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“Political Capital in a Market Economy”

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Forthcoming, *Social Forces*

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Abstract:

The paper applies a transaction-focused institutional analysis to compare the value of political capital in different institutional domains of China's market economy. Our results show that the value of political capital is associated with institutional domains of the economy in which agents can use political connections to secure advantages. Political capital is most fungible in institutional domains where government restricts economic activity. In this sense, the value of political connections in China does not differ fundamentally from patterns observable in established market economies. We interpret this as evidence suggesting China may have experienced a tipping point in its transition to a market economy around the turn of the new century.

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1. INTRODUCTION

That political connections grease the wheels in all economic orders is a near universal supposition. In nonmarket economies, production and distribution turn on the power of principals at the center of a hierarchy. As cadres of a redistributive state, political actors directly set the prices; hence, agents seeking comparative advantage compete for positional power in the hierarchy, and cultivate political connections (Szelényi 1983). In market economies, political capital also matters. Political actors impose restrictions on economic activities, giving rise to rents that agents compete for. Whether to control entry of new competitors or to promote strategic interests, desire to capture or to channel the coercive power of the state motivates the demand for regulation favorable to an industry or firm (Stigler 1971). Given the fungibility of political capital in all types of economies, it is not surprising that its value in transition economies has motivated cross-disciplinary research in the social sciences.

Recent empirical research on transition economies indicates that at the firm-level there are no simple answers about the overall economic value of political capital. On the one hand, there is evidence indicating that state-owned firms with connections to the old political elite perform worse than private firms (Fan, Wong and Zhang 2007). Firms with partial state ownership are subject to state interference, are forced to maintain higher employment levels and often serve as tools for private enrichment of politicians (Shleifer and Vishny 1994). Moreover, political screening is a persistent feature of party recruitment for the managerial elite (Bian, Shu and Logan 2001). On the other hand, there is some indication that political capital may still have a positive impact on firm equity value and measures of firm performance (Peng and Luo 2000). This suggests that politically connected firms can secure positional advantages over unconnected firms, even if overall firm productivity might be lower. Such advantages may be most pronounced under tight resource constraints. For the allocation of credit, for instance, positional advantages of politically connected firms are documented not only in transition economies (Park and Sehnert 2001), but also in mature market economies (Faccio, Masulis, and McConnell 2006).

To identify whether economic actors and firms actually secure advantage through reliance on political capital, our analysis shifts to examine in which institutional domains political connections are substantively helpful to the firm's chances for survival and profitability.

This approach also allows us to identify what features of the institutional environment contribute to either preserving or to reducing the value of political capital. We define institutional domains as distinct institutional arrangements that enable and guide economic transactions. These include economic markets ranging from competitive markets to state-controlled markets, and political markets such as public service provision and the regulatory market. Broadly, our use of institutional domain is similar to Scott and Meyer's (1991) conception of "societal sectors" in their analysis of the variability of institutional elements that shape the environment in which organizational actors transact.

More than 90 field interviews we conducted with Chinese entrepreneurs in Zhejiang province and Shanghai from 2005 to 2008 underline the complex nature of the issue. Two distinct entrepreneurial types coexist, and both seem to prosper in their own way: There are purely competitive players—often active in privately organized markets and knowledge intensive sectors—who refuse any type of political networking. The general manager of a computer company in Zhejiang province rejected the idea of playing the "game of politics," and explained, "In my sector, the government cannot give me much, not much tax breaks, and not much government contracts." In parallel, there are many who invest heavily in political networking through party donations, active involvement as party secretaries or vice deputies, inviting government officials to serve on so-called "expert committees" and maintaining close social ties to local government authorities. These entrepreneurs often regard their political connections as their most important asset.

Evidently, assessments of the pervasiveness and sources of political capital advantages need to go beyond aggregate claims of whether political capital is diminished or augmented in departures from state socialism. We focus on distinct transaction outcomes across a broad spectrum of company activities to compare the value of political capital in different types of institutional domains of China's market economy. Greif's (2006:45-46) definition of transaction is consistent with our usage: "A *transaction* is defined here as an action taken when an entity, such as a commodity, social attitude, emotion, opinion, or information, is transferred from one social unit to another." A transaction-focused institutional analysis shifts attention to examine the nature of the institutional arrangements in which economic actors compete and cooperate to secure rewards. An advantage of a focus on distinct transactions is that it allows for a more nuanced view of the fungibility of political capital. This also provides a fresh approach to assess

the claim that in transition economies political connections with local administrators continue to be highly fungible “*not only despite, but because of marketization*” (Parish and Michelson 1996: 1045). Such aggregate, society-wide claims about the value of political connections would be rejected if the fungibility of political capital varied in the context of discrete institutional domains in which firms actually transact. We argue instead that in a market economy the fungibility of political capital corresponds with the extent to which government continues to restrict economic activity.

In section 2, we define political capital as a form of capital distinct from human, social and financial capital. We then explore the interplay between different markets and the value of political capital in section 3. Specifically, we assert that the inherent value of positional advantages stemming from political capital depends on the institutional arrangement enabling and guiding economic transactions. Section 4 sketches a representative sample of institutional domains, which we utilize to identify sources and patterns of persisting political advantage in China’s economic and political markets. Section 5 introduces the research design and section 6 provides empirical evidence based on the World Bank Investment Climate Survey. The final section concludes.

2. WHAT IS POLITICAL CAPITAL?

Political capital shares with other forms of capital the quality of being productive insofar as it makes possible the realization of interests, which in its absence, would not be achieved; and its fungibility is like physical capital, limited to specified conditions. Although it shares these attributes with physical and human capital, political capital is more similar to social capital in that these forms of capital accumulate in relational ties. As Coleman (1988: S98) observed, the differentiating feature of social capital is that it “inheres in the structure of relations between actors and among actors.” Unlike social capital, however, political capital has the additional feature of being linked to the positional power of the politician, and thus it is rooted in institutional structures of the political order. When politicians transact with other politicians, their cumulative investment in political capital embeds itself both in the institutional arrangement of political exchange and in ongoing relationships among political actors. For example, Shepsle and Weingast (1987) show that the custom of deference and reciprocity among politicians in

Congress is enforced by the institutional mechanism of *ex post* veto by committees as a way of explaining the effectiveness of committees. An anecdote they use illustrates the exchange, “Sure, I let those people over on Education and Labor do pretty much what they think is reasonable. And they do the same for us on Armed Services. That’s the way things are done around here” (p. 100). This custom of deference and reciprocity is maintained by institutionalized norms and rules that enable enforcement of subcommittee autonomy. Thus the quality of informal and formal of institutions of the state contributes to the productivity and fungibility of political connections (Evans 1995; Nee and Opper 2007).

Another dimension of political capital’s existence in relationships has to do with the ties that connect politicians with their constituencies. The commonsense rendition of this aspect of political capital emphasizes the public’s approval or disapproval of a politician’s performance. A politician gains political capital through successful policies and initiatives. But the approval rating of a politician is ephemeral, whereas political capital is embedded in a more enduring manner in concrete relationships with constituents. In these relationships, obligations, expectations, and trust stem from social exchange in which a politician A does something for B and trusts that B will reciprocate the favor sometime in the future. This, over time, establishes an expectation in the politician and an obligation on the part of B. If a politician accumulates a large volume of credit through favors conferred by virtue of positional power, then the analogy to economic capital is clear-cut. Political capital in this view is both productive and fungible, and importantly, because it inheres in the relationship, both politician and constituent can secure gains cumulatively in maintaining the relationship. Further, political connections serve as conduits of information between politicians and constituents, with information flow favoring rent-seekers with the inside track to the politician. The institution of lobbying turns on the fungibility and productiveness of political connections as the basis of mutual expectations, obligations, trust and timely information.

