

Political Connection and Financial Performance: Evidence from Chinese Small-and-Medium Enterprises

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Introduction

Since 1978, China gradually adopted a series of reform policies aiming to transform its former central planned economy to a socialist market economy. For the past three decades, the economic reform has brought China a flourishing private sector: it has grown at an annual rate of twenty percent, far above the economy's eight percent average growth for the same period (Tsai, 2002). Moreover, the non-state sector in China has accounted for two-thirds of total productivity and GDP (Welborn, 2003). The high-speed development of the private sector has been achieved primarily by decentralization of decision making power from the government to enterprises (McMillan & Woodruff, 2002; Siu & Liu, 2005). This decentralization process led to transformation of those large state-owned enterprises and spur of private small-and-medium enterprise (SMEs), such as the flourishing of township-and-village enterprises (TVEs). While most attention has been paid on how the transformation of large SOEs accelerated the development of private sectors, the creation and development of SMEs has had a significant influence on the development of the private economy, a fact that has been noted recently by sociologists.

The rise of those small businesses raises several questions about the way in which China's SMEs has developed. One of these is whether there is a Chinese style of the development of SMEs which differs from that in capitalist economies. According to

resource-based theory, in capitalist economies the basis for a firm's competitive advantage lies primarily in its application of the valuable resources that are at the firm's disposal (Rumelt, 1984, p557-558; Wernerfelt, 1995, p172). However, developing in a transitional economy where the market is not the dominant mechanism for the allocation of resources, China's SMEs have developed different strategies to gain better financial performance. This paper, therefore, tries to explain both theoretically and empirically what is the China's style of development of SMEs, particularly focusing on the political connectivity and the financial performance of SMEs. For the rest sections of this paper we firstly deal with the theoretical debate on the development of firms in China's traditional economy.. Secondly, the methodology of this paper will be discussed. A multi-level modelling is used to describe the political connectivity and the financial performance of China's publically listed SMEs. Finally, research results will be presented and further discussed.

Theoretical Debate

There are two major perspectives explaining the practice and performance of China's domestic enterprises: new institutional sociology and local corporatism. Each gives special emphasis to a distinct reason for the development of the Chinese enterprises.

The first perspective is the new institutional sociology, forcefully argued by Victor Nee (Nee 1989, 1991, 1992, 1996, 2000; Nee and Cao 1999, 2002; Nee and Matthews 1996; Nee and Su 1996, 1998). Nee (1989) proposes the market transition theory to account for the China's rapid growth. The basic argument of this theory is that market mechanisms began to develop and replace the redistributive mechanisms to direct the economic activity. Market mechanisms and redistributive mechanisms are two different economic systems. Under the market economy, the resources are allocated by market and economic actors, for example entrepreneurs and direct producers, have their own incentives to enlarge their market shares. By contrast, under the redistributive economy all of the resources are allocated by the central government and the economic activities are also directed by the central planning. In the process of transition the increasing market force inevitably decrease the state regulation power. Therefore, the market – rather than the party state apparatus – increasingly generates market-based power, opportunity, and incentives (Bian and Zhang 2006).

The second approach to examining China's transitional process is the local corporatist approach, articulated initially by Andrew Walder (1995b, 1996b, 2003). He emphasizes the continuity of political institutions and suggests it is the political processes – such as the change within different levels of government jurisdictions – that determine how China's private economy developed (Walder 1995b, 2003) . Small firms, particularly those governed by governments at the lower level of the state bureaucratic hierarchy, cannot compete with large SOEs that are usually protected by state government in obtaining factor resources. Therefore, they need a third party's help in order to keep stability in the market.

The major arguments of each perspective are summarized in Table 1.

Table 1: The Economic Transition: New institutional sociology and local corporatism

	NEW INSTITUTIONAL SOCIOLOGY	LOCAL CORPORATISM
Analysis variable	The market institution	Local governments as corporations
Perspectives on the market mechanism	Continuous developing, gradually replacing the state to regulate the economy	Influential, but not essential to determine the transition trajectory
The trajectory of transition	Hybrid economy is transitory; the reform will lead to the full capitalist economy	Not transitory: the political power adapts to the changing institutions and thus retaining their control rights.
Nature of social network	Horizontal networks	Vertical networks
Property rights	Privatization is the central to improve the enterprise performance.	Privatization is not necessary as most current ownership structure still can create incentives
Force behind change	Markets	Political power

Hypotheses

We will follow the local corporatism theory to access the influence between political connectivity and firm's financial performance.

