

# Corporate Governance, Political Interference, and Corporate Performance of China's Listed Companies

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## **Abstract**

In the corporate governance literature, the notion that political interference in enterprise decision-making is detrimental to corporate performance is widespread and is buttressed by a large body of theoretical studies. However, few empirical studies support the theories these studies espouse. For our study, we construct measures with which to capture political interference in the decision-making of China's listed companies and perform direct tests to determine the relationship between political interference in the decision-making of these companies and their performance. We offer evidence that political interference in these companies' decision-making negatively affects their performance. This study not only addresses an important corporate governance issue for China's listed companies but also brings together the theoretical and empirical aspects of the corporate performance implications of political interference.

JEL classification: G34; G38; P26

Keywords: Corporate Governance; Political Interference; Corporate Performance; China's Listed Companies

## **I. Introduction**

The notion that political interference in enterprise decision-making is detrimental to corporate performance is well documented throughout the robust body of theoretical studies on corporate governance. It is frequently argued that by maintaining control over enterprise decision-making, politicians can use enterprises to pursue so-called higher national goals, (e.g., employment maximization, regional development, industrial policies).<sup>1</sup> They may also seek to control enterprises to achieve their own political and personal goals (e.g., increasing their political support and power).<sup>2</sup> Their pursuit of such goals may result in shareholders' inability to maximize wealth and thus in less favorable corporate performance.

Empirical studies of the relationship between political interference in enterprise decision-making and corporate performance are scarce, on the other hand, because it is difficult to identify objective measures of such interference. Most of the existing evidence for how political interference affects corporate performance comes from studies that document the poor performance of state-owned enterprises (SOEs) compared with the performance of non-state-owned enterprises (NSOEs). The logic here is that the corporate governance structure of SOEs is associated with a higher degree of political interference and that their poor performance thus supports the idea that political interference damages corporate performance [Shleifer and Vishny (1994)].

There is an extensive volume of empirical studies that document the inferior performance of SOEs relative to NSOEs [Boardman and Vining (1989), Vining and Boardman (1992), Shirley and Walsh (2000)] and the improvement in efficiency after privatization [Kikeri, Nellis, and

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<sup>1</sup> For example, see Millward (1976, 1983), Vickers and Yarrow (1989), Shapiro and Willig (1990), Shleifer and Vishny (1994), Boycko et al. (1996), Shleifer and Vishny (1998), and Shleifer (1998).

<sup>2</sup> For example, see Niskanen (1975), Jones (1985), Levy (1987), Krueger (1989), Shapiro and Willig (1990), Shleifer and Vishny (1994), Boycko et al. (1996), and Shleifer and Vishny (1998).

Shirley (1992), Megginson et al. (1994), Megginson and Netter, (2000)]. Economics and finance theories, however, suggest that political interference is only one of the major flaws in the corporate governance structure of SOEs. Another equally if not more important reason for SOEs' poor performance, according to these theories, is the fact that SOEs face a more serious agency problems than NSOEs [Shirley and Walsh (2000)]. Alchain (1965) argues that since SOEs' ownership is widely distributed, their owners tend not to monitor managers well, because a state owner stands to gain little from the improvement in his enterprise's performance that would result from alleviating the agency problems. SOEs' agency problems can also be attributed to the absence or ineffectiveness of external disciplinary mechanisms including (1) competition from other firms [Machlup (1967)], (2) the possibility of hostile takeover [Yarrow, (1986)], and (3) the threat of bankruptcy [Kornai (1980)]. Without these external mechanisms of corporate control, SOE managers can rest assured that inefficiency will almost certainly not result in hostile takeover and bankruptcy that would cost them their job. As a result, SOE managers have little incentive to strive to improve the performance of their enterprises.

Because the corporate governance structure of SOEs is plagued with not only political interference but also serious agency problems, poor performance relative to that of NSOEs cannot be attributed entirely to political interference. Even though many empirical studies have found a negative relationship between state ownership and corporate performance, this is at best only indirect evidence that a negative relationship exists between political interference and the corporate performance.

That China's listed companies are subject to extensive political interference is well known [Tam (1999), Shanghai Stock Exchange (2000), Opper et al (2001), McGregor (2001)]. But although a few surveys have been published on this topic, no systematic empirical study investigating how political interference affects the corporate performance of these companies has been conducted. There are, however, three existing studies devoted to investigating the relationship between state shareholding and the companies' corporate performance. Using pooled firm-level data of all the companies listed by the Shanghai and Shenzhen Stock

Exchanges, Xu and Wang (1999) and Qi et al. (2000) find that the corporate performance of China's listed companies is negatively related to the proportion of a company's shares that are owned by the state. Tian (2000), however, fails to find a negative relationship between the proportion of state shares and corporate performance. Instead, he finds a U-shaped relationship. He explains that this relationship results from the fact that state shareholders perform two opposing functions: they hobble companies by directing the companies' wealth toward government uses, and, on the other hand, they offer companies preferential treatment and corporate governance that, in fact, are beneficial to the companies. His interpretation further implies that the relationship between state ownership and corporate performance may be different from the relationship between political interference and corporate performance.<sup>3</sup>

This study examines the relationship between political interference and corporate performance for China's listed companies. Owing to the confounding effects of agency problems and to the possibility that state shareholders may introduce certain interventions that, in some respects, benefit these companies, we purposely refrain from using state shareholding to proxy and examine the effects of the political interference of state shareholders. Instead, we base our research on a survey of China's listed companies conducted by the Shanghai Stock Exchange

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<sup>3</sup> Tian (2000) assumes that the probability and magnitude of political interference are increasing but the probability and magnitude of preferential treatments and corporate governance provided by state shareholders keep at a constant level with increased state shareholding until the state shareholding reaching a certain threshold. After the threshold, the probability and magnitude of political interference stop increasing but the probability and magnitude of preferential treatments and corporate governance increase incrementally with increased level of state shareholding. He basically attributes the first-half of the U-shape to the political interference and the second-half of the U-shape to the beneficial interventions introduced by state shareholders. His interpretation suggests that state shareholding may be a good proxy for political interference for the level of state shareholding before the threshold. Nevertheless, such a result is based on the assumption that the level of preferential treatments and corporate governance provided by state shareholders keeps at a constant level for state shareholding before the threshold. The assumption is in fact sufficient but not necessary for his explanation of the U-shape. If state shareholders gradually increase beneficial interventions with increased state shareholding rather than increase them after reaching certain threshold of shareholding, the relationship between state shareholding and corporate performance will be different from the relation between political interference and corporate performance.

and Integrity Management Consulting Firm (hereafter, the survey is referred to as “SSES”)<sup>4</sup>. Using data from the SSES, we attempted to construct measures to capture two sources of political interference in China’s listed companies: (1) the involvement of the grassroots organizations of the Chinese Communist Party (CCP) (hereafter called “local party committees”) in the companies’ decision-making processes, and (2) the presence of government officials on the companies’ boards of directors (BoDs). We then directly test the relationship between political interference from these sources and the companies’ corporate performance. We offer evidence that both the interference of local party committees and the presence of government officials on a company’s BoD pose a negative impact on the corporate performance. This study not only addresses an important corporate governance issue for China’s listed companies, but also fills the gap between the theoretical debate and empirical investigation of the performance implication of political interference.

