

Political Motivation, Over-investment and Firm Performance

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Abstract

This study investigates politically driven investments, a commonly used but little explored means through which politically motivated executives establish political connections. Using a sample of the Chinese listed firms, we find that politically motivated firms exhibit a significant tendency to over invest prior to the establishment of political connections, and they reduce their investments to the levels of their peers afterwards. We also find that the over-investment problem is more severe for private firms, which may benefit more from political connections and have stronger incentives to establish political connections. Our further analysis shows that politically motivated investments are less efficient, and adversely affect subsequent firm performance. Our study highlights the importance of understanding how political connections are established and sheds light on the mixed empirical evidence on the relation between political connection and firm performance.

Keywords Political motivation, over-investment, corporate governance, firm performance

1. Introduction

Business leaders around the world seek close relations with politicians, and some of them even enter politics. The economic effects of political connections however are mixed. While politically connected firms may enjoy benefits such as preferential access to financing and government contracts and bailouts, tax benefits and government subsidies, and favorable policies and legislative conditions,¹ several studies find that political connections could be costly and may well reduce firm performance (e.g., Hellman et al., 2003; Bertrand et. al., 2006; Fan et al., 2007; and Boubakri et al., 2008). As emphasized by Shleifer and Vishny (1994), political connections enhance firm value only when their marginal benefits outweigh their marginal costs. Obviously, to understand the value effect of political connections, it is important to gauge the benefits and costs associated with political connections. Unveiling the channels through which political connections are established is thus the key.

Executives may establish political connections using a wide range of means including contributions to electoral campaigns, appointing outside directors with political experience, close relationship or friendship with top politicians, having top government officials as large shareholders or top directors, etc.² Against the backdrop of a sample of the Chinese listed firms, this paper examines a commonly used but little explored means to establish political connections – making politically motivated investment. We examine two related issues: Do executives make politically motivated investment decisions when they seek promotions in their political status? If so, how do these investment decisions affect firm performance?

¹ See, for example, Fisman, 2001; Khwaja and Mian, 2005; Faccio et al., 2006; Leuz and Oberholzer-Gee, 2006; Claessens et al., 2008; Bunkanwanicha and Wiwattanakantang, 2009; and Goldman et al., 2009, among the others.

² See Faccio et al. (2006) for discussions on different means used by executives to establish political connections.

In our analysis, we capture corporate executives' political motivation by their election to the People's Congress (PC)³ or the Chinese People's Political Consultative Conference (CPPCC).⁴ As a representative of PC or CPPCC, an executive may enjoy a wide range of private benefits including social and political recognition, opportunities to influence policy making, access to an elite network, and potentials to build up strong ties with important government bureaucrats in PC or CPPCC.⁵ While a political title such as a PC or CPPCC representative rests on individuals rather than firms, executives have a strong incentive to establish such political connections by mobilizing firm resources.

We focus on corporate investment decisions made by politically motivated executives. Such investments can greatly enhance their chances to be elected to either PC or CPPCC. Politically motivated executives need to establish a good track record, and demonstrate their capabilities to serve the public. Investments not only increase local GDP levels, but also bring more tax revenues to local governments. Investments also create new jobs, which helps maintain local employment level. Furthermore, investments in the form of acquiring unprofitable local plants may benefit local governments by loading off adverse consequences due to widespread bankruptcies, e.g., layoffs and subsequent increase in crime rates. As these investments are largely politically driven, their investment efficiency may very likely be compromised. Political connections established through such corporate investments may also

³ The National People's Congress (NPC) and its local branches, the People's Congresses (PCs), are China's legislative organizations. The people exercise state power through the people's congresses at all levels. NPC and its Standing Committee exercise the legislative power of the State. NPC has the power to amend the Constitution, enact and amend laws. The people's congresses determine and supervise officials of all administrative, judicial and procuratorial organs.

⁴ As a political advisory body, The Chinese People's Political Consultative Conferences (CPPCCs) at all levels provide political consultations on major policies to administrative, judicial and procuratorial organs, and exercise democratic supervision of governments.

⁵ In China, many key government bureaucrats are also PC or CPPCC representatives. See Li et al. (2006) for a detail description of PCs and CPPCCs.

adversely affect firm performance.

For all listed Chinese companies, we identify 109 firms that had their chairmen of the board or CEOs elected to either PC or CPPCC during their tenure between 1994 and 2010. For each sample firm, we also sort out a control firm by industry, year, firm size (measured by total assets), and ownership types (i.e., state vs. no-state). Our final sample consists of 1354 firm-year observations. Our empirical analysis yields several primary findings. First, we find that compared to control firms, firms run by politically-motivated executives are more likely to over-invest prior to their executives' election to PC or CPPCC. While the control firms' investment level does not change noticeably before and after, politically motivated firms' unexpected investments significantly drop to the levels of their controlled firms after the election.

Second, executives of privately controlled firms may demonstrate stronger incentives to establish political connections, and therefore exert more efforts on showcasing their value to the local government. We find that everything else being equal, politically motivated private firms exhibit more severe over-investments problem than state owned firms do. After the election, although both politically motivated private firms and state owned firms reduce their investment levels, we observe a significantly larger drop in private firms' investments.

Third, our further analysis shows that politically motivated firms experience sharp declines in both operating and stock market performance following their executives' election to PC or CPPCC. Compared with control firms, politically motivated firms exhibit significant decreases in return on assets (ROA) and return on sales (ROS); the degree of over investments prior to the election is significantly and negatively related to subsequent

operating performance. Moreover, we find that politically motivated firms experience much worse stock market performance in the subsequent years, and over-investments prior to the election negatively affect subsequent stock return performance. This finding suggests that the costs of establishing political connections through over investment outweigh the potential benefits, at least in China.

We cope with the potential endogeneity in political motivation in three ways. First, we apply a propensity-score matching method using observable pre-election firm characteristics as matching criteria (i.e., industry, state ownership, firm size, leverage, operating cash flows, Tobin's Q, executive age, executive prior job experience in the government, and PCs or CPPCC in the board or management team). We still find a significant difference in corporate investment behavior between our sample firms and the matched firms. Second, we use instrumental variables (IVs) to control for unobservable factors that may affect both political motivation variable and corporate investment. Specifically, we use the number of listed firms in the city where a sample firm locates, and an indicator variable that takes the value of 1 if the board chairman or CEO is female and 0 otherwise. The results based on 2SLS regressions yield the same conclusions. Third, we control for proxies for executive confidence.

Over-confidence presents itself as an alternative explanation for the relation between political motivation and over-investment. More confident executives tend to invest more, and therefore attract more attentions from the government. We find that our results are robust to the inclusion of executive overconfidence measures.

Our study relates to the growing literature on the economic effects of political connections. We contribute to this literature by focusing on how politically motivated firms

establish political connections and documenting an under investigated means used by politically driven executives, making politically driven investments. On a related point, our paper sheds light on the mixed empirical evidence on the relationship between political connections and firm performance. The findings in our paper suggest that when firms make politically motivated investments, such investments tend to have adverse effects on firm values. The costs associated with building up political ties may well outweigh the benefits of being politically connected.

Our paper also relates to the studies on the relationship between political connections and firm investments. Chen et al. (2011) find that political connections significantly reduce investment efficiency in SOEs, but not in non-SOEs. Wu et al. (2011) show that local SOEs with politically connected managers are prone to more severe over-investment problems. Our paper differs from the aforementioned ones in that we examine how corporate investments are used as a means to help politically motivated executives to establish political connections and the value effects of politically motivated investments. On this front, ours is close to Bertrand et al. (2006) and Aggarwal et al. (2011). Bertrand et al. (2006) find that French firms managed by politically connected CEOs open more plants or close fewer plants in more politically contested areas, especially around election years. Aggarwal et al. (2011) find that politically connected US firms engage in more acquisitions than do other firms, and these firms' acquisitions have significantly lower cumulative abnormal announcement returns. Notably, they identify political connections by checking whether firms make political donations.

The rest of the paper is organized as follows: Section 2 discusses the institutional setting and develops testable hypotheses. Section 3 describes our research design including the data,

variables, and empirical methods. Section 4 presents the empirical findings, and Section 5 reports robustness tests. Section 6 concludes the paper.

2. Hypothesis development

There is a growing literature that examines the costs and benefits associated with political connections and how they collectively affect firm performance. The existing studies investigate the economic effects of political connections established through means such as contributions to electoral campaigns (e.g., Roberts 1990; and Aggarwal et al. 2011), appointing outside directors or executives with political experience (e.g., Agrawal and Knoeber 2001; Fan et al. 2007; and Hung et al. 2011), close relationship or friendship with top politicians (e.g., Fisman 2001; Johnson and Mitton 2003; having top government officials as large shareholders or top directors (e.g., Faccio 2006), and others.⁶

While politically connected firms conceivably can benefit from their government ties to circumvent government regulations, gain preferential access to financing, and obtain protection from expropriation by low level of bureaucrats⁷, the evidence on the relation between political connections and firm performance is however mixed. The overall impact of political connections depends on costs and benefits of being politically connected. To fully understand these costs or benefits, it is important to unveil the underlying channel through which political connections are established.

In this paper, we measure executives' political motivation by their elections to the People's Congress (PC) or the Chinese People's Political Consultative Conference (CPPCC).

⁶A few studies rely on identifiable cases of corruption (e.g., Hellman et al., 2003; and Svensson, 2003).

⁷ Findings in Svensson (2003) indicate that political connection increases bargaining power by the firms during the corruption, and pay less bribes to public officials.

As a member of PC or CPPCC at either the national or local level, an executive may enjoy a wide range of private benefits. A political title may also protect executives from legal actions against their expropriation of firm resources (Qian et al., 2011). In a similar vein, Berkman et al. (2010) find that political-connected firms did not benefit from regulatory changes designed to improve minority shareholder protection in the Chinese stock markets. An executive thus is highly motivated to pursue a successful election to either PC or CPPCC.