Main Effect

The local corporatist perspective suggests the important role of political connection in

enterprises' financial performance. Walder (1996a) argues that the formation of markets can take various forms and therefore a firm's success is not necessarily related to the increasing market force. In the case of China, it is the state that determines the paths of the development of enterprises (Walder 1995b, 1996b). Therefore:

Hypothesis 1: Firms with more political connectivity have better financial performance.

Local corporatism focuses on the relation of firms with local governments. For the local corporatist perspective, the lower level government jurisdictions have the strongest incentives to improve the firms' financial performance. Based on these arguments, we assume that the political connectivity at lower level government jurisdictions is more beneficial for firms, especially for SMEs. Thus:

Hypothesis 2: The political connectivity at the lower level of government jurisdictions improves firm's financial performance.

Moderating Effects

Diprete and Forristal (1994) and Xie (2008) argued that micro-level units are located in different and distinguishable social contexts, and that the properties of these social contexts explain the variation in the micro-level coefficients. The influence of a firm's political connectivity on its financial performance is a function of industry's characteristics, moderated by the industrial context in which the firm operates. The level of marketisation varies with industries. In the industries with low levels of marketisation, industries' policies usually are not generated naturally by markets but made by government; firms can easily achieve an advantage through non-market methods, for example, close connections with government. In this sense, political connectivity may help firms win a larger market share, beat competitors and outperform others. Thus, we suppose the effect of political connectivity on financial performance becomes stronger for a firm in a lowly marketised industry (i.e. a highly concentrated industry). Therefore:

Hypothesis 3: The political connectivity has stronger contribution to a firm's financial performance if it operates in a lowly marketised industry (i.e. a highly concentrated industry).

Hypothesis 4: The political connectivity at the lower level of government jurisdictions has a stronger effect on firm's financial performance when the firm is in a lowly marketised industry (i.e. a highly concentrated industry).

Although we do not support Nee's market transition theory and neither propose any

hypothesis based on it, as a comparison to the political effects we will still explore whether the effects of advertising, research and development and human capital, three widely-used market mechanisms on firm's financial performance in the empirical study.

The Empirical Study

The Sample

The sample firms we have chosen for our research are all the 274 companies listed on the Small-Medium Enterprise board of the Shenzhen Stock Exchange in China. The data were hand-collected from each company's prospectus. Table one reports the distribution of sample. It breaks down the sample by industry sector, which is based on the Standard. & Poor's Global Industry Classification Standard (GICS).

Table 1: Distribution of Sample by Industry

Sector	# of Companies	Percent
Aerospace & Defense	2	0.70%
Alternative Energy	2	0.70%
Automobiles & Parts	10	3.60%
Banks	1	0.40%
Chemicals	37	13.50%
Construction & Materials	22	8.00%
Electricity	1	0.40%
Electronic & Electrical Equipment	40	14.50%
Food & Drug Retailers	2	0.70%
Food Producers	13	4.70%
Forestry & Paper	5	1.80%
General Industrials	5	1.80%
General Retailers	2	0.70%
Health Care Equipment & Services	2	0.70%
Household Goods & Home Construction	12	4.40%
Industrial Engineering	25	9.10%
Industrial Metals & Mining	10	3.60%
Industrial Transportation	3	1.10%
Leisure Goods	3	1.10%

Media	2	0.70%
Mining	3	1.10%
Mobile Telecommunications	2	0.70%
Oil & Gas Producers	1	0.40%
Oil Equipment & Services	2	0.70%
Personal Goods	19	6.90%
Pharmaceuticals & Biotechnology	13	4.70%
Real Estate Investment & Services	4	1.50%
Software & Computer Services	11	4.00%
Support Services	4	1.50%
Technology Hardware & Equipment	12	4.40%
Travel & Leisure	4	1.50%
Total	274	100.00%

Measures

Dependent variables

Inspired by the study of Fan et al. (2007), we employ both stock- and accounting-based measures to evaluate the financial performance of the sample companies. The stock-market-based performance measure is the market returns of each company. We also used one accounting performance measure: the average of return on assets (ROA) (as net income divided by total assets) in the one-, two-year pre-Initial Public Offering (IPO) and the year of IPO.