The paper is organized as follows. Section II reviews the relevant literature. Section III provides a brief overview of the corporate governance structure of China’s listed companies. The data and econometric methodology used to test the relationship between political interference and corporate performance are explained in section IV. Section V reports our results. Section VI offers some conclusions.

## **II. Theoretical Background**

Most of the arguments supporting the notion that political control in enterprise decision-making is detrimental to corporate performance rely on the assumption that politicians maximize

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<sup>4</sup> While we share the common concern regarding the reliability of any survey data, our confidence on this dataset is strengthened by the fact that the survey is part of a 3-year project conducted by the Shanghai Stock Exchange. It is the largest research project conducted by the Exchange since its inception. The results of the project have been reported and published under the title of “The Corporate Governance of China’s Listed Companies” by the Shanghai Stock Exchange and presented at an international conference in 2001.

social goals rather than shareholders' wealth. In some cases, it is assumed that politicians use enterprises to correct market failures such as natural monopolies and externalities [Vickers and Yarrow (1989), Shleifer and Vishny (1994), Shleifer (1998)]. Certain scholars suggest that politicians also use enterprises to accelerate capital formation and technology transfer [Sacristan (1980), Labra (1980)], reduce income inequality [Willner (1996)], and increase macroeconomic stability [Millward (1976)].

In fact, most of the social goals mentioned above can be achieved through taxation, subsidies, and/or contracting; there is no need for politicians to be directly involved in enterprise decision-making to achieve them [Coase (1937, 1960), Millward (1982), Shirley and Walsh (2000)]. Some scholars defend politicians' participation in enterprise decision-making on the grounds of the possible presence of information asymmetry between producers and politicians and/or incomplete contracts [Sappington and Stiglitz (1987), Hart, Shleifer, Vishny (1998)]. Leaving aside the important question of whether politicians can actually use enterprises to improve social welfare, the enterprises that politicians use to pursue social goals are forced to abandon profit maximization in favor of social-welfare maximization, which is likely to result in less favorable corporate performance.

An alternative view assumes that politicians act according to their own interests. Shapiro and Willig (1990) suggest that a politician's objective function is a weighted average of social welfare and his/her personal goals and that the relative weights placed on these two kinds of goals depend on the efficiency of the political market. Boycko et al. (1996) and Shleifer and Vishny (1994, 1998) examine the way politicians use enterprises to provide employment to obtain more political support. Krueger (1990) suggests that politicians tend to hire politically connected individuals rather than qualified individual. Jones (1985) describes numerous cases in which politicians in various countries use SOEs as vehicles to transfer wealth and favor from one group to another.

Political interference is more common in SOEs than in NSOEs [Jones (1985), Shleifer and Vishny (1994), Shleifer (1998)]. Different explanations have been offered for the unbalanced

distribution of political interference activities between SOEs and NSOEs. Jones (1985) argues that the transfer of wealth through SOEs is far less transparent than are traditional taxes and subsidies. As a result, politicians enjoy lower political costs if they transfer wealth to favored groups through SOEs. Sappington and Stiglitz (1987), on the other hand, hold that the residual rights of controls lower politicians' transactions costs when they attempt to intervene in SOEs.

The high degree of political interference in SOEs suggests that state ownership may serve as a good proxy for political interference. There is, however, evidence that degree of political interference is not a simple function of state ownership. Lioukas et al. (1993) find that fully state-owned enterprises in Greece are subject to different degrees of political interference depending on various factors (e.g. size, relative contribution to social objectives). In addition, NSOEs are also subject to political interference [McGregor (2001), Shirley and Walsh (2000)]. Furthermore, studies on the relationship between state ownership and corporate performance cannot perfectly substitute for an examination of the performance implications of political interference owing to the confounding effects of agency problems and to the possibility that state shareholders may introduce certain beneficial interventions. By employing measures of political interference rather than the proxy variable of state shareholding, this study offers direct evidence of the relationship between political interference and corporate performance.

### **III. Political Interference in China's Listed Companies**

Managers in China's SOEs have been subject to political control by local party committees since the founding of the People's Republic of China. In 1956 Mao Zedong ordered the "director (manager) responsibility system under the leadership of the Party Committees" to be implemented. Under this system, enterprise managers were subject to the control of local party committees. During the Cultural Revolution (1966–1976), SOEs' operation and management were dictated entirely by local party committees, and the position of enterprise manager was essentially abolished [You (1998)].



In late 1978, the leadership under Deng Xiaoping introduced economic reform. The first step of the reform in industry was to restore enterprise managers. This was followed by a two-decade-long effort to transfer decision-making rights from local party committees to managers [You (1998)]. During the early 1980s, the administration experimented with a new corporate governance structure selected SOEs. Under this new structure, managers enjoyed extended decision-making rights. The enterprise law that went into effect in August 1988 granted managers the right to fully operate and manage SOEs. Under this law, however, local party committees retained sufficient legal grounds to continue their supervisory roles in the management of SOEs<sup>5</sup>.

In 1993, China promulgated the Company Law. The law includes a set of relatively clear specification on the rights and authorities of major decision-makers in shareholding companies. The law's objective is to provide shareholders, BoDs, and managers with legal protection for their decision-making rights so as to reduce political interference from the CCP and the government (World Bank, 1997). With regard to the separation of ownership and control, Simon states that "recent Chinese reformers have seized on Berle and Means's rhetoric as if 'separation' were a solution to an entirely different problem—the interference of government officials in the operation of enterprises" [(1996), 287].

Public listed companies in China are generally privatized SOEs that have been transformed into shareholding companies according to the Company Law. They are propagated by the government as role models for China's evolving modern enterprise system and are supposed to be subject to less political interference than traditional SOEs. The corporate governance structure of listed companies, however, has several obvious loopholes that allow for political interference in these companies.

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<sup>5</sup> Art. 8 of the law stipulates that "the grass-root organization of the Chinese Communist Party in the enterprise shall guarantee and supervise the implementation of the guiding principles and policies of the Party and the state in the enterprises."

The first loophole is the state's insistence on retaining controlling shares in strategic sectors of the economy after listing companies. At the end of 1999, 36.13% of the outstanding shares of China's listed companies were state shares. Tian (2000) finds that, if we assume that listed companies are actually controlled by their largest shareholders, the government controls 44% of the listed companies. State shareholding enables the government to remain involved in the decision-making process and to introduce interventions in the capacity of the shareholder (ownership channel).

The second loophole is the Company Law's permission for local party committees to maintain their organizational presence in shareholding companies. On the subject of activities of local party committees, Art. 17 of the Company Law states that "the activities of the local party committees of the CCP in a company shall be carried out in accordance with the Constitution of the CCP." The constitution of the CCP, however, does not clarify the limits on party activities within enterprises, since Art. 31 broadly delegates the implementation of higher party decisions to local party committees and assigns local party committees the right to "supervise Party cadres and any other personnel to ensure that they strictly abide by the state laws and administrative disciplines, strictly observe the state's financial and economic regulations and personnel system, and refrain from encroaching on the interests of the state, the collectives and the masses." This provision, in effect, formally awards local party committees the right to supervise the personnel of listed companies.

