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**Rent-seeking and firm value:  
Chinese evidence**

**Abstract:** We examine whether engagement in rent-seeking improves firm value in China. Rent-seeking is defined as a firm's use of resources to establish a relationship with the government to obtain government-controlled resources. We incorporate political rents and associated costs into an analytical framework to examine the relationship between rent-seeking and firm value. Using a sample of non-state-owned firms listed on the Shenzhen Stock Exchange and the Shanghai Stock Exchange from 2007 to 2013, we find evidence of the presence of political rents in the form of government subsidies and evidence of associated costs in the forms of corporate philanthropy and excess management remuneration, which largely explains the insignificant relationship found between rent-seeking and firm value. Our further analysis shows that rent-seeking behavior of firms reduces production efficiency, providing additional evidence to support our thesis that engagement in rent-seeking does not enhance firm value in the Chinese context. In an economy with weak institutions, in particular with weak protection for shareholders, managers and politicians can become rent-seekers and take a considerable share of the economic benefits derived from rent-seeking.

**Keywords:** rent-seeking, firm value, government subsidies, management payment, corporate giving

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# 1 Introduction

Rent-seeking is pervasive around the world.<sup>1</sup> In the context of political economies, rent-seeking is defined as a firm's attempt to garner artificial rents, contrived by the government, by spending its scarce resources to manipulate government policy.<sup>2</sup> In management literature, this concept refers to the search for resources and capabilities that facilitate firm development and implement value-enhancing strategies with the intention of gaining inflated economic returns.<sup>3</sup> This study examines the economic benefits and costs associated with rent-seeking and whether engagement in rent-seeking eventually leads to improved firm value in China. We define rent-seeking as a firm's use of resources to establish a relationship with the government to obtain government-controlled resources.

China is a good case for testing the effects of rent-seeking. The rent-seeking relationship between governments and businesses in China is institutionally rooted.<sup>4</sup> Despite more than three decades of transformation from a centrally planned economy to a market-oriented economy, institutions in China are still underdeveloped. Political power still reflects the monopolized control of public property, and the Chinese government retains tight control over scarce resources.<sup>5</sup> China's institutional setting has determined the prevalence and importance of rent-seeking in obtaining political rents. More importantly, although rent-seeking has been acknowledged as posing ethical challenges for businesses, especially those in less developed economies, it is often justified in the name of economic efficiency.<sup>6</sup> Indeed, the existing literature shows that rent-seeking and corruption are contributing to China's fast economic growth by supporting a "grease the wheels" view which contends that rent-seeking and corruption may help compensate for poor governance.<sup>7</sup> As such, an examination of the interaction between governments and firms through rent-seeking in emerging economies is imperative for the literature on ethics and political economies. This study sheds light on this important ethical issue from an economic perspective and challenges the widely held belief that corruption and rent-seeking have positive impacts on China's economic growth. Furthermore, China offers a useful empirical case, because it is broadly representative and systemically important in the global

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1 Khwaja and Mian (2005).

2 Tollison (1982).

3 Bowman (1973).

4 Su and Littlefield (2001).

5 Ibid.

6 Lui (1996); Tullock (1996).

7 Jiang and Nie (2014); Wang and You (2012).

market. As the largest emerging economy, it plays an increasingly important role in the global economy and attracts a growing number of investors worldwide. Given the prevalence and importance of rent-seeking in firm operations in China, the engagement of Chinese firms in rent-seeking has a significant impact on both local and international investors. More broadly, insights from Chinese evidence are enlightening for other emerging economies where rent-seeking is also prevalent, such as in Malaysia,<sup>8</sup> Brazil,<sup>9</sup> Pakistan,<sup>10</sup> and Indonesia.<sup>11</sup>

Rent-seeking behavior by firms and its economic consequences have been the subject of extensive research. Political connections are a major form of rent-seeking, and some studies have documented that this form of rent-seeking results in premiums to firm value.<sup>12</sup> Wang,<sup>13</sup> for instance, indicates that politically connected polluters, defined as firms with at least one board member who was a former local bureaucrat, were less susceptible to pollution shock. Other studies, however, suggest that engagement in rent-seeking may be detrimental to financial performance. For example, Fan et al.<sup>14</sup> find that firms with politically connected CEOs underperform compared to those without politically connected CEOs. Khwaja and Mian<sup>15</sup> show that politically connected firms experience higher default rates although they are able to borrow more from government banks. This inconsistency in the extant literature shows the complexity of the relationship between rent-seeking and firm value.

Moreover, extant research has largely concentrated on the benefits derived from rent-seeking, with little attention given to its associated costs. Previous studies have demonstrated that preferential access to finance is a widely used channel for converting rent-seeking behavior into a value premium.<sup>16</sup> Faccio<sup>17</sup> introduced the concept of the cost of rent-seeking, arguing that the impact of political connections on firm value depends on both the marginal benefits and the cost of political connections. Nevertheless, there is scant empirical evidence of the costs associated with rent-seeking behavior.

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**8** Johnson and Mitton (2003).

**9** Claessens et al. (2008).

**10** Khwaja and Mian (2005).

**11** Fisman (2001).

**12** Cingano and Pinotti (2013); Claessens et al. (2008); Faccio (2006); Fisman (2001); Feng et al. (2014); Johnson and Mitton (2003); Wang (2015).

**13** Wang (2015).

**14** Fan et al. (2007).

**15** Khwaja and Mian (2005).

**16** Charumilind et al. (2006); Claessens et al. (2008); Dinç (2005); Guo et al. (2014); Khwaja and Mian (2005).

**17** Faccio (2006).

This study, which focuses on private firms in China, incorporates both the economic gains and the costs associated with rent-seeking in order to examine whether a firm's rent-seeking activities enhance its value. We address two fundamental questions of political economy that highlight the relationship between rent-seeking and firm value: (1) Does engagement in rent-seeking imply political rents? and (2) If firms are able to obtain political rents through rent-seeking, must they incur costs? In this paper, we present an analysis of the interaction of regulators, firms, and managers within a rent-seeking framework. Within this framework, each group has its own interests, and these interests are not necessarily aligned with one another. Using a sample of listed firms from the Shenzhen Stock Exchange and the Shanghai Stock Exchange between 2007 and 2013, we find evidence of the presence of political rents in the form of government subsidies and evidence of associated costs in the form of corporate philanthropy and excessive management remuneration, which largely explains the insignificant relationship between rent-seeking and firm value. Further analysis reveals that rent-seeking behavior reduces production efficiency, which provides additional evidence to support our thesis that engagement in rent-seeking does not enhance firm value in the Chinese context.

This paper contributes to the literature in the following ways. First, this research provides theoretical contributions to the business and political economy literature. Compared to the majority of previous studies, this study takes a different approach to exploring what constitutes rent-seeking in the corporate context. A detailed explanation of this approach is provided in our discussion concerning the methodological innovations of the study. Additionally, while existing literature predominantly uses political connections to capture rent-seeking,<sup>18</sup> we define rent-seeking as a firm's use of resources to socialize with politicians for the purpose of obtaining government-controlled resources. Thus, this study expands the definition of rent-seeking in the business literature and enriches our understanding of rent-seeking activities in the corporate context. Furthermore, conventional wisdom suggests that corporations are incentivized to engage in rent-seeking behavior because of various forms of associated value such as preferential access to finance,<sup>19</sup> less taxation,<sup>20</sup> and regulatory benefits like looser regulatory oversight for themselves or stiffer oversight for their

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**18** Claessens et al. (2008); Feng et al. (2014); Guo et al. (2014); Khwaja and Mian (2005); Wang (2015).