Independent Variables

There are 11 independent variables. We develop a nominal variable for the level of education attained by the directors and senior managers of the company (i.e. four for Ph.D., three for post-graduate level, two for college level, and one for high-school level or below). The level of political connectivity was measured by two variables. The first one was the percentage of board directors and senior managers are members of the Chinese Communist Party (CCP). The second one is related to the board directors and senior managers of each company who

are current or former officials of the central or local government or officers of the military (see Fan et. al, 2007). We first coded the rank of civil servant or of military officer for each person (i.e. three for senior level position, two for middle level position, one for junior level position, and zero for never worked as civil servant or military officer) and used the average as the independent variable. The information for these variables is obtained from the “Profile of Directors and Senior Managers” section of each company’s prospectus.

The following variables are included into our models as control variables: the firm age, firm size (measured by the nature logarithm transformed total assets), the market-to-book ratio, the average of leverage ratios of last three years, and the variable at the industry level, which quantifies the level of industry concentration and is measured by the Hirschman Herfindahl Index (HHI or HIndex) for each industry (Fan et al., 2007). Finally, we used the average advertising expenditure to sales and the average of Research-and-Development (R&D) expenditure to sales ratios of last three years as proxy variables of the traditional methods that firms can implement to achieve strategic advantages.

Models

The multilevel model, which specifies the effect of the social context on individual-level outcomes, has been theoretically analysed and is gradually being employed increasingly in sociological methodology (Diprete & Forristal 1994; Xie 2008). The multi-level modelling is often seen as an appropriate strategy for analysing data with a hierarchical structure. This is the case in this study, where companies are grouped into industries.

We conducted the analyses in three panels. The estimated models in Panel A are:

For Firm i operating in Industry j in the year of IPO (Year t):

$$(1) \text{MRI}_{ijt}/\text{ROA}_{ijt} = \beta_{0ij} + \beta_{1ij} * \text{Firm Age}_{ij} + \beta_{2ij} * \text{Firm Size}_{ijt-1} + \beta_{3ij} * \text{Leverage}_{ijt-1} \\ + \beta_{4ij} * \text{Market-to-Book Value}_{ijt} + \beta_{5ij} * (\text{Advertising}_{t-1} \text{ or } \text{R\&D}_{t-1} \text{ or } \\ \text{Education}_{t-1} \text{ or } \text{Party Percent}_{t-1} \text{ or } \text{Civil Servant Percent}_{t-1} \text{ or } \text{Civil} \\ \text{Servant Rank}_{t-1} \text{ or } \text{Military Officer Percent}_{t-1}) + \epsilon_{ij}$$

Panel B focuses on the moderating effect of SOE, thus:

$$(2) \text{MRI}_{ijt}/\text{ROA}_{ijt} = \beta_{0ij} + \beta_{1ij} * \text{Firm Age}_{ij} + \beta_{2ij} * \text{Firm Size}_{ijt-1} + \beta_{3ij} * \text{Leverage}_{ijt-1} \\ + \beta_{4ij} * \text{Market-to-Book Value}_{ijt} + \beta_{5ij} * (\text{Advertising}_{t-1} \text{ or } \text{R\&D}_{t-1} \text{ or } \\ \text{Education}_{t-1} \text{ or } \text{Party Percent}_{t-1} \text{ or } \text{Civil Servant Percent}_{t-1} \text{ or } \text{Civil} \\ \text{Servant Rank}_{t-1} \text{ or } \text{Military Officer Percent}_{t-1}) + \beta_{6ij} * \text{SOE} * (\text{Advertising}_{t-1} \\ \text{ or } \text{R\&D}_{t-1} \text{ or } \text{Education}_{t-1} \text{ or } \text{Party Percent}_{t-1} \text{ or } \text{Civil Servant Percent}_{t-1} \\ \text{ or } \text{Civil Servant Rank}_{t-1} \text{ or } \text{Military Officer Percent}_{t-1}) + \varepsilon_{ij}$$