The third loophole is government representation on BoDs (board channel). The SSES reveals that at the end of 1999, about 10% of China's listed companies had government officials as outside directors. These directors occupied 17.9% of the companies' board seats. Because they promote government interests, these directors constitute a source of additional political interference in the companies.

In 1997 the central government began intensifying its efforts to reduce political interference in enterprises through a new reform strategy adopted by the CCP's 15<sup>th</sup> Congress. Under this strategy large SOEs are to be converted into shareholding companies in accordance

with the Company Law, with the state retaining a controlling shareholding. Smaller SOEs are to be sold to private investors. While severing the property relationship is expected to reduce the degree of political interference in privatized SOEs, political interference in large shareholding companies remains extensive owing to the weaknesses in their corporate governance structure [Tam (1999), He (1998), You (1998), McGregor (2001)].

Existing studies on political interference in China's listed companies focus mainly on the ownership channel [Xu and Wang (1999), Qi et al. (2000), Tian (2000)]. In this study, we purposely refrain from using state shareholding to examine the effects of political interference in the ownership channel. Instead, we construct two measures to capture the political interference in the party channel and the board channels. The availability of these measures constitutes a valuable opportunity to test the performance implications of political interference and thus provides empirical evidence to substantiate existing theoretical arguments.

#### **IV. Data and Econometric Methodology**

This section describes in detail the data and the econometric methodology we used to examine the relation between political interference and the corporate performance of China's listed companies. We first introduce our data sources and measures of political interference and then explain our performance measures. After we discuss the control variables to be included in our models, we state our hypothesis and specify the regression equations for estimation.

##### **A. Data Source of Political Interference**

Our political interference data is from the SSES, which is part of a 3-year survey conducted by the Shanghai Stock Exchange and the Integrity Management Consulting Firm on the corporate governance structure of China's listed companies. For the survey, researchers distributed questionnaires to each of the 483 companies listed by the Shanghai Stock Exchange. Of these companies, 257 returned the questionnaires (a response rate of 53.54%). The respondents had no obvious biases in term of listing age, industrial structure, or shareholding

structure [Shanghai Stock Exchange, (2000)]. Of the 257 questionnaires, however, we excluded 7 because of inconsistent data.

The questionnaire, which was to be completed by the secretary to the chairman of the BoD, asked the respondents to rate the level of involvement of local party committees, shareholders meetings, BoDs, and managers in 63 decisions. Respondents were asked to use a 5-point scale. Responses ranged from no involvement at all (score=1) to complete control (score=5). We use the data on the involvement of local party committees to construct a measure of political interference in the party channel. In addition to using data on decision-making power, we also use data on the government representation on BoDs to construct another measure of political interference.

Among the respondents, 110, 85, 113, and 113 companies provided a complete set of ratings on the involvement of local party committees, shareholders meetings, BoDs, and managers (respectively) in all decisions.<sup>6</sup> Two hundred and thirty respondents provided detailed data on board composition. When we limit our sample to only those companies that provided complete data on both decision-making power and board composition, the number of companies in our sample falls to 72, or about 15% of the companies listed by the Shanghai Stock Exchange.

The SSES provides board composition data of the listed companies for the period 1996–1999. However, it provides data on decision-making power for 1999 only. This means that we were able to test only the relationship between party interference and corporate performance during 1999 (we call this sample *SAMPLE<sub>99</sub>*). We assume, however, that the relative involvement of various decision-makers in the listed companies had been stable for some time, so we were able to extend our analysis to the entire period. Because the CCP's 15<sup>th</sup> Congress

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<sup>6</sup> Detailed analysis of the response rates across decision types indicates no obvious pattern. Therefore, we are unable to determine why some respondents left some decisions unrated. However, we suspect that some respondents may simply leave a decision unrated if they have not encountered that decision. This is based on our observation that the response rates for the two questions relating to external donation, which is an uncommon activity of a typical company, are the lowest.

adopted new reform initiatives in 1997 that were aimed specifically at reducing political control in enterprises, which might have had an impact on the distribution of decision-making power in listed companies, we use 1997 as a cut-off point when we construct two sample data sets. Thus, our first extended sample data set includes observations for the period 1998–1999 (*SAMPLE<sub>98-99</sub>*), and our second set consists of observations for the period 1997–1999 (*SAMPLE<sub>97-99</sub>*). Of the 72 companies that provided complete data on both decision-making power and board composition at the end of 1999, 5 were listed in 1999 and 14 in 1998. Therefore, when we pool the data for the periods 1998–1999 and 1997–1999, the corresponding sample sizes are 139 and 192, respectively.<sup>7</sup>

## B. Measures of Political Interference

We use the data on the involvement of local party committees in 63 decisions to construct our first measure of political interference in the listed companies. For each company, we construct an index of party interference (PI) by averaging the level of involvement of the local party unit in all decisions.

$$PI_i = \frac{\sum_{j=1}^n S_{ij}}{n}$$

where  $S_{ij}$  is the level of involvement of the local party unit of company  $i$  in decision  $j$ , rated on a 5-point scale ranging from no involvement at all (score=1) to complete control (score=5) in 63 decisions ( $n=63$ ). Covering 63 decisions, the index provides a relatively complete measurement of party interference in the companies' decision-making.

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<sup>7</sup> Our samples include observations for companies that have been listed for less than 1 year. According to listing regulation of the Shanghai Stock Exchange, companies applying for listing must have been incorporated according to the Company Law for at least 3 years. In other words, the corporate governance structure of listed companies has been in place for at least 3 years, even for the newly listed companies. As a result, we did not exclude any of the newly listed companies from our samples. We attempt to exclude them in our robust tests, and consistent results are obtained.

In spite of its value, the measure has a few limitations. As is always the case, respondents' ratings are subject to their subjective assessment. On one hand, because the CCP still enjoys unchallenged political authority in China, it is reasonable to expect some respondents to think that local party committees *should* play an important role in company decision-making. On the other hand, respondents may tend to downplay the involvement of local party committees because the government has been implementing a series of reforms aimed at reducing party interference in enterprises since 1978. Thus we cannot ascertain whether the survey systematically underscores or exaggerates the actual level of political interference.<sup>8</sup>

As PI inevitably involves some subjective elements, we use the data of government representation on BoDs to construct another measure of political interference. Owing to the fact that 90% of our sample companies do not have government officials as outside directors, we refrain from constructing a continuous measure for this attribute. Instead, we construct a dummy variable (GB) indicating the existence of government directors. GB equals 1 when a company has government directors and 0 otherwise. Because we use a dummy variable rather than a continuous measure, we are unable to draw a conclusion about the continuous relationship

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<sup>8</sup> The fact that PI is based on a subjective assessment may create two problems for our study. First, the respondent of a poorly performing company might blame the poor performance on the involvement of the local party committee. As a result, owing to blame shifting, poorly performing companies may be associated with higher ratings of party involvement. Although we cannot rule out this possibility, blame shifting is not likely to have occurred, for two reasons: (1) the questionnaires were completed by the secretary to the chairman of the BoD, and these individuals have no incentive to blame poor performance on party committees instead of the managers, and (2) it is unlikely that respondents could have perceived the specific linkage between party involvement and corporate performance on the questionnaire, which contains 74 questions covering nearly every aspect of corporate governance structure. Second, it may not be appropriate to use the data cross-sectionally if respondents have very different judgments on the relative involvement of local party committees and tend to assign different rating for a similar degree of party involvement. We, however, are not aware of any suggestion of the presence of systematic perception bias. Furthermore, the measure benefits from the fact that it is obtained by averaging the ratings over 63 decisions and from a comprehensive survey in which respondents are unlikely to know how the data collected would be used by researchers. Nevertheless, caution should be employed in interpreting PI. It measures the level of party involvement as perceived by the secretary to the chairman of the BoD and may be different from the actual degree of party involvement, owing to the possible presence of perception biases.

between the degree of government representation on a company's BoD and the corporate performance of the company. Nevertheless, we use this measure as one of our political interference measures because it is an observable variable. It can serve as a good complement to PI, which is based on subjective assessment.