**19** Charumilind et al. (2006); Claessens et al. (2008); Dinç (2005); Guo et al. (2014); Khwaja and Mian (2005).

**20** De Soto (1989).

rivals.<sup>21</sup> This study challenges the conventional view that rent-seeking ought to be tolerated in the name of economic efficiency. Our analysis shows that rent-seeking may lead to sub-optimal production because the capital used for rent-seeking activities, such as payoffs and entertaining politicians, might be otherwise spent on more productive ends. Further, although engagement in rent-seeking may help a firm gain economic benefits, such as government-controlled resources, in weakly institutionalized environments, those benefits must be shared by powerful players, including management and politicians. Drawing on the literature that examines the economic gains associated with political connections<sup>22</sup> and Faccio's<sup>23</sup> notions on the cost of political connections, our theoretical framework integrates the economic benefits of rent-seeking with its associated costs to determine the relationship between rent-seeking and firm value. In addition to examining economic gains, we also investigate whether rent-seeking and its associated economic gains drive costs. This study, thus, extends the literature that focuses on the economic gains associated with rent-seeking.<sup>24</sup> We find that rent-seeking increases firms' access to government-controlled resources. We also find that rent-seeking and the acquisition of political rents can generate new costs, such as corporate donations and excessive management compensation. These results show that in an economy with weak institutions, and with weak protection for shareholders in particular, managers and politicians can become rent seekers and obtain a considerable share of the economic benefits derived from rent-seeking. As such, our theoretical framework, which incorporates both economic gains and costs, enables a richer understanding of the effects of rent-seeking. Additionally, by providing evidence of economic costs at the firm level, this study complements the literature that concentrates on the economy-wide costs of rent-seeking.<sup>25</sup>

Second, we identify government subsidies as an important channel for rent-seeking activities in China and, thus, we extend the literature that focuses on access to bank finance. With the commercialization of the banking sector in China over the past three decades, Chinese state-owned banks have undergone a remarkable privatization program and have become increasingly oriented toward profit.<sup>26</sup> As a result, government subsidies have become better instruments

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**21** Ibid.

**22** Claessens et al. (2008); Guo et al. (2014); Johnson and Mitton (2003); Khwaja and Mian (2005).

**23** Faccio (2006).

**24** Claessens et al. (2008); De Soto (1989); Dinç (2005); Guo et al. (2014); Khwaja and Mian (2005).

**25** Claessens et al. (2008); Khwaja and Mian (2005).

**26** Lin and Zhang (2009).

for capturing the economic consequences of rent-seeking than bank finance given the importance of subsidies to private firms and the degree of government discretion in their distribution. Nevertheless, research on how rent-seeking affects government allocation of subsidies is limited.<sup>27</sup> Johnson and Mitton<sup>28</sup> are only able to report anecdotal evidence that well-connected firms receive greater government subsidies, because of the difficulties in measuring the distribution of subsidies among firms.

Third, this study includes methodological innovations. An indicator of the level of rent-seeking that is explored to improve the measurement of rent-seeking activities. Previous studies have often used political connections as proxies for rent-seeking.<sup>29</sup> In studies conducted in the Chinese context, political connections (or participation) are defined in terms of whether any controlling shareholders or senior managers are members of either the Chinese Communist Party<sup>30</sup> or various other influential government institutions.<sup>31</sup> We argue that such political connections are only one way to facilitate rent-seeking. The majority of firms do not have such privileged connections, yet they still actively engage in rent-seeking. Indeed, in China, a more commonly used and effective method of building links with politicians is to socialize with them in a variety of entertainment activities. Yet, few previous studies have attempted to measure such important and widespread rent-seeking behavior. In this study, we develop direct and objective measures for rent-seeking activities based on the accounting information that largely captures the types of expenditure used to cultivate relationships between firms and politicians in China's context. This data set enabled us to measure the intensity of rent-seeking rather than simply indicating the presence of a certain type of political connection, such as membership in the ruling party or other government institutions, as has been used in prior research.<sup>32</sup>

The remainder of the paper is structured as follows. Section 2 presents the institutional background of private business in China and develops the hypotheses. Section 3 lays out the methodology used. Section 4 discusses the results and robustness checks. Section 5 presents the conclusions.

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**27** Guo et al. (2014).

**28** Johnson and Mitton (2003).

**29** Claessens et al. (2008); Khwaja and Mian (2005).

**30** Guo et al. (2014).

**31** Feng et al. (2014).

**32** Ibid.; Guo et al. (2014).

## 2 Institutional background and hypotheses development

### Private Chinese firms

The tendency for private Chinese firms to engage in rent-seeking is essentially determined by the institutional context in which they have evolved. Following the formation of the People's Republic of China in 1949, the Chinese government completely banned private business for nearly three decades under its centrally planned economy.<sup>33</sup> The state restored the legitimacy of private business in the Third Plenum of the Communist Party's Eleventh Central Committee in 1978. After more than three decades of rapid growth, private businesses now contribute to almost all job growth; they account for more than two-thirds of output and are the leading drivers of export growth.<sup>34</sup> Unsurprisingly, Chinese capital markets have also experienced a fundamental shift from the dominance of state ownership to an increase in private ownership. For example, the proportion of privately controlled firms on the Shanghai and Shenzhen stock exchanges climbed from 27 percent in 2000 to 79 percent in 2010.<sup>35</sup>

Yet, despite their increasing importance in the national economy, private businesses continually suffer various institutional difficulties. First, private firms endure ideological discrimination; the overall political atmosphere remains antagonistic toward them.<sup>36</sup> Because they are perceived to represent an inferior form of ownership from an ideological point of view, private firms often encounter hostility and prejudice from bureaucratic officials and the general public<sup>37</sup> and are frequently subject to arbitrary harassment by bureaucrats.<sup>38</sup> Second, private enterprises are constrained by an unfavorable economic environment. Compared to their state-owned counterparts, private firms are in a disadvantageous position with regard to obtaining government subsidies, bank loans, tax benefits, and other key resources.<sup>39</sup> Continuing ideological discrimination and the unfavorable economic environment have largely driven private businesses to use rent-seeking

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<sup>33</sup> Li et al. (2006).

<sup>34</sup> *Financial Times*, 15 September 2014, "China's Rise is a Credit to Private Enterprise not State Control," (Accessed 16 October 2015) <http://www.ft.com/intl/cms/s/0/b14e3d58-38f6-11e4-a53b-00144feabdc0.html#axzz3cLFdflh>.

<sup>35</sup> Conyon and He (2012).

<sup>36</sup> Li et al. (2008).

<sup>37</sup> Li et al. (2006).

<sup>38</sup> Pearson (1997).

<sup>39</sup> Brandt and Li (2003); Che (2002); Firth et al. (2009); Lee et al. (2014).

to gain political legitimacy and government-controlled resources, such as government subsidies.