As a form of capital, the distinguishing feature of political capital is that it is embedded in social relationships and in political institutions. This duality, of existing as an attribute of both positional power and relational ties, means that analysis of political capital must incorporate a focus on the institutional context in which transactions are conducted. To specify the productivity and fungibility of political capital, the focus of analysis needs to examine

transactions between economic and political actors in concrete institutional domains of the economy.

3. OF MARKETS AND POLITICAL CONNECTIONS

Our approach draws on new institutionalism in organizational theory and economic sociology in its focus on the effect of the institutional environment on firm behavior (DiMaggio and Powell 1983; Fligstein 2001; Nee 2005). Organizations are responsive to the nature of the resource and power arrangements in the institutional environment (Pfeffer and Salancik 1978). This suggests variability in the responses of firms to their institutional environment. For example, Meyer, Scott and Strang (1987) and Strang (1987) examine the effects of expanding federal and state involvement in education on the administrative complexity of local school districts. They show that the level of school district administrative complexity depends on the relative level and scope of federal, state and local funding. An analogous pattern of close-coupling of administrative complexity and fiscal budgets of central, provincial and local governments exists in China (Whiting 2000).

In command economies, the state assumed monopoly power over the allocation of all resources. Productive assets from farmland to factories were owned and managed by the state, which sets prices by administrative fiat to control the allocation of resources. Clearly, under the central plan government bureaucrats and party officials maintained an overwhelming advantage in power over economic actors. A firm's access to resources and its bargaining over production quotas mainly depended on positional advantage stemming from political connections with the planning authorities (Szelényi 1983). In decentralized market transactions, terms of exchange are determined by both sellers and buyers. Economic markets provide incentives insofar as rewards depend on a match of quality and price, and therefore producer incentives align with productivity. Further, the market mechanism provides opportunity for entrepreneurs and firms to identify new markets and profit-making opportunities. The increase of market power, material incentives and wealth-maximizing opportunities outside of the state-directed sectors trigger a shift in the balance of power from the established political actors towards economic actors (Nee 1989). Moreover, the shift to market allocation causes changes in relative rewards that reduce the payoffs of network advantages based on political position and offers incentives and opportunities for economic actors to engage in productivity-enhancing entrepreneurial activity. The gradual replacement of state planning by market allocation gives rise to a self-reinforcing empowerment

of the consumer as an economic actor. This endogenously motivates strategic adjustments by firms to the emergent market economy, which in turn undermines the previous institutional foundations of firm survival. Whether firms choose to rely on organizational improvements, superior exploitation of assets, higher innovativeness or minimized “time to market,” markets shift the focus to the importance of capabilities as opposed to investing in positional advantage through political capital (Saloner, Shepard, and Podolny 2001).

The greater importance that firm managers put on the development of firm capabilities is evidenced by rapid strategic changes in China’s economy. Widespread experimentation with new organizational forms, gradual divestiture of state ownership and the emergence of new property arrangements illustrate the search for a better fit between firm strategy and external environment (Nee 1992). Before the start of economic reforms in 1978, China’s industrial sector was made up of only two organizational forms (state-owned enterprises and collective enterprises). Now, China’s national statistics differentiate between ten distinct organizational forms in the urban industrial sector (National Bureau of Statistics of China). Rapidly expanding research budgets, employee training, patenting activities and shortened product life cycles signal that firms actively seek to develop new capabilities to gain and secure competitive advantages in market niches. China’s national research and development (R&D) expenditures, for instance, increased from 0.8% to 1.3% of gross domestic product (GDP) between 1999 and 2003. Further, more than 60% of R&D funds are provided by firms themselves (National Bureau of Statistics/Ministry of Science and Technology, 2005).

Concurrent with these trends, organizational autonomy embedded in decentralized markets enables economic actors to construct informal arrangements that build from ground up the informal institutions of a private enterprise economy. From informal lending arrangements that provide private capital for start-up firms to far-flung supply and distribution networks, informal economic institutions are constructed to facilitate the expansion of private-sector entrepreneurial activities challenging the state-controlled economy from below. With the continuing expansion of markets, the economic success of firms becomes increasingly independent of the direct involvement of politicians. Vertical ties linking economic actors in firms with the state decline in significance as horizontal ties—interfirm networks and network ties between buyers and sellers based on repeat exchange—gain in importance. In other words, the embedded nature of economic transaction shifts from self-enforcing reliance on vertical political connections characteristic of state socialism (Whyte and Parish 1984) to self-reinforcing investment in

horizontal network ties that sociologists emphasize as the basis of social capital in market economies (Uzzi 1996).

Our core hypothesis is this: *The more competitive markets replace state allocation of scarce resources and services, the less the value of political capital.*

This does not imply that political capital will be fully devalued in the course of market transition. The point we are making is that political capital, as a fungible form of capital, has greatest valuation in those institutional domains where government restricts economic activity. The stronger the government's commitment to introduce competitive markets in an industrial and commercial sector, the more the value of political capital will decline in that sector.

During departures from state socialism, the declining value of political capital is triggered by shifts in parameters that combine and interact to cause change in the firm's institutional environment. On the one hand, the hardening of public budget constraints and the reduction of the size of the redistributive sector as a consequence of market transition shifts a firm's income streams away from budgetary appropriations. Subsidies for loss-making state-owned enterprises, for instance, decreased from 25% of government expenditures in 1985 to 2% in 2000 (National Bureau of Statistics of China). On the other hand, the expanding market economy opens up new opportunities for entrepreneurship and profit-making, providing a favorable environment for the fledging private enterprise economy. In 2005, private firms produced more than 50% of China's GDP, and accounted for more than 75% of exports (Lague 2005). Our hypothesis expects that political capital will be less fungible in transactions that are based on market competition. The shift from state to market allocation did not occur at the same speed and to the same extent across the spectrum of economic activities and sectors, however. The value of a firm's political capital may therefore vary across distinct types of institutional domains and may continue to play a decisive role in distinct transactions. In partly liberalized markets where the state tightly controls market entry or remains involved as a market actor, firms with political capital are likely to secure preferential treatment.

Parameter shifts in the institutional environment, however, do not rule out that political actors also adapt and profit from new elite opportunities stemming from marketization. In political markets, political actors can still provide positional advantages by channeling government spending to clients, targeting most favored treatment in tax policies, and use of industrial policy to regulate market entry and exit. As Walder (2003:900) asserts the "decline of

bureaucratic allocation in the face of market reform does not imply a decline of elite opportunity.” He believed that the state’s still considerable redistributive and regulatory power allows the creation of new sources of power: “as regulators of markets and private enterprises, brokers and middlemen for market transactions, managers or consultants in public, market-oriented enterprise...” (Walder 1996: 1063). Preferential treatment in rule enforcement and regulatory markets would then provide the political elite with vast opportunities to create “new market value for official discretion” (Walder 2003:901). This line of reasoning reinforces the view that politically connected managers are advantaged in operating companies (Róna-Tas 1994:45). Despite considerable empirical research on the effect of political capital on individual and household level earnings, results remained inconclusive (Nee 1989, 1991, 1996; Róna-Tas 1994; Domanski and Heynes 1995; Parish, Zhe and Li 1995; Bian and Logan 1996; Parish and Michelson 1996; Xie and Hannum 1996; Gerber 2000, 2001, 2006; Zhou 2000; Bian and Zhang 2002; Walder 2002; Wu 2002; Zang 2002; Hauser and Xie 2005; Walder and Nguyen 2008). Particularly initial conditions, extent of markets, structural change and industrial growth seem to have influenced different effects on household income (Keister 2009).

