Journal of Corporate Finance 17 (2011) 259–271

Contents lists available at ScienceDirect

Journal of Corporate Finance

journal homepage: www.elsevier.com/locate/jcorpfin

Government intervention and investment efficiency: Evidence from China

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ARTICLE INFO

Available online 27 August 2010

JEL classification:
G31
G34
L33
P31

Keywords:
Government intervention
Political connections
Investment efficiency
China

ABSTRACT

The extant corporate investment literature has documented that information asymmetry and agency conflicts between managers and outside investors prevent firms from making optimal investment decisions. In this study, we investigate whether government intervention, as another form of friction, distorts firms' investment behavior and leads to investment inefficiency. Using Chinese data, we test this by measuring government intervention at two different levels. First, we compare investment efficiency between SOEs and non-SOEs. We find that the sensitivity of investment expenditure to investment opportunities is significantly weaker for SOEs. Second, we measure government intervention by whether a firm is politically connected through the employment of top executives with a government background. We find that political connections significantly reduce investment efficiency in SOEs. However, we do not find such evidence in non-SOEs. Taken together, our findings suggest that government intervention in SOEs through majority state ownership or the appointment of connected managers distorts investment behavior and harms investment efficiency.

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1. Introduction

What drives a firm's investment is a fundamental question in corporate finance. In the perfect world of Modigliani and Miller (1958), a firm's investment policy is solely dependent on its investment opportunities as measured by Tobin's (1969) *Q*. However, the literature has long recognized that firms in the real world deviate from this optimal investment behavior due to various frictions. Theoretical models and empirical studies focus on two such frictions: information asymmetry and agency problems (see Stein, 2003 for a comprehensive review). While models of costly equity and debt financing generally predict under-investment because of an adverse-selection problem, models of moral hazard mostly suggest over-investment for empire building. Empirical evidence supportive of both types of models is extensive, but studies are overwhelmingly based on mature markets where the agency conflict is between managers and outside investors. In the current study, we explore a Chinese setting to examine whether government intervention in state-owned enterprises (SOEs) constitutes another friction leading to investment inefficiency.

While government intervention in business is not unique to China, the Chinese setting is particularly interesting for two reasons. First, the Chinese government plays a vital role in business activities through its majority ownership in SOEs. Although listed private enterprises (non-SOEs) are growing in number and the private sector has fueled most of China's economic growth in the last two decades (Allen et al., 2005), listed SOEs still dominate the capital market in China. Moreover, recent years have observed increasing government policies favoring the state sector. In industries such as natural resources, civil aviation, real estate, and finance, SOEs have crowded the private firms out (Financial Times, 2008; China Economic Weekly, 2010).[1] Thus, state ownership and government politics are likely to continue to influence Chinese SOEs' corporate policies. Second, the government

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[1] This phenomenon is described as *Guo Jin Min Tui* in Mandarin Chinese (namely, the state advances and private sector recedes). It has generated serious attention during the 2010 annual meeting of National People's Congress (*Financial Times Chinese* 2010).

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doi:10.1016/j.jcorpfin.2010.08.004

maintains its control on listed SOEs by appointing top executives, many of whom possess political connections as current or former government officials/bureaucrats. The different ownership structures in listed firms in China together with political connections of top executives accord us an opportunity to examine whether and how government intervention affect firms' investment behavior.

We hypothesize that the Chinese government intervenes in SOEs to help accomplish social and political goals such as employment, fiscal health, regional development, social stability, etc., which alters firms' investment behavior and leads to investment inefficiency. We test this hypothesis by measuring government intervention at two different levels. First, we examine whether government ownership in listed SOEs has a negative impact on investment efficiency as compared with listed non-SOEs. By default, SOEs are government owned companies, and they are in the forefront of being solicited by government to help with its social and political agenda. Second, we further measure government intervention by whether a firm is politically connected or not. Following Fan et al. (2007), we classify a firm as politically connected if its chairman or CEO is a current or former government official/bureaucrat. We posit a negative relationship between political connections and investment efficiency for SOEs, but not necessarily for non-SOEs. Since the government ensures the control of SOEs through the appointment of top executives, SOEs with politically connected executives are more likely to be intervened and to engage in investment that does not aim to maximize firm value but to achieve objectives preferred by the government. In contrast, non-SOEs have a simpler goal structure of value maximization, and they will seek political connections only if these ties bring economic benefits. Considering the weak legal and economic infrastructure in China, we expect that political connections may even enhance investment efficiency in non-SOEs because of better investment opportunities offered by the government. However, the relation between political connections and investment efficiency can be insignificant for non-SOEs if they are motivated to seek political connections to enhance their relatively weaker position as compared with other firms. That is, in equilibrium, the advantages of connections offset the pre-connection disadvantages and we may not directly observe a positive association between political connections and investment efficiency.[2]