## Hypotheses development

The economics literature has documented a range of economic benefits obtained by firms that engage in rent-seeking. For example, previous studies have shown that political connections are associated with government bailouts in multiple countries,<sup>40</sup> government subsidies in Malaysia,<sup>41</sup> and access to bank finance in Brazil<sup>42</sup> and Pakistan.<sup>43</sup> Studies conducted in China find that private firms with political connections enjoy preferential treatment when accessing bank loans.<sup>44</sup> Following this line of research, we argue that private Chinese firms that engage in rent-seeking are more likely to receive government-controlled resources. Thus, we state our first hypothesis:

*Hypothesis 1: Firm rent-seeking positively impacts access to government-controlled resources.*

Agency theorists argue that managers motivated by self-interest may act at the expense of shareholders because of the separation of ownership and control.<sup>45</sup> The agency costs associated with rent-seeking have long been recognized and recorded by theoretical work on political economy. Edlin and Stiglitz,<sup>46</sup> for instance, argue that the well-established scope for managerial discretion affords managers the opportunity to obtain rents. Politically connected managers will themselves extract at least some of the rents generated by political connections from the companies they manage.<sup>47</sup>

Strong corporate governance and an effective legal system, in particular, are crucial for protecting shareholders from expropriation by managers.<sup>48</sup> Despite the attempts of the Chinese government to improve corporate governance by adopting the Anglo-American model of a corporate-governance system, the implementation of internationally accepted corporate governance principles is largely symbolic.<sup>49</sup> Furthermore, China's legal system is much younger and less

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<sup>40</sup> Faccio et al. (2006).

<sup>41</sup> Johnson and Mitton (2003).

<sup>42</sup> Claessens et al. (2008).

<sup>43</sup> Khwaja and Mian (2005).

<sup>44</sup> Guo et al. (2014).

<sup>45</sup> Jensen and Meckling (1976).

<sup>46</sup> Edlin and Stiglitz (1995).

<sup>47</sup> De Soto (1989); Faccio (2006); Shleifer and Vishny (1994).

<sup>48</sup> La Porta et al. (2000).

<sup>49</sup> Wu and Patel (2015).



developed than in advanced economies,<sup>50</sup> and it offers little protection to shareholders.<sup>51</sup> Given China's weak corporate governance and its legal system, managers have a strong incentive to grab a share of political rents by increasing their own remuneration following the acquisition of government-controlled resources. This leads to our second hypothesis:

*Hypothesis 2: Firm rent-seeking increases management remuneration through the use of government-controlled resources.*

In addition to managers, regulators also extract rents from rent-seeking firms. Regulators are not necessarily altruistic, and rent setters are themselves rent seekers.<sup>52</sup> Rent-seeking is competitive.<sup>53</sup> A competitive rent-seeking market is likely to offer opportunities for regulators to seek rents from firms in return for their services. Indeed, economics literature suggests that regulators benefit from an increase in the number of firms seeking rent.<sup>54</sup> Competition between rent-seeking firms for government-controlled resources is especially fierce in China because of its weak institutions and the discretion the Chinese government holds in allocating the resources under its control. As such, Chinese politicians are strongly motivated to seek rents from businesses.

Corporate donations can be an ideal and legitimate form of rents sought by politicians. While businesses tend to make use of rent-seeking to obtain political legitimacy along with government-controlled resources, the reciprocity principle in social relationships suggests that the government also places expectations on those businesses.<sup>55</sup> Corporate philanthropy is an ideal way for firms to reciprocate government support. Indeed, corporate donations are especially appreciated by Chinese authorities because the government does not have sufficient resources to engage in community and social-welfare projects, and therefore they largely rely on corporate contributions to alleviate resource shortages.<sup>56</sup> Anecdotal evidence suggests that the government often explicitly expects firms to donate to specific charitable activities. Following the Sichuan earthquake in 2008, the Chinese government explicitly called on firms to engage in disaster relief.<sup>57</sup>

Rent-seeking firms are also more likely to participate in government-proposed social and charitable activities and endeavor to fulfill donation expectations,

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**50** Allen et al. (2005); Cai (2007).

**51** Zou et al. (2008).

**52** Appelbaum and Katz (1987); Peltzman (1976).

**53** Krueger (1974).

**54** Appelbaum and Katz (1987).

**55** Aronson et al. (2005).

**56** Dickson (2003).

**57** Jia and Zhang (2011).

because they receive more government-controlled resources. Overall, the above discussion suggests that rent-seeking firms are more obliged and motivated to assist governments in attaining their political and social goals through contributions. Therefore, our third hypothesis follows:

*Hypothesis 3: Firm rent-seeking increases corporate donations through the use of government-controlled resources.*

Although empirical research about the economic consequences of rent-seeking through political connections largely suggests that rent-seeking adds to a firm's value,<sup>58</sup> Faccio<sup>59</sup> has documented that there is no significant price effect as a result of appointing politicians to corporate boards. Faccio<sup>60</sup> further points out that, in equilibrium, the cost of political connections may offset benefits and corporate value is enhanced only when the marginal benefits of political connections outweigh their marginal costs.

In the Chinese context, while engagement in rent-seeking facilitates the acquisition of government-controlled resources, firms also incur various costs associated with rent-seeking. Regulators and managers, who are among the most important players in rent-seeking, are in a position to extract rents generated by a firm's rent-seeking activities. As a result, we suspect that an engagement in rent-seeking by firms may not necessarily increase firm value.

Given the ambiguity associated with the relationship between rent-seeking and firm value, we developed two alternative hypotheses. The first follows conventional wisdom on rent-seeking, arguing that it enhances firm value by facilitating firm access to government-controlled resources as follows:

*Hypothesis 4a: Firm engagement in rent-seeking improves firm value through government-controlled resources.*

The second hypothesis takes the various costs associated with rent-seeking into account.

*Hypothesis 4b: Firm engagement in rent-seeking does not improve firm value although it increases government-controlled resources.*

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**58** Cingano and Pinotti (2013); Claessens et al. (2008); Slinko et al. (2005).

**59** Faccio (2006).

**60** Ibid.

### 3 Research method

#### Sample

Our initial study sample consisted of all private firms listed on the Shenzhen and Shanghai stock exchanges between 2007 and 2013. We removed firms with the following characteristics: firms in the year of their initial public offering (IPO), firms in the financial industry, firms with missing data or special treatment (ST), and firms that had experienced losses over two consecutive years. IPO firms were removed because these firms are likely to engage in earnings management around the IPO launch period.<sup>61</sup> Firms in the financial industry were removed because this industry is subject to different accounting regulations. ST firms are financially distressed firms facing the risk of delisting and are therefore motivated to manage their earnings.<sup>62</sup> The final study sample consisted of 1,544 firms. All continuous variables were winsorized of the top and bottom 1 percent to control for the effect of outliers. Financial data were obtained from the widely used CSMAR databases for the study of Chinese-listed firms,<sup>63</sup> and data related to rent-seeking and corporate donations were manually collected from publicly available financial reports.

#### Models and measures

After controlling for documented factors known to affect the dependent variables under investigation, we used the following regressions to test our hypotheses. First, we used model 1 to test hypothesis 1, which examines whether a firm's engagement in rent-seeking facilitates its access to government-controlled resources. We also examined whether a firm's rent-seeking behavior drives management remuneration (hypothesis 2) and corporate donations (hypothesis 3) by following the receipt of government-controlled resources using models 2 and 3, respectively. Finally, to address the two alternative hypotheses (hypotheses 4a and 4b), we ascertained whether firm rent-seeking behavior enhances firm value through government subsidies using model 4.

$$(1) \quad \text{Resource}_{it} = \beta_0 + \beta_1 \text{Rent-seeking}_{it} + \beta \text{Control} + \sum \text{INDUSTRY} \\ + \sum \text{YEAR} + \varepsilon$$

<sup>61</sup> Kao et al. (2009).

<sup>62</sup> Liu and Lu (2007).