To detect more directly the inherent value of positional advantages stemming from political connections requires a focus on the specific institutional domains where firms compete for survival and profits, and transact to secure needed resources. In focusing on different types of firm-level transactions both in economic and political markets, we incorporate elements of transaction-focused reasoning to link the payoff of political capital with distinct types of institutional domains. Our empirical tests examine transactions across a broad spectrum of firm activities in different institutional domains representing varying levels of marketization and state control. Analysis of different types of transactions allows us to discern variability in the fungibility of political capital across the different institutional domains in which firms engage in routine economic activities.

4. INSTITUTIONAL DOMAINS IN CHINA’S MARKET ECONOMY

Given the broad range of operational and strategic activities and corresponding institutional domains firms are typically involved in, our analysis of political capital is not aimed at inclusiveness. Instead, we seek to cover a representative set of distinct transactions and their

outcomes in various institutional domains to examine whether the value of political capital varies with the extent to which resource allocation remains bounded by the redistributive economy. Our focus is on typical transactions in daily business operations, which can substantively affect a firm's survival.

The transition to a market economy is an uneven evolutionary process, which does not proceed with obvious breakpoints. Hence, for our analysis of economic markets, we selected three institutional domains, which reflect high, moderate and low levels of marketization (see figure 1). First, we include the product market as the most competitive institutional domain of China's economy. Private enterprise participation in the product market is consistently high, with only a few state monopolies remaining, such as that for tobacco. Our data-set includes none of these monopolies. A provincial marketization index developed by China's National Economic Research Institute (NERI), which encompasses a set of sub-indicators assessing progress in marketization across different markets, confirms that the product market is the most liberalized, with a mean level of 7.84 points out of 10 across all provinces in the year 2003 (Fan and Wang 2003). Capability development and not political ties are central for firm survival.

In addition, we examine two partially liberalized market sectors sequentially according to increasing degrees of state controls in resource allocation: the credit market and the market for government contracts.

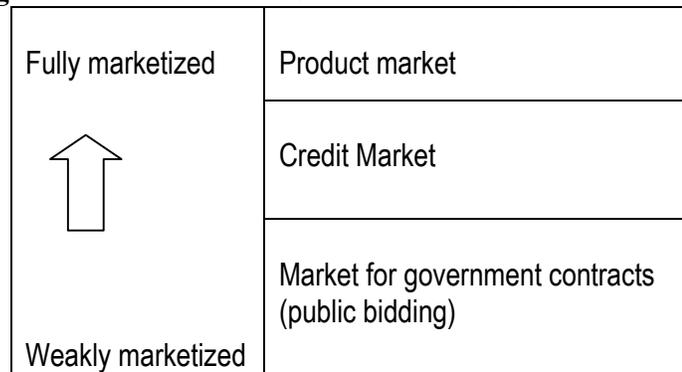
In the credit market, liberalization of commercial banking has proceeded slowly. While banking reform started in the mid-1980s, market competition was introduced only at a modest level. In spite of the market-entry of foreign-invested banks and private domestic banks, the credit market is still heavily state-controlled. At the time of the survey, over 70% of deposits and loans were still accounted for by the four largest state-owned commercial banks. Only 1% of loans by state commercial bank were allocated to the private-sector entrepreneurs, signalling a severe imbalance, given the high proportion of the industrial and commercial output by private enterprises (*Datastream*). The NERI-marketization index confirms slow progress in the market for bank loans. With a mean value of 2.67 out of 10 in 2002, credit allocation indeed occupied the lowest level of marketization of all 22 categories covered by the index.

In the market for government contracts, despite widespread efforts to standardize bidding rules and procedures, political connections matter and easily undermine competitive bidding guidelines. In this sense, the market for government contracts can be readily used to redistribute

rents to most favored bidders with political connections. This market thus exemplifies an institutional domain where the government acts as a monopolist. China’s firm managers are generally interested in securing government contracts, since the government is a trustworthy client. For instance, delays in payment or non-payment occur less frequently than in private, anonymous transactions. Also, firms with regular government contracts reduce substantively their market risk. The market for land use rights is an alternative example of this type of institutional domain. Both markets display similar features wherein government bureaus act as monopolist and enjoy undivided control rights over resources.

In spite of considerable regional variation, the relative ranking of marketization for these three institutional domains is invariant across China. Hence, product markets are in general the most marketized regardless of whether we explore product markets in Ningxia or in Zhejiang provinces. Similarly, markets for government contracts are in general ranked lowest in terms of marketization. If marketization and the value of political capital are negatively correlated as specified in our core hypothesis, we would expect to find little or no effect of political capital in the highly marketized product market, while political capital can be expected to still provide positional advantages in institutional domains of the economy where the state remains either the dominant supplier (credit market) or customer (government contracts).

Figure 1: Institutional domains in the economic market



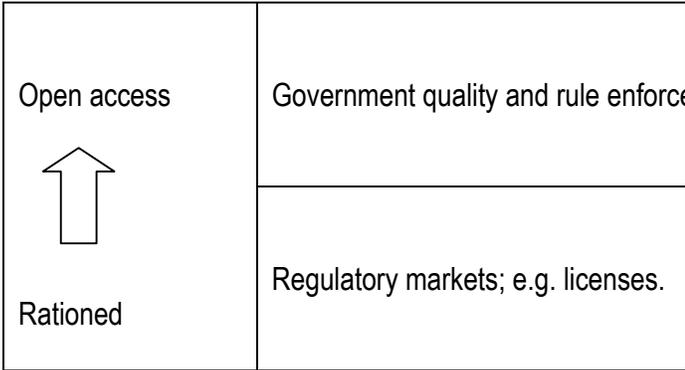
Naturally, economic success of firms does not only depend on markets for private goods. Equally important, regulatory markets can critically affect firm performance and survival chances. Our comparative institutional analysis therefore also incorporates selected institutional arrangements for rule

enforcement and regulatory markets. The expectation is that network advantages and political ties are more likely to secure preferential treatment due to the continuing role of the state as the sole supplier (Róna-Tas 1994; Parish and Michelson 1996).

First we look at whether firms with political capital receive better government services, and benefit from improved rule enforcement (see figure 2). Specifically, we explore how transacting with political capital affects the days needed for custom clearance, fines from regulatory inspection and the bribery by local tax inspectors. All these transactions contribute to calculability and facilitate strategic planning. Preferential treatment in these areas could substantively increase a firm’s survival chances. In the mid-1980s, for instance, cursory reports indicate that local cadres and tax officers squeezed entrepreneurs to increase their office or personal income. Often managers cultivated political connections to protect their businesses from overtaxing and expropriation (Parris 1993).

An even stronger test case is the market for government regulation. Similar to markets for private goods, the regulatory market and related rent-seeking activities have a competitive element. Firms invest time, effort and financial resources to compete over permits and licenses. If in addition government officials enjoy some discretionary power in deciding on license allocations, not only the firm’s efforts but also transacting through political connections may become decisive factors for success in rent-seeking (Krueger 1974). Typical cases of transactions in the regulatory market we review include the firms’ access to export licenses, tax exemptions, and costs of business licenses. If our tests indicate that firms do not compete on a level playing field and that political connections provide a competitive edge in firm-government transactions, the regulatory market mechanism is bound to be suspect.

