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Political Connections, Financing Constraints, and Corporate Investment: Evidence from Political Turnover in China

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Abstract

This study examines the relationship between local political turnover, financing constraints, and corporate investment in China. Using 7,200 firm-year observations of A-share listed firms from 2004 to 2009, this study links changes in Municipal Party Committee Secretaries to investment–cash flow sensitivity. The baseline regression includes firm and year fixed effects. Other model settings examine family ownership, the successor origin and the provincial legal environment. At zero cash flow, political turnover is related to lower fixed asset investment, and its positive interaction with cash flow indicates a stronger relationship between investment and internal funds. The increase in investment–cash flow sensitivity is smaller for family businesses and is mainly concentrated in replacements involving nonlocal successors. A stronger legal environment is related to the smaller sensitivity increase after the replacement of officials. These results are consistent with political relations helping firms obtain external resources and formal institutions reducing dependence on these relations. However, investment–cash flow sensitivity is an indirect measure of financing constraints, and these estimates do not completely exclude other explanations related to investment opportunities or local economic conditions. Sample characteristics and model specifications limit the generalisability of these findings.

Keywords: Political Connections, Political Turnover, Financing Constraints, Corporate Investment, Legal Environment

Introduction

Political connections can affect the opportunities for firms to obtain external resources. Existing studies have linked political connections with board appointments (Agrawal & Knoeber, 2001), political connections of firms in different countries (Faccio, 2006), preferential loans (Khwaja & Mian, 2005) and government assistance (Faccio, Masulis, & McConnell, 2006). These advantages suggest that the stability of the relationship between firms and government officials is closely related to enterprise financing and investment.

This paper studies whether the change of local political leaders is related to the higher dependence of firms on internal cash flow in Chinese listed firms. The analysis distinguishes

differences in family ownership, local promotion, nonlocal successors, and the legal environment.

Evidence from changes in the political environment suggests that political connections may have economic value (Fisman, 2001; Johnson & Mitton, 2003; Roberts, 1990). In China, executives with political experience provide an observable way to measure political connections (J. P. H. Fan, Wong, & Zhang, 2007). However, such measures also reflect the choices of firms themselves and may be related to unobserved financing constraints. Leader turnover provides a complementary research context for the study of changes in the value of existing relationships.

Relevant studies have examined the political relevance of the board of directors and enterprise value (Goldman, Rocholl, & So, 2009), the protection of minority shareholders (Berkman, Cole, & Fu, 2010), auditor choice (Lei, Li, & Wang, 2009) and staffing (Liu, Zhang, Wang, & Wu, 2010). The turnover of officials also reflects personnel incentives (Li & Zhou, 2005), and the relationship between the government and firms may affect the regulatory results (Nie & Jiang, 2011). The evidence on China's banking reform has further prompted research to focus on the institutional conditions of credit allocation (Park & Sehrt, 2001). Together, these studies provide motivation for the simultaneous study of financing benefits and institutional dependence.

This study links the change of local leaders with the research on financing constraints and internal funds (Almeida, Campello, & Weisbach, 2004; Fazzari, Hubbard, & Petersen, 1988) and examines the replacement of Municipal Party Committee Secretaries (MPCSs) from 2004 to 2009. Such changes may disrupt firms' access to local resources, but they may also be a response to local economic conditions. Therefore, this paper interprets the estimation results as evidence consistent with the financing channels, not definitive causal effects.

This study contributes to the literature by examining the potential fragility of financing benefits associated with political relationships. Khwaja and Mian (2005) document preferential bank lending to politically connected firms, while Fazzari et al. (1988) link investment–cash flow sensitivity to financing constraints. This paper connects these perspectives by examining whether MPCS replacement is associated with changes in firms' reliance on internal cash flow for fixed investment. It therefore adds evidence on how dependence on internal funds varies with changes in local leadership. More specifically, Xu, Xu, and Yuan (2013) examine political connections and investment among Chinese listed family firms; the present study extends that focus by comparing turnover-related changes in sensitivity across family and nonfamily firms. Distinguishing locally promoted from nonlocal successors further assesses whether the observed pattern is consistent with disruption of local relationships. Finally, building on research on formal institutions and relationship-based finance in China (Allen, Qian, & Qian, 2005, 2008), the legal-environment analysis examines whether stronger formal institutions are associated with a smaller turnover-related increase in investment–cash flow sensitivity.