<sup>63</sup> Li et al. (2015); Wang and Qian (2011).

$$(2) \quad \text{Overpay}_{it} = \beta_0 + \beta_1 \text{Resource}_{it} + \beta_2 \text{Rent-seeking}_{it} \times \text{Resource}_{it} \\ + \beta_3 \text{Rent-seeking}_{it} + \beta \text{Control} + \sum \text{INDUSTRY} \\ + \sum \text{YEAR} + \varepsilon$$

$$(3) \quad \text{Donation}_{it} = \beta_0 + \beta_1 \text{Resource}_{it} + \beta_2 \text{Rent-seeking}_{it} \times \text{Resource}_{it} \\ + \beta_3 \text{Rent-seeking}_{it} + \beta \text{Control} + \sum \text{INDUSTRY} \\ + \sum \text{YEAR} + \varepsilon$$

$$(4) \quad \text{Tobin's } Q_{it} = \beta_0 + \beta_1 \text{Resource}_{it} + \beta_2 \text{Rent-seeking}_{it} \times \text{Resource}_{it} \\ + \beta_3 \text{Rent-seeking}_{it} + \beta \text{Control} + \sum \text{INDUSTRY} \\ + \sum \text{YEAR} + \varepsilon$$

In these models, rent-seeking indicates the level of a firm's engagement in rent-seeking activities. We used two measures to assess each firm's rent-seeking behavior: excess general and administrative expenses (Rent-seeking1) and entertainment expenses (Rent-seeking2). In line with previous studies,<sup>64</sup> excess general and administrative expenses are operationalized as the difference between actual and expected administrative expenses and are estimated using model 5:

$$(5) \quad \text{Rent-seeking } 1_{it} = y_0 + y_1 \text{LN(Sale)}_{it} + y_2 \text{Leverage}_{it} + y_3 \text{Growth}_{it} + y_4 \text{Board} \\ \text{Size}_{it} + y_5 \text{Staff}_{it} + y_6 \text{Auditor}_{it} + y_7 \text{Firm Age}_{it} \\ + y_8 \text{Wages}_{it} + y_9 \text{Herfindahl Index}_{it} + y_{10} \text{Margin}_{it} \\ + y_{11} \text{Capital Intensity}_{it} \sum \text{INDUSTRY} \\ + \sum \text{YEAR} + \varepsilon$$

where LN(Sale) is the natural logarithm of sales in the prior period; Leverage is measured as the total debt divided by the total assets; Growth is computed as the percentage growth in operating income; Board Size is the number of directors on the board; Staff indicates the total number of employees; Auditor is a dummy variable that takes a value of 1 if the firm's auditor is one of the Big 4 accounting

**64** Du et al. (2010); Huang and Li (2013); Wei et al. (2015).

firms and 0 otherwise; Firm Age is measured as the years elapsed since the firm was founded; Wages is operationalized as the average employee wage; the Herfindahl Index indicates the ownership concentration, calculated as the sum of squares of equity share of the top five shareholders; Margin is measured as gross margin; Capital Intensity is operationally defined as fixed assets over total assets; INDUSTRY is a dummy variable that equals 1 if the firm falls within that industry and 0 otherwise; and YEAR is a dummy variable that equals 1 if the firm falls within that year and 0 otherwise.

In light of the extant literature,<sup>65</sup> we used entertainment expenses to capture the firms' engagement in rent-seeking. Entertainment expenses are a standard and significant expenditure item in Chinese firms. These expenses, on average, amount to approximately 3 percent of a firm's total added value with a considerable portion being used to cultivate relationships with government and politicians.<sup>66</sup> Rent-seeking through political power in China is often synonymous with a "wine and meat relationship."<sup>67</sup> Rent-seeking<sub>2</sub> was calculated as entertainment expenses  $\times$  100/operating income."

Resources were calculated as government subsidies  $\times$  100/operating income. Government subsidies in China take various forms including direct appropriations, tax refunds, compensation for interest expenses, and free non-monetary assets. Government subsidies are a major source of the external funding for Chinese firms. Chen et al.<sup>68</sup> report that government subsidies account for 12.27 percent of the net income received by Chinese listed firms. The total amount of government subsidies provided to listed firms in 2013 alone was more than RMB 100 billion (approximately U.S. \$16 billion).<sup>69</sup>

Excessive management payments, denoted as Overpay, were estimated using the following models. First, we used model 6 to calculate the expected management payment. The excessive management payment was then operationalized using model 7 as the difference between the expected payments and the actual payments.

$$(6) \quad \text{Ln(Expectedpay)}_{it} = \beta_0 + \beta_1 \text{Firm Size}_{it} + \beta_2 \text{ROA}_{it} + \beta_3 \text{Intangible}_{it} \\ + \beta_4 \text{Zone}_{it} + \sum \text{INDUSTRY} + \sum \text{YEAR} + \varepsilon$$

<sup>65</sup> Cai et al. (2011); Su and Littlefield (2001).

<sup>66</sup> Cai et al. (2011).

<sup>67</sup> Su and Littlefield (2001).

<sup>68</sup> Chen et al. (2008).

<sup>69</sup> Wei et al. (2015).

$$(7) \quad \text{Overpay}_{it} = \text{Ln}(\text{Wage})_{it} - \text{Ln}(\text{Expectedpay})_{it}$$

where,  $\text{Ln}(\text{Wage})$  is the natural logarithm of the sum of the remuneration of the top three highest-paid executives; Firm Size is measured as the natural logarithm of a firm's total assets; Return on assets (ROA) is computed as net profit over total assets; Intangible assets is computed as the ratio of intangible assets over total assets; Zone is a dummy variable for the region in which the firm is located; and INDUSTRY and YEAR are as previously defined.

Corporate donations, denoted as Donation, capture a firm's philanthropic contributions and were measured as corporate donations  $\times$  100/operating income, in line with previous research.<sup>70</sup>

Tobin's Q was used as a proxy for firm value, calculated as a firm's market value relative to its book value.

The control variables include: Cash, measured as cash over total assets; Largest Shareholder, operationalized as the shareholding of the largest shareholder; gross domestic product (GDP), operationalized as GDP per capita of the province in which the firm is located; and Duality, a dummy variable that equals 1 if the roles of chairperson and CEO are held by the same individual and 0 otherwise. Firm Size, ROA, Leverage, Growth, Firm Age, INDUSTRY, and YEAR are as previously defined.

## 4 Results

### Descriptive statistics

Table 1 provides the descriptive statistics of the variables and shows that the standard deviation of resources was 1.892 with the maximum proportion of subsidies accounting for 11.565 percent of the operating income. The minimum proportion was 0.003 percent, which suggests a wide variation in the government subsidies received across the firms. On average, the sampled firms spent 0.351 percent of their operating income on entertainment. Corporate donations amounted to 0.075 percent of operating income. With regard to the other variables, the standard deviation of firm size was 0.983, suggesting a considerably varied firm size. Average cash on hand accounted for 22.4 percent of total assets and leverage was 0.437, suggesting a relatively healthy liquidity and moderate level of debt. The shareholding of the largest shareholder was 32.4 percent, which is an indication of the dominant position taken by the largest shareholder.

<sup>70</sup> Li et al. (2015).

