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# SESSION IV
# How does the grabbing hand grab? Tunneling assets from Chinese listed companies to the state

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# The helping hand, the lazy hand, or the grabbing hand? Government shareholders in publicly listed firms in China

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Abstract

We analyze related party transactions between Chinese publicly listed firms and their state-owned enterprise (SOEs) shareholders to answer three questions. Do companies always benefit from the presence of government shareholders? Are government shareholders inefficient in maximizing shareholder value? Or do governments extract resources from companies, either to perform a social role or because they are corrupt? We find that related party transactions between firms and their government shareholders seem to result in the expropriation of the minority shareholders of the firm. The expropriation is concentrated in firms with the highest state ownership and controlled by local government SOEs, and in provinces where local government bureaucrats are less likely to be prosecuted for misappropriation of state funds. Overall, our results are most consistent with the grabbing hand model of government.

Keywords: International corporate governance; Government ownership; China; State-Owned Enterprises (SOE); Local government; Related party transactions; Expropriation; Political connections

JEL Classification: G15; G34; K33

## Introduction

In this paper, we analyze related party transactions between Chinese publicly listed firms and their state-owned enterprise (SOE) shareholders to examine three hypotheses. The *helping hand* hypothesis argues that companies benefit from the presence of government shareholders. The *lazy hand* hypothesis argues that government shareholders are inefficient. They are unable to monitor managers effectively and hence they do not maximize shareholder value. Finally, the *grabbing hand* hypothesis argues that governments extract resources from publicly listed companies, either to perform a social role or because they are corrupt.

The helping hand hypothesis (see Shleifer and Vishny, 1998) is motivated by prior academic research which has mostly argued that shareholders in firms with close ties to governments gain from political connections (see for example, Fisman, 2001, Leuz and Oberholzer-Gee, 2006, and Johnson and Mitton, 2003). Examples of these benefits include being allowed to borrow on preferential terms from state-owned banks (see for example, Sapienza, 2004, and Dinç, 2005), and government sponsored bailouts (Faccio, Masulis, and McConnell, 2006). Consistent with this, Faccio and Parsley (2006) document that around the world, the sudden deaths of politicians are associated with a market adjusted decline of 1.7% in the value of connected companies.

The lazy hand hypothesis is motivated by the literature on state-owned enterprises and privatization (see Megginson and Netter (2001) for a survey of this literature) and argues that state-owned enterprises do a poor job of monitoring management. Consequently, state-controlled enterprises underperform and performance improves when the firms are privatized. Bai et. al (2004) find for example, that Chinese firms where the state is the largest shareholder, trade at a discount compared to other firms. The worst performing state-owned firms are simply expected to do the worst deals.

The final hypothesis, the grabbing hand hypothesis, is motivated by Frye and Shleifer (1997), and Shleifer and Vishny (1998) who argue that governments may have a "grabbing hand", leading them to expropriate shareholder wealth from public firms. There are two reasons why government shareholders might expropriate wealth from minority shareholders. Shleifer and Vishny (1998) imply that government bureaucrats are corrupt and enrich themselves through

these transactions. They argue that the government consists of a large number of substantially independent bureaucrats pursuing their own agendas, including taking bribes. These bureaucrats remain largely independent of courts, imposing predatory regulations on firms, and imposing their will in commercial disputes with these firms. Enrichment may be direct (for example, misappropriation of funds) or indirect (for example, on-the-job consumption of lavish perks). Alternatively, they might be playing a social role, expropriating wealth from the minority shareholders in order to benefit other members of society. In this alternative framework, the government shareholders impose a tax on the remaining shareholders, but this ultimately benefits society.

However, while there is a rich theoretical literature on rent seeking and corruption (Shleifer and Vishny, 1993, 1994), in contrast to the empirical evidence on the helping hand or the lazy hand of government, there is little empirical evidence on the channels through which the grabbing hand might be manifested. This is not surprising since this kind of behavior is usually illegal and hence undisclosed. As a result, evidence on the government's grabbing hand is largely anecdotal. Zingales (1994) describes how the Italian wholly state-owned company IRI sold its stake in a software company to STET, a company that it partially owned along with private investors, at a substantial premium. In China, China Shipping Development entered into a charter agreement with its wholly state-owned parent China Shipping Group in 2004 which, according to analyst assessments, resulted in a net transfer of US$45 million from the listed company to its parent.[1] In another example, in 1998, Zhu Kuan, a company controlled by the government of the city of Zhuhai, defaulted on US$750 million borrowed from Standard Chartered, Morgan Stanley, Lehman Brothers and others. In 2003, during negotiations for a workout, creditors discovered that the Zhuhai government had transferred land worth US$125 million out of Zhu Kuan's control and back into the hands of the city (land that the creditors had assumed would serve as collateral for their loans).[2] In similar spirit, the popular press has reported a huge number of cases (more than 130,000 according to the Land and Resources Ministry) where farmland was illegally expropriated by local governments in China for development, with little or no compensation for the farmers whose only source of income was taken away.[3] This anecdotal

[1] *South China Morning Post*, 1 March 2004
[2] *BusinessWeek* (December 1, 2003).
[3] "Illegal land grab cases increase in China", *Japan Economic Newswire* (March 21, 2007).

evidence suggests that the expropriation of publicly listed companies may represent a transfer of resources from listed firms to corrupt government bureaucrats.

China is an appropriate testing ground for this research both because of the country's governance structure and because of the size of its economy. The median state ownership in a Chinese listed firm is 35%, giving us a large representative sample of firms in which to study the effects of government shareholders. Using purchasing power parity exchange rates, the Chinese economy is the second largest in the world, and at current growth rates, it may become the largest in less than 10 years (Allen, Qian, and Qian, 2005). By early 2007, the combined market turnover of the two Chinese stock exchanges (where more than 1,000 firms are listed) made them the second largest stock market in Asia, following Tokyo and ahead of Hong Kong. Increasing numbers of Chinese firms are cross-listed in the U.S., making their stock available to U.S. investors.

There is one additional reason why China is an appropriate market for conducting this research. The law and finance literature (see for example, La Porta, Lopez-de-Silanes, Shleifer, and Vishny, 1998) has mainly examined differences in firm policies and characteristics on a country-level basis, with classifications based on the rule of law at the central government level. However, there may be differences between the incentives and the behavior of central and local governments on a wide range of issues (Bardhan, 2002). For example, local governments may have fewer resources at their disposal that enable them to perform a social role, leading them to search for alternative sources of revenue. On the other hand, the actions of local governments may be less visible to the press or to central and judicial authorities, and their bureaucrats may feel less likely to be prosecuted for corruption, which suggests more opportunities for personal enrichment by local government officials. Strong local governments are found in large parts of the world (e.g. China, India, Russia, Brazil, Argentina etc.), where more than half of the world's population lives. According to the Investment Climate Surveys, conducted by the World Bank during 2002-2003, almost two-thirds of the more than 13,000 companies from 60 emerging markets surveyed, state that local governments influence the laws that affect them.[4] Cases where foreign companies have been victims of local government decisions that run contrary to

[4] Data available at www.worldbank.org/wdr2005

agreements with federal governments have been reported in India,[5] Russia,[6] and Mexico,[7] among others. In spite of this widespread anecdotal evidence, actions by local governments have not been examined empirically in the academic literature. China has decentralized economic governance and strong local or provincial governments often act independently of the central government in Beijing (in accordance with the saying "the hills are high, and the Emperor is far away" [8]).

In this paper, we analyze two unique hand-collected datasets in order to identify whether the presence of a government shareholder helps or hurts the minority shareholders in the firm. First, in a sample of Chinese publicly listed firms where the government holds a stake through a wholly state-owned enterprise (SOE), we examine a sample of 182 related party transactions between the firm and the SOE during 2001-2002. These related party transactions can provide direct opportunities for government bureaucrats to benefit or extract resources from listed companies under their control. We find that minority shareholders of publicly listed firms in China earn significant negative abnormal returns when the firms conduct related party transactions with their SOE shareholder. This effect is concentrated in firms where the state owns more than 35%, and which are controlled by *local* government SOEs. Firms with directors who are affiliated to local governments are not immune. Local government controlled firms represent the majority of the state-owned firms in China. The median value destruction by these firms corresponds to 45% of the value of the related party transaction, suggesting that our results are economically significant. In contrast, related party transactions conducted by the firms controlled by the *central* government, and similar arms' length (non-related party) transactions undertaken by state-owned firms, are not associated with value destruction. These results are more consistent with the grabbing hand than the helping hand.

Second, we analyze a sample of 801 corruption cases that have been prosecuted by Chinese judicial authorities in order to determine whether the transfer of resources away from the listed firms is more pronounced in provinces where corrupt government officials are less likely

[5] Eun, C.S., Resnick, B.G., "Enron versus Bombay politicians', *International Financial Management*, 3rd ed., McGraw Hill, 2005.
[6] Thornhill, J., "Investors look for Russian climate change: Prospects for cutting through the bureaucracy," *Financial Times*, 24 November 1994.
[7] Knight, D., "Mexico must pay U.S. company $17 million," *Business and Industry Interpress Service*, 31 August, 2000.
[8] Pu Songling, *The bonds of matrimony*, 17th century Chinese novel.

to be prosecuted for misappropriation of state funds. We also analyze data on the financial performance of provinces in order to determine whether the transfer of resources is concentrated in cash-strapped provinces which are more in need of revenue to perform a social role.

We find that the expropriation by the local government controlled SOEs is concentrated in provinces where local government bureaucrats are less likely to be prosecuted for misappropriation of state funds, suggesting the wealth transfer to government bureaucrats is driven by corruption. We find no evidence that the transfer of resources from publicly listed firms to provincial governments is motivated by a social role. The social role argument suggests a transfer of resources to the local governments of under-performing regions (provinces with large budget deficits and high unemployment), but we show that most of the expropriation is concentrated in China's *richest* provinces. In fact, the negative relationship between the magnitude of the expropriation and the frequency with which government officials are prosecuted for misappropriation of state funds in that province holds even after controlling for the province's economic performance and the performance of the expropriating SOE. We also obtain additional results consistent with expropriation (such as larger expropriation in firms controlled through pyramids, the relationship between IPO timing and related party transactions, and larger expropriation by firms located far from the capital).

Finally, our results are more consistent with the direct transfer of resources away from listed companies than with the poor performance of state-owned firms. The state-controlled firms in our sample do not under-perform relative to other state- or non-state-owned firms. In addition, the expropriation is concentrated in firms controlled by local governments and is not present in firms controlled by the central government. While this is consistent with expropriation (local governments may have more freedom to expropriate because their actions have less visibility to central authorities, to the press, or to judicial authorities), the literature on the under-performance of state-owned firms does not make such predictions. Also, in contrast to related party transactions, we show that similar arms' length transactions by state-owned firms *do not* destroy firm value.

Our results are robust to alternative interpretations. Since it is difficult to compute the "fair" value of any assets changing hands and compare it to the transaction price, our main results infer the expropriation by examining the stock market reaction at the announcement of

related party transactions using event-study methodology. However, though the negative market reaction that we document is consistent with asset transfers, it may also be consistent with two alternative hypotheses. First, the market may react to the announcement of an asset acquisition or sale, and the related nature of the deal may have no impact. Second, the related party transaction announcement may signal to the market that these firms are in some sort of distress, and the market reaction may reflect the revelation of this information. After we test these alternative explanations, we conclude on balance, that our results are most consistent with the expropriation hypothesis and the "grabbing hand" model of government (Frye and Shleifer, 1997; Shleifer and Vishny, 1998).