Institutional Background and Hypotheses

China's financial development combines formal financial institutions with relationship based arrangements (Allen et al., 2005, 2008). Local leaders can influence the environment in which

businesses have access to bank credit and other resources. If the relationship between the enterprise and the incumbent officials is conducive to external financing, the relative importance of funds generated within the enterprise may increase when these relationships are disturbed.

H1: MPCS replacement is associated with higher investment–cash flow sensitivity.

This effect may vary according to the initial reliance of firms on the relationship between government and firms. Research on listed family firms in China has recorded the link between political connections and investment behavior (Xu et al., 2013). Family ownership does not mean that there is no political relationship in the enterprise. On the contrary, the hypothesis tested in this paper is that, on average, family businesses are less dependent on specific relationships disturbed by the change of local leaders.

H2: The increase in investment-cash flow sensitivity following MPCS replacement is weaker for family firms than for other firms.

The source of succession provides additional information for the relationship to be disturbed. Locally promoted officials may already be familiar with local business and administrative networks. Officials transferred from other regions are unlikely to have these existing relationships (Li & Zhou, 2005). This distinction helps to assess relationship channels, although it does not by itself exclude differences in policy priorities or uncertainties.

H3: Investment–cash flow sensitivity increases more for nonlocal successors than for locally promoted successors.

A stronger legal environment may reduce the reliance of firms on personal relationships by improving the predictability of economic transactions (Allen et al., 2005, 2008; G. Fan, Wang, & Zhu, 2007). If the formal system can replace the relationship based access to resources, then in provinces with a stronger legal environment, the impact of leader change should be smaller.

H4: The effect of MPCS replacement on firms' investment-cash flow sensitivity is weaker in regions with a more efficient legal environment.

Data and Methodology

Sample and Variable Definitions

The sample covers A-share firms listed in Shanghai and Shenzhen from 2004 to 2009. After excluding financial firms, firms marked as ST or PT, and firms controlled by the central government, 7,200 firm-year observations remain in the final sample. The financial data is from the China Stock Market and Accounting Research database (CSMAR). MPCS replacement dates and the origins of incoming officials are collected manually through local government reports and official resumes. The provincial legal environment score is taken from the research of G. Fan et al. (2007). Table 1 gives the definition of variables.

Table 1
Variable definitions.

Variable	Definition
FI	**Change in net fixed assets plus depreciation and amortisation, divided by beginning-of-year total assets.**
CF	**Operating cash flow / beginning-of-year total assets.**
Pol0	**1 if the firm's city experiences MPCS replacement in the year; 0 otherwise.**
Pol1 / Pol2	**1 for a locally promoted / nonlocally transferred successor, respectively; 0 otherwise.**
Family	**1 if the listed firm is a family firm; 0 otherwise.**
TobinQ	**Market value / beginning-of-year total assets; non-tradable shares are valued at net asset value.**
Leverage	**Total debt / beginning-of-year total assets.**
Sales	**Revenue / beginning-of-year total assets.**
Law	**Provincial legal environment index reported by G. Fan et al. (2007).**
Promotion	**1 if the outgoing MPCS moves to a provincial or central government post; 0 for retirement or transfer to another prefectural city.**

Pol1 and Pol2 distinguish between two mutually exclusive succession categories. In the model containing both variables, observations from cities without MPCS replacement serve as the comparison group. Table 2 summarizes the MPCS replacements and the affected firms.

Table 2
Annual distribution of political turnover.

Indicator	2004	2005	2006	2007	2008	2009
Cities with turnover	**59**	**52**	**106**	**43**	**137**	**32**
Nonlocal-successors	**33**	**22**	**51**	**27**	**62**	**17**
Nonlocal share	**56%**	**42%**	**48%**	**63%**	**45%**	**53%**
Affected listed firms	**144**	**275**	**426**	**395**	**307**	**130**

Note: City-level turnover counts and firm-level exposure counts refer to different units of observation.

Investment opportunities, leverage, and sales are included in the control variables. Existing studies have linked financial leverage under the arrangement of China's banking system with firm investment (Firth, Lin, Liu, & Wong, 2008). In order to limit the influence of outliers, the continuous variables are winsorized at the 1st and 99th percentiles.

Descriptive Statistics and Empirical Specifications
Table 3 reports the distribution of the main financial variables. The mean values of fixed investment and operating cash flow are both 0.061 times beginning-of-year total assets. TobinQ and financial leverage show a large degree of dispersion, so their mean values should be interpreted in combination with the median.

Table 3
Descriptive statistics.