Figure 2: Institutional domains in the political market



5. RESEARCH DESIGN AND EMPIRICAL TEST

Resource dependence shapes a firm's interactions with its environment (Pfeffer and Salancik 1978). This suggests variability in a diverse sample of organizational forms and industrial sectors in firm-level responses. We use data from the 2003 World Bank Investment Climate Survey, which provides an in-depth account of 2400 firms of different legal status—state-owned, collective, private and foreign. The survey is based on a random sample of cities and firms, stratified first on sub-sectors, which were selected to represent the most important (in terms of contribution to national GDP) industries and service sectors, and then on location. Overall, 18 middle-sized and large cities were chosen, broadly covering all regions of China, including highly marketized cities in the coastal areas as well as less competitive, lagging cities such as Benxi in the northeast and Lanzhou in the northwestern region. Due to the urban focus the survey is not designed to be nationally representative, and we cannot rule out that the use of political connections may be more widespread in rural villages and townships, where more traditional forms of trading may persist.

Part One of the survey covers factual information on company activities, political capital and government relations. Questionnaires were filled out in face-to-face interviews with senior managers of the respective establishments. Part Two of the interview was conducted with the firm's accountant, who provided quantitative information on costs, expenditures, and asset evaluations (for a thorough discussion of the survey, see Dollar et al. 2004). Questions throughout are asked in an objective, quantitative manner, and provide credible measures on otherwise hard-to-assess factors such as red tape and the different dimensions of political capital. Thus the survey allows disentangling the role of economic capital from political capital in explaining a firm's success in discrete institutional domains and types of economic transactions. Detailed information on methodology, questionnaire and data collection is available at <http://www.enterprisesurveys.org>.

The overall ownership structure of the sample of firms resembles the general distribution of legal ownership forms (Table 1). Due to the urban focus of the World Bank survey, however, the proportion of state owned firms is significantly higher than in the total firm population, whereas the residual category of "others" (including small-scale individual firms) is considerably

smaller. The industrial structure provides a mix of labor-intensive, capital-intensive and knowledge-driven production, which approximates the country's overall production structure.

Table 1: Distribution of Legal Ownership Type of Firms, in 2002

	Sample firms (in percent)	Total firm population (in percent)
State-owned enterprise	26	16
Collective and cooperative firm	16	21
Non-publicly traded shareholding companies	18	17
private, non-listed firms	28	27
Joint ventures and subsidiaries of multinational firm	10	8
Others*	2	11

* A residual category which includes wholly foreign owned companies, limited liability companies, individually owned companies.

Source: Investment Climate Survey 2003 and National Statistical Bureau of China.

In this study, we focus our analysis on the non-state firms in the sample (n=1764). By virtue of property rights, government authorities seek and maintain direct ties with state-owned enterprises. This cannot be assumed for private firms where the stock of political capital stems from investment and strategic action. Hence analysis of non-state firms provides a more reliable measure of the value of political capital in China's transition economy. The total number of observations varies across our estimation models due to varying occurrence of firm-level transactions and incomplete data on some items.

Dependent Variables

We seek to test for positional advantage stemming from political connections in a range of institutional domains: economic markets, administrative service provision and regulatory markets. We measure outcomes through a set of three discrete transactional variables each. Our aim was to define outcome variables which are quantifiable, in order to contain the risk of a subjective perception bias. Table 2 provides summary statistics of the selected variables.

With regard to economic markets, (1) *Sales growth* is a key transaction-focused measure assessing a firm's ability to win market share and to survive in the respective product market. (2)

Obtaining *formal credit* signals a firm's access to secure external finance in the banking sector. Given the standard assumption in lending research that firms generally need external finance, one can assume that any firm would have formal bank credit, if credit could be secured (Uzzi 1999). (3) Getting *government contracts* reduces market risk through a more diversified customer portfolio. Our interviewees confirm that government contracts provide a certain level of security, as government authorities are reliable and solvent customers. Moreover, government contracts typically allow for higher profit margins. With less than 20 percent of public projects going through a public bidding process in 1998, rents distributed through the market of government contracts are substantial (Yang 2004: 187).

With regard to government quality or public service provision and rule enforcement (1) *Days needed for custom clearance* involves transactions enabling a firm to export goods in a timely and efficient manner. Delays can lead to loss of clients and weakens the firm's competitiveness in international trade. (2) *Inspection fines* were in China a common instrument to discriminate against new private start-ups and other non-state firms (Parris 1993). The absolute amount of inspection fines therefore indicates whether political capital is still helpful in dealing with inspections by local administrators. (3) Whether *local tax inspectors require gifts or bribes* serves as a measure of "hidden" transaction costs assessing the illegitimate and illegal use of political connections in standard administrative procedures. Corruption is an endemic feature of China's bureaucracy; political capital can lessen a firm's reliance on bribery to secure resources and service from government (Cao, Fang and Xu 2005).

With regard to regulatory markets, (1) *Export licenses* allow a firm to conduct international trade. If firms are not able to secure from government an export license, they must rely on authorized state trading companies, which entails higher transaction costs in foreign trade. (2) *Tax exemptions* are a common industrial policy instrument to support firm development and shape industrial structures. If a firm can secure tax exemptions from local government, this naturally helps the firm's chances for survival during the critical start-up stage, especially given competitive global markets. (3) *Total costs of getting a business license* can serve as market entry barriers, if regulators drive up registration costs or discriminate applicants based on economic or political factors.

Table 2: Summary Statistics for Dependent Variables

Variable	Obs	Mean	Std. De
<i>Private goods</i>			
Sales growth in 2002*	1746	60.58	805.9
Credit access (dummy = 1 if firm has a formal bank loan)	1714	.23	.42
Sales to government (dummy =1 if firm secures government contracts)	1765	.22	.42
<i>Government quality and rule enforcement</i>			
Average days for custom clearance	698	7.70	11.54
Inspection fines (total costs of fines / in 1000 RMB))	1752	15.13	250.71
Local tax inspectors require gifts/bribes (dummy = 1, if yes)	1765	.27	.444
<i>Regulatory markets</i>			
Firm holds an export license (dummy = 1 if yes)	1685	.23	.420
Firm enjoys tax exemptions (dummy = 1 if yes)	1763	.25	.434
Price of getting a business registration (total of fee and bribes / in 1000 R	598	126.13	1482.82

* We use sales growth in the most recent year covered in the survey (instead of using an average over all survey years) in order to be able to include absolute sales volume in preceding years as a control variable.

Source: Investment Climate Survey 2003

Independent variables--measures of political capital

Rent-seeking activity involves firms using their political capital to secure most favored treatment from government as a means to increase profits (Krueger 1974). Previous studies measured political capital by indicating whether the CEO is a party member or current or former government official (Fan et al. 2007). Political capital at the firm level, however, is likely to be embedded in multiple-dimensions of the firm's organizational structure; hence we use a broader set of measures. This allows us to examine the various channels through which political capital can work to a firm's competitive advantage.

In our data set, about 31% of chief executive officers (CEO) indicate that they hold a position as party secretary or deputy party secretary, which is consistent with the national trend of political screening and community party recruitment of the managerial elite (Bian et al. 2001; Coble 2007).

Former government bureaucrats who leave their position as part of China's *xia hai*-policy are likely to continue to have extensive ties with government. We therefore use a dummy variable to indicate whether the firm's CEO previously held a government position. Overall, 5.6% of the CEOs in the sample had held government positions.

Government routinely appoints the top managers of state-owned firms. The practice is also commonplace in corporatized and privatized firms in which the government retains partial ownership. Managers appointed directly by government are likely to have good political connections. In our sample, the government was involved in 16% of the recruitment decisions for managers of non-state firms.