Our paper is very different from the extant literature on tunneling. Most of this literature (see for example, Johnson, La Porta, Lopez-di-Silanes, and Shleifer, 2000; Bertrand, Mehta and Mullainathan, 2002; La Porta, Lopez-di-Silanes, and Zamarippa, 2003; Cheung, Rau, and Stouraitis, 2006) focuses on the role of individual controlling shareholders or directors in expropriating wealth from the minority shareholders in the firm. In this literature, firm value is negatively related to the separation of cash flow and control rights of their controlling shareholders. In contrast, we examine the role of the state as a large shareholder, specifically, the transfer of wealth from firms to government bureaucrats. Cash flow rights play no role in this case. The transfer occurs when corrupt officials take advantage of their SOE control rights to transfer wealth to their own control, which can then be misappropriated directly. The closest relevant paper to ours is Fan, Wong, and Zhang (2007) who show that Chinese firms going public with politically connected CEOs underperform those without politically connected CEOs by 18% in the three years after the initial public offering (IPO). They argue that partial privatizations in China are more likely to be associated with bureaucratic rent-seeking than with shareholder value maximization. Their findings, however, are also consistent with the social role argument.

The paper is organized as follows. Section I describes the institutional background of the Chinese economy. Section II describes the data. Sections III to VI report our main empirical results. Section VII reports a series of robustness tests and Section VIII concludes.

## I. Institutional background

Prior to the beginning of economic reforms in 1978, all Chinese firms were solely state-owned. Following the economic reform program, the state divested stakes in many firms, but retained shareholdings in most companies, and there were few outright privatizations. Stock exchanges were established in Shanghai and Shenzhen, in 1990 and 1991. By 2003, there were 1,286 companies listed, with total market capitalization almost RMB5 trillion (approximately US$600 billion). In early 2007, the daily turnover of the combined Chinese stock markets overtook Hong Kong to become the second largest in Asia after Tokyo.

Chinese listed shares are classified according to the residency of their owner as domestic (A shares) or foreign (B, H and N shares). A-shares (worth RMB4,470 billion, US$541 billion, in 2003) are available exclusively to Chinese domestic investors. B-shares (worth RMB272 billion, US$33 billion) were originally available for trade only by non-residents but were opened to domestic investors in 2001. Chinese companies were permitted to list on the Stock Exchange of Hong Kong (SEHK) as H-shares in 1993. H-shares are subject to stricter SEHK listing requirements. N-shares are traded in the U.S. in the form of American Depository Receipts (ADRs), mostly as Level I ADRs, which are traded over-the-counter and are not subject to the disclosure requirements of the SEC's Exchange Act. All shares have the same voting and cash flow rights by law.[9]

The China Securities Regulatory Commission (CSRC) is responsible for supervising and regulating issuing and trading activities but lacks the necessary investigative and prosecuting power and resources. Investors have few avenues to prevent expropriation and to seek redress. Due to the high cost and complexity involved in civil claims, individual investors are unlikely to sue in the courts for suspected infringements, and even if they did, court decisions are not universally enforced.

[9] State shares are held by government agencies (the Bureau of State Property Management and local finance bureaus) and by solely state-owned enterprises. During our sample period, they could not be traded, but could be transferred to domestic corporations when approved by the China Securities Regulatory Commission (CSRC).

## II. Data

We obtain our related party transactions data from 182 filings of related party transactions by listed companies submitted to Chinese stock exchange authorities during 2001-2002. According to the *Rules governing the listing of securities* (Shanghai Stock Exchange 2002; Shenzhen Stock Exchange 2002), a related party transaction is a transfer of resources or liabilities between a listed company and the legal entities or individuals who control it. Transactions with value greater than RMB1 million (US$ 121,000) or 0.5% of net assets, must be reported to the exchange within two working days following the signing of the contract. For each transaction, we obtain the hard copy of the filing describing the transaction and the related parties. We are interested in transactions that (i) involve a complete transfer of resources, and (ii) do not result in obvious benefits to the listed firm (as in the case of direct subsidies, for example). Our transactions involve acquisitions of assets or shares by the listed company from its state-owned parent (81 cases), sales of assets by the listed company to its state-owned parent (40 cases), asset swaps between the listed company and its controlling SOE (25 cases), trading of goods or services between the listed company and its controlling SOE (33 cases), and direct cash payments, loans or provision of loan guarantees by the listed company to its state-owned parent (13 cases). On a few occasions, firms may use the same announcement to announce two or more transactions of different types. These types of transactions represent the vast majority (84% according to our data) of related party transactions between listed firms and their SOE parents in China. In contrast, the transactions that directly benefit the listed firm constitute less than 10% of the total number of filings (31 cases where the listed firm receives assistance from its SOE parent and 4 cases where it transacts with its own subsidiaries).[10] We exclude these transactions to focus on transactions where it is not obvious *ex ante* how the minority shareholders are affected by

[10] Our data is hand-collected, limiting our ability to extend our sample period. These filings are submitted to stock exchange authorities in hard copy and are not available in any electronic file format. We copy and translate the filings used in this study from the exchange's archives. We do not expect that our results are sensitive to the particular time period that our sample covers. Out of a total 351 filings, we exclude 75 filings where the related party is not state-owned, and 59 filings that describe the formation of joint ventures or strategic alliances between a listed company and its controlling shareholders. The formation of joint ventures does not represent a complete transfer of resources, because no cash changes hands and the listed firm retains some control over the pledged assets (and the cash flows emanating from them) as a major shareholder in the joint venture. Only when the joint venture is dissolved can we evaluate its full impact. Announcements of joint venture dissolutions are included in our sample as asset acquisitions or sales.

their related party transactions with government shareholders. However, we note that our results are not sensitive to the inclusion of these transactions (see robustness tests, Section VII.A).

We also collect a comparison sample of arm's length (non-related) transactions by obtaining a sample of acquisitions of assets and equity, asset sales, and sales of equity stakes undertaken by Chinese publicly listed firms during 2001-2002 from the China Stock Market and Accounting Research (CSMAR) database. CSMAR is one of the most commonly used databases for China-related research. After eliminating transactions that are related, we are left with a final sample of 427 announcements of arms' length corporate transactions (218 announcements by acquirers and 209 by sellers).

Daily and monthly stock returns, financial data, ownership structure (state shareholdings and B-shares), the proportion of external directors on the board, and names of auditors for the universe of Chinese publicly listed firms are obtained from CSMAR. We obtain the affiliation of directors (central government, local government, and membership to the Communist party) from IPO prospectuses in the China Stock Initial Public Offerings Research Database (CSIPOR), company annual reports, and company web sites. We estimate market-adjusted abnormal returns for A-shares by subtracting the returns of the value-weighted market index from the raw returns earned by the sample firms (with reinvestment of cash dividends). We obtain lists of H-shares from the website of the CSRC, and lists of ADRs from the website of JP Morgan Chase at www.adr.com. We obtain data on the performance of the non-listed SOEs that control the listed companies in our sample from related party transactions filings, annual reports and company web sites. We also obtain figures for Gross Regional Product (GRP), unemployment, and budget deficit for China's 28 provinces and the four cities with independent province status (Chongqing, Shanghai, Shenzhen, and Tianjin), from the Statistical Yearbook of China and the Shenzhen Statistics Yearbook. Our sample for the universe of Chinese publicly listed firms consists of 2,031 firm-year observations.

Finally, we obtain data for 801 corruption cases that have been prosecuted by Chinese judicial authorities by searching the web sites of the Chinese news agency *Xinhua* (www.xinhuanet.com/lianzheng), and the publications *Legal Daily* (www.legaldaily.com.cn),

and *Procuratorial Daily* (www.jcrb.com). To be included in our sample, the corruption described in the news report must also have occurred during 2001-2002.

## III. Do related party transactions with SOEs reflect the helping hand or the grabbing hand?

Our analysis proceeds in three steps. First, we test whether the presence of government shareholders in the firm reflects the helping hand or the grabbing hand. To do this, we compare the characteristics of our sample firms that undertake related party transactions with their government SOE shareholder both with the universe of Chinese publicly listed firms, and with firms undertaking similar arm's length transactions (Section III.A). We also examine the valuation effects of these transactions. We then test whether the valuation effects are related to the related nature of the deal or to several alternative hypotheses, including the lazy hand hypothesis (Section III.B to III.D).

Second, we test the nature of the grabbing hand hypotheses, namely whether it plays a social role or whether it is related to corruption. We examine what types of SOE controlling shareholders destroy more value in related party transactions among firms with high state ownership (Section IV). We investigate whether the provinces where the expropriation is concentrated are poorly performing (suggesting that the local governments involved may need resources in order to perform a social role) or whether they are provinces where misappropriation of state funds by government officials is less likely to be prosecuted (suggesting that the expropriation is likely to be corruption related) (Section V).

Third, we re-visit the issue of whether the effects that we document are simply related to the poor performance of state-owned firms in general – the lazy hand of government (Section VI). Finally, as a robustness test, we also examine whether our results are dependent on our selection of related party transactions for our sample (Section VII).

*III.A. Characteristics of firms that undertake related party transactions with SOEs*

Table 1 reports descriptive statistics for related party transactions with SOE related parties. In column 1, we report statistics for all transactions with SOE related parties. In columns 2 and 3, we sub-divide this sample into transactions by companies where the state holds more or less than 35% of outstanding shares. This ownership cut-off corresponds to the proportion of state shareholdings in the median Chinese listed firm (see Table 2 below). It is also a percentage sufficient to confer effective control. Our results are not sensitive to the choice of a higher cut-off (such as 50%). We report significance levels for differences in column 4.

Almost 90% of the total related party transaction volume in our sample is concentrated in transactions by companies in which the state owns more than 35% of shares outstanding (RMB29 billion, US$3.5 billion). These cases represent almost 75% of the total number of related party transactions in our sample (133 out of 182 cases). The median value of a related party transaction between a listed firm and its controlling SOE shareholder is RMB45 million (US$5 million), representing 1.1% of the market value of the listed company. Although the transactions appear small relative to stock market capitalization, they represent 76% of the listed firm's absolute net profit figure, and can have a significant impact on profitability and cash flow. Furthermore, our figures are likely to underestimate both the true aggregate value and the size of the related party transactions. Since enforcement of the rules is weak, there may be companies that fail to disclose related party transactions or report only the best deals. It is also possible that some firms understate the true value of the deal in their filings.[11] Consequently, the contribution of our study is in highlighting the *process* through which potential expropriation might happen, rather than in documenting the full magnitude of the problem.

In Panel B, firms with state ownership over 35% have significantly higher proportion of directors who are members of the Chinese Communist Party compared to the remaining firms. There are no significant differences across firms in the proportion of directors who are affiliated with central or local governments. In Panel C, a significantly greater number of related party transactions are carried out by SOEs owned by local governments.

[11] Such examples have been reported in the Hong Kong press. The China Shipping Development case, referenced in the introduction, is one such example.

Firms where the state holds more than 35% of outstanding shares earn significantly negative market-adjusted cumulative average abnormal returns (CARs) around the announcement, namely −1.1% for days [−2,+2] (column 2, Panel D).[12] The results are even stronger for day [−2,+5] CARs, and hold for all four measures of value in the table. Although the magnitude of the abnormal returns appears small, we note that the sub-samples reported in Table 1 do not correspond to our main tests. As we show in Section IV, the absolute magnitude of the CARs is much higher within some sub-samples of related party transactions with SOEs. Furthermore, the abnormal returns represent considerable value losses in economic terms. The median value loss ([−2,+2] day CAR multiplied by market value) for firms in which the state owns more than 35%, is RMB33 million (US$4 million). This figure represents 41% of the stated amount of the related party transaction, and is also highly statistically significant. The small magnitude of the abnormal returns is consistent with Morck, Yeung, and Yu (2000), who show that in China, 80% of the stock prices move together, with little movement of prices due to firm-specific events. In addition, if firms under-report related party transactions, it is more likely that only the best deals get reported. These factors would bias our results towards *not* finding expropriation, and may also account for the low CAR values. [13]

In Table 2, we compare the characteristics of firms undertaking related party transactions with SOEs (columns 3 and 6) with firms undertaking arm's length (non-related) transactions (columns 2 and 5), and with the remaining universe of Chinese publicly listed firms that conduct neither related party nor arm's length transactions (columns 1 and 4). We report statistics for the entire sample (columns 1-3) and for the sub-sample of firms with state ownership greater than 35% (columns 4-6). We report tests of differences in columns (7)-(10).