Variable	Mean	S.D.	Min	Max	Median
FI	**0.061**	**0.154**	**-1.327**	**3.539**	**0.029**
CF	**0.061**	**0.130**	**-1.977**	**4.090**	**0.054**
TobinQ	**2.058**	**20.735**	**0.048**	**1660.449**	**1.231**
Leverage	**0.789**	**10.613**	**0.000**	**877.256**	**0.532**
Sales	**0.820**	**0.820**	**0.000**	**18.825**	**0.639**

Note: FI and CF are ratios, not percentage-point entries.

Investment–cash flow sensitivity is used as an indirect indicator of financing dependence (Fazzari et al., 1988). Cash flow may also reflect investment opportunities, so sensitivity alone cannot determine that access to credit is restricted. Therefore, this study examines the interaction term of official turnover while considering ownership and institutional differences, and carefully explains the estimated results.
The baseline model tests H1 using equation (1):

$$FI_{it} = \alpha_i + \lambda_t + \beta_1 CF_{it} + \beta_2 P_{it} + \beta_3 CF_{it} P_{it} + \gamma' X_{it} + \varepsilon_{it} \quad (1)$$

Here, i indexes firms and t indexes years; P is Pol0; X includes TobinQ, Leverage, and Sales; α and λ are firm fixed effects and year fixed effects respectively. A positive β_3 indicates higher investment–cash flow sensitivity in years of official replacement. The baseline coefficient of official replacement is conditional on CF=0; The overall relationship between official turnover and investment also depends on the interaction term.

For the analysis of family business and legal environment, the pooled ordinary least squares (pooled OLS) model setting reported in this paper can be summarized as formula (2):

$$FI_{it} = \beta_0 + \lambda_t + \beta_1 CF_{it} + \beta_2 P_{it} + \beta_3 CF_{it} P_{it} + \beta_4 CF_{it} P_{it} Z_{it} + \gamma' X_{it} + \varepsilon_{it} \quad (2)$$

In hypothesis H2, Z is Family; in hypothesis H4, Z is Law. The third column of the family-firm regression also controls the promotion. A negative β_4 is consistent with the weakening effect. These models use constrained interaction terms, whose interpretation depends on the omitted low-order terms. For hypothesis H3, Pol1 and Pol2 and their interaction with cash flow enter the company's fixed effect model together. The analysis of the legal-environment also reports a specification that contains two types of succession variables and includes their triple interactions with cash flow and Law.

Empirical Results

Political Turnover and Family Ownership

Table 4 reports the baseline firm fixed-effects estimates. The CF × Pol0 coefficient is positive in both columns (0.071 and 0.070), consistent with H1. With controls, the Pol0 coefficient is −0.007 at zero cash flow. The interaction implies that this association varies with firms' cash flow; it is not a uniform reduction in investment.

Table 4
Political turnover and investment–cash flow sensitivity.

Variable	(1) FI	(2) FI
CF	0.045** (2.53)	0.005 (0.28)
Pol0	-0.007** (-1.98)	-0.007** (-2.07)
CF×Pol0	0.071** (2.18)	0.070** (2.18)
TobinQ	—	-0.006*** (-3.23)
Sales	—	0.049*** (10.03)
Leverage	—	0.008 (1.26)
Year effects	Yes	Yes
Firm effects	Yes	Yes
Overall R^2	0.0245	0.0293

Notes: Dependent variable: FI. Parentheses contain reported t-statistics. *, **, and *** denote significance levels of 10%, 5%, and 1%.

Table 5 reports the family-firm specifications. The negative CF × Pol0 × Family coefficients indicate a smaller turnover-related increase in sensitivity among family firms, consistent with H2 under the reported specification. The pattern remains after including the outgoing official's promotion indicator.

Table 5
Family ownership and political turnover.

Variable	(1) FI	(2) FI	(3) FI
CF	0.221*** (14.06)	0.193*** (12.08)	0.193*** (12.10)
Pol0	-0.011*** (-2.88)	-0.010*** (-2.71)	-0.010*** (-2.82)
CF×Pol0	0.094*** (2.67)	0.086** (2.48)	0.087** (2.50)
CF×Pol0×Family	-0.128** (-2.43)	-0.099* (-1.91)	-0.103** (-1.98)
TobinQ	—	-0.014*** (-9.47)	-0.014*** (-9.45)
Sales	—	0.013*** (6.30)	0.013*** (6.40)
Leverage	—	-0.017*** (-5.12)	-0.017*** (-5.28)
Promotion	—	—	0.008*** (3.16)
Year effects	Yes	Yes	Yes
Adjusted R^2	0.0473	0.0737	0.0748

Notes: Dependent variable: FI. Pooled OLS with year effects. Parenthesised statistics and significance markers follow Table 4. Promotion is included only in column (3).