To enhance the chance of being elected, executives have to demonstrate an excellent track record and showcase their contributions to the local economy. Economic performance plays a critical role in the promotion of local government officials in China (see, e.g, Chen et al., 2005; Li and Zhou, 2005). If an executive can help local governments to achieve goals in employment, GDP growth, and tax revenue, the governments may reciprocally nominate this executive to PC or CPPCC, and help him/her get elected⁸. They are thus strongly incentivized to invest more. Thus, we expect firms with politically-motivated executives to invest more prior to the elections.

H1: Politically motivated executives tend to over invest in order to get themselves politically connected.

Similar to investments driven by the empire building incentives (Jensen, 1986, 1993), these politically motivated investments decisions are largely suboptimal, and are conducted to pursue political connections rather than economic benefits. We expect the firms to reduce the investment level back to the level of their peers – that is, the firms without politically motivated executives. We have:

⁸ The Communist Party of China and the government still maintain a very strong influence over PCs or CPPCCs, for instance, recommending candidates, controlling the extensive screening process, and sometimes directly hand pick the members of the PCs or CPPCCs at various levels.

H2: After attaining a political title, executives become less politically motivated and therefore adjust down the investment level back to the level of their non politically motivated peers.

The literature finds evidence that ownership (i.e., state vs. non state) affects corporate investment efficiency (e.g., Allen et al., 2005; Cull and Xu, 2005; and Liu and Siu, 2011). We conjecture that executives in private firms have investment behavior different from those in state-owned enterprises (SOEs) when pursuing political goals. As a result of state ownership, executives of SOEs have natural communication channels with party/government officials⁹. Some were even previously affiliated to the bureaucratic system (Fan et al., 2007). These inherent connections provide them with advantages over executives in private firms. The government has better knowledge about SOE executives' credentials and political reliability. As a result, in order to gain government support for the election to PC or CPPCC, executives of private firms must exert more efforts, that is, invest more in our context. We thus have:

H3: The over-investment problem is more severe for private firms, all else being equal.

Finally, since investments made by politically motivated executives prior to their elections to PC and CPPCC are largely politically driven, they are conducted at the expense of efficiency. Meanwhile, the benefits from holding a political title are mainly associated with executives rather than the firms they are running. We conjecture that the costs of investing to be politically connected outweigh the benefits. The politically motivated investment thus may have long-term implications for firms' subsequent performance. We have:

⁹ The Communist Party Committee at the central, provincial and municipal levels have personnel control over key SOEs (Chang and Wong, 2004).

H4: All else being equal, the politically motivated firms tend to have worse operating and market performance subsequent to their executives' elections to PC and CPPCC; and the firm performance in the post-election period is negatively associated with the extent of the pre-election over-investment.

3. Research design

3.1. Sample

Our initial sample consists of all A-share listed firms in China from 1994 to 2010. We exclude firms in financial services industries from our analysis. We read through the background information on top executives and top directors in the annual reports compiled in the WIND database. The CSMAR database provides us with other information.

We apply three filtering criteria to sort firms with political motivation and construct our sample: (1) if the board chairman or CEO won the election to either PC or CPPCC for the first time in his/her current position, we classify the firm as a politically motivated firm; (2) in order to compare changes in investment behavior, we require at least two-year observations before the election and one-year observation after the election, we delete firms with missing data; (3) we require firms to have no turnovers in board chairman or CEO for the sample period (three years before the election to three years after the election). We manually collect data on when an executive was elected as a member of either PC or CPPCC by searching announcements made by PC or CPPCC¹⁰. We define the election year as the event year, and identify 109 politically motivated firms.

¹⁰ Not all the announcements gave out the exact date of election results. However, we can identify the year and the month.

Table 1 describes the distribution of our sample firms by industry, event year, and ownership type. 72 firms are from the manufacturing sector, 10 from the wholesale and retail trade sector, 9 from the comprehensive sector, 7 from real estate, 3 from agriculture, forestry, livestock farming and fishery, and 8 firms from other sectors.¹¹ Notably, close to half of executives were elected to PC or CPPCC in 2003; 19 firms had their executives elected to PC or CPPCC in 2008; the next common year is 1998 – 18 firms had their executives elected in that year. 62 percent of our sample firms are SOEs; and 38 percent are private firms. Finally, 76 percent of the executives were elected to PC, and the rest were elected to CPPCC.

(Insert Table 1 here)

For each sample firm, we identify a control firm based on information in the year immediately prior to the event year. The control firm has to follow five conditions: (1) its chairman or CEO is not a representative of either PC or CPPCC; (2) it is in the same industry as its counterpart; (3) it has a similar size by total assets; (4) it has the same ownership type; and (5) it does not experience a turnover in either CEO or board chairman in the next three years. We thus have 109 control firms.

3.2. Measures of over-investment

Our paper defines annual total investments ($I_{Total,t}$) as the change in long-term assets such as fixed assets, intangible assets, and long-term investments, divided by total assets at the beginning of the year. We estimate abnormal investments in three different ways. First, we use the industry median investment level to capture the expected investment level for a firm. We define our first measure of abnormal investment (Overinvest1) as $I_{Total,t}$ minus the industry

¹¹ The industry classification is based on one-digit SIC codes adopted by the China Securities Regulatory Commission (CSRC).

median of $I_{Total,t}$.¹²

Following Richardson (2006), we decompose total investments ($I_{Total,t}$) into two components: maintaining purpose ($I_{Maint,t}$, proxied by amortization and depreciation), and new investments ($I_{New,t}$). Then, we estimate expected new investments by using the following equation for all the listed firms between 1994 and 2010:

$$I_{NEW,t} = \alpha + \beta_1 TQ_{t-1} + \beta_2 Debt_{t-1} + \beta_3 Cash_{t-1} + \beta_4 Age_{t-1} + \beta_5 Size_{t-1} + \beta_6 Return_{t-1} + \beta_7 I_{NEW,t-1} + \sum Industry + \sum Year + \varepsilon \quad (1)$$

Where TQ_{t-1} is Tobin's Q in year t-1, $Debt_{t-1}$ is total liabilities to total assets in year t-1, $Cash_{t-1}$ is the sum of cash and marketable securities deflated by total assets in year t-1, Age_{t-1} is the number of years being a public company as of year t-1, $Size_{t-1}$ is the natural log of total assets in year t-1, $Return_{t-1}$ is annual stock return calculated as the change in market capitalization in year t-1, and Industry indicators are based on the SIC one-digit codes.

We define the residuals from the equation (1) as our second measure of unexpected investment (Overinvest2).

Our third measure is based on the estimation equation in Biddle et al. (2009):

$$I_{Total,i,t+1} = \alpha + \beta_1 \times SalesGrowth_{i,t} + \varepsilon_{i,t+1} \quad (2)$$

where SalesGrowth is percentage change in sales in year t. We estimate equation (2) in each year for all the listed companies, and define the residuals as our third measure of unexpected investments (Overinvest3).

3.3. The benchmark model

Our paper applies “difference in differences” design to investigate how investment behavior of firms with political motivation differs from that of matching firms. Thereby, we

¹² We define industries at the SIC one-digit SIC level for all industries except manufacturing sectors, where we define industries at the SIC two digit level.

construct two indicators: *PM*, which equals 1 if a firm has political motivation and zero if it is a matching firm; *Before*, which equals 1 if an observation is in the previous years of the event year, otherwise, zero.

We then employ the following equation to test the relation between political motivation and investment behavior:

$$Investment_{it} = \alpha + \beta_1 PM + \beta_2 Before + \beta_3 PM \times Before + \beta_4 Size_{it} + \beta_5 Debt_{it} + \beta_6 CF_{it} + \beta_7 TQ_{it} + \beta_8 CEOAge_{it} + \beta_9 Government_{it} + \beta_{10} Other_{it} + \sum Industry + \sum Year + \mu_{it} \quad (3)$$

where Investment indicates three measures of unexpected investments (Overinvest1, Overinvest2, and Overinvest3).

In the equation (3), the estimated coefficient (β_1) measures the association between political motivation and unexpected investments after the firm executive got elected to PC or CPPCC. Likewise, the sum of the coefficients ($\beta_1 + \beta_2$) measures the impact of political motivation on firm investment behavior before the executive got elected to PC or CPPCC. We expect that politically motivated firms tend to over-invest before the election and decline their investment to the same level of peer firms after the election. Thereby, $\beta_1 + \beta_2$ is expected to be significantly positive, while β_1 is expected to be insignificant.

Following prior literature (e.g., Richardson, 2006; Biddle et al., 2009), we control for Size (natural log of total assets), Debt (total liabilities deflated by total assets), CF (operating cash flows deflated by total assets), and TQ (Tobin's Q). Since Jensen (1986) suggests that executives have incentive to invest for empire building, we use CEO age (CEOAge) to proxy executive's motivation of empire building. We also control executive job experience in the government, Government, a dummy variable that equals to one if the executive is a current or former officer of the central or local governments or the military (Fan et al., 2007). In order to

control the impact of other executives' political motivation, we construct a dummy variable (Other) that equals to one if any executive or director other than the chairman or CEO is a deputy of PC or CPPCC. We also include industry fixed-effects using the CSRC industry classification to control for industry- specific shocks to investment. Furthermore, we include year fixed-effects. All of continuous variables are winsorized at 1 percent and 99 percent. Our estimation of the equation (3) adjusts the standard errors for heteroskedasticity.

3.4. Descriptive statistics

Table 2 presents summary statistics of the sample. It reports means and medians of firm characteristics for both firms with political motivations (PM firms) and their matched peers. While they have similar level of total investments, PM firms have higher unexpected investments than the matching firms. For instance, the mean (median) unexpected investment (Overinvest1) in the PM firms equals to 1.7 percent (0.3 percent) of prior year's assets, while 0.5 percent (-0.3 percent) in the matching firms. 38.4 percent of the PM firms employ a board chairman or CEO with job experience in the government, significantly higher than 7.7 percent of the matching firms. Another noteworthy feature of the PM firms is that, compared to the matching firms, they are more likely to have other executives or directors with a political title of PC or CPPCC.