**Table 1:** Descriptive Statistics.

<b>Panel A: Main variables</b>						
<b>Variable</b>	<b>N</b>	<b>Mean</b>	<b>Standard Deviation</b>	<b>Minimum</b>	<b>Median</b>	<b>Maximum</b>
Resource	1544	1.297	1.892	0.003	0.652	11.565
Rent-seeking1	1544	0.019	0.436	-1.145	0.027	1.230
Rent-seeking2	1544	0.351	0.416	0.018	0.227	3.124
Efficiency	1517	0.621	0.156	0.072	0.650	1
Donation	1256	0.075	0.252	0	0.020	5.016
Tobin's Q	1544	2.049	1.120	0.841	1.685	6.942
Firm Size	1544	21.673	0.983	19.027	21.584	25.133
Cash	1544	0.224	0.161	0.003	0.179	0.815
ROA	1544	0.042	0.055	-0.273	0.038	0.193
Leverage	1544	0.437	0.201	0.048	0.440	0.966
Largest Shareholder	1544	0.324	0.144	0.079	0.301	0.714
Growth	1544	0.474	1.618	-0.919	0.148	16.823
GDP	1544	5.129	1.804	1.312	5.296	8.817
Firm Age	1544	8.793	5.122	3.003	7.167	23.049

<b>Panel B: A comparison of rent-seeking activities between politically-connected and non-politically-connected firms</b>				
	<b>Rent-seeking1</b>		<b>Rent-seeking2</b>	
	<b>Mean</b>	<b>Standard Deviation</b>	<b>Mean</b>	<b>Standard Deviation</b>
Non-politically-connected firms	0.016	0.442	0.360	0.449
Politically-connected firms	0.022	0.432	0.344	0.389
Difference in means		-0.006		0.016
T value		-0.311		0.758
p value		0.756		0.448

Another aim was to ascertain whether investment in socializing with government officials serves as a substitute for, or complements, formal political connections. To answer this question, we divided our sample into firms with formal political connections and those without formal connections and compared their rent-seeking activities. A firm was considered to have formal political connections if its CEO held a position in the People's Congress or in the Chinese People's Political Consultative Conference. As noted in Panel B, there were no significant differences in entertainment expenses between the two groups ( $T = -0.311$  for Rent-seeking1;  $T = 0.758$  for Rent-seeking2). The results show that private Chinese firms invest in socializing with government officials regardless of their formal political connections. For firms without formal connections, socializing is used to establish connections. For firms with formal political connections, socializing serves to complement and strengthen their connections. Collectively, these results suggest the importance and prevalence of socializing with bureaucrats as a rent-seeking strategy in China.

In addition, these results provide justification for the approach to measuring rent-seeking adopted in this study. Our evidence suggests that whether or not private Chinese firms possess formal political connections, they all consider socializing with politicians important in either establishing or strengthening their relationship with the government. While formal connections can be used to garner overt forms of rent-seeking, our measures are appropriate for capturing those covert, but more widespread, forms of rent-seeking.

## Regression analyses

Fixed-effect models were used to conduct panel analysis. We also followed Driscoll and Kraay's<sup>71</sup> approach for adjusting standard errors to address issues associated with autocorrelation and heteroscedasticity.

Hypothesis 1 predicts that engagement in rent-seeking by firms facilitates their access to government-controlled resources. Table 2 reports a regression test on the relationship between rent-seeking and government subsidies, which shows that, for both measures of rent-seeking, government subsidies are positively and significantly related to the level of rent-seeking activities ( $p < 0.01$  for Rent-seeking1 and  $p < 0.05$  for Rent-seeking2). Furthermore, two standardized coefficients resulting from the regression analysis also indicate the significant effect of rent-seeking activities on government subsidies. Specifically, our results suggest that an increase of one standard deviation in rent-seeking expenditure (measured by Rent-seeking1) leads to an increase of 0.32 standard deviations in the government subsidies obtained ( $0.32 =$

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71 Driscoll and Kraay (1998).



**Table 2:** Rent-Seeking and Government Subsidies.

Variable	(1) Resource	(2) Resource
Rent-seeking1	1.395*** (6.23)	
Rent-seeking2		1.067** (2.54)
Firm Size	0.017 (0.25)	0.137 (1.40)
Cash	-0.248 (-1.40)	-0.662*** (-3.68)
ROA	3.703*** (5.64)	0.205 (0.56)
Leverage	-0.619*** (-3.48)	-0.865*** (-3.15)
Largest Shareholder	-0.760 (-1.07)	-1.277 (-1.48)
Growth	0.021* (1.69)	-0.004 (-0.68)
GDP	0.035 (0.23)	0.094 (0.55)
Firm Age	0.210*** (2.89)	-0.069 (-0.38)
INDUSTRY	controlled	controlled
YEAR	controlled	controlled
N	1544	1544
R <sup>2</sup>	0.120	0.084
P	0.000	0.000

The T values are reported in parentheses; the other figures are regression coefficients.

\* $p < 0.1$ , \*\* $p < 0.05$ , \*\*\* $p < 0.01$

$1.395 \times 0.4362523 / 1.891663$ ). Similarly, an increase of one standard deviation in rent-seeking expenditure (measured by Rent-seeking2) leads to an increase of 0.23 standard deviations in the government subsidies obtained ( $0.23 = 1.067 \times 0.4155485 / 1.891663$ ). These results suggest that rent-seeking improves a firm's relationship with the government and thus facilitates the acquisition of government-controlled resources in the Chinese context. Therefore, hypothesis 1 is supported. Our results are consistent with previous literature, which has demonstrated that rent-seeking behavior gives preferential access to government-controlled resources.<sup>72</sup>

<sup>72</sup> Charumilind et al. (2006); Claessens et al. (2008); Dinç (2005); Guo et al. (2014); Khwaja and Mian (2005).

Hypothesis 2 predicts that a firm's engagement in rent-seeking gives rise to an increase in payments to senior managers through the use of government-controlled resources. We added CEO duality to our model to control for the effect of variation in management power. Table 3 provides a regression analysis on how these payments to managers are associated with firm rent-seeking and government-controlled resources. The first two models do not include the interaction terms for rent-seeking and resources. The results show that excessive management payments are negatively related to rent-seeking activities ( $p < 0.01$  for Rent-seeking1 and  $p < 0.10$  for Rent-seeking2). The interaction terms were then added into models 3 and 4. As noted in table 3, the coefficient of both interaction terms is positive and significant ( $p < 0.01$  for Rent-seeking1  $\times$  Resource and  $p < 0.10$  Rent-seeking2  $\times$  Resource; the marginal effects of rent-seeking on excessive management remuneration are shown in figure 1). These results are consistent with our expectation that self-interested managers will use their power to receive a share of the economic benefits obtained from the government in the context of a weak corporate governance system.

Hypothesis 3 postulates that corporate donations are driven by engagement in rent-seeking through obtaining government-controlled resources. The results of the regression analysis are reported in table 4. Models 1 and 2 do not include the interaction terms for rent-seeking and resources. As noted in table 4, corporate donations are positively related to rent-seeking activities ( $p < 0.01$  for both Rent-seeking1 and Rent-seeking2). Furthermore, the regression results from models 3 and 4 show that the coefficient for both interaction terms are positive and significant ( $p < 0.10$  for Rent-seeking1  $\times$  Resource and  $p < 0.05$  for Rent-seeking2  $\times$  Resource; the marginal effects of rent-seeking on corporate donations are shown in figure 2). Collectively, our results suggest that rent-seeking has a positive effect on corporate donations and that obtaining government subsidies further drives corporate donations. These findings support our prediction that a portion of the government-controlled resources obtained by firms will flow back to regulators in the form of corporate donations. Our findings supplement those of Li et al. (2015),<sup>73</sup> who have documented that politically connected firms are more likely to participate in philanthropy and contribute more than their peers with no political connections.