Tables 4 and 5 show that political turnover is related to the dependence of enterprises on internal funds, and there are ownership differences. Fazzari et al. (1988) pointed out that

when internal and external funds cannot be perfect substitutes, higher external financing costs may make investment more dependent on cash flow. After the control variable is added in Table 4, the coefficient of CF × pol0 only changes from 0.071 to 0.070, which is still significant at the level of 5%, which is consistent with H1. In column (2), the cash flow slope is 0.005 in non turnover years and 0.075 in turnover years. The conditional relationship between turnover and investment is − 0.007+0.070 × CF, so the negative coefficient of pol0 cannot be interpreted as the same decline in investment of all enterprises.

The CF × Pol0 × Family coefficient in Table 5 is negative in all three columns, which is consistent with H2. In column (2), the turnover-related change in investment–cash flow sensitivity of nonfamily firms is 0.086, and that of family firms is 0.086 − 0.099=− 0.013. And the overall cash flow slope of family firms in the turnover year is still positive, and the point is estimated to be 0.180. Xu et al. (2013) found that political ties can alleviate the under investment of listed family enterprises, especially in enterprises with strong financing constraints. Thus, the results show that family firms show a smaller turnover-related change in investment–cash flow sensitivity.

After adding the promotion indicator, the ownership difference in Table 5 still exists. However, table 5 uses pooled OLS with year effects, and table 4 uses firm and year fixed effect. The CF coefficients of the two tables cannot be directly compared. Thereby, the results and the turnover of officials will disturb the existing relationship and increase the internal capital dependence of enterprises.

Origin of the Incoming Official

Table 6 distinguishes locally promoted successors from officials transferred from outside the locality. The regression includes two types of replacement indicators and their interaction with cash flow, and includes the fixed effect of the firm and the fixed effect of the year. When the control variable is not added, the estimation coefficient of CF × Pol2 is 0.089; After adding the control variable, the coefficient is 0.088. The corresponding local-successor interaction coefficient is 0.028 in both columns.

Table 6
Successor origin and investment–cash flow sensitivity.

Variable	(1) FI	(2) FI
CF	**0.045** (2.49)**	**0.004 (0.24)**
Pol1	**0.004 (0.66)**	**0.003 (0.59)**
CF×Pol1	**0.028 (0.55)**	**0.028 (0.55)**
Pol2	**-0.013*** (-2.98)**	**-0.013*** (-3.05)**
CF×Pol2	**0.089** (2.34)**	**0.088** (2.34)**
TobinQ	**—**	**-0.006*** (-3.19)**
Sales	**—**	**0.049*** (10.03)**
Leverage	**—**	**0.008 (1.33)**

Variable	(1) FI	(2) FI
Year effects	Yes	Yes
Firm effects	Yes	Yes
Overall R^2	0.0244	0.0293

Notes: Dependent variable: FI. Parenthesised statistics and significance markers follow Table 4. The omitted turnover category is no replacement.

The interaction items of nonlocal successors are positive, while the interaction items of local successors are small and statistically insignificant, which is consistent with hypothesis H3. However, the significant results of one group and the insignificant results of the other group cannot prove the statistical difference between the two coefficients. To reach a more powerful conclusion, it is necessary to directly test the difference between the two coefficients.The pattern is compatible with disruption of established relationships: firms may need time to learn about and establish contact with a new official from outside the locality. Alternative explanations remain possible, including different policy mandates or local economic conditions associated with nonlocal appointments. The estimates consequently provide suggestive evidence on the relationship channel.

The Legal Environment

The legal environment may affect the relationship between political turnover and enterprise investment by changing the way in which firms obtain external funds (Allen et al., 2005).

Table 7 uses the provincial legal environment indicators (G. Fan et al., 2007) to examine whether the legal environment moderates the relationship between political turnover and investment–cash flow sensitivity. In column (1) and column (2), the coefficients of CF × Pol0 × Law are − 0.017 and − 0.019, which are significant at the levels of 10% and 5%, respectively. After TobinQ, Sales and Leverage are added, the interaction term is still negative and significant, indicating that this result still exists after controlling the characteristics of relevant firms. This is consistent with H4's expectation that the better the legal environment, the smaller the increase in investment–cash flow sensitivity corresponding to political turnover.

Table 7
Legal environment and political turnover.