Following Loughran and Ritter (1997), we use EBITDA (earnings before interest, taxes, depreciation, and amortization) to construct firm operating performance measures, since it is less subject to managerial discretion than earnings (net income). We calculate ROA as EBITDA divided by average assets, ROS as EBITDA divided by sales, and Adj_ROA as EBITDA divided by net total assets excluding cash and marketable securities. On average, the

PM firms do not differ from the matching firms on all the performance measures. In addition, the PM firms and the matching firms have similar total assets, leverage, operating cash flows, Tobin's Q, and CEO age.

(Insert Table 2 here)

4. Empirical results

4.1. Political motivation and over-investment

To investigate change in investment behavior, our observations include three years prior to the event year, the event year, and three years subsequent to the event year. Table 3 describes summary statistics of unexpected investments for each year, and compares between the PM firms and the matching firms. Panel A of table 3 reports mean comparisons, and panel B shows median comparisons. On average, politically motivated firms have positive unexpected investments for each year before the event year. Significantly greater than the mean of 0.001 in the matching firms, Overinvest1 in the PM firms has the mean of 0.047 for the period of year (-3, -1), indicating that the unexpected investment is around 4.7 percent of prior year's assets before the election to PC or CPPCC. This finding is consistent with our first hypothesis that politically motivated firms tend to overinvest to obtain political connection. We observe the same results when using Overinvest2 and Overinvest3 as measures of unexpected investments.

We observe that the PM firms significantly change their investment behavior after their executives got elected to PC or CPPCC. During the three years subsequent to the event year, the PM firms exhibit negative median of unexpected investments for all the measures, and negative mean for both Overinvest1 and Overinvest2. Their unexpected investments are not

different from their peer firms after the event year, except that Overinvest1 indicates a significantly lower level of unexpected investments. Moreover, their unexpected investments sharply decline during the period of (1, 3). For instance, in the PM firms, the mean (median) of Overinvest3 is 0.055 (0.031) in the period of (-3, -1), but decreases to 0.011 (-0.003) in the period of (1, 3). The matching firms, however, show no significant change in investment behavior during the same period. The test of “difference-in-differences” demonstrates that change pattern of unexpected investments is statistically significant for all three measures. Overall, the analysis provides consistent support for our second hypothesis.

(Insert Table 3 here)

Figure 1 illustrates the distribution of the median unexpected investments over the period of (-3, 3) for both the politically motivated firms and the matching firms. The graphic patterns are similar for all three measures of unexpected investments. The pictorial evidence shows that prior to the event year, the PM firms exhibit more unexpected investments than the matching firms; but their investment levels decline in the event year and after, and become negative and lower than those of the matching firms in year 2 and year 3.

(Insert Figure 1 here)

We then examine the effects of political motivation on unexpected investments through regression analysis. Table 4 presents results on three measures of unexpected investments. The estimated coefficient on the indicator of political motivation (PM) is insignificant, but the interaction of political motivation and periods prior to the event year has positive and significant coefficient in all three specifications of unexpected investments. In column (1), the coefficient of the interaction between political motivation dummy and period dummy (Before)

is 0.047 and significant at the level of 1 percent. The results indicate that political motivated firms invest more before their executives get elected to PC or CPPCC, but after the election, their investments do not differ from those of the matching firms. In terms of economic significance, the investments in the PM firms on average are higher than the matching firms by 4.7 percent of total assets before the event year. Given that the mean total investment is 1 percent of total assets in the matching firms, this effect represents a serious problem of over-investment. Column (2) and column (3) show similar results. We find evidence consistent with our hypotheses H1 and H2.

Some control variables have significant impacts on unexpected investments. In column (1) and column (3), firm size is positively related to unexpected investments. Firms with higher leverage show lower levels of unexpected investments, consistent with the findings on financial constraints (e.g., Whited, 2006). CEO age is negatively associated with unexpected investments, indicating that when a CEO approaches the end of his career, he tends to underinvest. Column (2) shows that Size and Debt have opposite coefficients to those in column (1) and column (3). The differences result from the estimation process of unexpected investments. Unlike Overinvest1 and Overinvest3, we consider the impacts of firm size and leverage in estimating Overinvest2.

(Insert Table 4 here)

There are alternative explanations for our results on the relationship between political motivation and unexpected investments. First, the quality of financial reporting can affect firm investments (e.g., Biddle and Hilary, 2006; Biddle et al., 2009). The investment behavior we observe may be driven by executives' accounting choices instead of their political

motivations. Following Dechow and Dichev (2002), we estimate accruals quality as a proxy for financial reporting quality. Our results remain the same after we control accruals quality. Second, overconfidence plays a critical role in firm investment. Confident executives invest more. We use two proxies for overconfidence: the sum of compensations for 3 highest paid executives divided by total executive compensations, and the sum of stock ownership by top management. Including overconfidence proxies does not change our findings.

We further investigate whether state ownership affects the relation between political motivation and unexpected investment. We define a dummy variable (*Private*), which equals to one if a firm is private company and zero if a firm is a SOE. Table 5 reports results for subsample of politically motivated firms. The interaction between private firm dummy and a dummy for periods prior to the event year has positive coefficients, significant at the level of 1 percent and 5 percent in column (1) and column (3) respectively. We find some evidence that private firms invest more than SOEs in the years when their executives pursue a political title of PC or CPPCC. The insignificant coefficient of private firm dummy indicates that private firms and SOEs exhibit no difference in unexpected investments after their executives get elected to PC or CPPCC. In column (1) and column (2), *Before* is positively related to unexpected investments, suggesting that executives in SOEs also tend to invest more in the years prior to the event year than in the years subsequent to their elections to PCs or CPPCCs. The findings support our hypothesis H3 that expects the over-investment problem to be more severe in private firms before obtaining political connection.

(Insert Table 5 here)

4.2. Political motivation and operating performance

To address performance consequences of political motivation, we use three measures of operating performance, return on assets (ROA), return on sales (ROS), and return on net total assets excluding cash and marketable securities (Adj_ROA).

Table 6 describes summary statistics of operating performance for seven-year observations. Panel A of table 6 shows the mean comparisons of operating performance measures, while Panel B provides the median comparisons. On average, operating performance of the politically motivated firms declines significantly after their executives got elected to the PC or CPPCC, while the matching firms exhibit unchanged performance. For instance, ROA of the PM firms has the mean (median) of 0.077 (0.076) for the period of (-3, -1), and decreases to 0.054 (0.064) for the period of year (1, 3). Difference-in-differences tests show that the negative change in operating performance is more dominant in the PM firms than that in the matching firms. Consistent with Fan et al. (2007), we find that political connection from political title of executives harms firm performance. Both ROS and Adj_ROA yield to similar results. Figure 2 presents the graphic patterns of performance change.

(Insert Table 6 and Figure 2 here)

We then investigate whether firm investments in the period of year (-3, -1) have any impact on operating performance in the period of year (1, 3). We first construct change in ROA (Δ ROA) as the median ROA during the period of (1, 3) minus the median during the period of (-3, -1). Then, we regress Δ ROA on the political motivation indicator (PM), median unexpected investments in the period of (-3, -1), and median change of other firm characteristics such as firm size (Δ Size), leverage (Δ Debt), operating cash flows deflated by

total assets (ΔCF), Tobin's Q (ΔTQ), CEO age ($\Delta CEOAge$), the indicator of CEO's job experience in the government ($\Delta Government$), and the indicator of other executives' political titles ($\Delta Other$).¹³ We define *Overinvest1_Before* as median of *Overinvest1* in the period of (-3, -1), *Overinvest2_Before* as the median of *Overinvest2*, and *Overinvest3_Before* as the median of *Overinvest3*. Table 7 presents the regression results on three measures of unexpected investments. The indicator of political motivation group (PM) has negative and significant coefficients in Column (1) and (2), suggesting a decrease in ROA after the event year for the politically motivated firms. All the interactions between PM and median unexpected investments in the period of (-3, -1) are negatively related to median change in ROA, and significant at the level of 1 percent. Compared to the matching firms, unexpected investments of the politically motivated firms have more negative consequences on operating performance. We document similar results for median change in ROS and median change in *Adj_ROA*. Overall, we find evidence that firms with political motivation perform worse after the executive's election to the PC or CPPCC, and political motivated investments before harm long-term operating performance.

(Insert Table 7 here)

4.3. Political motivation and stock market returns

Prior literature argues that political connection can bring long-term benefits to firms. These benefits may not be reflected in operating performance (e.g., Fisman, 2001; Faccio et al., 2006, among the others). In order to investigate stock market performance of politically motivated firms, we define the event month as the month in which an executive got elected to

¹³ When using regression of mean change, we find the same results.

the PC or CPPCC. Following Fan et al. (2007), we measure stock performance by using the one-, two-, and three-year cumulative abnormal market-adjusted stock returns (CARs) post the event month. Our return measures are based on monthly stock returns and benchmarked by the equally weighted market index.¹⁴ Three measures start from six months prior to the event month, and the other three starts from one month prior to the event month.

Figure 3 plots the mean CARs of sample firms grouped by whether a firm has political motivation. The PM group exhibits negative mean CAR over the three years subsequent to the event month, while the control group has a large and positive mean CAR over the same period. The difference between the two groups is small before the event month, but becomes greater as the time goes by. At the end of three years subsequent to the event month, the mean CAR of the PM group is 15% lower than that of the control group.

