



# Political connections, financing constraints, and the optimization of innovation efficiency among China's private enterprises



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## ABSTRACT

Innovation efficiency is an effective measure of an enterprise's innovation level. This study focuses on those factors that decide the innovation efficiency of Chinese private enterprises, and on the impacts that political relations and financing constraints have on enterprises' innovation efficiencies. By using dynamic panel data models, this study empirically examines 269 private listed companies between 2003 and 2008, and investigates the effects of political connections on financing constraints; furthermore, it discusses how financing constraints caused by political connections have differential effects on various enterprises' innovation efficiency. The results indicate that in an incomplete competition market environment, the "visible hand" and "invisible hand" dominate market resources simultaneously, and enterprises with political connections indeed face fewer financing restraints than those that do not. Nonetheless, this distribution mode of resources leads directly to a distortion in the distribution of all social resources. Based on this finding, to improve the innovation efficiency of Chinese private enterprises, the government should initiate long-term change and provide strong, short-term supervision. Enterprises themselves should strengthen internal management, use funds appropriately, optimize resource allocation, and actively carry out production and research and development activities—such as those involving innovation, which are beneficial to long-term development.

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## 1. Introduction

For private enterprises, the possession of advanced and innovative technology and high-innovation efficiencies represents a key competitive edge. Baumol (1990) believes that innovation-related capabilities promote economic growth when entrepreneurs integrate them into productive activities; conversely, when entrepreneurs integrate them into nonproductive activities—such as rent-seeking—it might restrict economic growth. Innovation is a condition essential to economic development, and so innovation efficiency is an effective standard by which to measure the innovation level of an enterprise. Innovation efficiency is restricted by a number of factors, including the institutional environment, government

preferential policy, and financial support, *inter alia*; therefore, whether enterprises have political connections or face financing constraints is likely to affect their innovation efficiency. Private enterprises can enjoy government preferential policies and access financial subsidies by first establishing political connections. Meanwhile, in the course of conducting innovation-related activities, enterprises need to source external financing to fund innovation-related investments. It is expensive to meet funding requirements by using higher-cost capital or credit-rationing, and when enterprises use them—especially in the presence of information asymmetry within the actual market—external financing costs will exceed internal ones, and they will face financing constraints. Therefore, the impacts of political connections and financing constraints on the innovation efficiency of enterprises will reflect not only the effects of government supports with regard to innovation among private enterprises, but also the effect of financing level on innovation efficiency.

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This study looks to examine the important issue of whether political connections have a “relieving” effect on enterprises’ financing constraints; it also looks to examine the mechanisms of financing constraints and political connections as they affect enterprise innovation efficiency. This study seeks to determine whether enterprises have political connections and whether those connections help relieve financing constraints—and, if they do, the kind of impact the relieving of financing constraints has on enterprise innovation efficiency. To this end, we analyze data gathered from the representatives of private listed enterprises from 2003 to 2008, as well as from the ultimate controllers of enterprises who currently serve or have served as government officials, National People’s Congress (NPC) members, or Chinese People’s Political Consultative Conference (CPPCC) members.

Within the literature, many studies consider the impact of political connections on financing constraints, but only a few consider the impact of political connections and financing constraints on enterprise innovation efficiency. Most of the previous studies analyze only the impact that political connections have on economic indicators other than enterprise innovation efficiency. For example, [Chen et al. \(2011\)](#) studied the impact that political connections have on enterprise overinvestment; [Chaney et al. \(2011\)](#) studied the relationship between political connections and enterprise value; [Faccio \(2010\)](#) discusses the impact that political connections have on economic growth or the performance of enterprise accounting; and [Fuller \(2014\)](#) probes the impact that the local environment has on the innovation model of manufacturing industries in China and India. The current study examines the impact that political connections and financing constraints have on enterprise innovation efficiency, based on data from private listed enterprises in China from 2003 to 2008; hence, it makes a significant contribution to the research in the field.

The remainder of this paper is organized as follows. The second section comprises a literature review and presents the research hypotheses, and the third section discusses the data and model used. The fourth section presents the results and provides further analysis, and the fifth section offers concluding remarks and policy recommendations.

## 2. Literature review and research hypotheses

### 2.1. *The impact of political connections on enterprise financing constraints*

On one hand, many governments provide preferential treatment directly—or as extended welfare terms, or better financing platforms—to enterprises that have political connections; such items can be considered as constituting a “direct effect” of political connections. First, this “direct effect” indicates that politically connected enterprises are more likely to receive government assistance than those that are not connected. [Faccio \(2010\)](#) asserts that it is easier for politically connected enterprises to access government assistance when the International Monetary Fund or the World Bank provides financial assistance to domestic enterprises. Second, [Bartels and Brady \(2003\)](#) believe that private enterprises that have established political connections with local government are able to access more financial subsidies. Finally, [Gordon and Li \(2003\)](#) assert that enterprises with political connections can

receive a better financing platform, along with the advantages of resource provision and information, and that these in turn relieve financing constraints.

On the other hand, since enterprises need to seek production and operational loans from financing institutions like banks, political connections—which act as a “middle power”—can bring about for enterprises favorable loan terms and greater convenience. In this study, this chain of events is referred to as an “indirect effect” of political connections. [Faccio \(2006\)](#) finds that enterprises with political connections can access more bank loans and more favorable interest and tax rates than those without political connections. Meanwhile, [Li et al. \(2006\)](#) also consider that acquired preferential loans help private enterprises obtain access to appropriate credit resources from local financial institutions.

Special institutional arrangements under China’s economic transformation have given the government varying degrees of control over the majority of domestic banks; this constitutes a certain obstacle for private enterprises that do not have the political connections needed to obtain bank loans. Meanwhile, the conditions surrounding the self-development of private enterprises are not perfect (e.g., high default rates and information asymmetry), and so it is difficult for banks to carry out lending decisions with regard to them. Therefore, to promote their growth, many private enterprises seek out political connections and hope to relieve financing constraints through them. Following the analysis, we see that the “direct effect” and “indirect effects” of political connections are conducive to giving private enterprises access to greater financial support and thus to relieving their financing constraints. Based on this, the current study proposes the following hypothesis:

**Hypothesis 1.** All else being equal, political connections can relieve the financing constraints of private enterprises.

### 2.2. *The impact of financing constraints on enterprise innovation efficiency*

With regard to how financing constraints affect the innovation efficiency of enterprises, some scholars believe that the greater the financing constraints are, the higher an enterprise’s innovation efficiency will be. First, [Wang \(2003\)](#) believes that enterprises will strive to improve their pure technical efficiency, to offset the scale-of-efficiency losses created by financing constraints. Second, [Fisman and Love \(2003\)](#) believe that financing constraints reduce the negative effect of enterprise agencies in improving the innovation investment efficiency of enterprises. Finally, [Maietta and Sena \(2010\)](#) and [Hovakimian \(2011\)](#) believe that cooperation among producers can increase their technological innovation efficiency, even in the presence of tightened financing constraints. Financing constraints will force enterprise managers to provide funds for more valuable investment opportunities, chiefly by reducing net cash flow; in this way, they improve the innovation efficiency of their respective enterprises.

Other scholars believe that financing constraints lead to insufficient innovation funding among enterprises, and hence to reduced innovation efficiency. [Love \(2003\)](#) asserts that financing constraints will “act out” and work to postpone investments to the next period, if the enterprise has a low

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