Variable	(1) FI	(2) FI	(3) FI	(4) FI
CF	0.221*** (14.06)	0.193*** (12.07)	0.221*** (14.06)	0.193*** (12.08)
Pol0	-0.010*** (-2.85)	-0.010*** (-2.71)	—	—
CF×Pol0	0.157** (2.56)	0.17*** (2.82)	—	—
CF×Pol0×Law	-0.017* (-1.90)	-0.019** (-2.18)	—	—
Pol1	—	—	-0.005 (-0.88)	-0.005 (-0.82)
CF×Pol1	—	—	0.155 (1.54)	0.161 (1.63)

Variable	(1) FI	(2) FI	(3) FI	(4) FI
CF×Pol1×Law	—	—	-0.01 (-0.71)	-0.011 (-0.80)
Pol2	—	—	-0.014*** (-3.21)	-0.013*** (-3.07)
CF×Pol2	—	—	0.188** (2.46)	0.206*** (2.73)
CF×Pol2×Law	—	—	-0.026** (-2.28)	-0.029** (-2.57)
TobinQ	—	-0.014*** (-9.56)	—	-0.014*** (-9.58)
Sales	—	0.013*** (6.33)	—	0.013*** (6.33)
Leverage	—	-0.017*** (-5.17)	—	-0.017*** (-5.12)
Year effects	Yes	Yes	Yes	Yes
Adjusted R^2	0.0470	0.0738	0.0475	0.0744

Notes: Dependent variable: FI. Pooled OLS with year effects. Columns (1)–(2) use Pol0; columns (3)–(4) distinguish Pol1 and Pol2. Parenthesised statistics and significance markers follow Table 4.

This result needs to be explained in combination with the specific meaning of interactive terms. In column (2), the difference in the slope of cash flow corresponding to political turnover is 0.170 − 0.019 × Law. Therefore, for each unit increase in the legal environment index, the estimated difference will decrease by 0.019. The negative coefficient here reflects the moderating effect of the legal environment, and does not mean that the overall relationship between enterprise investment and cash flow is negative. The overall cash flow slope also needs to be judged in combination with the value of CF coefficient, political turnover interaction term and legal environment.

After distinguishing the origins of successor officials, table 7 further shows that the moderating role of the legal environment is mainly reflected in nonlocal successors. The coefficients of CF × Pol2 × Law in column (3) and column (4) were − 0.026 and − 0.029 respectively, which were significant at the level of 5%. In column (4), the difference in cash flow slope corresponding to nonlocal succession is 0.206 − 0.029 × Law; The difference corresponding to local promotion is 0.161 − 0.011 × Law, but the triple interaction of the latter is not significant. This shows that the evidence of negative adjustment in the sample is more clear in the case of nonlocal succession. However, the fact that one group is significant and the other group is not significant does not directly prove that there is a significant difference between the coefficients of the two groups, and a formal coefficient difference test is still needed.

The above model can be understood from the perspective of relationship financing. Xu et al. (2013) found that political ties can alleviate the underinvestment of Chinese listed family firms, and this effect is more obvious in firms with strong financing constraints. This finding suggests that political ties may have financing value. Combined with the results of this paper, a possible explanation is that the arrival of nonlocal successor officials is easier to interrupt

the existing relationship, making the enterprise more dependent on internal cash flow for the time being; In areas with better legal environment, firms may rely less on an official to obtain external funds, so the impact of relationship changes is weak. This is the mechanism explanation proposed in this paper based on the regression results, which cannot be regarded as a direct verification of credit channels.

Discussion and Conclusion

For Chinese listed companies from 2004 to 2009, the MPCS replacement is related to the higher dependence of corporate investment on internal cash flow. This association is weaker in family businesses, and is mainly concentrated in the case of nonlocal successors. A better provincial legal environment is associated with a smaller increase in sensitivity related to the replacement of officials. In general, these results are consistent with the following explanation: the existing relationships help enterprises obtain external resources, while the formal system can reduce the dependence of enterprises on these relationships.

This interpretation is subject to a number of limitations. Official turnover may be a response to local conditions, and cash flow may also be a proxy variable for investment opportunities. The family-firm and legal-environment specifications use pooled ordinary least squares and restricted interaction terms, not the firm fixed-effects design used in the baseline model.

Future research should use underlying data and code to verify the above aspects, estimate models containing all lower-order terms and interactions, and evaluate alternative financing measures and pre-turnover trends. This paper does not report the results of robustness test using alternative indicators. The samples in the historical period also limit the generalisability of the findings to the current situation. Under these constraints, this study regards the change of local leaders as a useful research situation to examine how political relations and legal environments are related to enterprise investment.

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