(Insert Figure 3 here)

Table 8 reports the mean and median values of stock performance for our sample. The mean CARs of the PM group become worse over time, while the mean CARs of the matching group improve. Firms with political motivation perform significantly worse than the matching firms. For instance, they have a mean CAR of -0.031 for the period of six months prior to and 12 months post the event month, which is significantly lower than 0.072 of mean CAR for the matching firms.

(Insert Table 8 here)

We next examine the effects of unexpected investments before the event year on subsequent stock performance. Table 9 presents our regression results for one-year CAR

¹⁴ Our results remain when using the value-weighted indexes.

measure of stock performance. Our key independent variables are the dummy variable for firms with political motivation (PM) and measures of median unexpected investments before the event year (Overinvest1_Before, Overinvest2_Before, and Overinvest3_Before). We also include some control variables in the event year, such as the log of total assets, debt-to-assets ratio, operating cash flows deflated by total assets, Tobin's Q, and CEO age. The regression results show that unexpected investments in the firms with political motivations are significantly related to worse future stock performance subsequent to the executive's election to the PC or CPPCC for all the models. The interaction of PM and Overinvest1_Before has a coefficient of -1.488 with a t-statistic of 2.32. The magnitude of the coefficient is economically large, and indicates that if the median of unexpected investment increases one standard deviation (0.005), then the subsequent one-year stock return of the PM group will be 0.7% lower than that of the matching group. The finding is consistent with prior literature that firms that invest more earn lower subsequent stock returns (e.g, Baker et al., 2003; Titman et al., 2004, 2010; and Polk and Sapienza, 2009). Our findings are consistent with the hypothesis H4, suggesting that unexpected investments have long-term negative impact on the stock returns of the politically motivated firms.

(Insert Table 9 here)

In summary, the empirical tests show that politically motivated firms tend to over-invest before their executives got election to the PC or CPPCC, and these unexpected investments have negative long-term impact on operating performance and stock returns in the subsequent years. The benefits from political connection may not compensate the negative impact.

5. Robustness tests

5.1. Propensity Score Matching Method

To alleviate the effect of the observed heterogeneity across our sample firms, we apply propensity score matching method proposed Rosenbaum and Rubin (1983). Specifically, we first run a probit model for all the listed firms to obtain the likelihood that a firm has political motivation, by using observable firm characteristics such as industry dummy, year dummy, total assets, leverage, operating cash flows, Tobin's Q, CEO age, chairman or CEO's job experience in the government, and political titles of other persons in the top management and the board. Then, we carry out one-by-one "nearest neighborhood" matching for firms with political motivations. Table 10 reports the comparisons of unexpected investments and firm performance by using propensity score matching method. Consistent with the empirical results in section 4, firms with political motivation invest more than the matching firms, and exhibit worse future operating performance and stock market performance.

(Insert Table 10 here)

5.2. Instrument variables and two-stage least squares (2SLS) model

The executive's choice to pursue political title and firm investments are potentially endogenous. To address this endogeneity, we apply a two-step estimation procedure of instrumental variables (Maddala, 1983; Wooldridge, 2001). For the purpose of identification, we need instrumental variables that affect a CEO's propensity of obtaining a political title, but do not affect a firm's excess investment directly. Our first choice of the instrumental variable is CityNumber, the natural logarithm of the number of listed firms in the city where a sample firm's headquarter locates. More listed firms in the same city mean more competition for a political title, and thereby a CEO has lower probability of getting elected to the PC or CPPCC.

Our second instrument is a dummy variable, Female, which takes the value of 1 if the CEO is female. Since the PC or CPPCC has gender diversification concerns, a female CEO is more likely to get elected. In the first stage of estimation, for our sample firms¹⁵, we predict the CEO's likelihood of getting elected to the PC or CPPCC by using instruments and other control variables. And then we use the estimated probability to do the second stage regression in which dependent variable is unexpected investments. The results in table 11 confirm our findings in table 4, indicating that firms with higher probability of pursuing political goals are associated with more unexpected investments.

(Insert Table 11 here)

6. Conclusion

This study explores the relation between political motivation and firm investment behavior. Using data on Chinese firms from 1994 to 2010, we provide evidence that politically motivated firms are more likely to overinvest before their executives obtain a political title, but afterward reduce their investments to the level of their peer firms. This phenomenon exists even after controlling for firm-specific factors such as firm size, leverage, Tobin's Q, CEO's age and CEO's job experience in the government and so on. Moreover, private firms exhibit more severe over-investment problem than state-owned firms. Further analysis suggests that politically motivated investments are less efficient. After the political achievement of their executives, politically motivated firms experience poorer accounting and stock return performance relative to their peer firms. The worse performance can be explained by the previous excess investments. The overall evidence is consistent with the idea that a

¹⁵ Results are qualitatively similar when we use all listed firms to do 2SLS estimation.

firm's politically motivated investments adversely affect subsequent firm performance, and the costs of these investments outweigh the potential benefits from established political connection.

Our results can be driven by CEO's characteristics other than political motivations, for instance, overconfidence. We have considered control variables for executive overconfidence, as well as accounting choice by executives. We have also implemented propensity score matching and two-stage least squares (2SLS) model to mitigate endogeneity problem. Our results are robust for all these tests.

The existing studies provide mixed findings on the relation between political connection and firm performance. We extend this literature by documenting politically motivated investments as a means to establish political connection and their negative impacts on long-term firm performance. Our findings reveal that political goals of business leaders make the firms suffer in investment efficiency and subsequent firm performance. We believe the evidence from China has implications for other countries around the world, especially those without clear boundary between politicians and business leaders. Our study suggests a need for more attentions on the costs of establishing political connection.

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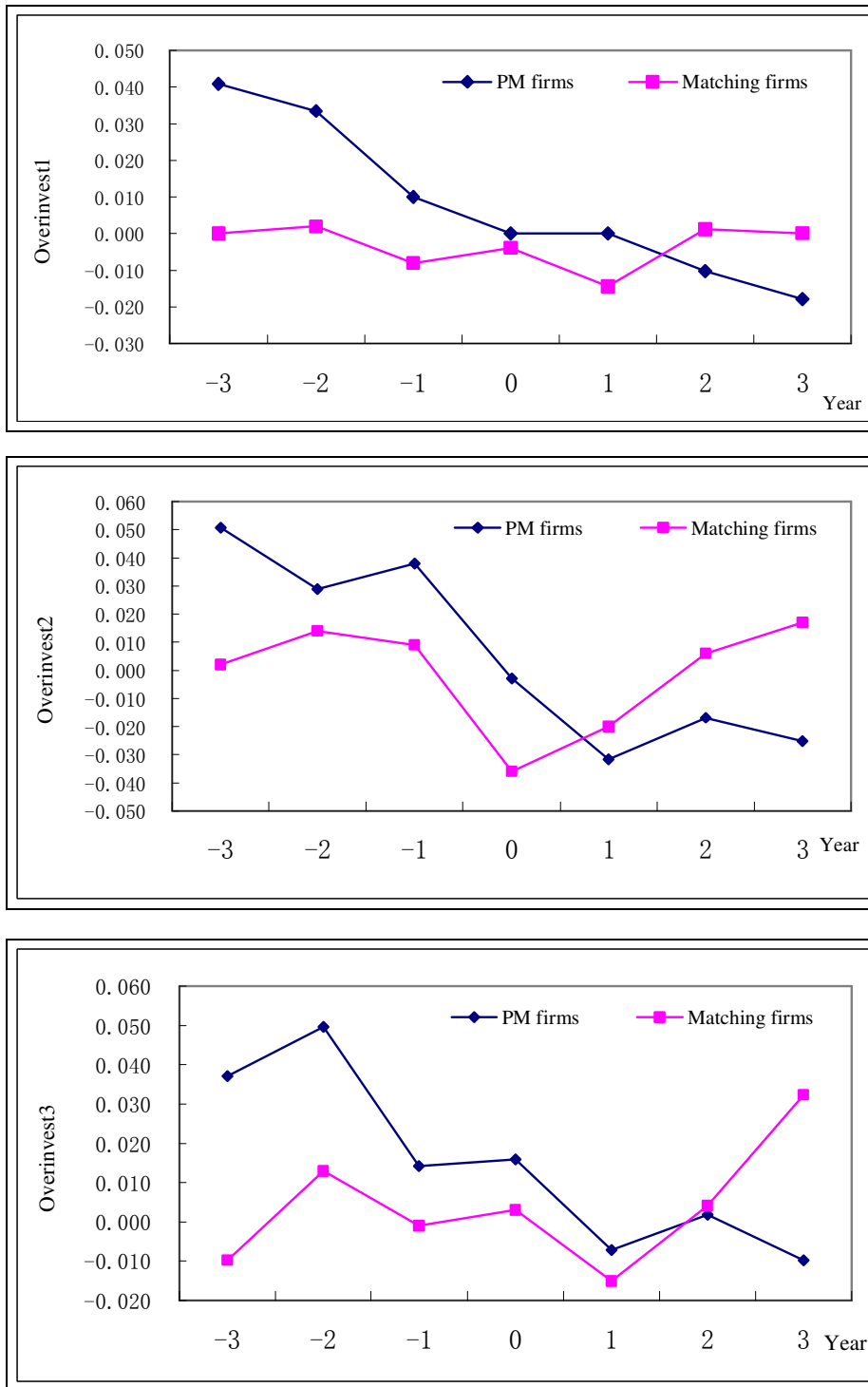


Figure 1: Median unexpected investments for the period between three years prior to and three years after Chinese executives' election to the People's Congress or the Chinese People's Political Consultative Conference, for both firms with political motivations and the matching firms.