In column (3), firms that conduct related party transactions with SOEs are significantly larger than other listed firms, have significantly larger state ownership – which is not surprising since firms with higher state ownership are more likely to have SOE controlling shareholders –

[12] We report windows that start on day −2 because Chinese firms are allowed up to two days before announcing the signing of a related party transaction contract, and hence insiders may have an opportunity to trade before the public announcement. We also estimate CARs for alternative windows around the announcement (namely [−1,+1], [−1,+3], [−1,+5], [−2,+2], [−2,+3], [−2,+5], [−3,+3], and [−5,+5]). Our results are qualitatively similar. Similarly, our inferences about total value changes associated with the transactions reported below, are not sensitive to the window over which CARs are estimated.

[13] In analysis not reported in the tables, all five types of related party transactions are associated with negative announcement CARs.

and significantly fewer external directors (2.3% compared to 4.2% or 3.9%). We also report operating performance and capital structure measures for the last fiscal year before the related party transaction announcement (return on equity, market-to-book ratio, total liabilities over total assets, short- and long-term debt over market value of equity, and short-term liabilities over total liabilities). Prior to announcing the related party transaction, firms that conduct transactions with SOEs (column 3) report higher return on equity values than other Chinese listed firms. There are no statistically significant differences in capital structure between firms that conduct transactions with SOEs and the universe of Chinese listed firms.

Given that firms conducting related party transactions with SOEs are significantly larger compared to other listed firms, we perform the same comparisons in the sub-sample of firms with state ownership greater than 35% (columns 4-6 and 9-10). These sub-samples of firms have similar size and state ownership. Again, firms with related party transactions have significantly fewer external directors on their boards, suggesting poor corporate governance. There are no other statistically significant differences between the three sub-samples. Therefore, the sample firms do not under-perform with respect to other firms. It is especially noteworthy that there are no significant differences in firm performance, valuation, and capital structure between firms conducting related party transactions with SOEs and the remaining Chinese firms. This suggests that firms conducting transactions with their controlling SOE shareholders are not in distress.

*III.B. Are related party transactions different from arms' length transactions?*

It might be argued that the negative stock market reaction that we observe for firms conducting related party transactions with SOEs in Table 1 is due to the type of corporate transaction undertaken and not to the related nature of the deal. We therefore compare the related party transactions with SOEs with similar arms' length (non-related) transactions. Table 3, Panel A reports [−2,+2] and [−2,+5] day CARs, the total value change associated with the transaction ([−2,+2] day CAR multiplied by the market capitalization of the listed firm), and the ratio of total value change divided by the amount of the deal, for different sub-samples of related party and arms' length transactions. Again we report results separately for all firms and for the sub-sample of firms with state ownership greater than 35%.

In contrast to the statistically significant negative CARs for related party transactions with SOEs (columns 1 and 4), arms' length transactions are associated with highly statistically significant *positive* CARs and other value measures (columns 2 and 5). Interestingly, even firms with state ownership over 35% that undertake arms' length transactions earn positive [–2,+2] day CARs of 0.6% (statistically significant at the 1 percent level). Across all measures of value, the differences between related party transactions with SOEs and arms' length transactions are statistically significant at the 1 percent level (columns 7 and 9). The results hold for firms with all levels of state ownership and for firms with state ownership greater than 35%. The CARs earned by firms that conduct related party transactions with SOE related parties are also significantly lower compared with those experienced by firms that conduct arms' length transactions with SOE third parties (columns 3, 6, 8 and 10). [14]

Table 3, Panel B, shows that these results are robust in cross-sectional regressions of [–2,+2] day CARs that control for firm size and corporate governance characteristics. These regressions are performed in sub-samples that combine related party transactions with SOEs with arms' length transactions. Related party transactions with SOEs in the first row of the table are associated with significantly lower CARs relative to arms' length transactions (columns 1 and 2), and the difference is even more pronounced in the sub-sample of deals by firms with state ownership greater than 35% (columns 3 and 4). Furthermore, related party transactions with SOE related parties are also associated with significantly lower CARs relative to arms' length transactions with SOE third parties (columns 5 and 6), and again the difference is even more pronounced in the sub-sample of deals by firms with state ownership greater than 35% (columns 7 and 8).

Overall, our results show that it is the presence of SOE related parties that drives the negative market reaction of related party deals, and not the type of the deal. In addition, the differences in the market reactions between related party and arms' length deals are even larger for firms with state ownership greater than 35%. Our results are consistent with the expropriation of minority shareholders of firms with state ownership over 35% that conduct related party

[14] Our results are not sensitive to grouping together acquirers and sellers in arms' length transactions. Related party transactions CARs are statistically different irrespective of which sub-sample they are compared with. We also compare sub-samples of related party and arms' length transactions undertaken *by the same firms*. The differences in CARs are of the same magnitude as those reported in the table but they are marginally not statistically significant at conventional levels due to the smaller sample size.

transactions with their SOE shareholders. These firms destroy value when they undertake related party transactions but experience increases in value when they undertake similar arms' length transactions.

*III.C. Are the results driven by under-performing state-owned firms?*

One alternative interpretation of the results, consistent with the lazy hand hypothesis, is that what we document is not expropriation but simply an indication that the worst state-owned firms do the worst deals. We note that in Table 2, the firms with high state ownership conducting the value-destroying related party transactions with SOEs do not under-perform the rest of the Chinese market in terms of ROE, market-to-book ratios or leverage.

Two additional pieces of evidence show that the value destruction is *not* concentrated among the most poorly performing state-owned firms. First, we regress announcement CARs on pre-announcement operating performance (results not reported in tables). We find that while the industry-adjusted market-to-book ratio is never statistically significant in any of our specifications, the firm's industry-adjusted ROE is significantly negatively related to its CAR at announcement. However this result is driven by firms with *negative* ROE that experience a *positive* market reaction at the announcement of related party transactions. We obtain similar results with "special treatment" firms (firms that are under "probation" at the stock exchange because they have had two consecutive years of losses). Firms which *do not* under-perform are the ones that experience value destruction when they conduct related party transactions.

*III.D. Do related party transactions signal future deteriorating performance?*

A second alternative interpretation of the results is that the pattern in announcement period returns is not due to expropriation, but because the market believes that these firms are in distress in some way. In this section, we examine changes in stock and operating performance for years [−1, +1] relative to the year of the related party transaction (year 0). To economize on space, we do not report these results in tables.

The industry-adjusted ROE and market-to-book of firms with state ownership greater than 35% that conduct related party transactions with SOEs decline by −0.1% and −0.5

respectively. These declines are slightly *smaller* compared to the remaining Chinese listed firms that have state ownership greater than 35% (but do not report related party transactions), which experience −0.8% and −0.6 respectively. The differences between the two groups are not statistically significant.

We also compute long-horizon abnormal returns using a size benchmark, formed by sorting our universe of Chinese listed firms into 5 independent quintiles on the basis of their market capitalization in the month before the announcement date. Abnormal returns are calculated for each firm as the difference between its monthly return and that of its control portfolio, every month from 12 months before to 12 months after the event date. CARs are calculated by averaging across all sample firms every month and then summing these averages over time. We test the statistical significance of these results using bootstrapping (as applied by Ikenberry et al., 1995). Lyon, Barber, and Tsai (1999) find that the bootstrap method yields well-specified test statistics and is more powerful than the control firm method in detecting abnormal performance.[15]

During the 12-month period following the related party transaction, our sample firms earn bias-adjusted abnormal returns of 0.9% (p-value 0.449). Firms with state ownership over 35% earn −0.2% (p-value 0.490). Local government controlled firms (see next section) earn 4.1% (p-value 0.273). Overall, the firms that experience a negative market reaction at the announcement of related party transactions do not under-perform relative to the remaining Chinese listed firms during the 12-month period following the announcement. Similarly, they also do not under-perform during the 12-month period preceding the announcement, again earning insignificant CARs.

In summary therefore, the announcement of related party transactions with SOEs does not appear to signal future deteriorating stock or operating performance. These firms do not

[15] For each firm in the sample, we randomly select with replacement, a Chinese listed firm that has the same matching portfolio ranking at that point in time. This matching firm is treated as though it had announced a transaction at that point in time. We carry out this process for each firm in the sample, ending up with a pseudo-portfolio consisting of a set of randomly drawn firms, matched in portfolio characteristics and time to the firms in the sample. We repeat this process till we have 1000 pseudo-portfolios and thus, 1000 abnormal return observations. This gives us an empirical distribution for the abnormal returns drawn under the null model specific to our hypotheses. Since the empirical distribution computed through bootstrapping is not centered at zero (Kothari and Warner, 1997), following Rau and Vermaelen (1998), we subtract the mean CAR for the empirical distribution from the CAR value for the sample. This bias-adjusted CAR value gives us a better idea of the economic significance of the results (their statistical significance is not affected).

under-perform prior to the transaction. In addition, it is the best firms that do the worst deals. Consequently, the negative stock market reaction that we document is more likely to be consistent with expropriation of minority shareholders (and the grabbing hand of government) than with the deteriorating performance of the sample firms (and the lazy hand of government).

## IV. Which SOEs expropriate more?

The above analysis leads us to conclude that the grabbing hand, rather than the helping hand or the lazy hand, is the most likely explanation of our results among firms with state ownership over 35% that conduct related party transactions with SOE controlling shareholders. In Table 5, we examine this sub-sample in more detail in order to investigate which SOEs are more likely to expropriate. Specifically, we examine central or local government control of SOEs, and the political affiliation of directors.

Table 4 reports [−2,+2] and [−2,+5] day CARs, the total value change associated with the related party transaction and the ratio of total value change divided by the amount of the deal. Panel A, columns (1) and (2) repeat earlier results showing that firms where the state owns more than 35% of shares conduct value-destroying related party transactions with their controlling SOEs (statistically significant at the 1% level across all four measures of value change). In columns (3) and (4), we split the sample into SOE related parties controlled by a central government agency or by a local (provincial) government. Only related party transactions with SOEs controlled by local governments (column 4) are associated with statistically significant negative CARs (all four measures of value are negative and statistically significant at the 1% level). There are also four times as many related party transactions with SOEs controlled by local governments than there are with SOEs controlled by the central government. In columns (5) and (6), we split the sub-sample of related party transactions by firms where the state owns more than 35% from column (2), into transactions with SOEs controlled by the central or a local government. Again, the related party transactions with SOEs controlled by local governments (column 6) are the only ones associated with statistically significant value changes. These firms earn excess returns of −1.3% for days [−2,+2] and their value losses correspond to 45% of the announced value of the related party transaction (all four measures are negative and statistically

significant at the 1% level). Our results indicate that it is firms that are ultimately controlled by local governments that are subject to the worst expropriation. This is especially true for firms where the local government has high share ownership. On the other hand, firms that are under the ultimate control of the central government do not appear to be subject to expropriation. The difference between the two would be even more pronounced if firms controlled by universities (whose ultimate owner is the Ministry of Education but who have a lot of local autonomy) were re-classified as being locally controlled.

The political connections literature has typically argued that shareholders in firms with close ties to governments gain from political connections (Fisman, 2001). We therefore examine if the presence of politically connected directors mitigates the value losses to minority shareholders. In Panel B, we report results after sorting the firms on the basis of the political affiliation of their directors. In column (1), related party transactions by firms where the proportion of directors affiliated with the local government is greater than 20% are associated with statistically significant [−2,+2] day CARs of −1.5%, which correspond to a median total reduction in value equivalent to 162% of the amount of the deal. In firms where the proportion of local government directors is greater than 20% and the state holds more than 35%, the [−2,+2] day CAR is −2.1%, corresponding to a median total reduction in value equivalent to 261% of the announced amount of the transaction. These are hugely economically significant transactions. Our results are consistent with Fan, Wong, and Zhang (2007) who find that firms led by politically connected CEOs are more likely to appoint other bureaucrats to the board of directors than professional directors. In contrast, we find no relationship between the proportion of directors affiliated with the central government and related party transactions CARs (not reported in the table), and a much weaker negative market reaction for companies with less than 20% of directors affiliated with local governments (in column 3). We find similar results for transactions by firms where more than 20% of the directors belong to the Communist Party in columns (4) and (5). Consistent with Fan, Wong, and Zhang (2007), related party transactions by firms with politically connected directors are associated with negative CARs. Transactions by firms where Communist Party members comprise less than 20% of the board are not associated with statistically significant CARs in column (6).