### C. Performance Measurement

We measured the performance of the companies with three variables that have been used in previous studies to analyze the corporate performance of China's listed companies: return on assets (ROA), return on equity (ROE), and market-to-book value ratio (MBR) [Xu and Wang (1999), Qi et al. (2000)]. ROA (ROE) is defined as the net profit divided by average total assets (equity), while MBR is the ratio of market value to book value of equity. We obtain the data for our two performance measures from the Shanghai Wind Information Co., Ltd. (WIND) and the Taiwan Economic Journal.<sup>9</sup>

### D. Control Variables

Our main focus in this paper is the relationship between political interference and the corporate performance of China's listed companies. Some factors, however, can affect both political interference and corporate performance and thus may induce a spurious correlation between them. Based on economic arguments that we discuss later, we introduce the following five sets of control variables to isolate the performance effects of political interference.

#### *Market Conditions*

The companies in our sample come from various industries, are at differing stages of the product life cycle, and are subject to different degrees of competition and regulation (i.e., market conditions). Different market conditions provide companies with different opportunities to capture profit. They also leave different amounts of room for political interference. For example,

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<sup>9</sup> This privately owned company is a major company specializing in providing China's securities market data. It was established in Shanghai in 1992.

the existence of a highly competitive market environment would force companies to minimize costs and would therefore leave less room for political interference [Oppen et al. (2001)]. As market conditions affect both political interference and corporate performance, we introduce a set of industrial dummies ( $INDUSTRY_i$ ) to capture the different market conditions so as to isolate the performance effects of political interference. The industry code is obtained from *China Securities and Futures Statistical Yearbook 2000*.<sup>10</sup>

#### *Involvement of Shareholders, Boards of Directors, and Managers*

The level of involvement of shareholders, BoDs, and managers in the decision-making process of companies may affect both corporate performance and political interference. On one hand, a high level of involvement on the parts of shareholders and BoDs implies a high level of monitoring activities. This would reduce agency problems and lead to improved corporate performance. On the other hand, a high level of involvement on the parts of shareholders and managers decreases the government's predatory behaviors. We construct three indices to measure the involvement of shareholders through shareholders meetings (SI), BoDs (BI), and managers (MI) in the decision-making process. These indices are constructed in the same manner in which PI is constructed. The data here is from the SSES as well.

$$SI_i = \frac{\sum_{j=1}^n S_{ij}}{n} \quad BI_i = \frac{\sum_{j=1}^n S_{ij}}{n} \quad MI_i = \frac{\sum_{j=1}^n S_{ij}}{n}$$

where  $S_{ij}$  is the level of involvement of the power holders of company  $i$  in decision  $j$ , rated on a 5-point scale ranging from no involvement at all (score=1) to complete control (score=5) in 63 decisions ( $n=63$ ).

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<sup>10</sup> There are two kinds of industrial classifications for China's listed companies. The first is the 5-industry code (i.e., manufacturing, trade, utility, real estate, and conglomerates), as used by previous studies on China's listed companies. The second is a new classification provided by the newly promulgated Guidelines on Industries Classification of Listed Companies (Provisional). We adopt the new classification that divides the listed companies into 12 industries.



### *Sales*

The size of a firm is another basic company characteristic that may affect both the level of political interference and corporate performance. On one hand, large companies may have scale economies and better access to financial resources, which can improve corporate performance [(Fama and French (1995)]. Xu and Wang (1999) and Qi et al. (2000) show that the financial performance of China's listed companies is positively related to company size (measured by total sale volume and book value of assets). On the other hand, large enterprises may be associated with a higher degree of political interference because they can deliver more benefits to politicians [Lioukas et al. (1993)]. In this study, we follow Xu and Wang's (1999) example in using the logarithm of sales volume (SALE) to proxy the company size. The data is from WIND. We expect SALE to be positively correlated with the corporate performance.

### *Capital Structure*

We also take into account the possible effects of capital structure on corporate performance and political interference. In their analysis of the relationship between state ownership and corporate performance of China's listed companies, Qi et al (2000) and Xu and Wang (1999) find that the debt-to-equity ratio of China's listed companies is negatively related to ROA but positively related to MBR. There may also be a positive relationship between the government's involvement in the decision-making process and the amount of bank loans a company is able to obtain, because good government connections are vital to a company's ability to obtain bank credit [McGregor (2001)]. As capital structure can affect both party interference and corporate performance, we introduce the debt-to-equity ratio (DER) as a control variable and expect it to be correlated negatively with performance measures. The data here is from WIND.

### *State Shareholding*

We purposely refrain from using state shareholding as a measure of political interference in this study. We do, however, include the percentage of state shares (PSTATE) as a control variable because it has been found that state shareholding is negatively related to the corporate performance of China's listed companies [Qi et al (2000), Xu and Wang (1999)]. Furthermore,

there may be a correlation between state shareholding and political interference in party channel and board channels. State shareholders, for example, may have special political interest in accommodating demands and requests from local party committees and government officials.

### *Macroeconomic Shocks*

When we investigate the relationship between political interference and corporate performance of the companies for *SAMPLE*<sub>1998-1999</sub> and *SAMPLE*<sub>1997-1999</sub>, year dummies (YEAR<sub>j</sub>) are introduced to capture the macroeconomic shocks in different years. YEAR<sub>97</sub> takes the value of 1 for year 1997 observations and the value of 0 for others. YEAR<sub>98</sub> takes the value of 1 for year 1998 observations and the value of 0 for others.