Another measure of political capital is whether a firm receives “government support” in acquiring needed resources and services (Ayyagari, Demirguc-Kunt, and Maksimovic 2008). Not every firm benefits from government assistance; hence a firm’s ability to secure direct government assistance signals it has political connections. The survey includes six typical fields of local government support (locating foreign technology; obtaining bank financing; identifying foreign investors, foreign clients, foreign suppliers, and domestic clients). Assistance in these areas is among the most sought after services, which companies need and seek to support domestic and global growth and development. For these measures of political capital it does not matter whether government assistance was provided through formal channels and procedures, or rests on informal network-based support. We construct an index (ranging from 0 to 6) of government assistance received in all six fields of support. Overall, 32% (546) of respondents reported receiving some kind of government assistance over the last business year. Most of these respondents report that they have received government assistance in identifying potential domestic clients (n= 308). It should be noted that government assistance does not guarantee successful outcomes. In this sense, we are not running the risk of including a tautological independent variable. In a more abstract way, the indicator signals a general political approval of the firm and reflects the local reputation that firms enjoy with government authorities. In sum, government support signals that the firm is on good terms with bureaucrats and politicians. It can also be interpreted as a signal of otherwise not explicitly revealed political connections.

Pairwise correlation coefficients ranging from -0.01 to 0.23 confirm that these selected measures capture different dimensions of firm-based political capital (see Appendix 1). Table 3 provides summary statistics for all independent variables. We have checked Pearson correlation statistics and variance inflation factors, and can rule out multi-collinearity concerns. Throughout, we have ensured that the joint use of these measures does not have a dampening effect on any single measure. Hence, we only report complete models instead of stepwise results.

Control variables

We introduce a set of control variables (also shown in Table 3) to differentiate positional advantages stemming from political capital from other potentially confounding effects that may influence transactions in the institutional domains we examine.

Company-specific capital

Firm age: The firm's age may affect outcomes in regulatory and economic markets. Older firms, for instance, will naturally have a more extensive inter-firm network than younger, recently founded firms.

Firm size: Not only may firm size influence a firm's market position, but larger firms are also more attractive to extract rents. In order to capture potentially confounding effects of firm size, we include the lagged natural logarithm of a firm's sales value (in model 1, in order to control the sales level in the preceding year) and assets (model 2 -9) of the preceding period.

Capital structure: Financial leverage is positively correlated with a firm's capability development. Because financial leverage may stem from a firm's use of political connections in securing loans from state-owned banks, we include the debt-to-asset ratio (DAR).

Industry: Because many regulations and industrial policies are sector specific, we included industrial dummy variables indicating 14 different sectors (estimation results will not be presented). Another dummy variable signals whether a firm is located in an industrial or technology park. Such parks benefit from more favorable government treatment and have other political capital advantages, which may affect outcomes in different types of transactions. Further, we include a firm's capital-to-labor ratio. As China's industrial policy aims to shift the industrial structure away from labor-intensive production, a firm's production technology may have an impact on the value of political connections. We control whether a firm is listed on one of China's two stock exchanges. Listed firms comprise key enterprises, singled out to be the mainstay of economic development. As large-scale modern corporations, these firms are not only the most powerful economic actors but they are also targets of state intervention. We also control for government ownership, as public ownership shares may strengthen a firm's ability to seek political support. Politicians and government officials are usually more willing to distribute rents to fully or partly state-owned enterprises (Shleifer and Vishny 1994). State ownership can also be interpreted as a measure of political capital. However, because state ownership controls for core organizational and governance characteristics of the firm, we prefer to interpret state

ownership as a general control variable. Ten percent of the firms included in our sample indicate to have partial state-ownership shares.

Human capital and incentive structure. We also control for professional competence of firm managers and for management's incentive structure.

Manager education: Whether managers act in an entrepreneurial and innovative manner or as rent-seekers may be tied to educational attainment. Moreover, education is positively associated with high-ranking party positions and the ability to secure political rents. To separate educational attainment from political power, we include a dummy variable that indicates whether the CEO has college education.

Manager tenure: The managers' tenure may not only determine firm-specific human capital, but long-time managers may be in a better position to secure government help—they have had more time to develop a broader political network reflecting firm-specific needs.

Incentive Contract: Incentive contracts are a common corporate governance device. However, they are not evenly distributed. They are particularly uncommon when governments remain involved in recruitment decisions or when former government employees are recruited. This may affect the management's interest in performing different types of transactions.

Regional control variables. We included a set of regional, provincial and city-level controls that could affect outcomes in distinct transactions and also the market value of political capital.

Regional context: Five control variables sort China into main regions (coastal, central, northeast, northwest and southwest). Coastal China, the most liberalized and developed region, is our benchmark (Estimation results will not be presented).

Provincial-level marketization: Provincial control variables for marketization (NERI-Index) are useful, as most of our survey firms operate at the provincial and even national level. Success in economic transactions is therefore not only locally determined but also depends on both provincial economic development and policy-making.

City-level economic development: Finally, we include the natural logarithm of per capita GDP at the city-level, as local economic development may not only affect outcomes in various transactions but also a firm's ability to benefit from political capital.

Table 3: Summary Statistics for Independent Variables

Variable	Obs	Mean	Std. Dev.
<i>Political ties</i>			
CEO holds formal position in the party (dummy = 1 if yes)	1731	.31	.46
CEO previously held government position (dummy = 1 if yes)	1752	.06	.23
Government involvement in CEO appointment (dummy = 1 if yes)	1744	.16	.37
Government support index (over 6 categories)	1715	.64	1.21
<i>Company</i>			
Log of firm age	1764	2.24	.68
Log of sales value in 2001	1747	8.93	2.25
Log of total assets in 2001	1692	8.15	2.40
Debt equity ratio in 2001	1678	2.86	19.91
Capital labor ratio	1719	161.65	2399.04
Location in industrial park (dummy = 1 if yes)	1739	.30	.46
Listed firm (dummy = 1 if yes)	1744	.03	.17
Government ownership	1763	7.20	23.79
<i>Management</i>			
CEO has college education (dummy = 1 if yes)	1754	.80	.40
Tenure of CEO	1747	6.19	4.41
CEO has incentive contract (dummy = 1 if yes)	1764	.27	.45
<i>Regional Controls</i>			
Provincial level marketization of product market (NERI)	1764	8.43	1.03
Provincial level marketization of credit market (NERI)	1764	3.34	2.93
Overall provincial level marketization index (NERI)	1764	6.08	1.77
Log value of per capita GDP (City level)	1764	9.65	.60

Source: Investment Climate Survey 2003; Fan & Wang 2003; National Statistical Bureau of China.

Model Specification

The stratified nature of the sample, with 100 to 150 observations each in 18 municipalities, calls for caution not to overlook confounding city-level effects. It is in general not unlikely that firms within a geographical context may be more similar than firms in other municipalities, due to local economic, political and also cultural factors. Within-city variation in the estimated errors would thus potentially bias the standard errors downwards. Multilevel analysis appears as a standard approach to correctly separate regional from individual effects. The asymptotic maximum likelihood estimation methods used in multilevel-analysis, however, require a minimum sample size. Simulation studies confirmed that the standard errors of the second level variances (here “city effects”) are estimated as too small when the number of groups is substantially lower than 100 (Maas and Hox 2005), though 30 clusters are often

indicated as a minimum number of groups (Kreft and De Leuw 1998). Given the relatively small number of only 18 cities, we therefore chose to estimate city-clustered standard errors instead of using multi-level estimations. Our choice is further justified as we find mainly relatively low intraclass correlation in our sample (between 0 and 4%) (Twisk 2006). Low intraclass correlation is most likely caused by broad organizational heterogeneity at the individual level, which overrules regional effects. In spite of serious concerns on the correctness of second-level effects, we have, however, also run multilevel models, which confirmed the first-level effects estimated by city-clustered estimations presented below.