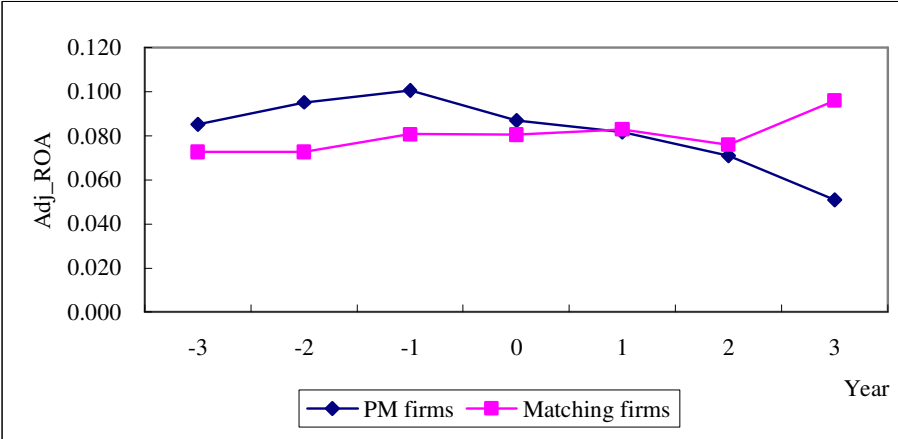
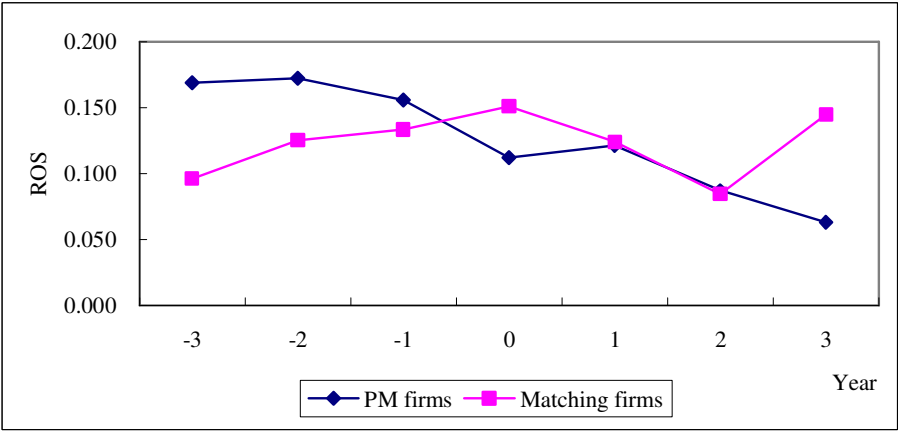
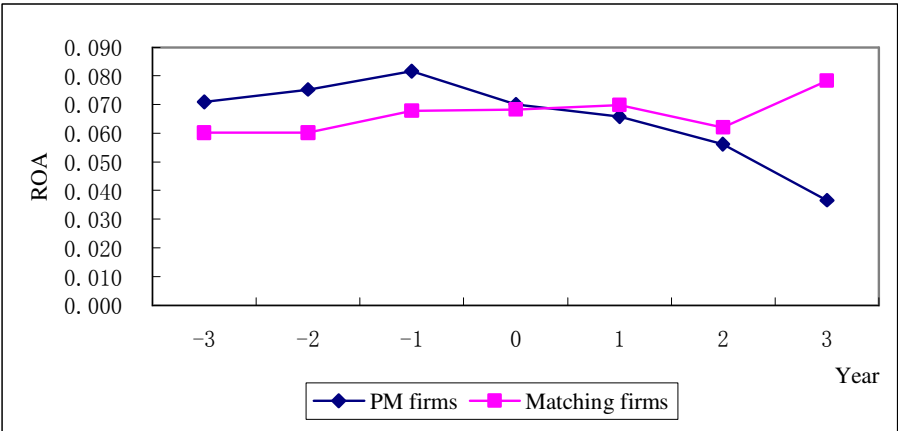


Figure 2: Median operating performance for the period between three years prior to and three years after Chinese executives' election to the People's Congress or the Chinese People's Political Consultative Conference, for both firms with political motivations and the matching firms.

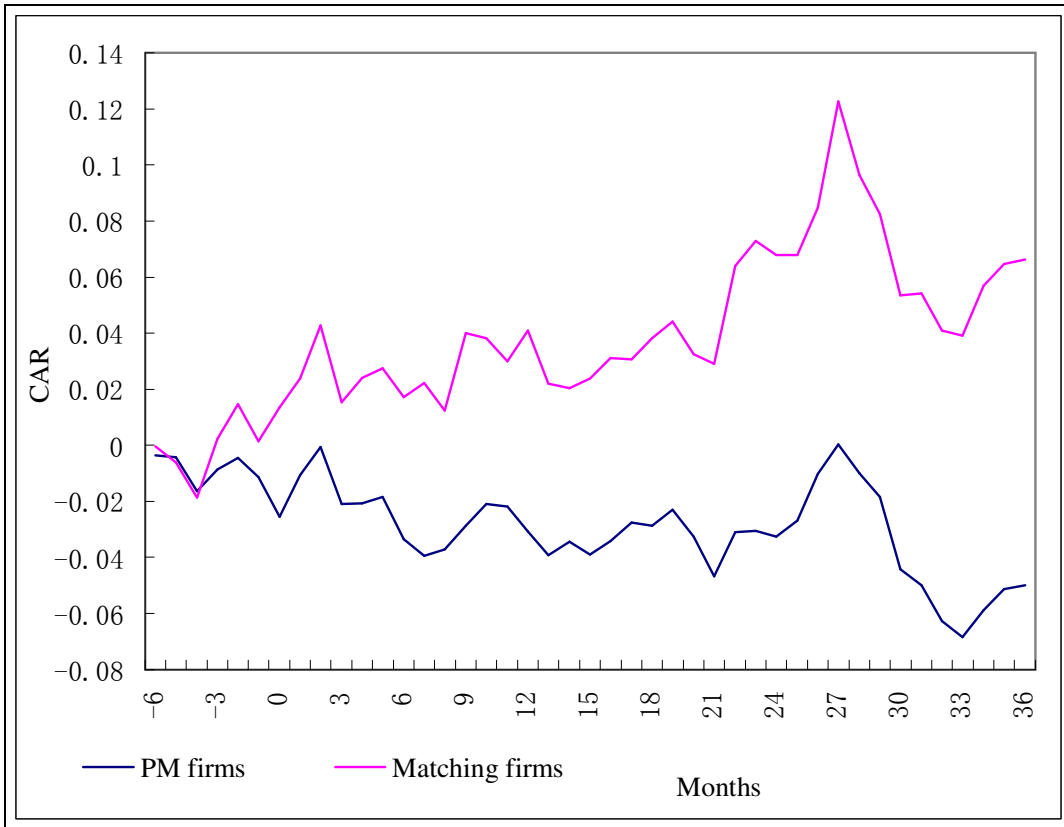


Figure 3: Mean cumulative market-adjusted stock returns (CARs) from 6 months before to 36 months after Chinese executives' election to the People's Congress or the Chinese People's Political Consultative Conference, for both firms with political motivations and the matching firms.

Table 1 Sample Firms with Political Motivations

The table includes Chinese firms with political motivations. A firm is defined as one with political motivations if its chairman or CEO won the election to either the People’s Congress (PC) or the Chinese People’s Political Consultative Conference (CPPCC) for the first time in his career after he took the current job. Panel A reports the sample by industry sector. A: agriculture, forestry, livestock farming and fishery; C: manufacturing; D: utilities; E: construction; F: transportation; G: IT; H: wholesale and retail trade; J: real estate; K: social services; M: comprehensive sector. Panel B reports the sample by year of a CEO got elected to the PC or CPPCC. Local indicates local PCs or CPPCCs. National indicates national PC or CPPCC. Male/Female suggests the gender of the chairman or CEO. Panel C reports the sample by ownership type (state-owned vs. private firms).

Panel A: By Industry											
Industry	A	C	D	E	F	G	H	J	K	M	Total
N	3	72	1	1	2	2	10	7	2	9	109
%	3	66	1	1	2	2	9	6	2	8	100

Panel B: By year in which a chairman or CEO got elected to the PC or CPPCC									
Year	1998	2002	2003	2005	2006	2007	2008	Total	
N	18	7	53	1	2	9	19	109	
%	17	6	49	1	2	8	17	100	
Local	6	7	19	1	2	9	12	56	51.38%
National	12	0	34	0	0	0	7	53	48.62%
Male	16	7	51	1	2	9	18	104	95.41%
Female	2	0	2	0	0	0	1	5	4.59%

Panel C: By Ownership Type					
	total	State-owned		Private	
		N	%	N	%
CPPCC	26	14	54	12	46
%	24	21		29	
PC	83	54	65	29	35
%	76	79		71	
Total	109	68	62	41	38

Table 2: Mean and median statistics of sample firms

This table presents the mean and median values of firm characteristics for both firms with political motivations (PM firms) and matching firms. A firm is defined as one with political motivations if its chairman or CEO won the election to either the People's Congress (PC) or the Chinese People's Political Consultative Conference (CPPCC) for the first time in his career after he took the current job. For each PM firm, we identify a matching firm in the same industry, with the same ownership type (either state-owned firm or private firm), with a chairman or CEO who did not have a political title of PC or CPPCC, with similar total assets, and without chairman turnover or CEO turnover in the next three years. I_{total} is change in long-term assets such as fixed assets, intangible assets, and long-term investments, divided by beginning total assets. $Overinvest1$ is unexpected investments estimated as I_{total} minus the median in the same industry. $Overinvest2$ is unexpected investments estimated by the model of Richardson (2006). $Overinvest3$ is unexpected investments estimated by the model of Biddle et al. (2009). ROA is EBITDA (earnings before interest, taxes, depreciation, and amortization) divided by average assets. ROS is EBITDA divided by total sales. Adj_ROA as EBITDA divided by net total assets, in which cash and marketable securities are deducted from total assets. $Size$ is the natural log of total assets. $Debt$ is total liabilities deflated by total assets. CF is operating cash flows deflated by total assets. TQ is Tobin's Q. $CEOAge$ is CEO age. $Government$ is a dummy variable that equals to one if the executive is a current or former officer of the central or local governments or the military. $Other$ is a dummy variable that equals to one if any executive or director other than the chairman or CEO is a deputy of PC or CPPCC. All continuous variables are winsorized at 1% and 99%. Z value is based on Wilcoxon tests. ***, **, and * denote significance at the 1%, 5%, and 10% level, respectively.