### E. Regression Models

Our investigation into the effects of political interference on the performance of China's listed companies is divided into two parts. First, we examine how the party affects corporate performance; our null hypothesis is that party interference is uncorrelated with corporate performance. We estimate this model by using three sample data sets: *SAMPLE*<sub>99</sub>, *SAMPLE*<sub>98-99</sub> and *SAMPLE*<sub>97-99</sub>. The regression equation for *SAMPLE*<sub>99</sub> is

$$P = \mathbf{a} + \sum_{i=1}^{12} \mathbf{I}_i \text{INDUSTRY}_i + \mathbf{b}_1 \text{SALES} + \mathbf{b}_2 \text{DER} + \mathbf{b}_3 \text{SI} + \mathbf{b}_4 \text{BI} + \mathbf{b}_5 \text{MI} + \mathbf{b}_6 \text{PSTATE} + \mathbf{b}_7 \text{PI} + \mathbf{e} \quad (1)$$

where P denotes the performance measures of ROA, ROE, and MBR. PI is the degree of political interference from the party committees;  $\hat{a}$ ,  $\hat{e}_i$ ,  $\hat{a}_1$ ,  $\hat{a}_2$ ,  $\hat{a}_3$ ,  $\hat{a}_4$ ,  $\hat{a}_5$ ,  $\hat{a}_6$ , and  $\hat{a}_7$  are the coefficients for estimation. Our null hypothesis is that  $\hat{a}_7$  is indistinguishable from zero. We add one (two) yearly dummy variable to equation (1) when using the extended sample *SAMPLE*<sub>98-99</sub> (*SAMPLE*<sub>97-99</sub>).

Second, we analyze how the existence of government representation on BoDs affects corporate performance.

$$P = \mathbf{a} + \sum_{i=1}^{12} \mathbf{I}_i \text{INDUSTRY}_i + \mathbf{b}_1 \text{SALES} + \mathbf{b}_2 \text{DER} + \mathbf{b}_3 \text{SI} + \mathbf{b}_4 \text{BI} + \mathbf{b}_5 \text{MI} + \mathbf{b}_6 \text{PSTATE} + \mathbf{b}_7 \text{GB} + \mathbf{e} \quad (2)$$

where  $P$  denotes the performance measures of ROA, ROE, and MBR.  $GB$  is the dummy variable indicating the presence of the government officials on the BoD, and  $\alpha$ ,  $\beta$ ,  $\hat{\alpha}_1$ ,  $\hat{\alpha}_2$ ,  $\hat{\alpha}_3$ ,  $\hat{\alpha}_4$ ,  $\hat{\alpha}_5$ ,  $\hat{\alpha}_6$ , and  $\hat{\alpha}_7$  are the coefficients for estimation. Our null hypothesis is that  $\hat{\alpha}_7$  is indistinguishable from zero. Again, we add one (two) yearly dummy variable to equation (1) when using the extended sample  $SAMPLE_{98-99}$  ( $SAMPLE_{97-99}$ ).

## V. Results

### A. Descriptive Statistics and Sample Data

Table 1 shows the summary statistics of variables for our three samples ( $SAMPLE_{99}$ ,  $SAMPLE_{98-99}$ , and  $SAMPLE_{97-99}$ ). For comparison purposes, we also report the corresponding statistics for all the companies listed by the Shanghai Stock Exchange ( $ALL_{99}$ ,  $ALL_{98-99}$ , and  $ALL_{97-99}$ ). For brevity, unless there is a significant discrepancy, our discussion focuses on  $SAMPLE_{97-99}$  and  $ALL_{97-99}$ . The ROA and MBR of our sample companies (0.049 and 4.199) are very similar to those of the population companies (0.048 and 4.891). Our sample companies and the population companies also match in terms of size ( $SAMPLE_{97-99}=827$  vs.  $ALL_{97-99}=813$ ) and proportion of state shareholding ( $SAMPLE_{97-99}=0.315$  vs.  $ALL_{97-99}=0.318$ ). The ROE of our sample companies (0.084) is, however, higher than that of the population companies (0.05). The average debt-to-equity ratio of our sample companies ( $SAMPLE_{97-99}=1.061$ ) is also lower than the corresponding ratios of the population companies ( $ALL_{97-99}=1.367$ ). Our samples may be biased in the sense that they include companies with higher returns on equity and a lower leverage level.

Among the major power holders in the listed companies, BoDs are most heavily involved in the decision-making process (mean=3.63), followed by managers (mean=3.19) and shareholders through shareholders meetings (mean=2.69). The involvement of local party committees is the lowest (mean=1.62). The list of 63 decisions and the average involvement of local party committees, BoDs, shareholders through shareholders meetings, and managers in our sample

companies (ranked by the level of involvement of local party committees) is provided in Appendix I. Further analysis of the relative level of party interference by decision type reveals that party interference concentrates on personnel policy issues like recruitment decisions, performance appraisal, and dismissals of leading personnel. This is consistent with the fact that the Company Law and the relevant stipulations in the constitution of the CCP actually grant local party committees formal rights to supervise company personnel in the companies. Nevertheless, only 11.5% of our sample companies have government officials as outside directors. The relatively low levels of party involvement and outside government board membership suggest that local party committees and government officials no longer dominate the decision-making process of China's listed companies, as they did under the old central planning system in the pre-reform era. Local party committees and government officials do, however, remain involved in the decision-making process, despite the two-decade-long effort to reduce their interference.

[Insert table 1 about here]

Table 2 shows the industrial structure of our three samples and the corresponding statistics for all the companies listed by the Shanghai Stock Exchange. The companies listed by the Exchange are unevenly distributed across industries. At the end of 1999, 58.21% of the companies belonged to the manufacturing industry, 11.66% belonged to the wholesale and retail industry, and 8.05% were conglomerates. The top 5 industries account for 77.92% of all the listed companies. Our samples include observations for only 7 of the 12 industries represented on the Exchange. The 5 unrepresented industries are banking and insurance, construction, mining and quarrying, farming, and cultural production. However, the number of companies belonging to these 5 industries is relatively small (with percentages in *ALL99* at less than 1.84%). The distributions of companies in other industries in all our samples are very similar to the distributions of the population companies. At the end of 1999, 59.38% of our sample companies belonged to the manufacturing industry (58.21% in *ALL99*) and 11.98 % belonged to the

wholesale and retail industry (11.66 % in *ALL<sub>99</sub>*). Therefore, our samples appear to comprise a reasonably accurate representation of the overall industrial structure of the companies listed by the Shanghai Stock Exchange.

[Insert table 2 about here]

## B. Regression Results

In this section, we present the empirical results of the two models. The first model examines the relationship between party interference and corporate performance. The second investigates the performance implications of government representation on BoDs. The coefficients are estimated by the ordinary least square (OLS) technique, and the results are reported in table 3 and table 4 respectively. We estimate each of the two models by employing three sample data sets. As the coefficients obtained from our three samples are generally consistent, with a somewhat lower t-value and adjusted R-square for the smaller samples, we report only the results of the *SAMPLE<sub>97-99</sub>*, for conciseness.

In line with our prediction, table 3 shows that SALES generates significant positive effects in both the ROE and the MBR regressions for all samples. The effect of company size is, however, statistically insignificant in the ROA regression. However, we find a significant negative relationship between DER and ROA and a significant positive relationship between DER and MBR for all samples.<sup>11</sup> Our results are consistent with those found by Qi et al (2000) as well as with those found by Xu and Wang (1999).

With regard to the involvement of major decision-makers, the coefficients of BI are positively related to ROA but not to ROE and MBR. The coefficients of SI are insignificant in all regressions, but the coefficients of MI are significantly positive in all regressions. The findings suggest that the involvement of BoDs and shareholders, whose monitoring activities are

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<sup>11</sup> Other gearing ratios such as the debt-to-asset ratio were tested, and consistent results were obtained.

supposed to reduce agency problems, do not improve corporate performance. However, the involvement of managers, whose objective agency theory assumes is not profit maximization, is positively related to corporate performance. This result is consistent with the finding of Groves et al. (1995) that expansion in managerial decision-making power in China is beneficial to enterprise performance.