4.4 Analyses

Descriptive Analyses

Zero-order correlations are shown in Table 2. The ROA is significantly correlated to the firm age (-0.149, $p < 0.05$), firm size (-0.233, $p < 0.01$), leverage (-0.0654, $p < 0.01$), R&D expenditure (0.326, $p < 0.01$), education level (0.207, $p < 0.01$), percentage of the Party (-0.157, $p < 0.05$), percentage of civil servant (-0.181, $p < 0.01$), and the rank of former or current civil servant (-0.188, $p < 0.01$). Market return index is significantly correlated to market/book value (0.423, $p < 0.01$), advertising expenditure (-0.389, $p < 0.01$), H Index (-0.148, $p < 0.05$), and the rank of former or current civil servant (0.124, $p < 0.05$). As the following multilevel analyses show, the effects of political connectivity and market mechanisms on financial performance are conditional on the environment a firm is embedded in.

Tabel 2: Correlation Matrix

	2	3	4	5	6	7	8	9	10	11	12	13	14
1. ROA	-0.054	-0.149*	-0.233**	-0.654**	0.101	0.045	0.326**	0.077	0.207**	-0.157*	-0.181**	-0.188**	0.008
2. Market Return		0.041	0.109	-0.064	0.423**	-0.389**	-0.058	-0.148*	-0.082	-0.033	0.102	0.124*	0.07
3. Firm Age			0.108	-0.003	-0.088	-0.052	0.031	0.033	-0.059	0.158*	0.256**	0.262**	0.066
4. Firm Size				0.257**	-0.011	0.055	-0.192**	0.06	-0.03	0.081	0.084	0.125*	0.013
5. Leverage					-0.139*	0.102	-0.391**	-0.048	-0.144*	0.028	0.099	0.089	-0.119
6. Market/Book Value						-0.131*	0.102	-0.027	0.091	-0.190**	-0.02	-0.051	-0.041
7. Advertising							-0.017	0.236**	0.155*	0.009	-0.077	-0.053	-0.147*
8. R&D								-0.105	0.277**	-0.118	-0.128*	-0.146*	0.049
9. H Index									0.098	0.004	0	0.033	0.023
10. Education										-0.077	-0.04	-0.08	0.033
11. Party%											0.391**	0.400**	0.119
12. Civil Servant %												0.929**	0.127*
13. Civil Servant Rank													0.140*
14. Military %													

* Correlation is significant at the 0.05 level (2-tailed).

** Correlation is significant at the 0.01 level (2-tailed).

Hypotheses Testing

Table 3 reports the results of multi-level regression for the ROA. Panel A focuses on the main effects of market mechanisms and political connectivity. Model 1 includes control variables. Firm age has a slightly negative impact on ROA (-0.0001, $p < 0.01$), which means when firms get older, their profitability decreases. The impact of leverage on a firm is significantly negative (-0.232, $p < 0.01$), which refers to the amount of debts a firm has; the more debts, the less the firm is able to obtain a better financial performance.

The model 2, 3 and 4 examine how market mechanism influences the firm financial performance. As stated in the previous section, we choose the three most commonly-used market mechanisms – the advertising investment, the R&D expenditures, and the education level of board directors and senior managers. Of all the variables, advertising investment has the largest influence on a firm's ROA (0.016, $p < 0.05$), which means the more money a firm spends on the advertising, the more profitable the firm is. The indicator of the education level shows that firms with board members who have higher educational degrees are likely to perform well (0.009, $p < 0.05$). For the R&D expenditure, it has slightly positive effects on a firm's profitability (0.158, $p < 0.1$).

