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PII: S0929-1199(14)00066-2
DOI: doi: 10.1016/j.jcorpfin.2014.05.013
Reference: CORFIN 810

To appear in: Journal of Corporate Finance

Received date: 4 December 2013
Revised date: 23 May 2014
Accepted date: 25 May 2014

Please cite this article as: Fan, Joseph P.H., Huang, Jun, Morck, Randall, Yeung, Bernard, Institutional Determinants of Vertical Integration in China, Journal of Corporate Finance (2014), doi: 10.1016/j.jcorpfin.2014.05.013

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Institutional Determinants of Vertical Integration in China

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Where legal systems and market forces enforce contracts inadequately, vertical integration can circumvent these transaction difficulties. But, such environments often also feature highly interventionist government, and even corruption. Vertical integration might then enhance returns to political rent-seeking aimed at securing and extending market power. China offers a suitable background for empirical examination of these issues because her legal and market institutions are generally weak, but nonetheless exhibit substantial province-level variation. We report that Chinese firms in the 2000’s are more vertically integrated than the U.S. firms in the 1990s. We find that vertical integration is more common where legal institutions are weaker and where regional governments are of lower quality or more interventionist. Further, firms led by insiders with political connection are more likely to be vertically integrated. Finally, vertical integration among politically unconnected firms is associated with elevated per capita GDP level and growth, while vertical integration among politically connected firms is unrelated to local economy performance.

JEL Classification: L22; P14; G38; P16
Key Words: Vertical Integration; Rent seeking; Institutional Development; Government

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We are grateful for helpful comments from Pedro Dal Bó, Zhiwu Chen, Kai Li, Harold Mulherin, Joanne Oxley, Ivan Png, Pablo Spiller, Tracy Wang, Larry White and other participants in seminars and conferences at the American Finance Association, the China International Conference in Finance, Harvard Business School, the Hass School at UC Berkeley, the National Bureau of Economic Research’s China Working Group Workshop, New York University, and the University of Copenhagen. Joseph Fan gratefully acknowledges financial support from Institute of Economics & Finance of CUHK. Jun Huang thanks the National Natural Science Foundation of China (No. 71102136, No. 71272008 and No. 71372038), the MOE Project for Key Research Institutes of Humanities and Social Science in Universities (No. 11JJD790008), the Shanghai Philosophy and Social Science Foundation (2013BGL008), the Innovation Program of the Shanghai Municipal Education Commission (14ZS078), and the Program for Innovative Research Team of Shanghai University of Finance and Economics. Randall Morck thanks the SSHRC and the Bank of Canada for partial funding. Bernard Yeung acknowledges partial funding from The Lally School of Management and Technology at Rensselaer University, where he was a visiting scholar in Jan 2008. * Corresponding author at: Institute of Accounting and Finance, Shanghai University of Finance and Economics, No.777 Guoding Road, Yangpu District, Shanghai 200433, China. Tel.: +86 21 65904822.
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