The focus of this model is the performance implications of party interference. Table 3 indicates that the coefficients of PI are negative in all performance measures, with statistical significance at 1% in ROA and ROE and at 10% in MBR. A 1% increase in party interference is associated with a 1.8% decrease in ROA, a 3.8% decrease in ROE, and a 47.6% decrease in MBR. Our hypothesis that party interference has no effect on corporate performance is rejected. It should be noted that the negative impact of party interference is obtained after controlling for the level of state shareholding.<sup>12</sup> This suggests that party interference is a source of political interference that cannot be captured by the variable of state shareholding.

[Insert table 3 about here]

Table 4 reports the results of the model that examine the performance implication of government representation on BoDs (GB). Unlike PI, GB is an observable variable that is free from subjective assessment. In this sense, GB provides a more reliable measure of political interference than PI. Much like the first model, SALES generates significant positive effects in ROE and MBR regressions but not on ROA regression. Again, a negative relationship between DER and ROA and a positive relationship between DER and MBR are found. The negative

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<sup>12</sup> To explore further the relationship between state shareholding and our measures of political interference, we have attempted to drop the control variable of state shareholding as well as to add an additional nonlinear term of state shareholding, as Tian (2000) has done. In the first case, the sign, size and statistical significance of the coefficients of our two political interference measures are identical or very close to those of the coefficients obtained from our models. In the second case, the sign and the statistical significance of the coefficients of our two political interference measures remain unchanged but absolute size of the coefficients increases slightly.

coefficient of DER in the ROE regression, however, becomes statistically insignificant. As for the involvement of the major decision-makers, coefficients of BI are positively related only to ROA. The positive impact of managerial decision-making power, however, disappears in all regressions.

The coefficients of GB are negative with statistical significance at 1% in all regressions. The presence of government representation on BoDs is associated with a 3% decrease in ROA, a 7.2% decrease in ROE, and a 117.1% decrease in MBR. All samples reject our null hypothesis that government representation on BoDs exerts no effect on corporate performance. Furthermore, the negative performance implications of government representation on BoDs are obtained by controlling the level of state shareholding. This again suggests that government representation on BoDs is a source of political interference that cannot be captured by state shareholding. However, GB is a dummy variable that only describes how the presence of government representation on BoDs affects corporate performance. Based on the coefficient of GB, we are unable to draw any conclusions about the continuous relationship between political interference and corporate performance, as we could in the case of PI. Nevertheless, the consistent results obtained from both measures can complement and check each other.

[Insert table 4 about here]

## **VI. Conclusion**

Existing quantitative evidence supporting the detrimental implications of political interference on corporate performance usually comes from studies that document the poor performance of SOEs relative to NSOEs. Ownership analysis, however, cannot substitute for a direct test of the relationship between political interference and corporate performance, because the corporate governance structure of state ownership implies not only more political interference but also more serious agency problems. This study directly examines the

relationship between political interference and corporate performance in China's listed companies. Instead of using state shareholding to proxy and examine the effects of political interference, we construct two measures to capture the political interference of local party committees and of government officials who sit on BoDs. We then perform tests of the performance implications of the political interference of these two sources. We offer evidence that both party interference and government representation on BoDs have a negative impact on the corporate performance of the listed companies.

This study finds that the corporate governance structure of China's listed companies has at least two loopholes that allow for detrimental political interference. While party interference may be a unique feature of the corporate governance structure of China's listed companies, the presence of politicians and representatives of political organizations on BoDs is not a China-specific phenomenon. In their analysis of the relationship of corporate performance and mechanisms to control managerial discretion, Agrawal and Knoeber (1996) find that having outside directors on BoDs negatively impacts the corporate performance of U.S. firms. Although they provide no evidence, they suggest that this puzzling finding may be explained by the presence on BoDs of non-owner stakeholders such as politicians, environmental activists, and consumer representatives. Our study provides evidence in support of the theory that having government and political representatives as outside directors negatively impacts the performance of a company. The corporate governance of outside directorship, which is supposed to be a mechanism for exercising independent monitoring over managers, may have negative consequences if the outside directors pursue their own political objectives rather than exercising effective monitoring on behalf of shareholders.



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**Table 1**  
**Summary Statistics of Variables**

This table presents the means and standard deviations of variables for the companies included in our three samples and all companies listed by the Shanghai Stock Exchange. SAMPLE<sub>99</sub> comprises 72 observations for 1999. SAMPLE<sub>98-99</sub> comprises 139 firm-year observations for the period 1998–1999. SAMPLE<sub>97-99</sub> comprises 192 firm-year observations for the period 1997–1999. ALL<sub>99</sub>, ALL<sub>98-99</sub>, and ALL<sub>97-99</sub> are the corresponding data sets for all listed companies. The involvement of local party committees, boards of directors, shareholders and managers in SAMPLE<sub>98-99</sub> and SAMPLE<sub>97-99</sub> is obtained by assuming that the relative involvement of these power holders remained unchanged from 1997 to 1999 and that the levels of their involvement at the end of 1997 and 1998 are identical to those levels in 1999. Standard deviations are in parentheses.

Variables <sup>a</sup>	SAMPLE <sub>99</sub>	SAMPLE <sub>98-99</sub>	SAMPLE <sub>97-99</sub>	ALL <sub>99</sub>	ALL <sub>98-99</sub>	ALL <sub>97-99</sub>
	Mean (Std.dev.)	Mean (Std.dev.)	Mean (Std.dev.)	Mean (Std.dev.)	Mean (Std.dev.)	Mean (Std.dev.)
Return on Asset (ROA)	0.046 (0.042)	0.047 (0.043)	0.049 (0.045)	0.038 (0.089)	0.043 (0.080)	0.048 (0.081)
Return on Equity (ROE)	0.087 (0.083)	0.084 (0.084)	0.084 (0.093)	0.068 (0.455)	0.049 (0.661)	0.050 (0.697)
Market-to-Book-Value Ratio (MBR)	4.450 (2.424)	4.224 (2.124)	4.199 (2.122)	5.451 (12.713)	5.022 (10.010)	4.891 (8.836)
Debt-to-Equity Ratio (DER)	1.084 (1.159)	1.053 (1.118)	1.061 (1.148)	1.433 (5.237)	1.324 (4.435)	1.367 (5.962)
Sales (SALES)	853 (1128)	824 (1082)	827 (1108)	889 (1387)	843 (1329)	813 (1334)
Percentage of State Shares (PSTATE)	0.322 (0.275)	0.318 (0.273)	0.315 (0.269)	0.327 (0.275)	0.323 (0.276)	0.318 (0.274)
Involvement of Local Party Committees (PI)	1.623 (0.688)	1.636 (0.690)	1.663 (0.700)			
Involvement of Board of Directors (BI)	3.638 (0.404)	3.627 (0.395)	3.617 (0.398)			
Involvement of Shareholders (SI)	2.672 (0.681)	2.662 (0.682)	2.670 (0.691)			
Involvement of Managers (MI)	3.021 (0.567)	3.030 (0.570)	3.031 (0.578)			
Existence of Government Representation on Board of Directors (GB)	0.111 (0.316)	0.108 (0.311)	0.115 (0.319)			
Number of Observations	72	139	192	484	921	1304

Sources: Shanghai Wind Information Co., Ltd. (WIND) and Shanghai Stock Exchange Survey (SSES).