The model 5, 6, 7, 8 and 9 in table eight present the effects of political connectivity on the ROA. In model 5, percentage of the CCP membership slightly damages ROA (-0.026, $p < 0.05$), which shows that the more presence of members of Communist party on the board, the less likely a firm can get a better ROA. In model 6, the percentage of civil servants has marginally positive effect on ROA (0.017, $p < 0.10$). In Model 8, the percentage of military officers has no significant impact on ROA. Basically, Hypothesis 1 is rejected. However, Hypothesis 2 is supported by Model 7. The negative coefficient -0.011 ($p < 0.05$) suggests that the links with lower levels of government improves firm's profitability.

Panel B addresses the moderating effect of industry concentration or industry

marketization. In highly concentrated industries, advertising expenditure marginally decrease (-0.085, $p < 0.10$) but R&D expenditure strongly improves a firm's ROA (2.083, $p < 0.05$). The interactive effects between industry concentration and percentages of the CCP membership and of civil servants are significantly negative (-0.174, $p < 0.05$; -0.218, $p < 0.05$) and that between industry concentration and percentage of military officials, rejecting Hypothesis 3. The interactive effect between industry concentration and the rank of civil servants is significantly negative (-0.102, $p < 0.05$), in support of Hypothesis 4.

Table 3: Results of regression with ROA as dependant variable

Panel A: Main Effect

Dep V:ROA	Model 1	Model 2	Model 3	Model 4	Model 5	Model 6	Model 7	Model 8
Intercept	0.293**	0.292**	0.276**	0.256**	0.293**	0.294**	0.291**	0.294**
	0.035	0.035	0.037	0.038	0.035	0.035	0.035	0.035
Firm Age	-0.001**	-0.001**	-0.001**	-0.001	-0.001**	-0.001**	-0.001**	-0.001**
	0.00001	0.00001	0.00001	0.00001	0.00001	0.00001	0.00001	0.00001
Firm Size	-0.002	-0.002	-0.002	-0.002	-0.002	-0.002	-0.002	-0.002
	0.002	0.002	0.002	0.002	0.002	0.002	0.002	0.002
Leverage	-0.232**	-0.236**	-0.221**	-0.226**	-0.233**	-0.23**	-0.23**	-0.235**
	0.018	0.018	0.019	0.018	0.018	0.018	0.018	0.018
Market/Book	-0.0009	-0.0009	-0.0009	-0.0009	-0.001	-0.001	-0.001	-0.001
	0.001	0.001	0.001	0.001	0.001	0.001	0.001	0.001
Advertising		0.016*						
		0.007						
R&D			0.158+					
			0.097					
EducationLevel				0.009*				
				0.004				
Party%					-0.026*			
					0.01			
Civil Servant %						-0.017+		
						0.011		
Civil Servant Rank							-0.011*	
							0.006	
Military %								-0.062
								0.053
2LL	-941.905	-943.24	-940.04	-938.46	-938.74	-935.255	-936.184	-934.175

** : $p < 0.01$ (very significant), * : $p < 0.05$ (significant), + : $p < 0.1$ (marginally significant)

Panel B: The Moderating effect of Industry Concentration

DEP V:ROA	MODEL 9	MODEL 10	MODEL 11	MODEL 12	MODEL 13	MODEL 14	MODEL 15	MODEL 16
Intercept	0.288**	0.275**	0.275**	0.291**	0.286**	0.286**	0.294**	0.294**
	0.035	0.036	0.036	0.035	0.035	0.035	0.035	0.035
Firm Age	-0.001**	-0.001**	-0.001**	-0.001**	-0.001**	-0.001**	-0.001**	-0.001**
	0.00001	0.00001	0.00001	0.00001	0.00001	0.00001	0.00001	0.00001
Firm Size	-0.003	-0.002	-0.002	-0.002	-0.002	-0.002	-0.002	-0.002
	0.002	0.002	0.002	0.002	0.002	0.002	0.002	0.002
Leverage	-0.233**	-0.214**	-0.214**	-0.233**	-0.226**	-0.226**	-0.233**	-0.234**
	0.018	0.019	0.019	0.018	0.018	0.018	0.018	0.018
Market/Book	-0.001	-0.001	-0.001	-0.001	-0.001	-0.001	-0.001	-0.001
	0.001	0.001	0.001	0.001	0.001	0.001	0.001	0.001
Hindex	0.05	-0.034	-0.067	0.044*	0.086*	0.072*	0.011	0.018
	0.034	0.031	0.143	0.025	0.036	0.032	0.024	0.026
Advertising	0.024**							
	0.009							
Hindex*Advertising.	-0.085+							
	0.052							
R&D		0.018						
		0.117						
Hindex*R&D		2.083*						
		0.923						
Education			0.007					
			0.005					
Hindex*Education			0.019					
			0.034					
Party%				-0.008				
				0.014				
Hindex*Party%				-0.174*				
				0.092				
Civil Servant %					0.004			
					0.014			
Hindex*Civil %					-0.218*			
					0.096			
Civil Servant Rank						-0.001		
						0.008		
Hindex*Civil Rank						-0.102*		