These results are robust in cross-sectional regressions controlling for firm size, foreign ownership of shares, the presence of external directors, and auditor characteristics in Panel C. In

columns (1) and (2), the dummy variable indicating state ownership greater than 35% is negative and statistically significant. In columns (3) and (4), we interact the state ownership dummy variable with indicators of central or local government control of the related party SOEs. The coefficients suggest that SOEs controlled by local (provincial) governments are the ones that expropriate. The coefficient of the variable indicating central government control is not statistically significant. Finally, in columns (5) and (6) we examine the effect of the political affiliation of directors. The dummy variable indicating that more than 20% of the listed firm's directors are affiliated with a local government is negative and statistically significant at the 10 percent level (the dummy variable indicating that at least 20% of the firm's directors are members of the Communist Party is not statistically significant). We note that the presence of directors affiliated with a local government is significant even after controlling for high state ownership and local government control of the SOEs in column (6). In fact, the coefficients of both variables retain their magnitude and their statistical significance when included along side each other compared to their inclusion separately in columns (4) and (5). This suggests that local government control of the related party SOEs and the presence of directors affiliated with local governments on the board of the listed firms are both associated with value-destroying related party transactions.

## V. Corruption or social role for SOEs?

Our results so far show that state ownership over 35% is associated with value-destroying related party transactions, but only in firms that are controlled by a local government or that have more than 20% of directors affiliated with a local government on their boards (as opposed to firms controlled by the central government, which do not conduct value-destroying transactions). In this section we investigate the potential motivations behind the actions of the SOEs that control the listed firms and behind the local governments that control the SOEs.

We identify three potential motivations. First, the transfer of resources from listed firms to local governments may be because local governments (or the SOEs) need resources in order to supplement their budgets and provide social services. This does not mean that minority shareholders of publicly listed firms are not expropriated but it suggests that at least other groups

in society may benefit. Alternatively, the transfer of resources may be related to corruption activity in the provinces if it ultimately results in a transfer of wealth to government bureaucrats. Bureaucrats of local governments may find it easier to misappropriate state funds in provinces where they are less likely to be detected and prosecuted. Finally, local government SOEs may prop up firms that they plan to list in the stock market in order to satisfy listing requirements and obtain a good IPO price. Following the listing, these resources may be transferred back to the SOE through related party transactions.[16] We note, however, that if the transfer takes place too long after the IPO, it may be difficult not to attribute the motive to corruption. The financial press has suggested that local government controlled SOEs may start interfering with listed firms once the latter become successful.[17]

*V.A. Preliminary analysis*

The analysis of the potential motivations behind related party transactions between listed firms and their controlling state-owned shareholders is reported in Table 5. Panels A and B report univariate analyses and Panel C reports results of least squares regressions.

In Panel A, column (1), we examine the impact of pyramids. We define a listed firm as controlled through a pyramid when its controlling SOE shareholder is itself controlled by another SOE, that is, when there are at least two SOEs in the chain of control between the listed firm and the ultimate government shareholder. Pyramids provide additional opportunities to expropriate and to conceal expropriation (Bertrand, Mehta, and Mullainathan, 2002). Not surprisingly, the [−2,+2] day CAR for firms controlled through a pyramid is −2.4%, corresponding to a median total reduction in value of RMB116 million (US$14 million), equivalent to 298% of the amount of the deal (all value measures are highly statistically significant).

The actions of local governments of provinces located near the capital are more visible to central and judicial authorities. Hence, these governments may be less likely to expropriate, in line with central authorities, which do not appear to expropriate the companies they control. On the other hand, government bureaucrats in provinces located far from the capital may feel less

[16] There is also anecdotal evidence that Chinese government authorities rescinded the preferential treatment of some firms following their successful stock market listing. The China Shipping Development case, referenced in the introduction, is one such example.
[17] The myth of China Inc, *The Economist* (September 3, 2005), p. 53-54.

likely to be prosecuted for corruption, and may therefore lead the SOEs they control to transfer more resources out of listed firms. Although geographical distance appears at first sight as an imperfect proxy, in Panel B, columns (2) and (3), transactions by firms in provinces whose distance from Beijing is longer than the median provincial capital are associated with highly statistically significant negative CARs, whereas transactions by firms in closer proximity to Beijing are not associated with statistically significant CARs. As we will show in the next section, using data on corruption cases that have been prosecuted in China, distance from Beijing is strongly negatively correlated with the likelihood that misappropriation of state funds by provincial government officials is prosecuted in a province.

In columns (4) and (5), we examine another motivation behind the expropriation, namely the impact of the timing of the transaction. We find that only related party transactions taking place at least four years following the firm's IPO are associated with statistically significant negative CARs. Transactions within less than four years following the IPO are not associated with statistically significant CARs. When we classify the observations by year, only transactions in the $6^{th}$ (N=27), $9^{th}$ (N=28), and $11^{th}$ (N=13) year following the IPO are associated with significantly negative CARs. Therefore, we cannot conclude with confidence that the listed firms return assets injected to them prior to the IPO with the related party transactions. Most likely, local governments interfere with companies that have done well.

The remaining columns investigate whether the performance of the SOE parent or of the province where the firm operates has any impact on the wealth transfer during related party transactions. If the managers of the controlling SOE want to improve their firm's profitability, extracting resources from listed firms under their control may be a way of doing so. In line with this argument, we find that firms whose SOE parent has below median profitability (compared to the small sample of all non-listed parents for which we can obtain performance data) experience significantly negative excess returns in column (6). These SOEs may be in greater need of boosting their performance. In contrast, we find no statistically significant results for firms whose parent has above median profitability in column (7). The median ratio of related party transaction value to the parent's net profit before the announcement is 125%. Therefore, the median related party transaction could make the difference between reporting a profit or a loss in a given year. Related party transactions may also have cash flow consequences for cash-strapped

parents that are equally significant as their impact on profits. Jiang and Wong (2003) show that some SOEs may be using related party transactions to manipulate earnings.

Another explanation behind the results may be that local governments have a social role to play. The minority shareholders of listed firms may still be expropriated but the motivation behind the transactions may not be stealing but the need to play a social role. In Panel B, we classify the provinces whose local governments control the firms in our sample into above- or below-median based on budget deficit (scaled by the province's Gross Regional Product, GRP), unemployment, and GRP per capita. The medians are calculated across all 32 Chinese provinces annually, irrespective of whether there are firms from each province in our sample. Firms conducting expropriating related party transactions with SOEs controlled by the local governments of regions with above median budget deficit and below median GRP per capita do earn statistically significant negative CARs in columns (1) and (5) (results for regions with above median unemployment in column (3) are not significant). However, so do firms controlled by local governments from regions with below median budget deficit and unemployment and above median GRP per capita in columns (2), (4), and (6). Furthermore, there are four times as many observations from outperforming regions as there are from under-performing ones. In columns (7) and (8), we classify provinces as under- (out-) performing if they under (out) perform the median across all three measures. Firms from under-performing provinces do not earn significantly negative excess returns, while firms from outperforming provinces do, and there are still four times as many observations in the latter sub-sample. We obtain qualitatively similar results using the 25% and 75% quartiles to separate regions into under- and over-performing. Overall, SOEs *do not* appear to expropriate when they are located in poor regions, where the local governments that control them may need resources in order to perform a social role.

*V.B. Provincial anti-corruption effectiveness and related party transactions with SOEs*

In this section, we investigate in more detail whether the expropriation by the local government controlled SOEs is concentrated in provinces where local government bureaucrats are less likely to be prosecuted for misappropriation of state funds. Subsequently we contrast this explanation with proxies for the province's economic performance in cross-sectional regressions.

Our analysis is based on a hand-collected sample of 801 corruption cases that have been prosecuted by judicial authorities in China. We focus on prosecution since prior research (see Bhattacharya and Daouk (2002) for example) show that enforcement of the law is more important than passing of the law in curbing abuses.[18] Out of these 801 corruption cases, 103 cases involve misappropriation of state funds by government officials (the remaining cases involve mostly bribery, but also a few less frequent cases such as abuse of power). These numbers of publicly disclosed cases appear small relative to perceptions of corruption in China. This is not surprising, since the judicial system in China is widely perceived as lacking independence. Consequently, we do not expect to find direct evidence that match the names of government officials who control listed firms with those that have been prosecuted in corruption cases. As a result, our analysis has to rely on indirect proxies for corruption.

Our *anti-corruption effectiveness index* is constructed as the first principal component of eight variables, namely distance from Beijing (in km), the number of layers involved in the pyramid controlling the listed firm, the proportion of misappropriation of state funds by government officials cases over total corruption cases, the natural logarithm of the total amount of state funds misappropriated by government officials, the natural logarithm of the amount misappropriated by government officials per case, the natural logarithm of the amount of state funds misappropriated per government official arrested, the number of government officials arrested per misappropriation case, and the ratio of the proportion of total misappropriation cases contributed by each province divided by the contribution of the province to China's GRP. Our procedure yields the following anti-corruption effectiveness index:

$$\textit{Anti-corruption effectiveness} = 0.35 \times \textit{Misappropriation cases in total corruption cases} + 0.44 \times \textit{Total amount misappropriated in the province} + 0.43 \times \textit{Amount misappropriated per case} + 0.43 \times \textit{Amount misappropriated per official arrested} + 0.31 \times \textit{Number of officials arrested per case} + 0.26 \times \textit{Misappropriation frequency over GRP contribution} - 0.31 \times \textit{Pyramid layers} - 0.23 \times \textit{Distance from Beijing}$$

The variables included in the index are all highly correlated with each other. Our rationale for including them is as follows. Corruption cases involving misappropriation of state

[18] Bhattacharya and Daouk (2002) find that the cost of equity in a country does not change after the introduction of insider trading laws, but decreases significantly after the first prosecution.

funds can only be detected and prosecuted if the internal auditing and control mechanisms of the local governments are good and if the judicial authorities in the province are effective in investigating and prosecuting them. On the other hand, corruption cases involving bribery or abuse of power by government officials can be initiated by outside aggrieved parties (for example, by the competitors of the firm that received favors by bribing the government officials). Therefore, a larger proportion of misappropriation cases over the total number of corruption cases of any type prosecuted in the province, suggests that internal anti-corruption mechanisms in the province are more effective. Similarly, if judicial authorities are more thorough in investigating cases, they will uncover larger amounts of misappropriated funds and there will be more government officials arrested for each prosecuted case. Finally, we include the proportion of total misappropriation cases prosecuted in each province divided by the province's share of aggregate GRP. All the factors above are also highly negatively correlated with distance from Beijing which may proxy for additional factors not captured in these variables (for example, local governments of faraway provinces may have more freedom to expropriate because their actions have less visibility to central authorities, to the press, or to judicial authorities). Distance from Beijing is also highly positively correlated with the number of layers in pyramidal structures in our sample. Pyramids create additional opportunities to conceal expropriation.

The results of regressions of the anti-corruption effectiveness index on related party transaction announcement CARs are reported in Table 5, Panel C. In column (1), the anti-corruption index is positively related to announcement CARs, suggesting that related party transactions with SOEs in provinces where government officials are less likely to be prosecuted for misappropriation of state funds are associated with a more negative market reaction and vice versa. The coefficient of the index retains its significance when we include in successive specifications the province's budget deficit divided by the province's GRP, the province's unemployment rate (to test the social role motive), and a dummy variable indicating that the related party transaction takes place at least four years following the firm's IPO in columns (2)-(4). Finally, we add the controlling SOE economic performance for the small sub-sample of observations for which it is available in column (5). The coefficient of the anti-corruption index is highly significant (at the 1 percent level) in this specification, whereas the SOE and provincial performance variables are still not significant. In specifications that we do not report, in order to economize on space, we also enter the variables that constitute the anti-corruption index as

separate explanatory variables. Many of the variables are statistically significant on their own and appear with the same signs that they appear in the anti-corruption index. Nevertheless, given that many of these variables are highly correlated with each other and cannot be included alongside each other, we prefer to include them in the form of the index.