<sup>a</sup> Definition of variables: Return on Asset (ROA) is measured as net income over asset. Return on Equity (ROE) is measured as net income over equity. Market-to-Book-Value Ratio (MBR) is measured as market value over book value of a company. Debt-to-Equity Ratio (DER) is measured as total debt over equity. Sales (SALES) is the total volume of sales measured by million yuan (RMB). State Shares (PSTATE) is the number of state shares divided by the total number of outstanding shares. Involvement of Local Party Committees (PI) is the average involvement of local party committees in 63 decisions on a 5-point scale. Involvement of Board of Directors (BI) is the average involvement of boards of directors in 63 decisions on a 5-point scale, Involvement of Shareholders (SI) is the average involvement of shareholders through shareholder meetings in 63 decisions on a 5-point scale, Involvement of Managers (MI) is the average involvement of managers in 63 decisions on a 5-point scale. Existence of

Government Representation on Board (GB) is a dummy variable that equals 1 when a company has government officials as outside directors and 0 otherwise. (For all 5-point scales, 1 is the lowest and 5 is the highest.)

**Table 2**  
**Industrial Structure of Companies**

This table presents comparison of industrial structures of the companies included in our three samples and of all companies listed by the Shanghai Stock Exchange. *SAMPLE<sub>99</sub>* comprises 72 observations for 1999. *SAMPLE<sub>98-99</sub>* comprises 139 firm-year observations for the period 1998–1999. *SAMPLE<sub>97-99</sub>* comprises 192 firm-year observations for the period 1997–1999. *ALL<sub>99</sub>*, *ALL<sub>98-99</sub>*, and *ALL<sub>97-99</sub>* are the corresponding data sets for all listed companies. The industry classification is based on the “Guidelines on Industries Classification of Listed Companies (Provisional)” promulgated by the China Securities and Regulatory Commission, 2000.

Industries <sup>a</sup>	<i>SAMPLE<sub>99</sub></i>	<i>SAMPLE<sub>98-99</sub></i>	<i>SAMPLE<sub>97-99</sub></i>	<i>ALL<sub>99</sub></i>	<i>ALL<sub>98-99</sub></i>	<i>ALL<sub>97-99</sub></i>
	Number (%)	Number (%)	Number (%)	Number (%)	Number (%)	Number (%)
Farming	0 (0.00%)	0 (0.00%)	0 (0.00%)	9 (1.86%)	17 (1.85%)	23 (1.76%)
Mining Quarrying	0 (0.00%)	0 (0.00%)	0 (0.00%)	4 (0.83%)	8 (0.87%)	9 (0.69%)
Manufacturing	44 (61.11%)	85 (61.15%)	114 (59.38%)	286 (59.09%)	541 (58.74%)	759 (58.21%)
Production and Supply of Electric Power Gas and Water	2 (2.78%)	4 (2.88%)	5 (2.60%)	17 (3.51%)	34 (3.69%)	49 (3.76%)
Construction	0 (0.00%)	0 (0.00%)	0 (0.00%)	10 (2.07%)	18 (1.95%)	24 (1.84%)
Transportation, Storage, and Postal	5 (6.94%)	9 (6.47%)	13 (6.77%)	26 (5.37%)	48 (5.21%)	68 (5.21%)
Wholesale and Retail	8 (11.11%)	16 (11.51%)	23 (11.98%)	51 (10.54%)	102 (11.07%)	152 (11.66%)
Banking and Insurance	0 (0.00%)	0 (0.00%)	0 (0.00%)	4 (0.83%)	7 (0.76%)	10 (0.77%)
Real Estate	3 (4.17%)	6 (4.32%)	9 (4.69%)	14 (2.89%)	27 (2.93%)	40 (3.07%)
Social Services	2 (2.78%)	4 (2.88%)	6 (3.13%)	21 (4.34%)	39 (4.23%)	56 (4.29%)
Cultural Production	0 (0.00%)	0 (0.00%)	0 (0.00%)	3 (0.62%)	6 (0.65%)	9 (0.69%)
Conglomerate	8 (11.11%)	15 (10.79%)	22 (11.46%)	39 (8.06%)	74 (8.03%)	105 (8.05%)
Number of Observations	72 (100%)	139 (100%)	192 (100%)	484 (100%)	921 (100%)	1304 (100%)

Sources: *China Securities and Future Statistical Yearbook* and Shanghai Stock Exchange Survey (SSES).

<sup>a</sup> Classification of industry: Farming = farming industry group; Mining Quarrying = mining and quarrying industry group; Manufacturing = manufacturing industry group; Production and Supply of Electric Power, Gas, and Water = production and supply of electric power, gas, and water industry group; Construction = construction industry group; Transportation, Storage, and Postal = transportation, storage, and postal industry group; Wholesale and Retail = wholesale and retail industry group; Banking and Insurance = banking and insurance industry group; Real Estate = real estate industry group; Social Services = social services industry group; Cultural Production = cultural production industry group; Conglomerate = conglomerate industry group.

**Table 3**  
**Party Interference and Corporate Performance of China's Listed Companies**

This table presents the results of our OLS estimates of the regression model that investigates the effects of party interference on the corporate performance of China's listed companies. The model is estimated by using three sample data sets. *SAMPLE<sub>99</sub>* includes 72 observations for 1999. *SAMPLE<sub>98-99</sub>* consists of 139 firm-year observations for the period 1998–1999. *SAMPLE<sub>97-99</sub>* comprises 192 firm-year observations for the period 1997–1999. The corresponding performance measures of the three samples are distinguished by the subscripts attached. Standard errors are in parentheses. One asterisk denotes statistical significance at the 10% level, two at the 5% level, three at the 1% level.

Independent Variables <sup>b</sup>	Dependent Variables <sup>a</sup>		
	<u>ROA<sub>97-99</sub></u>	<u>ROE<sub>97-99</sub></u>	<u>MB<sub>97-99</sub></u>
	Coeff. (Std.err.)	Coeff. (Std.err.)	Coeff. (Std.err.)
(Constant)	-0.084 (0.061)	-0.284** (0.134)	14.424*** (2.712)
Manufacturing	-0.008 (0.011)	-0.021 (0.024)	0.817* (0.477)
Production and Supply of Electric Power, Gas, and Water	0.006 (0.021)	0.023 (0.047)	1.747* (0.950)
Transportation, Storage, and Postal	-0.004 (0.016)	-0.016 (0.036)	-0.524 (0.719)
Wholesale and Retail	0.006 (0.014)	0.015 (0.030)	1.429** (0.607)
Real Estate	0.001 (0.017)	0.004 (0.037)	0.417 (0.744)
Social Services	0.022 (0.020)	0.047 (0.043)	0.277 (0.874)
YEAR <sub>99</sub>	-0.010 (0.007)	-0.003 (0.017)	0.342 (0.333)
YEAR <sub>98</sub>	-0.009 (0.008)	-0.006 (0.017)	-0.173 (0.337)
Debt-to-Equity Ratio (DER)	-0.009*** (0.003)	-0.004 (0.006)	0.766*** (0.123)
log Sale (SALES)	0.004 (0.003)	0.012* (0.006)	-0.525*** (0.125)
Involvement of Board of Directors (BI)	0.023** (0.010)	0.031 (0.022)	-0.609 (0.440)
Involvement of Shareholders (SI)	-0.004 (0.006)	0.005 (0.012)	-0.183 (0.249)
Involvement of Managers (MI)	0.011* (0.007)	0.027* (0.015)	0.682** (0.308)
Percentages of State Shares (PSTATE)	0.005 (0.013)	0.011 (0.029)	0.167 (0.587)
Involvement of Local Party Committees (PI)	-0.018*** (0.006)	-0.038*** (0.013)	-0.476* (0.269)