	PM firms				Matching firms				Difference			
	N	Mean	median	std	N	Mean	median	std	mean	t	median	z
I_{total}	677	0.068	0.055	0.124	677	0.058	0.044	0.128	0.010	1.444	0.011	1.925*
$Overinvest1$	677	0.017	0.003	0.108	677	0.005	-0.003	0.120	0.012	1.978**	0.005	2.318**
$Overinvest2$	677	-0.001	0.005	0.303	677	-0.038	0.002	0.661	0.037	1.333	0.003	2.486**
$Overinvest3$	677	0.033	0.014	0.171	677	0.017	0.001	0.203	0.017	1.765*	0.013	2.695***
ROA	677	0.066	0.071	0.066	677	0.067	0.072	0.071	-0.001	-0.18	-0.001	-0.467
ROS	677	0.126	0.142	0.255	677	0.124	0.125	0.243	0.002	0.165	0.016	0.634

<i>Adj_ROA</i>	677	0.083	0.085	0.078	677	0.080	0.086	0.083	0.002	0.566	-0.001	-0.268
<i>Size</i>	677	21.200	21.078	0.923	677	21.153	21.112	0.900	0.047	0.944	-0.034	-0.195
<i>Debt</i>	677	0.502	0.495	0.210	677	0.517	0.515	0.235	-0.015	-1.25	-0.020	-1.174
<i>CF</i>	677	0.049	0.047	0.074	677	0.054	0.050	0.075	-0.005	-1.126	-0.004	-0.735
<i>TQ</i>	677	1.482	1.268	0.604	677	1.543	1.292	0.704	-0.061	-1.723*	-0.024	-0.478
<i>CEOAge</i>	677	49.820	50.000	7.020	677	49.194	49.000	8.263	0.626	-1.503	1.000	1.559
<i>Gouvernement</i>	677	0.384	0.000	0.487	677	0.077	0.000	0.266	0.307	14.406***	0.000	13.418***
<i>Other</i>	677	0.877	1.000	0.328	677	0.196	0.000	0.398	0.681	34.345***	1.000	25.116***

Table 3: Statistics of Unexpected investments

The table reports means and medians of three measures of unexpected investments for each year, and tests of differences. *Overinvest1* is unexpected investments estimated as I_{total} minus the median in the same industry. *Overinvest2* is unexpected investments estimated by the model of Richardson (2006). *Overinvest3* is unexpected investments estimated by the model of Biddle et al. (2009). A firm is defined as one with political motivations if its chairman or CEO won the election to either the People’s Congress (PC) or the Chinese People’s Political Consultative Conference (CPPCC) for the first time in his career after he took the current job. The year of the election is regarded as Year 0. For each PM firm, we identify a matching firm in the same industry, with the same ownership type (either state-owned firm or private firm), with a chairman or CEO who did not have a political title of PC or CPPCC, with similar total assets, and without chairman turnover or CEO turnover in the next three years. Panel A reports the means of unexpected investments. Panel B reports the medians of unexpected investments. ***, **, and * denote significance at the 1%, 5%, and 10% level, respectively.

Panel A: Means of Unexpected Investments								
Year	PM firms					Matching Firms		
	N	<i>Overinvest1</i>	<i>Overinvest2</i>	<i>Overinvest3</i>	N	<i>Overinvest1</i>	<i>Overinvest2</i>	<i>Overinvest3</i>
-3	76	0.050	0.030	0.044	76	-0.006	-0.066	0.008
-2	93	0.060	0.104	0.089	93	0.006	-0.092	0.026
-1	109	0.033	0.021	0.032	109	0.002	-0.017	0.030
0	109	0.021	-0.023	0.050	109	-0.009	0.010	0.002
1	109	0.000	-0.056	0.013	109	-0.006	0.033	0.004
2	101	-0.012	-0.058	0.001	101	0.012	-0.074	0.012
3	80	-0.024	-0.018	0.019	80	0.016	-0.061	0.057
Period of (-3~1)	278	0.047	0.051	0.055	278	0.001	-0.055	0.023
Period of (1~3)	290	-0.011	-0.046	0.011	290	0.007	-0.031	0.021
(-3~1) - (1~3)		0.058	0.097	0.044		-0.005	-0.024	0.001
t-value		6.487***	3.846***	3.257***		-0.491	-0.406	0.080
Period of (-3~1)	PM-match	0.045	0.106	0.032				
	t-value	4.017***	3.101***	2.317**				
Period of (1~3)	PM-match	-0.018	-0.015	-0.011				

	t-value	-2.232**	-0.248	-0.897
Difference-in-difference	PM-match	0.063	0.121	0.043
	t-value	5.074***	2.549**	2.519**

Panel B: Medians of Unexpected Investments

Year	PM firms			Matching Firms				
	N	<i>Overinvest1</i>	<i>Overinvest2</i>	<i>Overinvest3</i>	N	<i>Overinvest1</i>	<i>Overinvest2</i>	<i>Overinvest3</i>
-3	76	0.041	0.051	0.037	76	0.000	0.002	-0.01
-2	93	0.033	0.029	0.050	93	0.002	0.014	0.013
-1	109	0.010	0.038	0.014	109	-0.008	0.009	-0.001
0	109	0.000	-0.003	0.016	109	-0.004	-0.036	0.003
1	109	0.000	-0.032	-0.007	109	-0.014	-0.020	-0.015
2	101	-0.010	-0.017	0.002	101	0.001	0.006	0.004
3	80	-0.018	-0.025	-0.010	80	0.000	0.017	0.032
Period of (-3~-1)	278	0.026	0.040	0.031	278	0.000	0.010	0.001
Period of (1~3)	290	-0.01	-0.024	-0.003	290	-0.003	0.012	0.001
(-3~-1) - (1~3)		0.036	0.065	0.034		0.003	-0.002	0.001
z-value		6.082***	8.779***	4.236***		-0.369	-0.217	-0.101
Period of (-3~-1)	PM-match	0.026	0.03	0.03				
	z-value	4.217***	5.331***	3.648***				
Period of (1~3)	PM-match	-0.007	-0.036	-0.004				
	z-value	-1.618	1.466	0.639				
Difference-in-difference	PM-match	0.033	0.067	0.034				
	z-value	5.121***	2.748***	2.826***				

Table 4: Regression results of the impact of Political motivation on unexpected investments

The dependent variables are three measures of unexpected investments: *Overinvest1*, *Overinvest2*, and *Overinvest3*. *Overinvest1* is unexpected investments estimated as I_{total} minus the median in the same industry. *Overinvest2* is unexpected investments estimated by the model of Richardson (2006). *Overinvest3* is unexpected investments estimated by the model of Biddle et al. (2009). *PM* is a dummy variable, which equals 1 if a firm's chairman or CEO won the election to either the People's Congress (PC) or the Chinese People's Political Consultative Conference (CPPCC) for the first time in his career after he took the current job, and zero otherwise. *Before* is a dummy variable, which equals 1 if an observation is in the previous periods of the year of the election, otherwise, zero. *Size* is the natural log of total assets. *Debt* is total liabilities deflated by total assets. *CF* is operating cash flows deflated by total assets. *TQ* is Tobin's Q. *CEOAge* is CEO age. *Government* is a dummy variable that equals to one if the executive is a current or former officer of the central or local governments or the military. *Other* is a dummy variable that equals to one if any executive or director other than the chairman or CEO is a deputy of PC or CPPCC. All continuous variables are winsorized at 1% and 99%. All regressions are clustered by firms. *t* statistics are in parentheses. ***, **, and * denote significance at the 1%, 5%, and 10% level, respectively.

	(1)	(2)	(3)
	<i>Overinvest1</i>	<i>Overinvest2</i>	<i>Overinvest3</i>
<i>PM</i>	-0.005 (-0.48)	-0.038 (-0.85)	0.013 (0.79)
<i>Before</i>	0.007 (0.70)	0.021 (0.44)	0.018 (1.03)
<i>PM x Before</i>	0.047*** (3.90)	0.128** (2.32)	0.039** (2.17)
<i>Size</i>	0.023*** (5.58)	-0.089*** (-4.75)	0.025*** (3.63)
<i>Debt</i>	-0.063*** (-4.38)	0.202*** (3.09)	-0.066*** (-2.71)
<i>CF</i>	0.093** (2.13)	0.132 (0.67)	0.035 (0.48)
<i>TQ</i>	-0.003 (0.39)	-0.023 (0.78)	-0.010 (0.90)
<i>CEOAge</i>	-0.044** (-2.12)	0.066 (0.70)	-0.067* (-1.91)
<i>Government</i>	-0.011 (-1.35)	0.037 (1.03)	-0.005 (-0.38)
<i>Other</i>	-0.001 (-0.11)	0.024 (0.62)	-0.013 (-0.90)
Constant	-0.270** (-2.29)	1.281** (2.41)	-0.156 (-0.79)
Year	Controlled	Controlled	Controlled
Industry	Controlled	Controlled	Controlled

Number of Firms	218	218	218
Number of Observations	1354	1354	1354
Adjusted R ²	11%	10%	8%

Table 5: Regression results of the impact of ownership type on unexpected investments

The dependent variables are three measures of unexpected investments: *Overinvest1*, *Overinvest2*, and *Overinvest3*. *Overinvest1* is unexpected investments estimated as I_{total} minus the median in the same industry. *Overinvest2* is unexpected investments estimated by the model of Richardson (2006). *Overinvest3* is unexpected investments estimated by the model of Biddle et al. (2009). The tests use only a subsample of firms whose chairman or CEO won the election to either the People's Congress (PC) or the Chinese People's Political Consultative Conference (CPPCC) for the first time in his career after he took the current job. *Private* is a dummy variable, which equals to one if a firm is private company and zero if it is state-owned. *Before* is a dummy variable, which equals 1 if an observation is in the previous periods of the year of the election, otherwise, zero. *Size* is the natural log of total assets. *Debt* is total liabilities deflated by total assets. *CF* is operating cash flows deflated by total assets. *TQ* is Tobin's Q. *CEOAge* is CEO age. *Government* is a dummy variable that equals to one if the executive is a current or former officer of the central or local governments or the military. *Other* is a dummy variable that equals to one if any executive or director other than the chairman or CEO is a deputy of PC or CPPCC. All continuous variables are winsorized at 1% and 99%. All regressions are clustered by firms. t statistics are in parentheses. ***, **, and * denote significance at the 1%, 5%, and 10% level, respectively.