In summary, our analysis shows that there is a transfer of assets from listed firms to their controlling SOE shareholders. Most of the transfer is concentrated in firms where the state owns more than 35%, and which are controlled by *local* government SOEs. Firms with directors who are affiliated to local governments are also subject to expropriation. The results are mainly driven by SOEs controlled by local governments of the better performing regions, and therefore cannot be attributed to a social role motive. Instead we find that the transfer of assets to local government controlled SOEs is concentrated in provinces where local government bureaucrats are less likely to be prosecuted for misappropriation of state funds, suggesting that these transfers are more likely to be correlated with wealth transfer to local government bureaucrats.[19]

Our evidence is in line with widespread anecdotal evidence on the use of off-budget sources of revenue by Chinese provincial authority bureaucrats. According to some estimates, non-tax revenue (which includes, among others, revenue from state-owned assets and state resources) has been growing rapidly in recent years and in many localities exceeds tax revenue. Given its off-budget nature, the use of this revenue is not supervised by the Ministry of Finance as closely as tax revenue. Consequently, its use is not transparent, leaving room for corruption.[20] Part of this revenue may be misappropriated directly by local government officials, as our data on corruption cases suggest. According to numerous press reports, however, another part has been appropriated by local government bureaucrats in the form of bonuses to staff,[21] building luxury headquarter office complexes with lavish facilities in numerous provinces,[22] and extravagant entertainment or travel expenses for provincial government staff, who often charge

[19] In addition, in specifications that are not reported, we also include a dummy variable for companies with directors in *Forbes* magazine's "China's richest 200" list, whose coefficient is also significantly negative. It has been suggested in the press that many individuals appearing on China's richest lists have subsequently been prosecuted for corruption.
[20] See "Better manage non-tax revenue", *Chinadaily.com.cn* (February 14, 2007).
[21] See "Central government seeks strengthened authority to improve efficiency", *Xinhua Economic News Service* (March 15, 2007).
[22] "Check willful local spending", *Chinadaily.com.cn* (February 1, 2007); "China's official opulence", *Los Angeles Times* (December 18, 2006).

personal expenses to government accounts.[23] As a result, the central government has recently dispatched inspectors to numerous provincial governments and is trying to strengthen monitoring mechanisms in an effort to tackle land expropriation and corruption.[24]

## VI. Can our results be attributed to the poor performance of state-owned firms?

While previous research suggests that state-owned firms do not maximize firm value, our results are more consistent with the direct transfer of resources away from listed companies than with the poor performance of state-owned firms. Our results differ from a situation of inefficient managers being unable to maximize firm value for four reasons.

First, the expropriated state-controlled firms in our sample do not under-perform relative to other state- or non-state-owned firms (see Sections III.C and III.D). Second, the expropriation is concentrated in firms controlled by local governments and is not present in firms controlled by the central government (Section IV). While this is consistent with expropriation (local governments may have more freedom to expropriate because their actions have less visibility to central authorities, to the press, or to judicial authorities), the literature on the under-performance of state-owned firms does not make such predictions. Also, in contrast to related party transactions, we show that similar arms' length transactions by state-owned firms *do not* destroy firm value (Section III.B). Third, we examine deals between publicly listed partially state-owned firms and their wholly state-owned parents. Since the managers of listed firms should have better incentives to maximize firm value, it is not clear why the deals should be systematically detrimental to the listed firms' values. Finally, we also obtain additional results consistent with expropriation (such as larger expropriation in firms controlled through pyramids, the relationship between IPO timing and related party transactions, and larger expropriation by firms located far from the capital), which are not predicted by the literature arguing that state-owned firms are

[23] See "Corrupt official receptions shock Zhongnanhai", *Hong Kong Economic Journal* (November 10, 2006). According to the Group of Macroeconomic Policies and Trend under the Economic Forecasting Department of the National Information Centre in China, US$47 billion was charged by government officials for personal dining expenses throughout China in 2004 alone.

[24] "China sends out inspectors to monitor local government land use", *Xinhua Economic News Service* (December 18, 2006); "Rural unrest in China", *Economist.com* (March 15, 2007).

poor performers in general (Section V.A). Overall, our evidence is most consistent with the "grabbing hand" model of government (Frye and Shleifer, 1997; Shleifer and Vishny, 1998).

## VII. Robustness tests

*VII.A. Are the results dependent on our classifications of related party transactions?*

Our analysis was performed in a sample of related party transactions that we defined as not obviously beneficial to the listed firm. Here we examine whether our main inferences about state ownership and local government control are dependent on this *a priori* selection of transactions. We therefore include the 35 transactions that represent direct benefits to the listed firm and redo the previous analyses. Our results are qualitatively similar.

In Table 6, in columns (1)-(2), we use the market reaction at the announcement of the transaction in order to classify our transactions into value-enhancing and value-destroying. We report logit models of the likelihood of undertaking value-destroying or value-enhancing transactions, estimated in the universe of Chinese publicly listed firms (irrespective of whether they have undertaken a related party transaction or not). Our dependent variable takes the value of one when a firm has undertaken any transaction associated with negative [−2,+2] day CAR in a given year (column 1), and when it has undertaken any transaction associated with positive [−2,+2] day CAR in a given year. Irrespective of classification, higher state ownership is associated with *value-destroying* related party transactions but not with value-enhancing related party transactions. In column (3), we report a logit model of the likelihood of undertaking value-destroying related party transactions using all observations of transactions with SOE related parties (that is, our original 182 transactions as well as the 35 observations that we had originally excluded from the sample because they may be beneficial to listed firms). The interaction between state ownership greater than 35% and local government control of the SOEs is significantly positively related to the likelihood of a value-destroying related party transaction.

In columns (4)-(6), we report results of cross-sectional regressions of announcement period abnormal returns performed in the same sub-sample of all related party transactions with SOEs (including the 35 cases where listed firms receive benefits), and on the sub-sample of such

transactions where the related party is an SOE. State ownership greater than 35%, and local government control of SOEs are again associated with significantly more value-destroying related party transactions, irrespective of the sub-sample in which we perform the analysis. In specifications that are not reported, the anti-corruption index also remains significant (and the province's economic performance remains insignificant) in the same sub-sample. Therefore, our main inferences are not sensitive to our initial exclusion of direct subsidies to the listed firms. Nevertheless, our sample selection enables us to understand in greater detail which transactions are associated with transfer of resources to government bureaucrats, and consequently enable us to better understand the grabbing hand process.[25]

*VII.B. Have expropriated firms benefited in other transactions?*

Governments have many channels through which they can affect firm performance. In this paper, we argue that *as far as the specific channel of related party transactions is concerned*, state ownership and local government control of SOEs seem to be associated with transfer of resources from Chinese listed firms to local governments. We cannot observe the full range of relations between firms and the state in order to determine whether expropriated firms in our sample have benefited otherwise. This is consistent with the approach in the extant literature on tunneling (for example, Johnson et al., 2000; Bertrand et al., 2002; La Porta et al., 2003), that does not examine empirically the possibility that firms subject to tunneling have received assistance from their controlling shareholders on other occasions. Our data however does allow us to go further than the previous literature, and to make some indirect inferences on this issue.

First, borrowing from state banks is one of the major benefits that firms derive from political connections (Sapienza, 2004; Khwaja and Mian, 2005). If firms that are subject to expropriation have benefited by receiving more loans from state banks, then we would expect them to have higher leverage than other Chinese listed firms. The evidence in Table 2 does not support this conjecture. Second, there are significantly more *a priori* expropriating than *a priori* beneficial related party transactions (84% to 10%) in our sample. We find no evidence that firms

[25] We estimate additional specifications that we do not report in order to economize on space. The relative size of the transaction (transaction value divided by the stock market capitalization of the listed firm) is negatively related to the CARs earned by firms undertaking related party transactions, though the coefficients are not significant across all specifications. Other variables from Table 1 are not significant and our main results are not affected.

which are expropriated in one transaction benefit in others. Only one company has both value-enhancing beneficial (two) and expropriating (one) deals (all three deals are associated with positive CARs). Nevertheless, since the full range of transactions is not always reported, we cannot conclude that firms do not benefit in other ways from their relations with government bureaucrats.

## VIII. Conclusions

On balance, our results are most consistent with the hypothesis that minority shareholders in Chinese publicly listed firms are subject to expropriation when they enter into related party transactions with their government shareholders. Our results are strongest for firms in which the state owns more than 35%, and for firms where the state-owned shareholders are controlled by one of China's local (provincial) governments. 45% of the value of the related party transactions, on average, is dissipated by these listed firms. Local government controlled firms represent the majority of the state-owned firms in China. Therefore, the expropriation appears to be of considerable economic significance. The presence of directors with political connections does not mitigate the value losses suffered by shareholders in expropriating transactions.

While the previous literature suggests that state-owned firms do not maximize firm value, our results are more consistent with the direct transfer of resources away from minority shareholders than with the poor performance of state-owned firms. The expropriation of resources by the state-controlled firms is more pronounced in provinces where corrupt government officials are less likely to be prosecuted. Our evidence is in line with widespread anecdotal evidence that documents corruption among local government bureaucrats in China.

Our findings are consistent with Frye and Shleifer (1997), and Shleifer and Vishny (1998), who argue that the government may have a "grabbing hand", and we describe one of the ways in which the grabbing hand grabs. Furthermore, we highlight differences in the behavior of the central and local governments in China, which previous studies on government ownership have not addressed. China may be representative of a number of other large countries (such as India, Russia, Mexico, Brazil, Argentina etc.), that are characterized by strong local governments with autonomy in influencing economic policy. Our evidence suggests that the implications of local government actions may differ from those of central government actions.

Our results are accompanied by three caveats. We analyze only one of the channels through which the government may affect the value of publicly listed firms. Therefore, we cannot make general statements about whether state ownership is good or bad. What we document is that state ownership and political connections seem to be associated with transfer of resources away from Chinese listed firms *through this specific channel*. More research is however, necessary to determine whether expropriated firms have received other benefits.

Similarly, our sample is from a period when the Chinese economy has been expanding rapidly. We cannot test whether state-controlled Chinese firms may be subject to potential expropriation during periods of growth, but may be bailed out during periods of economic distress. Finally, we examine large related party transactions, for which stock exchange notification is required. We cannot establish the impact of transactions that are below the thresholds for stock exchange notification or illegal transactions that companies do not disclose, although this probably suggests that the problem is more serious than our results document. However, we believe that our results have important implications for shareholders of publicly listed firms in China by highlighting a channel through which they might be expropriated.

We leave some puzzles unanswered. Why might central government incentives be different from local government incentives? Why is it that the central government does not seem to follow the grabbing hand but local government does? One reason might be that the possibility of adverse publicity is higher at the central government level but less likely in remote provinces. Alternatively, central government officials may simply extract resources directly from the firms through bribes rather than using an intermediate SOE. Under what conditions would adverse publicity prevent expropriation? What are the tradeoffs between the helping and the grabbing hand and when do governments decide which hand to use? Are the same firms that are more likely to be expropriated by the government also the same ones to be helped? Further research is needed to answer these questions.