We use the following reduced form model.

$$Y_i = \beta_0 + \beta_1 P_i + \beta_2 Z_i + a_r + a_s + \varepsilon_i$$

Y denotes the specified outcome variable of transactions in 9 distinct institutional domains. P denotes a vector of dimensions of political capital. Z is a vector of firm-level control variables covering company characteristics and management features likely to influence the outcome variables. In addition we control for region (a_r) and sector (a_s). The variety of outcome variables involves OLS and Probit-models.

6. RESULTS

Table 4 presents our findings for the three institutional domains in the economic market. For sales growth in the highly competitive product market (model 1), firms with political capital seem not to have positional advantage. None of the different dimensions of political capital has a significant positive effect on sales growth. Firms with CEOs appointed by the government even have a disadvantage in sales development. Clearly, this finding does not yet suggest a negative causality. Without longitudinal data we cannot rule out that poorly performing companies simply invite government involvement in recruitment decisions to help mitigate bad company performance. Our robustness tests will return to this point. Notwithstanding, our results indicate that political capital is not associated with positive growth effects in the product market. To confirm the robustness of the model we experimented with log values of sales growth, but our results remain unchanged. We also explored whether political capital may potentially work through other forms of priority treatment. The inclusion of additional explanatory variables such

as the availability of tax exemptions, sales contracts with government and trade licenses, however, does not affect our findings. The explanatory power of model 1 remains the same, also.

Another consideration is that gains from political connections could also be linked to a firm's market-based competencies. On the one hand, local governments might be more willing to support economically capable firms; on the other hand, capable firms might be in a better position to transform political support into market success. In order to explore a potential relation between market-based competencies and the value of political capital, we have calculated different measures of firm innovativeness to proxy firm capabilities. First we have included into our benchmark model a firm's share of new products in total sales (t-1) and added corresponding interaction effects with our political capital measures. Secondly, we have conducted the same exercise with an index of firm innovativeness (covering the opening of new business lines, product-, process-, management- and quality control-innovations over a three-year period from 1999 to 2001). Our estimation results (not presented), however, do not confirm that firms with stronger market-based competencies yield higher payoffs from their political capital.

In contrast, political capital has a significant impact on economic transactions in the state-controlled credit market (model 2). Government support is positively associated with success in securing formal bank loans. And as expected, political connections provide the strongest competitive advantage in the market for government contracts (model 3). One of our interviewees in the Yangzi delta region indicated, "Competitive bidding is just a form... Political connections are still as important as before... If some senior government official gives a signal we will get the project. Sometimes we lose bids, because someone else gets the nod from a senior official." Two measures of political capital confirm significant positive effects on a firm's percentage of sales to the government. First of all, a good standing with local government as indicated by the government support index provides advantages in securing government contracts. Moreover, managers with a previous career as a government bureaucrat increase a firm's ability to secure government contracts. Our interviews confirmed that many former bureaucrats who left their government position and picked up a job as a CEO systematically build on their insider's networks to cultivate political connections in order to secure government contracts. Some of these businesses were even founded on the idea of becoming a major government supplier and to thereby reduce market risk in the highly competitive commodity market.

In sum, we find confirmation for our hypothesis that the value of political capital is connected with the level of marketization in discrete institutional domains. Sales growth in the liberalized, predominantly privately organized product market does not benefit from political connections. Net advantages of positional power and chances for elite enrichment, in contrast, occur in those markets that remain under dominant state-control, with the government either the main supplier of a scarce resource (credit market) or the customer (market for government contracts).

Table 4: Economic Markets and the Role of Political Ties

	Model 1 Sales growth* Coeff (t-ratio)	Model 2 Credit access Coeff (z-ratio)	Model 3 Sales to government Coeff (z-ratio)
<i>Political ties</i>			
CEO holds a party position	26.60 (1.13)	.15 (1.60)	.03 (.43)
CEO previously held government position	79.31 (.82)	-.03 (-0.17)	.31* (1.94)
Government involvement in CEO appointment	-59.76** (-2.41)	-.13 (-1.06)	.002 (.02)
Government support index	-11.52 (-1.17)	.09*** (2.54)	.15*** (3.32)
<i>Company</i>			
Log firmage	12.00 (1.21)	-.09* (-1.86)	-.11** (-2.20)
Log sales (lagged)	-76.85* (-2.10)		
Logassets_2001		.18*** (6.72)	-.002 (-.10)
Debt equity ratio (lagged)	.411 (.91)	-.002 (-1.75)	-.001 (-0.48)
Capital labor ratio	.57*** (3.44)	-.0003* (-1.81)	-.001** (-2.50)
Located in industrial park	107.38 (1.16)	.07 (1.14)	-.14* (-1.66)
Listed company	-32.27 (-.51)	.48** (2.30)	.48** (2.04)
Government ownership shares	.85* (2.04)	-.002 (-.28)	.002 (1.45)
Sector (14 industries)	YES*	YES***	YES*

Management			
CEO holds university degree	59.15 (1.37)	-.19 (-1.34)	.32*** (3.21)
Log of CEO tenure	-45.58* (-1.77)	.10** (2.13)	-.003 (-.06)
CEO has incentive contract	-21.08 (-.54)	.17* (1.77)	.281*** (3.71)
Location			
Region	YES*	YES	YES
Log pc GDP (city level)	31.04 (.93)	-.14* (-1.13)	-.103** (-1.97)
Marketization of commodity market	88.54 (1.39)		
Marketization of credit market		.15** (2.39)	
Marketindex			-.06 (-1.45)
Constant	-413.42 (-.71)	-2.01 (-1.21)	.49 (.66)
Method	OLS	Probit	Probit
R2 / pseudo R2	.18	.16	.11
N	1503	1447	1496

* p < .10 ** p < .05 *** p < .01; standard errors are clustered on city.

The persistent value of positional advantage in non-marketized or only partially marketized sectors of the economy may invite inferences on persisting or even increasing value of political capital in the political market. Our results on rule enforcement (Table 5), however, indicate that firms with politically connected CEOs do not enjoy a systematic advantage when it comes to rule enforcement. Only in one case do former government officials seem to enjoy advantages, when it comes to timely custom clearance of export goods (model 4). The case, however, is not clear-cut. In the same model, our estimates indicate that government-appointed CEOs have to expect on average three days more for custom clearance. While we have no decisive explanation, we suspect that the delay in custom clearance may be related to specific product types. The negative effect actually disappears if we attach a lower weight to outliers and run robust regressions. Estimation results of model 5 indicate that the total amount of inspection fines depends neither on political capital nor on key characteristics of the company or management. Estimations with alternative dependent variables such as the ratio between total

inspection fines in relation to total business costs confirm these results. Model 6 displays another unexpected finding. Firms with a good standing with the government – as indicated by the government support index – seem to experience more cases of bribery in their dealings with local tax inspectors. Both the level of significance as well as the marginal effect is relatively low, however, so that we do not wish to overemphasize this estimate. Notwithstanding, it is notable that neither political capital nor company features such as size, age and industry help to explain how individual firms are treated by administrative authorities.