	(1)	(2)	(3)
	<i>Overinvest1</i>	<i>Overinvest2</i>	<i>Overinvest3</i>
<i>Private</i>	-0.000 (-0.02)	-0.005 (-0.14)	-0.002 (-0.08)
<i>Before</i>	0.029** (2.21)	0.096** (2.44)	0.027 (1.25)
<i>Private x Before</i>	0.064*** (3.78)	0.073 (1.17)	0.059** (2.40)
<i>Size</i>	0.010* (1.82)	-0.003 (-0.16)	0.012 (1.31)
<i>Debt</i>	-0.044** (-2.02)	-0.032 (-0.50)	-0.056 (-1.58)
<i>CF</i>	0.179*** (2.94)	-0.288 (-1.59)	0.030 (0.30)
<i>TQ</i>	-0.016 (-1.57)	0.036 (1.17)	-0.025 (-1.48)
<i>CEOAge</i>	-0.050 (-1.45)	0.087 (0.85)	-0.076 (-1.33)
<i>Government</i>	-0.008 (-0.88)	0.039 (1.43)	-0.014 (0.98)
<i>Other</i>	-0.015 (-1.08)	0.003 (0.07)	-0.008 (-0.35)
Constant	-0.009 (-0.05)	-0.263 (-0.52)	0.164 (0.59)
Year	Controlled	Controlled	Controlled

Industry	Controlled	Controlled	Controlled
Number of Firms	109	109	109
Number of Observations	677	677	677
Adjusted R ²	19%	8%	12%

Table 6: Statistics of operating performance

The table reports means and medians of three measures of operating performance for each year, and tests of differences. *ROA* is EBITDA (earnings before interest, taxes, depreciation, and amortization) divided by average assets. *ROS* is EBITDA divided by total sales. *Adj_ROA* as EBITDA divided by net total assets, in which cash and marketable securities are deducted from total assets. A firm is defined as one with political motivations if its chairman or CEO won the election to either the People’s Congress (PC) or the Chinese People’s Political Consultative Conference (CPPCC) for the first time in his career after he took the current job. The year of the election is regarded as Year 0. For each PM firm, we identify a matching firm in the same industry, with the same ownership type (either state-owned firm or private firm), with a chairman or CEO who did not have a political title of PC or CPPCC, with similar total assets, and without chairman turnover or CEO turnover in the next three years. Panel A reports the means of operating performance. Panel B reports the medians of operating performance. ***, **, and * denote significance at the 1%, 5%, and 10% level, respectively.

Panel A: Means of Operating Performance												
	Year	-3	-2	-1	0	1	2	3	Before(-3~-1)	After(1~3)	Difference	T -value
PM firms	<i>ROA</i>	0.071	0.075	0.082	0.070	0.066	0.056	0.037	0.077	0.054	-0.022	-4.142***
	<i>ROS</i>	0.169	0.172	0.156	0.112	0.121	0.087	0.063	0.165	0.093	-0.072	-3.560***
	<i>Adj_ROA</i>	0.085	0.095	0.101	0.087	0.082	0.071	0.051	0.095	0.070	-0.025	-4.014***
Match firms	<i>ROA</i>	0.060	0.060	0.068	0.068	0.070	0.062	0.078	0.063	0.069	0.006	1.019
	<i>ROS</i>	0.096	0.125	0.133	0.151	0.124	0.084	0.145	0.121	0.116	-0.005	-0.215
	<i>Adj_ROA</i>	0.073	0.073	0.081	0.080	0.083	0.076	0.096	0.076	0.084	0.008	1.152
PM-match	Dif-in-dif		T-value									
	<i>ROA</i>	-0.029		-3.543***								
	<i>ROS</i>	-0.067		-1.939*								
	<i>Adj_ROA</i>	-0.033		-3.848***								
Panel B: Medians of Operating Performance												
	Year	-3	-2	-1	0	1	2	3	Before(-3~-1)	After(1~3)	Difference	Z-value
PM firms	<i>ROA</i>		0.068	0.080	0.076	0.077	0.061	0.055	0.076	0.064	-0.012	-3.660***
	<i>ROS</i>	0.158	0.162	0.159	0.142	0.144	0.105	0.104	0.159	0.120	-0.039	-4.184***

Match firms	<i>Adj_ROA</i>	0.087	0.080	0.097	0.092	0.092	0.075	0.071	0.089	0.080	-0.010	-3.297***
	<i>ROA</i>	0.073	0.069	0.075	0.071	0.069	0.072	0.074	0.072	0.072	-0.000	-1.107
	<i>ROS</i>	0.152	0.131	0.135	0.130	0.123	0.112	0.115	0.138	0.117	-0.021	-0.678
	<i>Adj_ROA</i>	0.086	0.077	0.088	0.085	0.086	0.088	0.089	0.085	0.087	0.001	1.370
PM-match	Dif-in-dif	Z-value										
	<i>ROA</i>	-0.012	-3.389***									
	<i>ROS</i>	-0.018	-1.693*									
	<i>Adj_ROA</i>	-0.011	-3.578***									

Table 7: Regression results of the impact of unexpected investments on subsequent operating performance

Year 0 is defined as the year when a chairman or CEO won the election to either the People's Congress (PC) or the Chinese People's Political Consultative Conference (CPPCC) for the first time in his career after he took the current job. The dependent variable is median change of ROA (ΔROA), calculated as the median ROA during the period of (1, 3) minus the median during the period of (-3, -1). *Overinvest1_Before* is the median of unexpected investments estimated as I_{total} minus the median in the same industry during the period of (-3, -1). *Overinvest2_Before* is the median of unexpected investments estimated by the model of Richardson (2006) during the period of (-3, -1). *Overinvest3_Before* is the median of unexpected investments estimated by the model of Biddle et al. (2009) during the period of (-3, -1). *PM* is a dummy variable, which equals 1 if a firm's chairman or CEO won the election to either the People's Congress (PC) or the Chinese People's Political Consultative Conference (CPPCC) for the first time in his career after he took the current job, and zero otherwise. $\Delta Size$ is median change of total assets. $\Delta Debt$ is median change of total liabilities deflated by total assets. ΔCF is median change of operating cash flows deflated by total assets. ΔTQ is median change of Tobin's Q. $\Delta CEOAge$ is CEO age. $\Delta Government$ is a dummy variable that equals to one if the executive is a current or former officer of the central or local governments or the military. $\Delta Other$ is a dummy variable that equals to one if any executive or director other than the chairman or CEO is a deputy of PC or CPPCC. All continuous variables are winsorized at 1% and 99%. t-values in parentheses are adjusted by robust standard errors. ***, **, and * denote significance at the 1%, 5%, and 10% level, respectively.

	(1)	(2)	(3)
	ΔROA	ΔROA	ΔROA
<i>PM</i>	-0.015* (-1.86)	-0.023*** (-3.00)	-0.013 (-1.57)
<i>Overinvest1_Before</i>	-0.106 (-1.41)		
<i>PM x Overinvest1_Before</i>	-0.291*** (-2.80)		
<i>Overinvest2_Before</i>		0.024 (1.40)	
<i>PM x Overinvest2_Before</i>		-0.241*** (-6.75)	
<i>Overinvest3_Before</i>			-0.115* (-1.86)
<i>PM x Overinvest3_Before</i>			-0.347*** (-3.60)
$\Delta Size$	0.030*** (3.54)	0.024*** (2.87)	0.030*** (3.63)
$\Delta Debt$	-0.073*** (-3.51)	-0.054** (-2.58)	-0.065*** (-3.16)
ΔCF	0.173***	0.174***	0.183***

	(3.70)	(3.86)	(4.03)
ΔTQ	0.008	0.011**	0.008*
	(1.62)	(2.50)	(1.81)
$\Delta CEOAge$	0.054*	0.041	0.051*
	(1.72)	(1.34)	(1.68)
$\Delta Government$	-0.004	-0.007	-0.000
	(-0.25)	(-0.48)	(-0.02)
$\Delta Other$	0.005	0.005	0.000
	(0.50)	(0.53)	(0.02)
Constant	0.012	0.009	0.015
	(0.43)	(0.36)	(0.57)
Industry	Controlled	Controlled	Controlled
Number of Observations	218	218	218
Adjusted R ²	39%	43%	42%

Table 8: Statistics of stock market performance (CARs)

The table reports means and medians of various measures of cumulative market-adjusted stock returns (CARs), and tests of differences. Month 0 is defined as the month when a chairman or CEO won the election to either the People's Congress (PC) or the Chinese People's Political Consultative Conference (CPPCC) for the first time in his career after he took the current job. CARs are accumulated for 12, 24, and 36 months starting from either 6 months or 1 month prior to the month 0. Monthly stock returns are used for calculating the CARs measures. Market returns are the equally weighted returns. A firm is defined as one with political motivations if its chairman or CEO won the election to either the People's Congress (PC) or the Chinese People's Political Consultative Conference (CPPCC) for the first time in his career after he took the current job. The year of the election is regarded as Year 0. For each PM firm, we identify a matching firm in the same industry, with the same ownership type (either state-owned firm or private firm), with a chairman or CEO who did not have a political title of PC or CPPCC, with similar total assets, and without chairman turnover or CEO turnover in the next three years. ***, **, and * denote significance at the 1%, 5%, and 10% level, respectively.