Overall, our results suggest that rent-seeking is costly. Although socializing with bureaucrats helps firms obtain government-controlled resources, acquiring those resources subsequently drives increases in excessive management payments and corporate donations.

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73 Li et al. (2015).

**Table 3: Rent-Seeking, Government Subsidies, and Excessive Management Remuneration.**

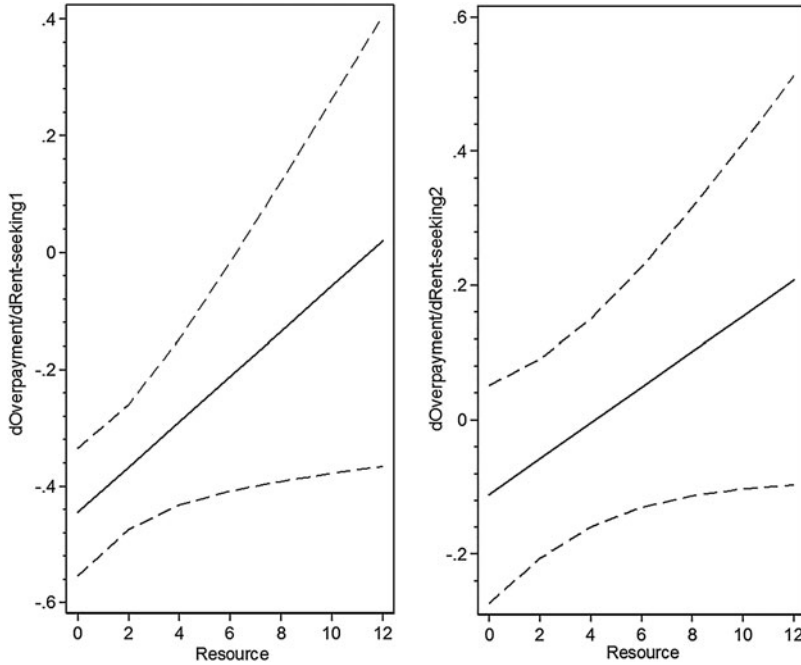
Variable	(1) Overpay	(2) Overpay	(3) Overpay	(4) Overpay
Rent-seeking1	-0.376*** (-8.23)		-0.445*** (-9.74)	
Rent-seeking2		-0.043* (-1.70)		-0.111*** (-2.99)
Resource			0.007** (2.17)	-0.012 (-1.15)
Rent-seeking1 × Resource			0.039*** (6.70)	
Rent-seeking2 × Resource				0.027* (1.83)
Firm Size	0.176*** (5.40)	0.158*** (5.03)	0.187*** (6.47)	0.162*** (5.83)
ROA	-1.148*** (-14.89)	0.011 (0.07)	-1.231*** (-17.89)	-0.048 (-0.31)
Cash	0.454*** (8.89)	0.538*** (10.83)	0.448*** (8.33)	0.531*** (9.61)
Leverage	0.701*** (6.62)	0.793*** (6.76)	0.689*** (5.95)	0.789*** (6.51)
Largest Shareholder	-0.040 (-0.33)	0.055 (0.65)	-0.017 (-0.17)	0.011 (0.11)
Growth	0.030*** (7.62)	0.037*** (9.04)	0.030*** (8.23)	0.038*** (10.34)
GDP	0.203*** (9.95)	0.177*** (10.30)	0.197*** (9.25)	0.176*** (9.60)
CEO Duality	-0.005 (-0.24)	-0.013 (-0.52)	0.000 (0.01)	-0.015 (-0.58)
Firm Age	-0.444*** (-4.44)	-0.411*** (-4.30)	-0.472*** (-5.07)	-0.425*** (-4.98)

(Table 3: Continued)

Variable	(1) Overpay	(2) Overpay	(3) Overpay	(4) Overpay
INDUSTRY	controlled	controlled	controlled	controlled
YEAR	controlled	controlled	controlled	controlled
N	1533	1533	1533	1533
R <sup>2</sup>	0.209	0.158	0.218	0.162
P	0.000	0.000	0.000	0.000

The T values are reported in parentheses; the other figures are regression coefficients.

\* $p < 0.1$ , \*\* $p < 0.05$ , \*\*\* $p < 0.01$



**Figure 1:** The marginal effect of rent-seeking on excessive management remuneration with 95% CIs.

To ascertain whether a firm's rent-seeking behavior enhances firm value by facilitating access to government-controlled resources, we used two-year and three-year lagged Tobin's Qs to determine the time required to transform access into resources and resources into increases in firm value. The results reported in table 5 show that the coefficient of the interaction term for models 1 and 2 is insignificant, which suggests that a firm's engagement in rent-seeking behavior does not have a significantly positive impact on the firm's value. The coefficient of the interaction term in models 3 and 4 is significantly negative ( $p < 0.01$ ), suggesting that rent-seeking for government-controlled resources may even be detrimental to firm performance. These results support hypothesis 4b, which states that firm engagement in rent-seeking does not improve firm value, although it does increase government-controlled resources.

## Further analyses

Prior literature suggests that engagement in rent-seeking for natural resources by private firms diminishes their ability to operate productively.<sup>74</sup> Further, our

<sup>74</sup> Torvik (2002).

**Table 4:** Rent-Seeking, Government Subsidies, and Corporate Donations.

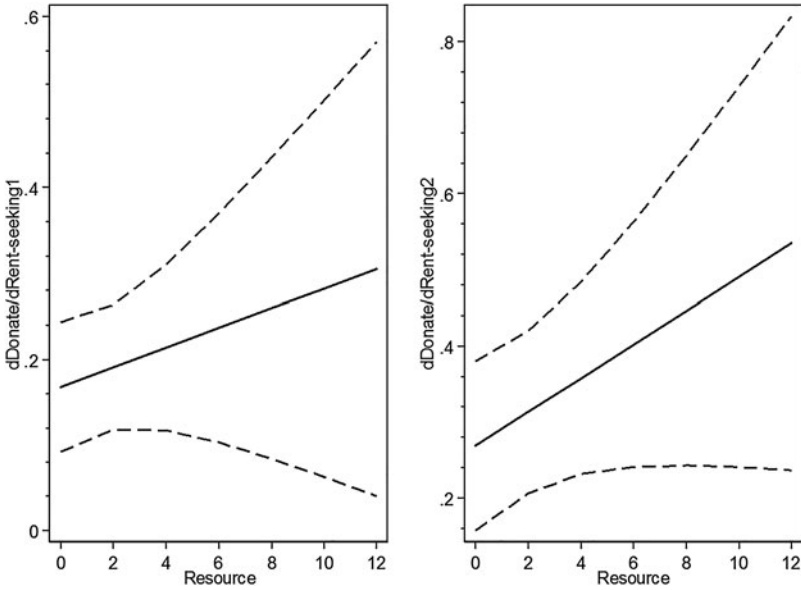
	(1) Donation	(2) Donation	(3) Donation	(4) Donation
Rent-seeking1	0.174*** (5.73)		0.168*** (4.60)	
Rent-seeking2		0.299*** (10.73)		0.268*** (9.13)
Resource			−0.009*** (−3.90)	−0.013*** (−5.21)
Rent-seeking1 × Resource			0.011* (1.79)	
Rent-seeking2 × Resource				0.022** (2.14)
Firm Size	−0.049*** (−4.41)	−0.018 (−1.34)	−0.046*** (−4.22)	−0.011 (−1.09)
ROA	0.770** (2.42)	0.386* (1.72)	0.774** (2.35)	0.353 (1.55)
Cash	0.063*** (3.57)	−0.013 (−0.56)	0.059*** (2.88)	−0.027 (−1.26)
Leverage	0.129*** (2.61)	0.097* (1.68)	0.114** (1.98)	0.085 (1.47)
Largest Shareholder	−0.046 (−0.69)	−0.107** (−2.48)	−0.024 (−0.31)	−0.113** (−2.58)
Growth	0.017* (1.91)	0.015* (1.72)	0.017* (1.96)	0.015* (1.82)
GDP	0.080*** (12.44)	0.085*** (18.98)	0.079*** (12.42)	0.083*** (17.37)
CEO Duality	−0.030*** (−6.28)	−0.020*** (−3.13)	−0.029*** (−5.02)	−0.021*** (−2.80)
Firm Age	0.146*** (5.72)	0.069** (2.03)	0.141*** (5.77)	0.057** (2.18)