						0.047		
Military %							-0.082	
							0.067	
Hindex*Military %							0.232	
							0.493	
2LL	-946.002	-946.163	-939.163	-942.94	-941.043	-932.113	-935.142	-934.45

** : $p < 0.01$ (very significant), * : $p < 0.05$ (significant), + : $p < 0.1$ (marginally significant)

Table 4 summarizes the results of regressions with stock market return as dependent variables.

Panel A focuses on the main effects of market mechanisms and political connectivity. Model 1 includes control variables. The firm age has marginally positive impact on the market return (0.53, $p < 0.10$). The firm size and the market-to-book value have strong influence on the market return (5.877, $p < 0.05$; 8.906, $p < 0.01$). In model 1 to 3, all the three market mechanism variables strongly decrease a firm's stock market return (advertising expenditure, -69.545, $p < 0.05$; R&D expenditure, -275.72, $p < 0.05$; education, -13.019, $p < 0.05$). In model 5, percentage of the CCP membership has no significant effect on the market return. In model 6 and 8, the percentages of civil servants and of military officers has marginally positive effect on the stock market performance (25.472, $p < 0.10$; 111.122, $p < 0.10$), marginally supporting Hypothesis 1. Hypothesis 2 is rejected in Model 7, as the positive coefficient 20.994 ($p < 0.05$) suggests that the links with the higher level of governments improves firm's stock market performance.

Panel B addresses the moderating effect of industry concentration or industry marketization. However, none of the interaction effects are significant.

Table 4: Regression Results with Stock Market Return as Dependent Variable.

Panel A: Main Effects

DEP V:MR	MODEL 1	MODEL 2	MODEL 3	MODEL 4	MODEL 5	MODEL 6	MODEL 7	MODEL 8
Intercept	-61.221	-61.522+	-31.52	-13.119	-64.782	-66.657+	-61.729	-66.9+
	54.415	50.352	56.536	59.271	54.68	54.466	54.243	54.534
Firm Age	0.53+	0.364	0.535+	0.492+	0.512+	0.379	0.317	0.511+

	0.384	0.357	0.383	0.382	0.389	0.397	0.396	0.384
Firm Size	5.877*	6.639**	5.312*	6.055*	5.885*	5.825*	5.479*	5.826*
	2.846	2.637	2.85	2.828	2.857	2.841	2.837	2.844
Leverage	-16.433	-3.227	-35.345+	-21.819	-13.793	-17.811	-17.735	-8.885
	27.252	25.303	29.006	27.452	27.445	27.431	27.268	27.611
Market/Book	8.906**	8.023**	9.207**	9.118**	9.061**	8.917**	8.985**	9.061**
	1.177	1.097	1.176	1.174	1.2	1.177	1.172	1.18
Advertising		-69.545**						
		10.381						
R&D			-275.72*					
			149.258					
Education				-13.019*				
				6.053				
Party%					8.182			
					16.296			
Civil Servant %						25.472+		
						16.275		
Civil Servant Rank							20.994*	
							9.524	
Military %								111.122+
								80.934
2LL	2904.865	2853.035	2891.363	2878.729	2883.068	2880.881	2878.752	2881.446