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**Table 1**
**Characteristics of related party transactions with SOE related parties**

The table reports descriptive statistics for a sample of 182 related party transactions between Chinese publicly listed companies and their controlling state-owned enterprise (SOE) shareholders, during 2001-2002. The data for each transaction is obtained from the hard copy of the filing to the stock exchange describing the transaction. If not specified in the filing, the status of the related party is obtained from the company's web site or the annual report. Transactions include acquisitions of assets (including shares) by the listed company from the related party, sales of assets by the listed company to the related party, asset swaps between the listed company and its controlling shareholder, trade of goods or services between the listed company and its controlling shareholder, and direct cash payments, loans or provision of loan guarantees by the listed company to the related party. Daily stock returns for sample firms, financial data (market value, total assets, net income), and the percentage of state shareholdings for Chinese publicly listed firms that announce related party transactions are obtained from the China Stock Market and Accounting Research (CSMAR) database, issued by Shenzhen GTA Technology Company Ltd, and from company annual reports. Financial and corporate governance data are the latest available for the fiscal year preceding the transaction. We estimate market-adjusted abnormal returns for A shares by subtracting from raw returns with cash dividends reinvested the returns of the value-weighted market index, for the windows comprising trading days [–2,+2] and [–2,+5] relative to the announcement day. Total value change is the [–2,+2] day abnormal return multiplied by the firm's market capitalization. *Central government control* indicates that the listed firm's controlling SOE is controlled by China's central government. *Local government SOEs* indicates that the listed firm's controlling SOE is controlled by one of China's 28 provincial governments or by one of the governments of the 4 large cities with independent province status (Chongqing, Shanghai, Shenzhen, and Tianjin). Data on the political affiliation of directors (affiliation with central government, local government, and membership in the Chinese Communist Party) are obtained from IPO prospectuses (available in the China Stock Initial Public Offerings Research Database - CSIPOR), company annual reports, and company web sites. *SOE related party controlled through pyramid* denotes that the listed firm is part of a pyramid (i.e. there are two or more SOEs between the firm and the government or alternatively the company's SOE parent is controlled by the government through another SOE and not directly). In columns (1)-(3), significance levels for means tests in parentheses are based on the *t*-test, and significance levels for medians tests in parentheses are based on the Wilcoxon signed-rank test. In column (4), significance levels for tests of differences in means are based on the *t*-test, significance levels for tests of differences in medians are based on the Mann-Whitney test, and tests for differences in proportions are based on the $\chi^2$ test. *, **, *** denote statistical significance at the 10%, 5%, and 1% level respectively.

| | Related party transactions with SOE related parties | | | Difference (*p*-values) |
|---|---|---|---|---|
| | All levels of state ownership | State ownership >35% | State ownership <35% | State ownership >35% (2) vs state ownership <35% (3) |
| | (1) | (2) | (3) | (4) |
| **A. Transaction characteristics** | | | | |
| Amount (RMB mil) (median) | 40 | 45 | 30 | (0.400) |
| Amount / Market value (%) (median) | 1.0 | 1.1 | 0.8 | (0.727) |
| Amount / Net income (%) (median) | 76.3 | 76.0 | 76.3 | (0.349) |
| **B. Proportion of directors affiliated with** | | | | |
| Central government (mean) | 4.5% | 5.0% | 3.2% | (0.239) |
| Local government (mean) | 12.3% | 13.1% | 10.1% | (0.131) |
| Communist Party (mean) | 43.7% | 46.6% | 36.1% | (0.019)** |
| **C. Number of observations where SOE related party controlled by** | | | | |
| Central government | 35 | 24 | 11 | (0.504) |
| Local government | 131 | 101 | 30 | (0.050)** |
| Pyramid | 18 | 13 | 5 | (0.931) |
| **D. Announcement period valuation effects** | | | | |
| CAR [-2,+2] (mean) | -0.8% (0.002)*** | -1.1% (0.000)*** | 0.1% (0.727) | (0.020)** |
| CAR [-2,+5] (mean) | -0.9% (0.004)*** | -1.4% (0.000)*** | 0.5% (0.281) | (0.007)*** |
| Total value change (RMB mil) (median) | -16 (0.003)*** | -33 (0.001)*** | -6 (0.913) | (0.040)** |
| Ratio of total value change over deal amount (median) | -29% (0.001)*** | -41% (0.000)*** | -10% (0.493) | (0.246) |
| Total amount (RMB mil) | 32,194 | 28,676 | 3,518 | |
| Observations | 182 | 133 | 49 | |

**Table 2**
**Characteristics of firms undertaking related party transactions with SOEs compared to the universe of Chinese publicly listed firms**

The table reports descriptive statistics for Chinese publicly listed companies undertaking related party transactions with their controlling state-owned enterprise (SOE) shareholders, during 2001-2002, compared to the universe of Chinese publicly listed firms. We sub-divide the universe of the remaining Chinese publicly listed firms into firms conducting similar arm's length transactions during 2001-2002 and firms conducting neither related party nor arm's length transactions. The data for each related party transaction is obtained from the hard copy of the filing to the stock exchange describing the transaction. If not specified in the filing, the status of the related party is obtained from the company's web site or the annual report. Transactions include acquisitions of assets (including shares) by the listed company from the related party, sales of assets by the listed company to the related party, asset swaps between the listed company and its controlling shareholder, trade of goods or services between the listed company and its controlling shareholder, and direct cash payments, loans or provision of loan guarantees by the listed company to the related party. Arms' length transactions are obtained from the China Stock Market and Accounting Research (CSMAR) database, issued by Shenzhen GTA Technology Company Ltd., and include acquisitions, sales of assets and stakes, and spin-offs. We remove from the arms' length sample any transactions that are related party transactions. Daily stock returns for sample firms, financial data (market value, total assets, ratio of net income to shareholders' funds (ROE), market-to-book ratio, total liabilities over total assets, short- and long-term debt over market value of equity, and short-term liabilities over total liabilities), ownership structure (percentage of state shareholdings, B-shares) and the proportion of external directors for the universe of Chinese publicly listed firms are obtained from the China Stock Market and Accounting Research (CSMAR) database, issued by Shenzhen GTA Technology Company Ltd, and from company annual reports. Financial and corporate governance data are the latest available for the fiscal year preceding the transaction. Some figures are industry-adjusted by subtracting the industry median from the raw figures. We obtain lists of H-shares (firms cross-listed in Hong Kong) from the website of the China Securities Regulatory Commission, and lists of ADRs (firms cross-listed in the U.S.) from the website of JP Morgan Chase at www.adr.com. We obtain the name of the firm's auditor from company annual reports. In columns (7)-(10), significance levels for tests of differences in means in parentheses are based on the *t*-test, and significance levels for tests of differences in medians in parentheses are based on the Mann-Whitney test. Tests for differences in proportions are based on the $\chi^2$ test. *, **, *** denote statistical significance at the 10%, 5%, and 1% level respectively.

| | All publicly listed Chinese firms (without related party or arm's length transactions) | Arm's length transactions | Related party transactions with SOEs | All publicly listed Chinese firms (without related party or arm's length transactions) | Arm's length transactions | Related party transactions with SOE related parties | Differences (*p*-values) Related party transactions with SOE related parties (3) vs. | | Differences (*p*-values) Related party transactions with SOE related parties (6) vs. | |
|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | | All publicly listed Chinese firms (1) | Arm's length transactions (2) | All publicly listed Chinese firms (4) | Arm's length transactions (5) |
| | All levels of state ownership | | | State ownership >35% | | | All levels of state ownership | | State ownership >35% | |
| | (1) | (2) | (3) | (4) | (5) | (6) | (7) | (8) | (9) | (10) |
| **A. Firm size** | | | | | | | | | | |
| Market value (RMB mil) (median) | 2,999 | 3,107 | 3,437 | 3,113 | 3,477 | 3,488 | (0.013)** | (0.082)* | (0.143) | (0.765) |
| **B. Ownership and governance characteristics** | | | | | | | | | | |
| State ownership (%) (median) | 36.6 | 27.8 | 50.2 | 57.2 | 56.4 | 55.9 | (0.000)*** | (0.000)*** | (0.955) | (0.729) |
| External directors (%) (mean) | 4.2 | 3.9 | 2.3 | 4.2 | 3.1 | 2.4 | (0.013)** | (0.060)* | (0.053)* | (0.517) |
| **C. Operating performance** | | | | | | | | | | |
| ROE (%) (median) | 6.8 | 7.3 | 7.7 | 6.8 | 7.2 | 7.7 | (0.056)* | (0.256) | (0.190) | (0.287) |
| Ind.-adj. ROE (%) (median) | -0.1 | 0.4 | 0.9 | -0.1 | 0.4 | 0.9 | (0.058)* | (0.277) | (0.206) | (0.339) |
| Market-to-book (median) | 4.8 | 5.2 | 5.1 | 4.6 | 5.0 | 4.9 | (0.960) | (0.223) | (0.515) | (0.544) |
| Ind.-adj. market-to-book (median) | -0.1 | 0.3 | 0.1 | -0.3 | 0.0 | -0.1 | (0.943) | (0.430) | (0.502) | (0.977) |
| **D. Capital structure** | | | | | | | | | | |
| Liabilities-to-assets (%) (median) | 42.4 | 45.1 | 43.3 | 42.3 | 43.8 | 43.4 | (0.506) | (0.474) | (0.341) | (0.765) |
| Ind.-adj. liabilities-to-assets (%) (median) | -0.1 | 1.6 | 0.1 | -0.7 | 1.2 | 0.1 | (0.529) | (0.538) | (0.277) | (0.910) |
| Debt-to-equity (%) (median) | 7.1 | 9.1 | 7.2 | 7.0 | 9.1 | 7.2 | (0.531) | (0.148) | (0.545) | (0.330) |
| Ind.-adj. debt-to-equity (%) (median) | -0.3 | 1.3 | 0.3 | -0.6 | 0.7 | 0.3 | (0.349) | (0.359) | (0.299) | (0.547) |
| Short-term liabilities in total liabilities (%) (median) | 94.0 | 91.8 | 93.2 | 93.4 | 91.4 | 92.2 | (0.791) | (0.654) | (0.896) | (0.945) |
| Ind.-adj. short-term liabilities in total liabilities (%) (median) | 0.5 | -1.7 | -0.4 | -0.3 | -0.3 | -1.0 | (0.987) | (0.420) | (0.818) | (0.926) |
| **E. Cross-listing and auditor characteristics** | | | | | | | | | | |
| Number of observations where | | | | | | | | | | |
| Firm issues B-shares | 123 | 21 | 17 | 62 | 11 | 14 | (0.121) | (0.109) | (0.076)* | (0.333) |
| Firm issues H-shares | 37 | 3 | 2 | 29 | 2 | 2 | (0.432) | (0.739) | (0.327) | (0.899) |
| Firm issues ADRs | 17 | 5 | 4 | 17 | 5 | 4 | (0.087)* | (0.462) | (0.323) | (0.882) |
| Firm has Big-4 auditor | 132 | 12 | 13 | 65 | 2 | 10 | (0.876) | (0.038)** | (0.732) | (0.009)*** |
| Observations | 1,580 | 302 | 149 | 814 | 127 | 112 | | | | |

**Table 3**
**Comparison of valuation effects of related party and arms' length transactions**

The table reports comparisons of valuation effects of related party transactions with state-owned enterprise (SOE) related parties and similar arms' length transactions undertaken by Chinese publicly listed firms, during 2001-2002. The data for each related party transaction is obtained from the hard copy of the filing to the stock exchange describing the transaction. If not specified in the filing, the status of the related party is obtained from the company's web site or the annual report. Related party and arms-length transactions are defined as in Table 2. All other variables are defined in table 2. We estimate market-adjusted abnormal returns for A shares by subtracting from raw returns with cash dividends reinvested the returns of the value-weighted market index, for the windows comprising trading days [–2,+2] and [–2,+5] relative to the announcement day. Total value change is the [–2,+2] day abnormal return multiplied by the firm's market capitalization. Significance levels for tests of differences in means are based on the *t*-test, and significance levels for tests of differences in medians are based on the Mann-Whitney test. In the regressions, significance levels are based on White (1980) heteroskedasticity-consistent standard errors. Intercepts are estimated but not reported. *, **, *** denote statistical significance at the 10%, 5%, and 1% level respectively.