(Table 4: Continued)

	(1) Donation	(2) Donation	(3) Donation	(4) Donation
INDUSTRY	controlled	controlled	controlled	controlled
YEAR	controlled	controlled	controlled	controlled
N	1246	1246	1246	1246
R <sup>2</sup>	0.286	0.292	0.288	0.295
P	0.000	0.000	0.000	0.000

The T values are reported in parentheses; the other figures are regression coefficients.

\* $p < 0.1$ , \*\* $p < 0.05$ , \*\*\* $p < 0.01$



**Figure 2:** The marginal effect of rent-seeking on firm donations with 95% CIs.

analyses thus far reveal that, although a firm’s engagement in rent-seeking helps it obtain government-controlled resources, it also subsequently increases expenditure in executive remuneration and corporate donations. Hence, rent-seeking does not have a value-enhancing effect. From an overall resource allocation point of view, we are also interested in the production efficiency of rent-seeking firms relative to other firms. As such, we performed additional analyses to investigate the effect of rent-seeking behavior on firm efficiency using model 8.

$$(8) \quad \text{Efficiency}_{it} = \beta_0 + \beta_1 \text{RentSeeking}_{it} + \beta \text{Control} + \sum \text{INDUSTRY} + \sum \text{YEAR} + \epsilon$$

Data envelopment analysis (DEA) was used to measure production efficiency. DEA has been widely used in the study of operations and economics to measure the productive efficiency of decision-making units, which involve multi-input and multi-output production functions. In this study, our inputs included increases in fixed assets and increases in intangible assets, while the outputs included growth in total assets, ROA, and Tobin’s Q. The regression results reported in



**Table 5:** Rent-Seeking, Government Subsidies, and Firm Value.

Variable	(1) L2Tobin's Q	(2) L2Tobin's Q	(3) L3Tobin's Q	(4) L3Tobin's Q
Resource	−0.025** (−2.30)	−0.025 (−1.47)	0.011 (1.55)	0.025*** (5.27)
Rent-seeking1	−0.168** (−2.44)		0.079 (1.61)	
Rent-seeking1 × Resource	0.032 (1.58)		−0.087*** (−2.95)	
Rent-seeking2		−0.364*** (−3.91)		0.184 (1.48)
Rent-seeking2 × Resource		0.016 (0.78)		−0.065*** (−6.96)
Firm Size	0.235 (1.09)	0.205 (0.96)	0.842*** (10.09)	0.861*** (10.17)
ROA	−1.453*** (−3.29)	−1.332*** (−3.12)	−1.729*** (−4.85)	−1.624*** (−5.18)
Cash	0.136 (0.89)	0.200 (1.20)	−0.892** (−2.03)	−0.893** (−1.99)
Leverage	−0.541*** (−4.28)	−0.525*** (−4.66)	−0.791*** (−4.37)	−0.834*** (−4.67)
Largest Shareholder	−0.483 (−1.07)	−0.420 (−0.88)	−0.698 (−1.15)	−0.622 (−0.98)
Growth	0.023*** (3.12)	0.025*** (3.09)	0.004 (0.21)	0.004 (0.21)
GDP	−0.236*** (−3.34)	−0.232*** (−3.15)	−0.409*** (−3.13)	−0.415*** (−3.16)
Firm Age	−0.141 (−0.29)	−0.065 (−0.14)	−1.158*** (−11.42)	−1.189*** (−11.13)

(Table 5: Continued)

Variable	(1) L2Tobin's Q	(2) L2Tobin's Q	(3) L3Tobin's Q	(4) L3Tobin's Q
INDUSTRY	controlled	controlled	controlled	controlled
YEAR	controlled	controlled	controlled	controlled
N	1544	1544	1130	1130
R <sup>2</sup>	0.425	0.427	0.435	0.435
P	0.000	0.000	0.000	0.000

The T values are reported in parentheses; the other figures are regression coefficients.

\* $p < 0.1$ , \*\* $p < 0.05$ , \*\*\* $p < 0.01$

**Table 6:** Rent-Seeking and Firm Efficiency.

Variable	(1) Efficiency	(2) Efficiency
Rent-seeking1	-0.128*** (-8.64)	
Rent-seeking2		-0.058*** (-3.69)
Firm Size	-0.034*** (-3.65)	-0.028*** (-2.86)
Cash	0.212*** (10.02)	0.246*** (13.11)
Leverage	-0.030 (-0.52)	-0.055 (-0.80)
Largest Shareholder	0.101** (2.04)	0.171*** (5.69)
Growth	0.007*** (4.99)	0.010*** (11.11)
GDP	0.045*** (4.24)	0.037*** (3.34)
Firm Age	0.129*** (6.29)	0.118*** (6.15)
INDUSTRY	controlled	controlled
YEAR	controlled	controlled
N	1517	1517
R <sup>2</sup>	0.526	0.466
P	0.000	0.000

The T values are reported in parentheses; the other figures are regression coefficients.

\* $p < 0.1$ , \*\* $p < 0.05$ , \*\*\* $p < 0.01$

table 6 show that, for both measures of rent-seeking, firm-production efficiency is negatively and significantly related to the level of rent-seeking activities ( $p < 0.01$ ), indicating that firms' rent-seeking behavior reduces their production efficiency. The significantly negative effect of rent-seeking on production efficiency is further indicated by the standardized coefficients resulting from the regression analysis. Specifically, our results suggest that an increase of one standard deviation in rent-seeking expenditure (measured by Rent-seeking1) leads to a decrease of 0.36 standard deviations in firm production efficiency ( $-0.36 = -0.128 \times 0.4345554/0.1556598$ ). Similarly, an increase of one standard deviation in rent-seeking expenditure (measured by Rent-seeking2) leads to a decrease of 0.15 standard deviations in firm production efficiency ( $-0.15 = -0.058 \times 0.4159601/0.1556598$ ).

Our results agree with those of Claessens et al.,<sup>75</sup> who have documented that the additional investment generated by improved financing through political connections is not efficient. One possible explanation is that rent-seeking activities divert managers' efforts away from improving a firm's operating efficiency, and the capital used for rent-seeking might be otherwise spent on productive ends. Our results also echo Claessens et al.,<sup>76</sup> in that rent-seeking leads to misallocation of scarce resources. The negative impact of rent-seeking on firm efficiency provides further support for the lack of a significant relationship between rent-seeking behavior and firm value.

Taken as a whole, this study shows that rent-seeking behavior by firms causes both economic benefits and costs. Although a firm's engagement in rent-seeking facilitates its access to government subsidies, such a firm must endure incidental costs, such as excessive management compensation and increased corporate donations, and suffer a loss of operational efficiency. As such, rent-seeking activities do not have an enhancing effect on a firm's value.

