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Local fiscal distress and investment efficiency of local SOEs ☆,☆☆

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ABSTRACT

In this paper, we use A-share listed firms between 2002 and 2010 to investigate the relationship between local fiscal distress and the investment efficiency of local SOEs, along with the effect of corporate tax payments on this relationship. We find a positive relationship between the extent of local SOEs' overinvestment and the fiscal distress of the corresponding local government where the enterprise and this relationship become stronger for firms that pay fewer taxes. The pattern of underinvestment among local SOEs was in contrast, and these relationships do not exist for non-SOEs or central SOEs. Moreover, we find that expanding a firm's investment scale leads to an increase in total taxes paid, including income and turnover taxes, which further result in more local fiscal revenue. Overall, we conclude that local governments have an incentive to increase fiscal revenue when faced with fiscal distress by raising the investment scale of local SOEs and that the incentives and effects of such interventions appear to be stronger among firms that contribute less to local fiscal revenue.

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1. Introduction

Investment efficiency has long been a hot topic in accounting research (Jensen and Meckling, 1976; Jensen, 1986; Stulz, 1990; Wei and Liu, 2007), with Jensen (1986) initially investigating the problem using the agency theory framework, followed by Narayanan (1988) and Malmendler and Tate (2005) exploring the issue from the perspectives of information asymmetry and managerial overconfidence, respectively. The three main causes of enterprises' overinvestment are found to be agency problems, information asymmetry, and managerial overconfidence. Subsequently, Fazzari et al. (1988), Aggarwal and Samwick (2006), Tang et al. (2007), Xin et al. (2007) and Jiang et al. (2009) separately conduct in-depth assessments of the problem from the perspectives of financing constraints, management incentives, cash dividends, executive compensation, and management background, based on the theories of agency conflicts and information asymmetry.

The studies listed above restrict their focus to firm-level factors, which certainly do not cover all of China. State-owned enterprises (SOEs) in China are controlled by either the central or the local governments at different levels. The agency conflicts between the government, which is the biggest shareholder in most circumstances, and external minority shareholders are quite different from the common conflicts between managers and shareholders and between shareholders and bondholders (La Porta et al., 1999; Jensen and Meckling, 1976). Yang and Hu (2007), Cheng et al. (2008) and Chen et al. (2011) investigate the investment efficiency problem from the perspectives of the specific institutional environment and government intervention in China. They find that the institutional environment in China and government intervention influence the relationship between the factors of firms' free cash flow, debt financing, cash dividends, management compensation, and corporate governance and the level of corporate overinvestment, creating a non-negligible factor that leads to firms' overinvestment.

Controlled by the government, SOEs are endowed with the responsibility for assisting the corresponding regional government in achieving various goals, such as the economic, social, and political goals of boosting regional economic growth; facilitating increases in regional tax revenues and employment rates; maintaining social stability; and ensuring that investments in emerging industries flourish. This decreases the focus on the elementary goal of effective operations, compared to non-SOEs (Chen et al., 2011; Wei and Liu, 2007). SOEs bear heavy policy burdens that can lead to multiple targets and inefficient operations. Thus, SOEs may suffer from low investment and decreased operational efficiency, in addition to low pay performance sensitivity (PPS) among executives. Studies find that there have been incentives for local governments to boost their regional GDP by forcing the local SOEs under their control to overinvest (Tang et al., 2010) and that such activity has been an important approach for local bureaucrats to obtain promotions. Moreover, Xue and Bai (2008) and Chen et al. (2012) both find that local governments have an incentive to lift the local employment rate through overemployment in local SOEs.

Following China's decentralization reform in the 1980s, the planned economy has disintegrated gradually, providing local governments with extensive autonomous rights, including the right to control tax revenue. As a result, local governments acquire financial incentives to compete with each other (Jin et al., 2005; Young, 2000). After the 1994 reform of the tax system, tax revenue became a crucial source of local fiscal revenue and fiscal health became a core economic and social objective of local governments (Chen et al., 2011), together with the goal of regional economic development. In addition, it became an important approach to help local governments to implement their government functions and maintain social stability, along with the goal of regional employment. Each social and political goal is an important incentive for the local government to press political interventions into the operation of local SOEs and the firms that bear policy burdens from the government should behave differently from those without. However, studies on local fiscal and financial conditions' influence over the operation of local SOEs are rare, and this paper aims to fill this gap in the literature.

The State Council of China issued the *Decision of the State Council to Implement Tax Distribution Financial Management System* on December 15, 1993. It announced that every province, including provincial-level autonomous regions and municipalities, should abandon the present local fiscal responsibility system and switch to the tax distribution financial management system on January 1, 1994. The tax categories would