We draw on a sample of domestically listed non-financial A-share firms in China from 2001 to 2006 to test the relationship between government intervention and investment efficiency. Our main findings are summarized below. First, after controlling for other factors known to affect investment expenditure, we find that the sensitivity of investment expenditure to investment opportunities is significantly weaker for SOEs than for non-SOEs, suggesting less investment efficiency in SOEs. Second, for SOEs, we further find a significantly negative impact of political connections on investment sensitivity, but we do not have such evidence for non-SOEs. This is consistent with government intervention in SOEs through appointed top executives with political ties. Third, the negative effect of political connections manifests itself mainly in SOEs that are controlled by local governments. Taken together, our findings suggest that government intervention through majority state ownership or the appointment of connected managers in China distorts SOEs' investment behavior and harms investment efficiency, particularly in those SOEs controlled by local governments.

This study contributes to the literature in two ways. First, our evidence enriches the extant literature on corporate investment. Previous studies in this area are primarily based on information asymmetry and agency conflicts among shareholders, debtholders, and managers in mature markets. We find that, in a transitional economy, political forces also play an important role in the investment behavior of firms, thereby adding new evidence to this strand of literature. While our results appear similar in logic to the empire building evidence due to moral hazard, our findings reflect the role of government in firm investment as a result of a different type of agency conflict between the government majority shareholder and outside minority shareholders. Second, our findings of differential effects of political connections on investment efficiency between SOEs and non-SOEs enhance our understanding of firm political connections in general and in transitional economies in particular. There is a growing interest in the consequence of firm political connections from accounting and finance researchers in recent years. According to Faccio (2006), political connections are not an unusual phenomenon in the world's stock markets.[3] Many of the studies suggest that political connections enhance firm value (e.g., Fisman, 2001; Johnson and Mitton, 2003; Faccio, 2006). A common impression is that political connections are more important than operational efficiency in emerging markets such as those of Southeast Asian countries. However, Fan et al. (2007) provide contrary evidence based on a sample of newly partially privatized firms in China. They find that politically connected Chinese firms under-perform those without political connections in three-year post-IPO stock returns, earnings growth, sales growth, and change in returns on sales. We conjecture that ownership is an important reason for the difference between the findings of Fan et al. (2007) and those of previous studies. Although most of sample firms in Fan et al. are SOEs, other studies focus on the private sector. Our evidence is not only new in terms of the role of political connections in resource allocation, but also helpful in reconciling prior findings in the literature.

The rest of the paper proceeds as follows. Section 2 describes the theoretical and institutional background, and develops hypotheses. Section 3 gives details of the research methodology. Section 4 presents our empirical findings. Section 5 concludes the paper.

2. Background and hypothesis development

The efficiency of corporate investment is a fundamental concern in corporate finance. In a perfect capital market without frictions (Modigliani and Miller, 1958), capital is allocated so that the marginal product of capital is the same across each project in the economy. At the firm level, the theory prescribes that a firm obtains financing for all positive net present value projects at the

[2] This is consistent with Faccio's (2009) finding that under-performing firms tend to seek advantages from politicians by building connections; however, in equilibrium, connected firms do not outperform non-connected ones.

[3] Faccio (2006) finds firms in 35 of the 47 countries in her sample to be politically connected. Although these firms account for only 3% of the total sample firms, they represent 7.72% of the global market capitalization.

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