## Robustness tests

We conducted several robustness tests on our findings. First, we constructed an additional measure for rent-seeking. Because the Corporate Income Tax Law restricts the total amount of entertainment expenses to 0.5 percent of revenue, firms often use meeting expense accounts to record excess entertainment expenditure.<sup>77</sup> In line with Wei et al.,<sup>78</sup> we added meeting expenses to entertainment to construct a third measure for rent-seeking. Second, to address multicollinearity, we calculated the mean center of all the variables included in the interaction terms by subtracting the mean of each variable from all its values. Third, we used the total salaries of all senior management, including members of the board of directors and the supervisory board to conduct a test of the hypothesis concerning the relationship between rent-seeking and excessive management payments. Finally, we used change models to perform a panel analysis to investigate how changes in rent-seeking activities affect changes in outcomes, such as government subsidies, managers' pay, and firm value. All results remained largely unchanged.

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<sup>75</sup> Claessens et al. (2008).

<sup>76</sup> Ibid.

<sup>77</sup> Wei et al. (2015).

<sup>78</sup> Ibid.

## 5 Conclusion

### Discussion and implications

The political-economy literature indicates that rent-seeking helps firms to obtain scarce government-controlled resources, particularly in economies with weak institutional governance. An abundance of anecdotal evidence suggests that private Chinese firms often rely on rent-seeking activities to obtain government-controlled resources, such as government subsidies. However, the relationship between a firm's engagement in rent-seeking and the firm's value, along with the mechanisms underlying this relationship, have not been sufficiently examined in prior research.

This paper examines the impact of rent-seeking behavior on firm value and the mechanisms underlying the link between the rent-seeking and firm value using a sample of private firms listed on the Shanghai and Shenzhen stock exchanges from 2007 to 2013. Empirical results show that engagement in rent-seeking behavior does increase access to government subsidies. However, such economic benefits do not come without cost. Our results show that management compensation and corporate donations are significantly driven by a firm's rent-seeking behavior and the government-controlled resources acquired as a result of that behavior. These internal agency costs and external social costs largely absorb the economic gains obtained through rent-seeking. As a result, engagement in rent-seeking by firms does not improve firm value. Further analysis reveals that rent-seeking activities reduce operational efficiency, which provides additional support for our conclusion that rent-seeking does not enhance firm value in the current Chinese context. Overall, our results are consistent with previous literature that shows rent-seeking behavior may not generate sustainable business performance,<sup>79</sup> although it is necessary for achieving temporary results.<sup>80</sup>

This study has important theoretical implications. The insignificant relationship between rent-seeking, firm value, and losses in production efficiency documented in this study bolster one side of the debate in managerial theories—that rent-seeking may not necessarily increase firm value.<sup>81</sup> However, this study supports Faccio's<sup>82</sup> theory that both the benefits and the costs of political connections need to be brought into the equation to assess the effect of such connections on firm value. While our results show that rent-seeking facilitates a firm's access to

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<sup>79</sup> Lado et al. (1997).

<sup>80</sup> Schoemaker (1990).

<sup>81</sup> Faccio (2006); Lado et al. (1997).

<sup>82</sup> Faccio (2006).

government-controlled resources, which is consistent with conventional wisdom,<sup>83</sup> we also find evidence that rent-seeking gives rise to various costs. Specifically, our results reveal that some rents obtained through political connections flow to managers. This provides support for the agency perspective of managerial theories, which postulates that managers have considerable discretion when running firms and may use such discretion to pursue objectives other than maximizing shareholder interests.<sup>84</sup> Our results also show that rent setters, such as regulators, can become rent seekers.<sup>85</sup> This study demonstrates that incorporating both economic gains and costs into the theoretical framework provides a more comprehensive view of the economic consequences of rent-seeking. Researchers who are interested in investigating business strategies associated with rent-seeking will find our theoretical model useful. Our theoretical model is particularly applicable to transitional economies with weakly institutionalized environments where rent-seeking is prevalent and plays an important role in firm operations. Furthermore, our measurements of rent-seeking activities capture the real practices commonly used by Chinese firms to build relationships with governments and politicians. Thus, these results enrich the political-economy literature, which has traditionally used direct participation in politics as its yardstick. Our study shows that rent-seeking activities occur much more in the daily interactions between managers and politicians through various forms of entertainment.

Our findings that a firm's engagement in rent-seeking does not necessarily increase the firm's value have implications for strategic management and corporate governance. Our results show that allocating resources to rent-seeking is a waste of the firm's resources and engaging in rent-seeking distracts management's attention from running their business efficiently. Therefore, instead of viewing rent-seeking as an important strategy, Chinese firms should establish corporate governance mechanisms to monitor rent-seeking activities.

This study also has ethical implications for Chinese businesses. We have provided empirical evidence to challenge the assertion that rent-seeking improves shareholder value. Our findings reveal that managers and politicians who are motivated by self-interest are the winners in this game at the expense of shareholders. As such, a firm's engagement in rent-seeking cannot be justified from the perspective of shareholders. Rent-seeking in emerging economies is closely associated

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**83** Claessens et al. (2008); Faccio et al. (2006); Guo et al. (2014); Johnson and Mitton (2003); Khwaja and Mian (2005).

**84** Edlin and Stiglitz (1995).

**85** Appelbaum and Katz (1987); Peltzman (1976); Shleifer and Vishny (1994).

with corruption.<sup>86</sup> Anti-corruption has been the focus of the China's fifth generation of leadership, headed by President Xi Jinping. In his inaugural speech as general secretary,<sup>87</sup> Xi emphasized that great effort must be taken to address corruption. In the context of a nationwide crackdown on corruption, engagement in rent-seeking is likely to increase the business risks associated with ethical and legal issues.

More broadly, this study has implications for China's economic reform and growth. In the context of institutions with weak corporate governance, private Chinese firms are driven to engage in rent-seeking in order to compete for government-controlled resources. Chinese governments should improve the institutional environment to allow firms with a variety of ownership structures to compete on a level playing field. The Chinese government, in particular, should revamp its opaque subsidy allocation system to increase transparency and to facilitate the flow of capital to its highest value use. In addition, this study challenges the argument that China's economic growth has relied on certain forms of corruption that "grease the wheels." We provide theoretical and empirical support for the anti-corruption campaign launched by the Chinese government and argue that improving government transparency and further developing the market economy are key for the future of China's economic reform and growth.

## Limitations and directions for future research

Although this study provides important insights into rent-seeking behavior by firms, its findings should be interpreted in light of several limitations. First, our results may not be applicable to countries where institutions are strong and markets, rather than governments, play a fundamental role in resource allocation. Future studies are needed to examine whether managers and governments can be powerful rent seekers in the context of strong institutions and corporate governance.

Second, our measurements for rent-seeking were constructed using the accounts related to the expenditure used to develop relationships with politicians. This study represents a bold attempt to measure rent-seeking from an accounting perspective. Nevertheless, the usefulness and relevance of entertainment expenses in assessing the level of rent-seeking behavior in firms has been demonstrated by Cai et al.<sup>88</sup> Future studies might apply this approach to different contexts,

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<sup>86</sup> Su and Littlefield (2001), 203.

<sup>87</sup> BBC News (2012).

<sup>88</sup> Cai et al. (2011).

particularly where interacting with managers and politicians through entertainment and other activities is frequent and important to business operations.

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