The extremely low explanatory power of models 5 and 6 requires some clarification. Based on extensive interviews we conducted with municipal bureaucrats and entrepreneurs, we interpret these findings as a signal of increasing fairness and unbiased treatment of economic actors. Ultimately, in a rule-based economy, the total amount of inspection fines is determined by the individual cases of detected misdemeanor, but not by general company characteristics or political capital. In this sense the low explanatory power could reflect a case-by-case treatment based on a review of the specific facts and circumstances. The focal finding with respect to our analysis of rule enforcement, however, is that management network ties with government and firm characteristics obviously capture little of the variation in specific transaction outcomes.

Table 5: Rule Enforcement and Political Ties

	Model 4 Average days for local custom clearance of export goods Coeff (t-ratio)	Model 5 Inspection fines (absolute) Coeff (t-ratio)	Model 6 Local tax inspectors require gifts / bribes Coeff (z-ratio)
<i>Political ties</i>			
CEO holds a party position	.28 (.17)	5.78 (.50)	.04 (.43)
CEO previously held government position	-2.82* (-1.96)	31.20 (.72)	.07 (.45)
Government involvement in CEO appointment	3.39** (2.31)	-6.51 (-.80)	.10 (1.14)
Government support index	-.35 (-1.24)	-1.03 (-.33)	.05* (1.92)
<i>Company</i>			
Log firmage	.11 (.16)	-19.55 (-1.27)	-.07 (-1.08)

Logassets_2001	-.67** (-2.58)	-.32 (-.14)	-.02 (-1.03)
Debt equity ratio (lagged)	.05** (2.14)	.21 (.74)	.001 (.99)
Capital labor ratio	.002* (2.07)	-.001 (-.24)	.0001* (1.84)
Located in industrial park	.70 (.46)	-25.70 (-1.56)	-.11 (-1.32)
Listed company	1.86 (1.14)	-6.71 (-.67)	-.01 (-.05)
Government ownership shares	-.01 (-.65)	-.06 (-.67)	-.001 (-.37)
Sector (14 industries)	YES***	YES	YES**
Management			
CEO holds university degree	-2.64* (-2.08)	9.08 (.49)	.05 (.35)
Log of CEO tenure	-.08 (-.18)	1.16 (.27)	.002 (.07)
CEO has incentive contract	-.46 (-.42)	27.13 (1.21)	.03 (.32)
Location			
Region	YES*	YES	YES
Log pc GDP	-2.93* (-2.11)	-1.79 (-.47)	.26*** (4.72)
Marketization Index	-2.17 (-1.37)	.20 (.04)	-.01 (-.17)
Constant	66.267** (2.85)	88.55 (99.41)	-2.86*** (-4.16)
Method	OLS	OLS	Probit
R2 / pseudo R2p	.14	.01	.04
N	594	1490	1496

* p < .10 ** p < .05 *** p < .01; standard errors are clustered on city

Analysis of the effects of political capital in different regulatory markets provides an even stronger test of its fungibility in political markets (table 6). In contrast to the claim that the political elite relies on opportunities embedded in the regulatory roles of the state to compensate for a decline in redistributive power, we find no systematic evidence that companies with political connections enjoy advantages in the institutional domain of regulatory markets.

In two cases, we find slight disadvantages for politically connected firms. Firms with government involvement in CEO recruitment decisions are less likely (the marginal effect is -8%)

to hold an export license (model 7), which would allow the firm to directly conduct foreign trade without involving trading companies. We have also re-estimated model 7 for a reduced sample under exclusion of firms which do not currently export, but find this effect confirmed. While we do not expect any arbitrary discrimination of firms with government-appointed CEOs, we suspect that these managers feel a stronger pressure to continue to trade through the traditional foreign trade system operating through state-run trading companies.

Model 8 suggests similar disadvantages for former government officials in securing tax exemptions. Based on our field experience, we suspect that many of the former government officials open rather traditional businesses or service companies. These businesses do not qualify for tax exemptions, which are typically reserved for technology-based start-up enterprises. Inclusion of more fine-grained information on production technologies would most likely eliminate the borderline significant effect. Overall, firm age, size, production technology, and industry are the central determinants explaining the granting of export licenses and tax exemptions. This is in line with China's industrial policy guidelines, which specify certain company features as prerequisites for access to trade and tax exemptions in order to actively promote the modernization of the economy. Model 9 complements this overall impression and underscores that—in line with general regulations on market entry and competition—the price of business registrations is not affected by company characteristics or political capital.

Table 6: Regulatory Market and Political Ties

	Model 7 Firm holds an export license ^a Coeff (t-ratio)	Model 8 Firm enjoys tax exemption Coeff (z-ratio)	Model 9 Costs for obtaining a business registration over last two years (including fees, gifts, bribes etc.) Coeff (t-ratio)
<i>Political ties</i>			
CEO holds a party position	-.15 (-1.59)	-.11 (-.81)	-372.87 (-1.37)
CEO previously held government position	-.16 (0.69)	-.30* (-1.78)	-559.55 (-.94)
Government involvement in CEO	-.42***	-.14	-13.06

appointment	(-3.46)	(-1.26)	(-.08)
Government support index	.05 (1.24)	.02 (.46)	20.55 (.56)
Company			
Log firmage	-.16** (-2.10)	-.18** (-2.43)	129.48 (1.11)
Logassets_2001	.24*** (7.66)	.18*** (5.94)	61.60 (.94)
Debt equity ratio (lagged)	-.001 (-.33)	-.002 (-1.10)	.37 (.43)
Capital labor ratio	-.0001** (-2.34)	-.0001*** (-2.68)	-.42 (-1.02)
Located in industrial park	.29*** (3.42)	.63*** (5.51)	257.53 (1.12)
Listed company	.08 (.27)	.25 (.97)	2153.76 (.99)
Government ownership share	.001 (.43)	.002 (.97)	2.52 (.81)
Sector (14 industries)	YES***	YES***	YES
Management			
CEO holds university degree	.69*** (4.34)	.18 (1.19)	-168.48 (-1.06)
Log of CEO tenure	-.01 (-.14)	-.01 (-.14)	174.64 (.96)
CEO has incentive contract	.01 (.09)	-.07 (-.69)	292.528 (1.26)
Location			
Region	YES*	YES	YES
Log pc GDP	.29*** (3.21)	.03 (.30)	89.390 (.44)
Marketization Index	.15* (1.93)	-.02 (-.19)	-111.35 (-.83)
Constant	-6.61*** (-5.19)	-2.41 (-1.58)	-901.01 (-.40))
Method	Probit	Probit	OLS
R2 / pseudo R2	.33	.22	.13
N	1434	1477	523

* p < .10 ** p < .05 *** p < .01; standard errors are clustered on city.

Skeptics might object that political connections came to full play at earlier stages of market transition and have helped to build up specific company characteristics that now – at an advanced stage of transition – independently yield positive effects on transaction outcomes. Company size, for instance, might theoretically be the result of earlier asset appropriations in the

course of privatization policies. While clear counter evidence would require time series data covering earlier periods of China's transition, some observations contradict this idea. First, company size does not create a general advantage, but is only associated with advantages in four out of nine models (see table 4-6). Secondly, company size and the examined measures of political capital are only moderately correlated, with a negative correlation for former government officials. Even exclusion of company size as a control variable would not substantially affect our results for political capital. Hence, we do not see evidence for lasting economic advantages due to potential asset accumulation of politically connected firms in prior periods. Clearly, the weak correlation between firm size and political capital in the survey year does not rule out that political connections may have played a more decisive role during the firms' founding process. The main emphasis of our study, however, is to compare the current value of political connections in different types of institutional domains. As the qualities of institutional domains have gradually changed in the course of market transition, our results do not invite inferences on earlier stages of development.