** : $p < 0.01$ (very significant), * : $p < 0.05$ (significant), + : $p < 0.1$ (marginally significant)

Panel B: The Moderating effect of Industry Concentration

DEP V:MR	MODEL 9	MODEL 10	MODEL 11	MODEL 12	MODEL 13	MODEL 14	MODEL 15
Intercept	-58.886	-25.47	-17.286	-63.355	-69.13+	-63.849	-65.283+
	50.394	55.855	61.34	54.152	54.09	53.649	53.97
Firm Age	0.369	0.58+	0.521+	0.542+	0.455	0.424	0.542+
	0.357	0.379	0.379	0.385	0.397	0.398	0.381
Firm Size	6.773**	5.654*	6.412*	6.287*	6.183*	5.749*	6.218*
	2.636	2.818	2.809	2.834	2.814	2.807	2.82
Leverage	-6.555	-44.399+	-24.965	-18.08	-20.779	-20.12	-13.357
	25.488	29.059	27.37	27.234	27.214	27.03	27.45
Market/Book	7.998**	8.82**	8.902**	8.843**	8.731**	8.764**	8.849**
	1.097	1.164	1.171	1.192	1.168	1.16	1.172
Hindex	-45.129	-63.66+	-58.072	-67.448*	-32.677	-30.408	-67.948*
	48.438	48.417	219.629	38.211	55.975	48.57	36.87

Advertising	-71.316**						
	13.282						
Hindex*Advertising.	39.191						
	74.931						
R&D		-274.823+					
		180.516					
Hindex*R&D		-593.005					
		1419.522					
Education			-11.563+				
			7.854				
Hindex*Education			-1.709				
			52.547				
Party%				9.658			
				21.707			
Hindex*Party%				-21.6			
				143.079			
Civil Servant %					36.415*		
					21.235		
Hindex*Civil %					-120.407		
					148.317		
Civil Servant Rank						29.024**	
						11.879	
Hindex*Civil Rank						-80.572	
						72.332	
Military %							124.436+
							101.784
Hindex*Military %							-134.495
							751.095
2LL	2852.046	2884.57	2874.254	2877.77	2874.919	2871.874	2875.991
e2	3260.092	3692.737	3703.199	3753.622	3712.701	3669.54	3727.947
	321.124	323.253	324.792	329.214	325.625	321.84	326.963

** : $p < 0.01$ (very significant), * : $p < 0.05$ (significant), + : $p < 0.1$ (marginally significant)

Discussion

The Market mechanism for the firm and the Political Connectivity for Investors

The results of regression analysis show an apparent contradiction: while for the firm's ROA, political connection exerts negative influences and market mechanisms such as the R&D investment help the firm get a better financial performance; for the firm's

market return, the political connectivity has a positive effect but using market mechanisms do not improve a firm's market return. This incompatible result is the most interesting finding of this paper. It indicates that investors are more likely to invest firms with political connections based on the "stereotype" that the political connection helps the firm to get a better performance. For those sample SMEs, however, they are more likely to use the market methods – higher investment in advertising and R&D, hiring more staff with higher educational degrees – to pursue profitability.

ROA illustrates the historical records of a firm's actual financial performance. our findings indicate that market mechanisms, instead of political connectivity, are actually the factors that promote the firms' ROA. Therefore, these findings fail to support the perspectives of the local corporatism on the effects of the presence of the party members, civil servants and the military officials. In spite of this, the perspective of the local corporatism on the role of the connection to the local government officials is supported. Compared to the higher civil servant rank, the lower civil servant rank is more likely to benefit a firm's ROA. Although the market force grows increasingly, there are still a number of uncertainties resulting from the weak institutional environment such as ambiguous property rights and information vacuums (See Nee 1992). In this sense, SMEs, due to their fewer opportunities to get factor resources, need to depend on other mechanisms to gain those resources. One of these mechanisms is constructing or maintaining the connection to the government officials, particularly those working at lower government jurisdictions. The decentralization of control rights to the local governments enables them to manage the allocation of resources, which are only controlled by local government officials. This kind of privilege gives local government officials a "resources advantage" (Pfeffer and Salancik 1978). Therefore, the immoral connections, such as patron-client ties become a major method to allocate resources to the SMEs

