only the regression coefficient of political experience reaches the 10 percent significance level.

For the control variables in the full sample, we find that firm performance increases with CEO tenure, board size, the board's political connections, ownership concentration, and firm size, and decreases with CEO duality, CEO age, outside directors, state share, and leverage. No sharp difference is found between the firm performance of state- and privately-controlled companies. The coefficients of the control variables in the two sub-samples show some differences, which suggests that the effects of these variables are conditional on the level of firm performance.

Robustness Tests

Relative Industry Performance Measures. Previous studies suggest that internal monitors use relative industry performance measures to evaluate CEO performance (e.g., Morck, Shleifer, & Vishny, 1988). To examine the robustness of our results according to this definition of firm performance, we use the industry-adjusted return on assets (*IROA*) as an alternative firm performance measure. It is measured as *ROA* less the median value of *ROA* for all firms in the same industry. Using *IROA*, we thus re-estimate the regressions in equations (1) and (2) to evaluate the effect of CEOs' political connections on their forced turnovers and on future firm performance, respectively.

Alternative Classification of Forced CEO Turnover. Although existing research stresses the importance of precisely separating forced turnovers from voluntary turnovers, doing so is difficult, as the exact reasons for turnovers are rarely announced publicly (Cheng, Li, & Tong, 2008; Gibson, 2003; Shen & Lin, 2009). Following Firth et al. (2006), Kato and Long (2006), and Shen and Lin (2009), we use a binary variable called *All CEO turnover* that captures CEO turnovers for any possible reason. As a robustness check, we estimate the logistic regression based on equation (1) with *All CEO turnover* as the dependent variable to test the effect of CEOs' political ties on their forced turnover.

Weighted-Sum Political Connection Index. The value of political connections is in the differential access to various available resources that they can provide. However, such benefits may vary depending on the level of government involved. It is possible that political ties to the central government are more useful than those to the local government in obtaining bank loans and other key resources. This suggests that ties to higher levels of government are more valuable, and therefore will have a greater impact on firm performance. At the same time, the accompanying intervention costs also vary with the level of government involved. We expect that political connections with higher-level government bodies will result in more political intervention in the normal decision making of managerial turnover. To gauge these effects, we assign 4, 3, 2, and 1 to the four levels of government, which are state, province, city, and county, respectively, and obtain a weighted-sum political connection index for each level to use in the regressions. As a robustness check, we re-estimate the regressions with the weighted-sum political connection index as the independent variable based on equations (1) and (2) to evaluate the effect of political connections on forced CEO turnover and future firm performance, respectively.

In general, the results of these three robustness tests (unreported due to space constraints) are qualitatively similar to those of the main test specifications, and no inferences are affected.

DISCUSSION AND CONCLUSION

Although the effects of political connections have been widely investigated, evidence of their effects on firm performance and market value is mixed. Moreover, studies in this arena fail to address the direct influence of political connections on corporate governance, an important channel of influence on firm development. We explore for the first time the influence of CEOs' political ties on their forced turnovers, one of the most important decisions made by a board of directors reflecting the quality of corporate governance. We argue here that when faced with the risk of losing his or her job, a CEO will use political connections for his or her own benefit, which may decrease the possibility of forced turnover and weaken turnover-performance sensitivity. Furthermore, we examine the effect of the retained CEOs' political connections on future firm performance and compare this effect across firms with different levels of financial performance. The reasoning behind this is that under different operating statuses, CEOs may face different pressures and have different motivations for using their resources, which will influence the relationship between political connections and firm performance.

To test our hypotheses, we use a large sample of listed firms in China, and manually sort out CEOs' political connections by analyzing their curriculum vitae in detail. We confirm international evidence that firm accounting-based performance is an important factor in the forced CEO turnover decision. However, we find that CEOs' political connections significantly reduce their likelihood of forced replacement and that turnover-performance sensitivity is lower for connected CEOs than for their non-connected peers. We also find that the political connections enjoyed by the retained CEOs play a positive role in improving firm performance, a result that is robust to a series of specification tests. In particular, we find that the positive relationship between future firm performance and political connections is more significant when current firm performance is below the industry median than when it is above it. These findings reveal that the value of political connections is subject to actual firm performance and that the benefits of political connections may greatly outweigh their costs when firm profitability is below target. In general, our evidence does not deny the value of political connections in a transition economy, but suggests the need for better corporate governance mechanisms to reduce its potential negative effects.

Future research should address several limitations of our study. First, under Chinese corporate law, the chairman of the board is the legal representative of the company, and

tends to be powerful in day-to-day decision making. Therefore, he or she is also responsible for a company's daily operations and may be treated in the same way as the top manager (e.g., Kato & Long, 2006; Shen & Lin, 2009). Future studies could extend our work by examining the impact of the chairmen's political connections on their forced turnover and on firm performance. Second, although we have provided new evidence by demonstrating that the effect of political connections is significantly different when firms have different operating performances, future studies could conduct additional tests to identify the direct channel by which politically connected CEOs benefit or harm firm performance. Third, most listed firms in China are controlled by state shareholders, and government ownership represents an inherent tie with the government. This implies that the key advantages of CEOs' political connections may be partially offset in state-owned firms. Whether there is any difference in the effect of political connections on firm performance between state-controlled and private firms is another issue worthy of investigation.

Despite its limitations, this study has several cross-sectional policy implications for other transition countries. First, our findings suggest that political connections are a double-edged sword. On the one hand, political ties may intervene in the normal selection mechanism and limit the board's ability to fire incompetent managers. On the other hand, CEOs' political ties improve firm performance, i.e., connected firms may enjoy more favorable treatment in countries with interventionist governments and the weak protection of property rights, which is consistent with Faccio's (2006) argument. Therefore, when choosing a more qualified CEO, firms need to balance the need for political connections with the need for managerial skills. Our findings have implications for regulators in emerging markets that are currently carrying out Western-style management and corporate governance reforms working toward the "best practice" model. In this process, strengthening managerial accountability is crucial to improving both investor protection and market confidence. Our evidence shows that a CEO's political connections will strengthen his or her power in the firm and, accordingly, limit the board's authority, which may harm the corporate governance arrangement. It is important to reinforce the effectiveness of internal corporate governance mechanisms to constrain the power derived from political ties.

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NOTES

1. We also use a binary variable of political connections in the regression analysis, which is equal to 1 if *PolCon* is above zero and 0 otherwise. This produces very similar results (unreported) to those based on the unweighted-sum index of CEOs' political connections.
2. We use the industry classification system of the Chinese Securities and Regulatory Commission (CSRC), which classifies all listed firms into 21 industries, with nonmanufacturing industries given a one-digit code and manufacturing industries a two-digit code.
3. We also divide the sample into a profit-making sample and a loss-making sample on the basis of whether *ROA* is positive. The results are similar. Specifically, the positive relationship between political connections and future firm performance is more significant in the loss-making sample than in the profit-making sample.
4. As a robustness check, to eliminate the possible multicollinearity problem, we drop the variables of board size, outside directors, ownership nature, and state shares, the variance inflation factors that are greater than 3, and then rerun the regressions. The empirical results (unreported) remain qualitatively unchanged.

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