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Sources: China Securities and Future Statistical Yearbook, Shanghai Wind Information Co., Ltd. (WIND), and Shanghai Stock Exchange Survey (SSES).

<sup>a</sup> Definition of dependent variables: Return on Asset (ROA)= Net profit over total asset; Return on Equity (ROE)= Net Profit over equity; Market to Book Value Ratio (MBR) = Market value over book value of a company.

<sup>b</sup> Definition of independent variables: Manufacturing = manufacturing industry group; Production & Supply of Electric Power Gas & Water = production & supply of electric power gas & water industry group; Wholesale & Retail = wholesale & retail industry group; Real Estate = real estate industry group; Social Services = social services industry group; YEAR<sub>99</sub> = Dummy variable equals to 1 for the observations of the year 1999, and equals 0 for observations of other years; YEAR<sub>98</sub> = Dummy variable equals to 1 for observations of the year 1998, and equals 0 for observation of other years, Debt to Equity Ratio (DER) = total debt divided by equity; Log Sale= logarithm of the total sales volume measured in terms of million Yuan (RMB); Percentage of State Shares (PSTATE) = Number of the state shares divided by total number of outstanding shares; Involvement of Board of Directors (BI) = the involvement of board of directors in 63 decisions on a 5-point scale; Involvement of Shareholders (SI) = the involvement of shareholders through shareholder meetings in 63 decisions on a 5-point scale; Involvement of Managers (MI) = the involvement of managers in 63 decisions on a 5-point scale; Involvement of Local Party Committees(PI) = the involvement of local party committee in 63 decisions on a 5-point scale. (For all 5-point scales, 1 is the lowest and 5 is the highest.)



**Table 4**  
**Government Directors and Corporate Performance of China's Listed Companies**

This table presents the results of our OLS estimates of the regression model that examines how the existence of government directors affects the corporate performance of China's listed companies. The model is estimated by using three sample data sets. *SAMPLE<sub>99</sub>* includes 72 observations for the year of 1999. *SAMPLE<sub>98-99</sub>* consists of 139 firm-year observations from 1998 to 1999. *SAMPLE<sub>97-99</sub>* comprises of 192 firm-year observations from 1997 to 1999. The corresponding performance measures of the three samples are distinguished by the subscripts attached. Standard errors are in parentheses. An asterisk denotes statistical significance at the 10 percent level, two at the 5 percent level, three at the 1 percent level

Independent Variables <sup>b</sup>	Dependent Variables <sup>a</sup>		
	<u>ROA<sub>97-99</sub></u>	<u>ROE<sub>97-99</sub></u>	<u>MBR<sub>97-99</sub></u>
	Coeff. (Std.err.)	Coeff. (Std.err.)	Coeff. (Std.err.)
(Constant)	-0.004 (0.060)	-0.103 (0.133)	17.044*** (2.681)
Manufacturing	-0.012 (0.011)	-0.029 (0.023)	0.720 (0.466)
Production & Supply of Electric Power Gas & Water	0.017 (0.022)	0.049 (0.048)	2.212** (0.964)
Transportation, Storage & Postal	-0.004 (0.016)	-0.018 (0.035)	-0.563 (0.712)
Wholesale & Retail	0.007 (0.014)	0.018 (0.030)	1.454** (0.600)
Real Estate	0.014 (0.017)	0.033 (0.037)	0.854 (0.745)
Social services	0.008 (0.019)	0.017 (0.042)	-0.125 (0.848)
YEAR <sub>99</sub>	-0.008 (0.007)	0.001 (0.016)	0.384 (0.328)
YEAR <sub>98</sub>	-0.008 (0.007)	-0.005 (0.017)	-0.163 (0.333)
Debt to Equity Ratio (DER)	-0.010*** (0.003)	-0.004 (0.006)	0.775*** (0.122)
log Sale (SALES)	0.001 (0.003)	0.006 (0.006)	-0.616*** (0.123)
Involvement of Board of Directors (BI)	0.023** (0.010)	0.031 (0.022)	-0.627 (0.435)
Involvement of Shareholders (SI)	-0.011** (0.005)	-0.008 (0.012)	-0.372 (0.240)
Involvement of Managers (MI)	0.001 (0.006)	0.004 (0.012)	0.400 (0.251)
Percentages of State Shares (PSTATE)	-0.002 (0.013)	-0.003 (0.028)	0.016 (0.567)
Existence of Government Representation on Board (GB)	-0.030*** (0.010)	-0.072*** (0.022)	-1.171*** (0.451)

Adj R Square

0.169

0.079

0.279

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Sources: China Securities and Future Statistical Yearbook, Shanghai Wind Information Co. Ltd. (WIND) and Shanghai Stock Exchange Survey (SSES).

<sup>a</sup> Definition of dependent variables: ROA = Net profit over total asset; ROE = Net Profit over equity; Market to Book Value Ratio (MBR) = Market value over book value of a company.

<sup>b</sup> Definition of independent variables: Manufacturing = manufacturing industry group; Production & Supply of Electric Power Gas & Water = production & supply of electric power gas & water industry group; Wholesale & Retail = wholesale & retail industry group; Real Estate = real estate industry group; Social Services = social services industry group; YEAR<sub>99</sub> = Dummy variable equals to 1 for the observations of the year 1999, and equals 0 for observations of other years; YEAR<sub>98</sub> = Dummy variable equals to 1 for observations of the year 1998, and equals 0 for observation of other years; Debt to Equity Ratio (DER) = total debt divided by equity; Log Sale = logarithm of the total sale volume measured in terms of million Yuan (RMB); Percentage of State Shares (PSTATE) = Number of the state shares divided by total number of outstanding shares; Involvement of Board of Directors (BI) = the involvement of board of directors in 63 decisions on a 5-point scale ; Involvement of Shareholders (SI) = the involvement of shareholders through shareholder meetings in 63 decisions on a 5-point scale; Involvement of Managers(MI) = the involvement of managers in 63 decisions on a 5-point scale; Existence of Government Representation on Board (GB) is a dummy variable which equals to 1 when a company has government officials as outside directors and to 0 otherwise. (For all 5-point scales, 1 is the lowest and 5 is the highest.)