*Panel A. Excess returns to related party and arms'-length transactions*

| | Related party transactions | Arms' length transactions | | Related party transactions | Arms' length transactions | | Differences (*p*-values) | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | SOE related parties | All third parties | SOE third parties | SOE related parties | All third parties | SOE third parties | Related party transactions with SOEs (1) vs arms' length transactions with all third parties (2) | Related party transactions with SOEs (1) vs arms' length transactions with SOE third parties (3) | Related party transactions with SOEs (4) vs arms' length transactions with all third parties (5) | Related party transactions with SOEs (4) vs arms' length transactions with SOE third parties (6) |
| | All levels of state ownership | | | State ownership > 35% | | | All levels of state ownership | | State ownership > 35% | |
| | (1) | (2) | (3) | (4) | (5) | (6) | (7) | (8) | (9) | (10) |
| CAR [-2,+2] (mean) | -0.8% | 0.5% | 0.4% | -1.1% | 0.6% | 0.7% | (0.000)*** | (0.023)** | (0.000)*** | (0.008)*** |
| | (0.002)*** | (0.003)*** | (0.414) | (0.000)*** | (0.009)*** | (0.257) | | | | |
| CAR [-2,+5] (mean) | -0.9% | 0.3% | 0.2% | -1.4% | 0.5% | 0.3% | (0.001)*** | (0.087)* | (0.000)*** | (0.058)* |
| | (0.004)*** | (0.107) | (0.714) | (0.000)*** | (0.081)* | (0.665) | | | | |
| Total value change (RMB mil) (median) | -16 | 10 | 5 | -33 | 12 | 29 | (0.000)*** | (0.014)** | (0.000)*** | (0.007)*** |
| | (0.003)*** | (0.008)*** | (0.193) | (0.001)*** | (0.028)** | (0.130) | | | | |
| Ratio of total value change over deal amount (median) | -29% | 16% | 17% | -41% | 27% | 21% | (0.001)*** | (0.122) | (0.001)*** | (0.236) |
| | (0.001)*** | (0.147) | (0.731) | (0.000)*** | (0.194) | (0.991) | | | | |
| Observations | 182 | 427 | 55 | 133 | 166 | 28 | | | | |

*Panel B. Cross-sectional regressions of announcement period excess returns*

| | All arms' length transactions and all related party transactions with SOEs | | | | Arms' length transactions with SOE third parties and related party transactions with SOEs | | | |
|---|---|---|---|---|---|---|---|---|
| | All levels of state ownership | | State ownership > 35% | | All levels of state ownership | | State ownership > 35% | |
| | (1) | (2) | (3) | (4) | (5) | (6) | (7) | (8) |
| Related party transaction with SOE | -0.0127 | -0.0120 | -0.0173 | -0.0180 | -0.0116 | -0.0112 | -0.0176 | -0.0174 |
| | (0.000)*** | (0.000)*** | (0.000)*** | (0.000)*** | (0.036)** | (0.041)** | (0.007)*** | (0.012)** |
| State ownership | | -0.0010 | | -0.0089 | | -0.0099 | | -0.0133 |
| | | (0.860) | | (0.578) | | (0.332) | | (0.564) |
| External directors | | -0.0123 | | 0.0092 | | 0.0060 | | 0.0401 |
| | | (0.402) | | (0.719) | | (0.872) | | (0.300) |
| B shares | | 0.0014 | | -0.0036 | | -0.0115 | | -0.0192 |
| | | (0.850) | | (0.718) | | (0.236) | | (0.102) |
| H shares | | 0.0102 | | -0.0057 | | -0.0020 | | -0.0096 |
| | | (0.337) | | (0.678) | | (0.890) | | (0.566) |
| ADRs | | -0.0005 | | 0.0033 | | 0.0096 | | 0.0164 |
| | | (0.962) | | (0.794) | | (0.474) | | (0.288) |
| Big-4 auditor | | -0.0003 | | 0.0120 | | 0.0087 | | 0.0124 |
| | | (0.962) | | (0.061)* | | (0.176) | | (0.078)* |
| Log (Assets) | | -0.0026 | | -0.0023 | | -0.0005 | | -0.0011 |
| | | (0.203) | | (0.401) | | (0.875) | | (0.757) |
| $R^2$ | 0.03 | 0.03 | 0.07 | 0.08 | 0.02 | 0.04 | 0.04 | 0.08 |
| Obs | 608 | 578 | 298 | 298 | 237 | 231 | 161 | 161 |

**Table 4**
**Announcement period valuation effects of related party transactions with SOE related parties and political connections**

The table reports announcement valuation effects for a sample of 182 Chinese publicly listed firms undertaking related party transactions with their controlling SOE shareholders, during 2001-2002, for which data on the identity of the SOE is available. Data for each transaction are obtained as in Table 2. Market adjusted performance is computed as in Table 3. We report results for state ownership and control variables (Panel A), director political affiliation variables (Panel B), and cross-sectional regressions (Panel C). *State ownership >35%* is a dummy variable indicating that the percentage state ownership in the firm is over 35%. *Central government SOEs* is a dummy variable indicating that the controlling SOE is controlled by China's central government. *Local government SOEs* is a dummy variable indicating that the controlling SOE is controlled by one of China's 28 provincial governments or by one of the governments of the 4 large cities with independent province status (Chongqing, Shanghai, Shenzhen, and Tianjin). *External directors* is the proportion of external directors on the company's board. *B-shares*, *H-shares*, and *ADRs* are dummy variables indicating that the firm has shares traded in the Chinese B-share market, in Hong Hong or in the U.S. respectively. *Big-4 auditor* is a dummy variable indicating that the firm's auditor is one of the big-four audit firms. *Log (Assets)* is the natural logarithm of the firm's total assets (in RMB millions). Daily and monthly stock returns for sample firms, financial data, ownership structure (percentage of state shareholdings, B-shares) and the proportion of external directors for Chinese publicly listed firms conducting related party transactions are obtained from the China Stock Market and Accounting Research (CSMAR) database, issued by Shenzhen GTA Technology Company Ltd, and from company annual reports. Financial and corporate governance data are the latest available for the fiscal year preceding the transaction. We obtain lists of H-shares (firms cross-listed in Hong Kong) from the website of the China Securities Regulatory Commission, and lists of ADRs (firms cross-listed in the U.S.) from the website of JP Morgan Chase at www.adr.com. We obtain the name of the firm's auditor from company annual reports. In Panel A and Panel B, significance levels for means tests in parentheses are based on the *t*-test, and significance levels for medians tests in parentheses are based on the Wilcoxon signed-rank test. In the cross-sectional regressions in Panel C, significance levels in parentheses are based on White (1980) heteroskedasticity-consistent standard errors. Intercepts are estimated but not reported. *, **, *** denote statistical significance at the 10%, 5%, and 1% level respectively.

*Panel A: State ownership and control variables*

| | All related party transactions with SOE related parties | | | | | |
|---|---|---|---|---|---|---|
| | Central and local government SOEs | | Central government SOEs | Local government SOEs | Central government SOEs | Local government SOEs |
| | State ownership <35% | State ownership >35% | All central government SOEs | All local government SOEs | State ownership >35% | State ownership >35% |
| | (1) | (2) | (3) | (4) | (5) | (6) |
| CAR [-2,+2] (mean) | 0.1% (0.727) | -1.1% (0.000)*** | -0.4% (0.373) | -0.8% (0.003)*** | -0.5% (0.473) | -1.3% (0.000)*** |
| CAR [-2,+5] (mean) | 0.5% (0.281) | -1.4% (0.000)*** | -0.5% (0.419) | -1.0% (0.007)*** | -1.0% (0.199) | -1.6% (0.000)*** |
| Total value change (RMB mil) (median) | -6 (0.913) | -33 (0.001)*** | -16 (0.330) | -19 (0.003)*** | -20 (0.558) | -37 (0.000)*** |
| Total value change over deal amount (median) | -10% (0.493) | -41% (0.000)*** | -10% (0.283) | -42% (0.001)*** | -13% (0.466) | -45% (0.000)*** |
| Observations | 49 | 133 | 35 | 131 | 24 | 101 |

*Panel B: Variables relating to the political affiliation of directors*

| | All related party transactions with central and local government SOE related parties | | | | | |
|---|---|---|---|---|---|---|
| | Proportion of directors affiliated with local government >20% | Proportion of directors affiliated with local government >20% and State ownership >35% | Proportion of directors affiliated with local government <20% | Proportion of directors affiliated with Communist Party >20% | Proportion of directors affiliated with Communist Party >20% and State ownership >35% | Proportion of directors affiliated with Communist Party <20% |
| | (1) | (2) | (3) | (4) | (5) | (6) |
| CAR [-2,+2] (mean) | -1.5% (0.010)*** | -2.1% (0.005)*** | -0.5% (0.038)** | -0.9% (0.002)*** | -1.1% (0.000)*** | -0.4% (0.469) |
| CAR [-2,+5] (mean) | -1.3% (0.103) | -2.2% (0.037)** | -0.8% (0.020)** | -1.0% (0.006)*** | -1.6% (0.000)*** | -0.5% (0.388) |
| Total value change (RMB mil) (median) | -44 (0.004)*** | -69 (0.006)*** | -7 (0.098)* | -19 (0.002)*** | -35 (0.001)*** | -2 (0.460) |
| Total value change over deal amount (median) | -162% (0.000)*** | -261% (0.000)*** | -16% (0.089)* | -41% (0.000)*** | -42% (0.001)*** | -6% (0.619) |
| Observations | 42 | 30 | 140 | 145 | 109 | 37 |

*Panel C: Cross-sectional regressions of announcement period excess returns*

| | All related party transactions with SOE related parties | | | | | |
|---|---|---|---|---|---|---|
| | (1) | (2) | (3) | (4) | (5) | (6) |
| State ownership >35% | -0.012 (0.015)** | -0.012 (0.019)** | | | | |
| State ownership >35% × Central government control | | | -0.005 (0.476) | -0.007 (0.411) | | -0.008 (0.336) |
| State ownership >35% × Local government control | | | -0.013 (0.010)*** | -0.015 (0.006)*** | | -0.015 (0.007)*** |
| Proportion of directors affiliated with local government >20% | | | | | -0.011 (0.079)* | -0.011 (0.075)* |
| Proportion of directors affiliated with Communist Party >20% | | | | | -0.001 (0.888) | 0.002 (0.807) |
| External directors | | 0.029 (0.271) | | 0.028 (0.259) | 0.028 (0.260) | 0.022 (0.37) |
| B shares | | -0.017 (0.120) | | -0.019 (0.101) | -0.019 (0.119) | -0.020 (0.089)* |
| H shares | | 0.011 (0.314) | | 0.009 (0.466) | 0.011 (0.331) | 0.014 (0.311) |
| ADRs | | 0.023 (0.176) | | 0.025 (0.145) | 0.023 (0.190) | 0.028 (0.110) |
| Big-4 auditor | | 0.007 (0.294) | | 0.008 (0.219) | 0.008 (0.343) | 0.009 (0.258) |
| Log (Assets) | | -0.001 (0.851) | | 0.000 (0.878) | -0.001 (0.794) | 0.001 (0.733) |
| Adjusted $R^2$ | 0.02 | 0.06 | 0.03 | 0.03 | 0.01 | 0.04 |
| Obs | 182 | 182 | 182 | 182 | 182 | 182 |