	Mean				Median			
	PM	Match	Difference	T-value	PM	Match	Difference	Z-value
CAR(-6,12)	-0.031	0.072	-0.103	-2.006**	-0.041	0.007	-0.048	1.363
CAR(-6,24)	-0.032	0.101	-0.133	-1.757*	-0.065	-0.009	-0.056	1.417
CAR(-6,36)	-0.050	0.116	-0.166	-2.021**	-0.095	0.077	-0.172	1.975**
CAR(-1,12)	-0.026	0.052	-0.078	-1.704*	-0.041	0.007	-0.048	1.339
CAR(-1,24)	-0.028	0.081	-0.110	-1.731*	-0.065	-0.009	-0.056	1.335
CAR(-1,36)	-0.045	0.097	-0.142	-1.819*	-0.095	0.077	-0.172	1.811*

Table 9: Regression results of the impact of unexpected investments on CARs

Month 0 is defined as the month when a chairman or CEO won the election to either the People's Congress (PC) or the Chinese People's Political Consultative Conference (CPPCC) for the first time in his career after he took the current job. The dependent variable is the cumulative market-adjusted stock returns (CARs) accumulated for the months (-1, 12). *Overinvest1_Before* is the median of unexpected investments estimated as I_{total} minus the median in the same industry during the period of (-3, -1). *Overinvest2_Before* is the median of unexpected investments estimated by the model of Richardson (2006) during the period of (-3, -1). *Overinvest3_Before* is the median of unexpected investments estimated by the model of Biddle et al. (2009) during the period of (-3, -1). *PM* is a dummy variable, which equals 1 if a firm's chairman or CEO won the election to either the People's Congress (PC) or the Chinese People's Political Consultative Conference (CPPCC) for the first time in his career after he took the current job, and zero otherwise. *Size* is the natural log of total assets. *Debt* is total liabilities deflated by total assets. *CF* is operating cash flows deflated by total assets. *TQ* is Tobin's Q. *CEOAge* is CEO age. All continuous variables are winsorized at 1% and 99%. t-values in parentheses are adjusted by robust standard errors. ***, **, and * denote significance at the 1%, 5%, and 10% level, respectively.

	(1)	(2)	(3)
<i>PM</i>	0.007 (0.15)	-0.017 (-0.38)	-0.009 (-0.18)
<i>Overinvest1_Before</i>	-0.256 (-0.51)		
<i>PM x Overinvest1_Before</i>	-1.488** (-2.32)		
<i>Overinvest2_Before</i>		-0.022 (-0.18)	
<i>PM x Overinvest2_Before</i>		-1.088*** (-5.98)	
<i>Overinvest3_Before</i>			-0.389 (-0.86)
<i>PM x Overinvest3_Before</i>			-1.204** (-1.97)
<i>Size</i>	0.068** (2.36)	0.059** (2.02)	0.074** (2.51)
<i>Debt</i>	-0.093 (0.95)	-0.051 (0.49)	-0.100 (0.99)
<i>CF</i>	-0.007 (0.02)	0.011 (0.04)	0.068 (0.23)
<i>TQ</i>	0.095 (1.48)	0.076 (1.15)	0.103 (1.59)
<i>CEOAge</i>	0.038 (0.22)	0.108 (0.65)	0.018 (0.10)
Constant	-1.408 (1.63)	-1.510* (1.75)	-1.448* (1.66)

Industry	Controlled	Controlled	Controlled
Number of Observations	218	218	218
Adjusted R ²	21%	25%	19%

Table 10: Propensity-Score Matching for Firms with Political Motivations

A firm is defined as one with political motivations (PM) if its chairman or CEO won the election to either the People’s Congress (PC) or the Chinese People’s Political Consultative Conference (CPPCC) for the first time in his career after he took the current job. Propensity score is based on a probit model to estimate the likelihood that a firm’s executive pursues a political title such as PC or CPPCC, by using observable firm characteristics such as industry dummy, year dummy, total assets, leverage, operating cash flows, Tobin’s Q, CEO age, chairman or CEO’s working experience in the government, and political titles of other persons in the top management and the board. A match firm is selected by one-by-one “nearest neighborhood” matching. *Overinvest1* is unexpected investments estimated as I_{total} minus the median in the same industry. *Overinvest2* is unexpected investments estimated by the model of Richardson (2006). *Overinvest3* is unexpected investments estimated by the model of Biddle et al. (2009). ΔROA is median change of ROA, calculated as the median ROA during the period of (1, 3) minus the median during the period of (-3, -1). ΔROS is median change of ROS, calculated as the median ROS during the period of (1, 3) minus the median during the period of (-3, -1). $\Delta Adj-ROA$ is median change of *Adj-ROA*, calculated as the median *Adj-ROA* during the period of (1, 3) minus the median during the period of (-3, -1). CAR (-1,12) is the cumulative market-adjusted stock returns (CARs) accumulated for the months (-1, 12). CAR (-6,36) is the cumulative market-adjusted stock returns (CARs) accumulated for the months (-6, 36).

	Overinvestment			Performance				
	<i>Overinvest1</i>	<i>Overinvest2</i>	<i>Overinvest3</i>	ΔROA	ΔROS	$\Delta Adj-ROA$	CAR(-1,12)	CAR(-6, 36)
PM firms	0.047	0.051	0.055	-0.022	-0.072	-0.025	-0.026	-0.05
Matching firms	0.012	-0.071	0.008	0.001	-0.014	0.005	0.058	0.132
Difference	0.035***	0.122***	0.047***	-0.023***	-0.058*	-0.030**	-0.084*	-0.182**
T-value	2.838	3.524	2.828	-2.954	-1.851	-2.019	-1.962	-2.192
No. of PM firms	109	109	109	109	109	109	109	109

Table 11: 2SLS results of the impact of political motivation on unexpected investments

The table presents the results of two-stage least squares (2SLS) regressions by using instrumental variables for political motivation. The dependent variable in the first stage is *PM*, a dummy variable which equals 1 if a firm's chairman or CEO won the election to either the People's Congress (PC) or the Chinese People's Political Consultative Conference (CPPCC) for the first time in his career after he took the current job, and zero otherwise. Two instruments are used for *PM*: *CityNumber*, the natural logarithm of the number of listed firms in the city where a firm's headquarter locates; and *Female*, which takes the value of 1 if the CEO is female. The dependent variables in the second stage are three measures of unexpected investments: *Overinvest1*, *Overinvest2*, and *Overinvest3*. *Overinvest1* is unexpected investments estimated as I_{total} minus the median in the same industry. *Overinvest2* is unexpected investments estimated by the model of Richardson (2006). *Overinvest3* is unexpected investments estimated by the model of Biddle et al. (2009). *Before* is a dummy variable, which equals 1 if an observation is in the previous periods of the year of the election, otherwise, zero. *Size* is the natural log of total assets. *Debt* is total liabilities deflated by total assets. *CF* is operating cash flows deflated by total assets. *TQ* is Tobin's Q. *CEOAge* is CEO age. *Government* is a dummy variable that equals to one if the executive is a current or former officer of the central or local governments or the military. *Other* is a dummy variable that equals to one if any executive or director other than the chairman or CEO is a deputy of PC or CPPCC. All continuous variables are winsorized at 1% and 99%. All regressions are clustered by firms. t statistics are in parentheses. ***, **, and * denote significance at the 1%, 5%, and 10% level, respectively.

	First stage predicting	Second stage		
	<i>PM</i>	<i>Overinvest1</i>	<i>Overinvest2</i>	<i>Overinvest3</i>
	(1)	(2)	(3)	(4)
<i>PM</i>		0.091*** (4.81)	0.346*** (3.25)	0.151*** (3.78)
<i>Before</i>		0.006 (0.54)	0.022 (0.49)	0.017 (0.91)
<i>PM x Before</i>		0.052*** (4.31)	0.129** (2.49)	0.031** (2.12)
<i>Size</i>	0.013 (0.21)	0.024*** (5.63)	-0.085*** (-4.68)	0.026*** (3.56)
<i>Debt</i>	-0.369* (-1.65)	-0.055*** (-3.54)	0.255*** (3.84)	-0.051* (-1.93)
<i>CF</i>	-0.516 (-0.78)	0.087* (1.92)	0.112 (0.58)	0.033 (0.44)
<i>TQ</i>	-0.028 (-0.27)	-0.002 (-0.25)	-0.020 (-0.66)	-0.010 (-0.85)
<i>CEOAge</i>	-0.187 (-0.60)	-0.042* (-1.94)	0.085 (0.91)	-0.060 (-1.62)
<i>Government</i>	0.956*** (7.90)	-0.032*** (-3.58)	-0.039 (-0.96)	-0.035** (-2.19)
<i>Other</i>	2.117*** (-21.38)	-0.065*** (-4.64)	-0.230*** (-3.13)	-0.104*** (-3.69)

<i>Citynumber</i>	-0.157*** (-4.93)			
<i>Female</i>	1.076*** (4.43)			
Constant	-0.034 (-0.02)	-0.316*** (-2.59)	1.060** (2.03)	-0.219 (-1.05)
Year	Controlled	Controlled	Controlled	Controlled
Industry	Controlled	Controlled	Controlled	Controlled
Observations	1354	1354	1354	1354
Endogeneity Test				
Rho		-0.504	-0.456	-0.418
Chi-sq(1) statistic		14.44***	8.19***	5.78**
Prob> Chi-sq(1)		0.000	0.004	0.016