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Corporate finance and state enterprise reform in China

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Abstract

This paper uses a novel approach in addressing two puzzles in the field of corporate finance in China, where government is a major player. In addition to the traditional approach based on agency theory and information asymmetry, the paper uses the political costs approach in studying the stock dividend puzzle and rights issues puzzle. The paper finds that the extent of political interference, managerial entrenchment, and institutional control affects corporate financing choices and dividend distribution decisions. The result sheds new light on improving the important corporate governance aspects of state enterprise reform in China.

JEL classification: G32; G35; O53; P21
Keywords: Corporate finance; Dividend policy; Agency costs; Political costs; State enterprise reform

1. Introduction

The Chinese Communist government, wishing to avoid the political and economic turmoil that accompanied the mass privatization of the former Soviet Union and other Eastern European governments, has chosen, as a cornerstone of its political survival, the commercialization and partial privatization of claims over assets and profits and of its

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state-owned enterprises (SOEs). Its SOE reform strategy hinges on the modern enterprise system (MES) characterized by the separation of ownership and control. Ownership of an SOE's assets is distributed among the government, institutional investors, managers, employees, and private investors. Effective control rights are assigned to the management, which generally has a very small, or even nonexistent, ownership stake.

The separation of ownership and control creates a conflict of interest between management and newly enfranchised private investors that is the root cause of the principal-agent problem in traditional corporate finance theory (Jensen & Meckling, 1976). Moreover, because government desires to retain some control, in part, through partial retained ownership of commercialized SOEs, further conflicts arise between politicians and firms (Shleifer & Vishny, 1994). In addition to agency costs of managerial discretion, the newly corporatized SOEs face political costs of government control, defined as the reduction in firm value due to government administrative interference. The games played by the government, management, and outside investors become more complex than those addressed in the traditional corporate finance models. The principle challenge of this paper is to assess whether and to what extent the unique ownership conflicts under the MES can serve as a foundation for solving two puzzles in corporate China.

While stockholders respond positively to stock dividend announcements in the United States, which can be explained by the signaling theory, stockholders react negatively to stock dividend distributions in China. If stock dividend does not signal good news, why do so many Chinese firms bother to distribute stock dividends? While fewer and fewer firms issue uninsured rights in the United States and elsewhere, Chinese firms predominantly use uninsured rights in seasoned equity offerings (SEOs). Models of information asymmetry argue that firms issuing uninsured rights are of better quality, but Chinese firms using uninsured rights exhibit no evidence of superior investment opportunities and experience significant drop in their stock prices. The main contribution of this research is to analyze these apparent deviations from the prediction of the traditional corporate finance theory in terms of political and agency costs of the government–management–investor conflicts unique to the state enterprise reform in China. The papers find that dividend policies and financing choices are affected by ownership conflicts (agency and political costs) and the effectiveness of monitoring.

The rest of the paper is organized as follows: Section 2 discusses how earlier attempts to commercialize SOEs without privatizing them created adverse incentives that defeated the intent to increase profitability and reduce the need for continual government subsidies. This failure led to the establishment of the MES, with its unique ownership conflicts and lack of effective monitoring. Section 3 contains theoretical discussions on the dividend policies and post-IPO equity financing choices of Chinese firms. It explores the rationale behind the frequent use of stock dividends and the predominant use of uninsured rights in seasoned equity offerings in China. Three testable hypotheses are then formulated. Section 4 empirically investigates the stock dividend and rights issues puzzles, discusses the long-term performance of dividend distribution firms, and explains the negative valuation effect of stock dividends and rights issues announcements in terms of firm characteristics associated with agency and political costs. Section 5 concludes with a summary of findings.