**Table 5**
**Potential motivations behind related party transactions with SOE related parties**

The table reports announcement valuation effects for a sample of 182 Chinese publicly listed firms undertaking related party transactions with their controlling SOE shareholders, during 2001-2002, for which data on the identity of the SOE is available. We examine variables related to the potential motivations behind the related party transactions with SOE related parties. The data for each transaction is obtained as in Table 2. We estimate market-adjusted abnormal returns and the total value change as in Table 3. *At least 4 years following IPO* is a dummy variable indicating that the related party transaction takes place 4 or more years following the listed firm's IPO. *SOE related party controlled through pyramid* denotes that the listed firm is part of a pyramid (i.e. there are two or more SOEs between the firm and the government or alternatively the company's SOE parent is controlled by the government through another SOE and not directly). *Distance from Beijing above median* indicates that the firm is controlled by a local government based in a province whose capital is more distant from Beijing than the capital of the median province (more than 1,071Km away from Beijing). *SOE parent profitability below median* (or *–above median*) indicates that the net profit of the listed firm's controlling SOE is lower (or higher) than the median for the sample of all non-listed SOE parents (RMB21 million). Performance data for the non-listed SOEs have been obtained from the filings and from companies' web sites. The provincial economic performance variables have been obtained from the Statistical Yearbook of China and from the Shenzhen Statistics Yearbook. Budget deficit is the difference between government revenues and expenditures divided by the province's "Gross Regional Product" (GRP). For all three measures and for each year, we estimate the median across all of China's 32 provinces or autonomous cities with province status. Subsequently, we classify the companies in our sample according to whether they are controlled by the local government of a province with above or below median measure during the year of the related party transaction announcement relative to that year's median across all provinces. The *anti-corruption effectiveness* measure is constructed as the first principal component of eight variables, namely distance from Beijing (in km), the number of layers involved in the pyramid controlling the listed firm, the proportion of misappropriation of state funds by government officials cases over total corruption cases, the natural logarithm of the total amount of state funds misappropriated by government officials, the natural logarithm of the amount misappropriated by government officials per case, the natural logarithm of the amount of state funds misappropriated per government official arrested, the number of government officials arrested per misappropriation case, and the ratio of the proportion of total misappropriation cases contributed by each province divided by the contribution of the province to China's GDP. The corruption measures are per province. We obtain data on 801 corruption cases that have been prosecuted by judicial authorities in China by searching the web sites of the Chinese publications *Xinhua* and *Legal Daily*. For inclusion in the sample, the corruption must have taken place during at least one year of 2001-2002. Daily and monthly stock returns for sample firms and the percentage of state shareholdings are obtained from the China Stock Market and Accounting Research (CSMAR) database, issued by Shenzhen GTA Technology Company Ltd, and from company annual reports. Financial and corporate governance data are the latest available for the fiscal year preceding the transaction. In Panel A and Panel B, significance levels for means tests in parentheses are based on the *t*-test, and significance levels for medians tests in parentheses are based on the Wilcoxon signed-rank test. In the cross-sectional regressions in Panel C, significance levels in parentheses are based on White (1980) heteroskedasticity-consistent standard errors. Intercepts are estimated but not reported. *, **, *** denote statistical significance at the 10%, 5%, and 1% level respectively.

*Panel A: Other corporate governance variables*

| | Related party transactions with SOE related parties | | | | | | |
|---|---|---|---|---|---|---|---|
| | Central and local government SOEs | Local government SOEs | | | Central and local government SOEs | | |
| | SOE related party controlled through pyramid | Distance from Beijing above median | Distance from Beijing below median | At least 4 years following IPO | Less than 4 years following IPO | SOE parent profitability below median | SOE parent profitability above median |
| | (1) | (2) | (3) | (4) | (5) | (6) | (7) |
| CAR [-2,+2] (mean) | -2.4% (0.017)** | -1.5% (0.006)*** | -0.5% (0.144) | -1.0% (0.000)*** | 0.2% (0.587) | -1.3% (0.015)** | 0.5% (0.561) |
| CAR [-2,+5] (mean) | -3.4% (0.007)*** | -1.6% (0.010)*** | -0.7% (0.124) | -0.9% (0.012)** | -0.7% (0.158) | -1.5% (0.052)* | -0.4% (0.786) |
| Total value change (RMB mil) (median) | -116 (0.009)*** | -24 (0.011)** | -14 (0.086)* | -24 (0.001)*** | 9 (0.917) | -35 (0.026)** | -37 (0.320) |
| Total value change over deal amount (median) | -298% (0.009)*** | -53% (0.006)*** | -31% (0.043)** | -41% (0.001)*** | 1% (0.994) | -98% (0.041)** | -51% (0.379) |
| Observations | 18 | 43 | 87 | 143 | 39 | 18 | 15 |

*Panel B: Provincial economic performance variables*

| | Rrelated party transactions with local government SOE related parties | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | Province with above median budget deficit | Province with below median budget deficit | Province with above median unemployment | Province with below median unemployment | Province with below median GRP per capita | Province with above median GRP per capita | Province under-performing in all three measures | Province outperforming in all three measures |
| | (1) | (2) | (3) | (4) | (5) | (6) | (7) | (8) |
| CAR [-2,+2] (mean) | -1.3% (0.030)** | -0.7% (0.037)** | -0.6% (0.206) | -0.9% (0.043)** | -1.3% (0.016)** | -0.6% (0.056)* | -1.8% (0.112) | -0.8% (0.135) |
| CAR [-2,+5] (mean) | -1.2% (0.104) | -0.9% (0.028)** | -0.3% (0.593) | -1.3% (0.013)** | -1.4% (0.021)** | -0.9% (0.059)* | -1.0% (0.414) | -1.1% (0.073)* |
| Total value change (RMB mil) (median) | -17 (0.060)* | -19 (0.024)** | -12 (0.352) | -19 (0.018)** | -24 (0.035)** | -14 (0.038)** | -17 (0.197) | -11 (0.078)* |
| Total value change over deal amount (median) | -45% (0.029)** | -34% (0.009)*** | -33% (0.146) | -30% (0.012)** | -53% (0.011)** | -30% (0.017)** | -53% (0.142) | -26% (0.070)* |
| Observations | 29 | 101 | 54 | 58 | 35 | 95 | 11 | 42 |

*Panel C: Cross-sectional regressions of announcement period excess returns*

| | Related party transactions with *local government* SOE related parties by firms with state ownership >35% | | | | |
|---|---|---|---|---|---|
| | (1) | (2) | (3) | (4) | (5) |
| Anti-corruption effectiveness | 0.004 (0.070)* | 0.004 (0.071)* | 0.003 (0.082)* | 0.003 (0.083)* | 0.006 (0.001)*** |
| Provincial budget deficit | | -0.293 (0.973) | -0.091 (0.992) | 1.317 (0.879) | -5.312 (0.875) |
| Provincial unemployment | | | 0.311 (0.318) | 0.379 (0.226) | -0.027 (0.916) |
| At least 4 years following IPO | | | | -0.009 (0.120) | -0.033 (0.010)*** |
| SOE parent performance | | | | | 0.000 (0.835) |
| Adjusted $R^2$ | 0.04 | 0.03 | 0.03 | 0.04 | 0.21 |
| Obs | 100 | 100 | 100 | 100 | 20 |

**Table 6**
**Robustness tests for the regressions of related party transaction announcement abnormal returns**

The table reports results of logit models of the likelihood of undertaking value-destroying and value-enhancing related party transactions, and of ordinary least squares regressions of announcement abnormal returns on corporate governance explanatory variables for a sample of 216 Chinese publicly listed firms, undertaking related party transactions with their controlling state-owned enterprise (SOE) shareholders, during 2001-2002. The data for each transaction is obtained as in Table 2. Potentially expropriating transactions include acquisitions of assets (including shares) by the listed company from the related party, sales of assets by the listed company to the related party, asset swaps between the listed company and its controlling shareholder, trade of goods or services between the listed company and its controlling shareholder, and direct cash payments, loans or provision of loan guarantees by the listed company to the related party. Beneficial related party transactions include direct cash payments, loans or loan guarantees provided by the related party to the listed company (propping-up), repayment of loans or accounts payable by the related party to the listed company, and transactions between the listed company and its subsidiaries. In the logit models (columns (1-2), we use firm-year observations for the universe of Chinese publicly listed firms. We examine the likelihood that a firm undertakes a related party transaction in a given year, without distinguishing the identity of the related party. Our dependent variable takes the value of one when a firm has undertaken any type of transaction associated with negative [–2,+2] day CARs in a given year (columns 1 and 2), and when it has undertaken any type of transaction associated with positive [–2,+2] day CARs in a given year (columns 3 and 4). The classification into negative- and positive-CAR related party transactions is based on the sign of the [–2, +2] day cumulative abnormal return (CAR) relative to the day of the announcement of the related party transaction. Similarly for column 3, where the sample is all expropriating and beneficial related party transactions with SOE related parties. In the ordinary least squares regressions (columns 4-6), the dependent variable is the [–2, +2] day cumulative abnormal return (CAR) relative to the day of the announcement of the related party transaction. We estimate market-adjusted abnormal returns for A shares by subtracting from raw returns with cash dividends reinvested the returns of the value-weighted market index. *State ownership* is the proportion of company shares held by the state. *State ownership >35%* is a dummy variable indicating that the percentage state ownership in the firm is over 35%. *Central government control* is a dummy variable indicating that the controlling SOE is controlled by China's central government. *Local government control* is a dummy variable indicating that the controlling SOE is controlled by one of China's 28 provincial governments or by one of the governments of the 4 large cities with independent province status (Chongqing, Shanghai, Shenzhen, and Tianjin). *External directors* is the proportion of external directors on the company's board. *B-shares*, *H-shares*, and *ADRs* are dummy variables indicating that the firm has shares traded in the Chinese B-share market, in Hong Kong or in the U.S. respectively. *Big-4 auditor* is a dummy variable indicating that the firm's auditor is one of the big-four audit firms. *Log (Assets)* is the natural logarithm of the firm's total assets (in RMB millions). Daily and monthly stock returns for sample firms, financial data, ownership structure (percentage of state shareholdings, B-shares) and the proportion of external directors for Chinese publicly listed firms conducting related party transactions are obtained from the China Stock Market and Accounting Research (CSMAR) database, issued by Shenzhen GTA Technology Company Ltd, and from company annual reports. Financial and corporate governance data are the latest available for the fiscal year preceding the transaction. We obtain lists of H-shares (firms cross-listed in Hong Kong) from the website of the China Securities Regulatory Commission, and lists of ADRs (firms cross-listed in the U.S.) from the website of JP Morgan Chase at www.adr.com. We obtain the name of the firm's auditor from company annual reports. Intercepts are estimated but not reported. In the logit models (columns 1-3), significance levels in parentheses are based on Huber-White (quasi-maximum likelihood) standard errors and covariances. In the ordinary leas squares regressions (columns 4-6), significance levels in parentheses are based on White (1980) heteroskedasticity-consistent standard errors. *, **, *** denote statistical significance at the 10%, 5%, and 1% level respectively.

| | All Chinese publicly listed firms | All Chinese publicly listed firms | All related party transactions with SOE related parties | All related party transactions with SOE related parties | All related party transactions with SOE related parties | All related party transactions with *local government* SOE related parties |
|---|---|---|---|---|---|---|
| | Likelihood of negative-CAR related party transaction | Likelihood of positive-CAR related party transaction | Likelihood of negative-CAR related party transaction | [-2,+2] CAR ordinary least squares | [-2,+2] CAR ordinary least squares | [-2,+2] CAR ordinary least squares |
| | (1) | (2) | (3) | (4) | (5) | (6) |
| State ownership | 1.2331 (0.001)*** | 0.0941 (0.813) | | | | |
| State ownership > 35% | | | | -0.012 (0.028)** | | -0.021 (0.003)*** |
| State ownership > 35% × Central government control | | | 0.379 (0.444) | | -0.010 (0.168) | |
| State ownership > 35% × Local government control | | | 0.637 (0.056)* | | -0.014 (0.010)*** | |
| Proportion of external directors | -1.3583 (0.262) | -2.2667 (0.108) | -0.874 (0.710) | 0.004 (0.920) | 0.002 (0.940) | -0.024 (0.352) |
| B shares | -0.0666 (0.878) | 0.8002 (0.025)** | 0.322 (0.525) | -0.007 (0.401) | -0.008 (0.411) | -0.011 (0.314) |
| H shares | -0.5664 (0.490) | 0.0461 (0.965) | -0.567 (0.665) | 0.034 (0.057)* | 0.032 (0.064)* | 0.044 (0.055)* |
| ADRs | | 0.9082 (0.161) | -2.241 (0.013)** | 0.040 (0.002)*** | 0.041 (0.026)** | 0.042 (0.046)** |
| Big-4 auditor | 0.7109 (0.105) | -0.3865 (0.371) | 0.707 (0.220) | 0.005 (0.591) | 0.006 (0.471) | 0.008 (0.388) |
| Log (Assets) | 0.0542 (0.652) | 0.1604 (0.206) | -0.217 (0.245) | -0.001 (0.741) | 0.000 (0.995) | 0.001 (0.721) |
| $R^2$ | 0.02 | 0.02 | 0.05 | 0.06 | 0.06 | 0.08 |
| Obs | 2031 | 2031 | 216 | 216 | 216 | 160 |