If the effects of the political power on the firms' ROA can be viewed as the political influence on the companies' actual running, the effects of political power on the firm's market return, however, reflect the public perception of the effect of the political

connectivity. We might describe the latter as the impact of the legacy of socialist ideology on the economic confidence. The market return is strongly influenced by the investor's expectation for the listed firms. Or we can say that it is this kind of expectation that directs investors' choices. What is the most important consideration here is to find which institutions affect investors' expectations. This brings us to the nature of economic transition. According to Nee (2005), China's economic transition is promoted by the bottom-up force. The interaction between the informal rules and formal rules is important to understand the transition procedure. The formal rules followed the informal rules after the failure of the reform via the formal rules changes (Nee 2005). However, because the rise of informal rules are institutionalized *ex post*, rather than legitimized by the government before the reform, the public is confused concerning the concepts like "market economy" or the "capitalist economy." Further, although there is a consensus amongst scholars that China is an increasingly capitalist economy and it is true that local governments are creating a market-oriented environment for the development of China's capitalist economy (See Qian, Can and Weingast 1998), China's government has never officially claimed to be adopting capitalism. They usually use the expression such as "private economy should supplement the socialist economy of public ownership" (Dane, 2002), or introduce the ideology that developing the capitalist market are beneficial for the achievement of socialist lofty goals. This ambiguous attitude from the governments toward the development of capitalism and a capitalist economy in China caused the uncertainty amongst the public with relation to the capitalist market. Applying Keynes's idea of "animal spirit" to the sociological study on the collective response to uncertainty, Dimaggio (2002) suggests that due to the uncertainty and the risk, the choices of the public are irrational. This explanation can be applied here. The uncertainty facing the investors led them to dependence on the stereotype that firms with political connections usually have more advantages. In addition, the information vacuum is often deemed as a major problem for the development of China's economy (See Huang 1994). Especially for the public, correct information of the firm's practices and its financial performance is almost impossible to obtain. The uncertainty and risks

further make the public depend on the stereotype about the political connection for their investments.

Based on the above analysis, we can conclude that for the listed SMEs, market mechanisms are actually increasing and have positive effects on the firms' performance. However, because the SMEs, unlike large companies who can easily obtain useful resources, still need the political connections to the local governments which control several important resources such as license and contracting opportunities. The majority of the public lacks economic confidence in the capitalist economy due to the state's ambiguous attitudes to the development of capitalism in China. Therefore, the investors still respond to the uncertainty with the stereotype on the political power over the economic activities.

Moderating Effects of the Industry Concentration

The regression shows significant effects of industrial concentration. For the ROA, percentages of party memberships and civil servants continue exerting negative effects, while the marketing strategy of R&D have positive effects on a firm's ROA. This might indicate that even at less marketized industry, where perfectly competitive market are barely existent, the role of political power are gradually replaced by the rising market force. This kind of institutional change enforces firm employ market methods for a better performance at their daily operation.

On the market mechanism, only the R&D investment has a positive role on a firm's financial performance; while the advertising investment failed to show a beneficial role and the human capital has no significant effects. This can be explained by the industrial concentration in China's market. A variety of empirical studies shows a trend of increasing market concentration in the 1990s (See Chen and Lo 2002). During this time, large enterprises have successfully restructured themselves and are more competitive in the market (Chen and Lo 2002, p 436). In a highly concentrated market where the market share are largely owned by large enterprises, the strategy of investing in advertising for SMEs to win additional market share might only result in

financial losses. Instead, they might expand their market influence via R&D investment to achieve differentiation.

The rank of former or current government officials still plays an important role. The government officials from the lower government jurisdictions can bring more benefits for those listed SMEs. Compared to a highly marketized industry, SMEs in a low marketized industry have fewer opportunities to gain factor resources and therefore, with the connection to the local government officials, they are better able to keep stable in the marketplace.

Moreover, the industrial level results also support the argument that there is an increasing dependence of firms on the market mechanism for a better financial performance. For the stock market retrain, neither market mechanisms nor political connections have positive effects on a SME's market return. It might be that due to the lack of perfect information, investors often based investment decisions on the industrial concentration – large firms are more likely to gain more market shares and thus obtain a better financial performance.

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