A final note of caution should be added, which we share with the whole empirical literature studying the economic value of political connections. While we believe that we have provided the best possible approximation of political capital, we cannot rule out that specific state-firm connections are simply not revealed by the available survey data. Firms may for instance possess direct linkages through relatives or acquaintances of key personnel or owners, which are not covered by the World Bank survey instrument. "Not revealed" or "hidden" political connections may well exist, but they will most likely be correlated with at least one of the dimensions of political capital captured in our model. It is unlikely that firms without any formal party association and government assistance systematically possess informal connections that would create otherwise unrecognised advantages.

Robustness test

We consider three robustness issues. First, we checked whether our OLS results were driven by outliers or by predictor variables with high leverage. Robust regressions, however, generally confirmed our findings and did not indicate systematic advantages for firms with political connections.

Secondly, reverse causality is a potential risk when using cross sectional datasets. It is possible that political capital may have different effects depending on the firm's economic performance. For instance, political connections may be easier to activate for poorly performing firms facing bankruptcy, or alternatively, political capital might become more valuable for top performers thanks to the government's interest in cultivating national brands and global players. To mitigate the risk of reverse causality, we have experimented with different lagged performance measures (such as return on assets) as additional control variables, but our substantive findings remained unaffected. Also, our findings are confirmed for a subsample of loss-making firms. Theoretically, there is also a chance that firms that are performing weakly in the specified market settings respond by recruiting new CEOs with viable government ties. If such a selection effect actually existed, our estimation results would possibly not reveal positive effects of political capital. To rule out such concerns, we have explored whether our results still hold up if firms with recently recruited CEOs (we experimented with tenure of up to 5, 3 or 1 years) are excluded from the sample. Overall, however, our general findings were confirmed.

While our model specification has controlled for economic development, we cannot rule out that advantages stemming from political connections may not still be linked with it. Responding to the question whether economic advantages of political capital vary with economic development, we repeated our analysis for a subsample of cities with below-mean per capita GDP. To support a causal link between economic development and the role of political capital, we would expect stronger effects for positional power and political connections among the less developed municipalities. In order to explore the potential impact of structural contextual effects connected with the early stage of regional industrialization, a third test reduced our sample to municipalities with more than 50% rural population. As before, political capital was only associated with competitive advantages in the credit market and the market for government contracts. Outside of these markets, political connections yield no systematic positional advantages for firms with political capital.

7. DISCUSSION AND CONCLUSION

In economic markets, advantages stemming from political capital are highest in state dominated markets (such as the credit market and the market for government contracts), while we cannot

detect a positive payoff for political connections in the competitive product markets. Our findings correspond with earlier work on the connection between political capital and market regulation, which finds a positive correlation between the representation of political directors on corporate boards and the level of industry regulation (Helland and Sykuta 2004).

Surprisingly, we found no systematic advantage for politically connected firms in political markets. Instead, outcomes in administrative and regulatory markets seem to a large extent determined by company characteristics and firm location. Particularly, economic transactions, which are closely related to the government's ambition to launch an active industrial policy supporting promising and strong firms, depend in the first place on the firm's organizational characteristics. We observe advantages for younger and large firms, not involved in capital-intensive production, and located in industrial parks and technology zones in the markets for export licenses (model 7) and in applications for tax exemptions (model 8). In contrast, administrative fees are not determined by company features or political capital (model 9). In this sense, the development of the political market seems to move in the direction of a level playing field, where rule-based enforcement of regulatory standards prevails.

Our findings may be indicative of a linked state and market evolutionary development (Zhou 2000), where progress in marketization triggers subsequent changes in the reward structure for political actors, which eventually lead not only to a decline in the value of political connections in the marketized sectors, but also provide impetus for the creation of a rational-legal bureaucracy (Yang 2004; Nee and Opper 2007). Most importantly, the decentralization and privatization of economic activities render the socialist profit retention system, built on central planning and state-ownership, ineffective. Fiscal federalism has played a crucial role as a market-preserving mechanism that has helped to introduce business-oriented thinking in the regulatory and redistributive sector (Montinola, Qian and Weingast 1995). As lower-level governments increase their revenue to the extent that they succeed in promoting economic development in their jurisdiction, firms' chances to benefit from their political connections are weakened. Like other markets, regulatory markets gradually become competitive markets.

Overall, our findings suggest that by 2002 political connections in urban China provide advantages principally in economic markets where government restricts economic activity and where economic actors compete for rents. In the competitive product market, however, political capital—whether in the form of political connections or government support—does not seem to

confer competitive advantage in economic transactions. The absence of systematic advantages for political capital in administrative and regulatory markets, moreover, suggests that a linked evolution of market institutions and bureaucracy might strengthen rational-legal authority and procedures in the political market (Guthrie 1999). This does not mean that politically connected entrepreneurs may no longer benefit from their political capital to build up large-scale firms. Our findings on political advantages in the credit market and in the market for government contracts suggest that political capital still can yield valuable economic advantages. Entrepreneurs and firms who frequently transact in those markets will therefore have strong incentives to maintain and cultivate political ties.

Many on China's growing list of *parvenus* are politically connected, and a third of China's richest 800 entrepreneurs are party members (Kwong 2007). Consistent with our analysis, anecdotal evidence suggests that positional advantages are usually pervasive in highly regulated sectors, such as the real estate sector, construction industry, banking or foreign trade, where the "right connections" can help to secure super profits. Not surprisingly, China's first US dollar billionaire, former China vice-president Rong Yiren, made his wealth as the leader of the state-controlled China International Trust and Investment Company Corp. (CITIC) (Dickie 2005). In this sense, China's experience as a young market capitalist economy is not dissimilar from the experience of the US economy in the 19th and early 20th century, where Leland Stanford obtained a government-backed monopoly and massive state financial subsidies and land grants to build the Central Pacific Railroad, and the creation of corporations such as Union Pacific, Northern Pacific railroad was facilitated by political connections. Our results do not rule out that rent-seeking with positional power still offers routine sources of opportunity for the political elite, as it continued to be manifest in bribe-taking by government officials. The mean expenditure for fees and bribes used to obtain government-issued business registration, for example, was 125,000 *rmb* (model 9); the standard deviation (1,482,820 *rmb*) indicates that bribes in regulatory markets were not trifling.

Some final caveats apply: Our analysis aims to compare the value of political capital in different types of routine transactions by firms across a variation of distinct institutional domains. Our analytical focus does not imply that political capital may not also serve as "insurance"-a mechanism that helps firms to mitigate potentially unfavorable interference from political actors. When economic actors face uncertainty over political contingencies, investing in political capital

constitutes a prudent form of strategic action. In other words, we acknowledge that there may be incentives for economic actors to invest in the cultivation of political connections that go well beyond the scope of our transaction-focused analysis. Similarly, our study does not incorporate the role of financial contributions in rent-seeking activities of economic actors. In light of systematic evidence documenting in mature market economies the commonplace use of financial contributions to political coffers to buy outcomes from legislative processes (Monardi and Glatz 1998) and in access to strategic resource (Claessens et al. 2008), such use of political connections is likely also to persist in China. Reports of financial payments disguised as contributions to social projects and payments to “political consultants” (Huang 2008) suggest that “political support” is also purchased through financial contributions.

Finally, our predictions should not be interpreted as implying that the state loses power in the transition to a market economy. Indeed, with more relative autonomy, state power becomes less encumbered by rent-seeking activity (Evans 1995). Fuelled by dynamic market capitalism, economic development in China has generated growing revenues for state coffers, as reflected in the huge currency reserve held by the central bank. Growth in tax revenues augments the state’s wealth and power to make credible commitments to long-term national goals of modernization.

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