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# Government intervention and firm investment☆

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ABSTRACT

This paper examines how government intervention affects firms' investment and investment efficiency, focusing on the world's largest economic stimulus package (ESP) during the 2008 global financial crisis period. The RMB four trillion ESP aimed to restore the economy by promoting investment in priority areas. Thus it provided an exogenous shock to firms' investment environment and exacerbated the impact of government intervention on firms' investment and investment efficiency. We use propensity score matching to match government-intervened firms with their controls to reduce the endogeneity issue of government intervention. Our difference-in-differences analysis shows that government-intervened firms invested more than control firms. Further analysis shows that the source of funding for investment was mainly from bank loans rather than internal cash flows. However, the post-investment performance was poor. We find that the investment efficiency of government-intervened firms decreased and government-intervened firms overinvested after the ESP. Our results are robust to alternative model specifications and placebo tests. The findings suggest that government intervention can play a negative role in government-intervened firms.
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## 1. Introduction

A fundamental question in corporate finance is what determines firms' capital allocation and investment. In the perfect world without market friction (Modigliani and Miller, 1958), firms' investment would be determined only by their investment opportunities (Stein, 2003). However, in the real world, it has been long observed that a firm may underinvest due to market frictions such as information asymmetry (Myers and Majluf, 1984; Fazzari et al., 1988), or overinvest due to moral hazard and agency problems (Jensen, 1986; Lang et al., 1991). Using a sample of Chinese listed firms from 2001 to 2006, Chen et al. (2011) provide new evidence to the strand of literature by showing that a new friction in China, namely, government intervention in state-owned enterprises (SOEs), may distort firms' investment behavior. They measure government intervention by government ownership and political background of top executives (political connections). Their paper finds that SOEs, especially those with politically connected executives, have lower investment efficiency. Our research aims to extend the research on government intervention

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in firms' investment by focusing on an event that is likely to have exacerbated the impact of government intervention in firms' investment, namely the massive economic stimulus package (ESP) in China in 2008.

Corporate investment declined significantly during the 2008 global financial crisis.[1] To provide liquidity to the market and restore the economy, governments all over the world implemented various policies, among which capital injection by a quantitative easing (QE) monetary policy was an important instrument. For example, the US government approved a Troubled Asset Relief Program (TARP) in 2008 to purchase assets and equity from financial institutions. As an export-driven economy, China was also affected by the financial crisis with the economic slowdown in the US and Europe. To counteract the impact of the financial crisis on China and stabilize the economy, the Chinese government initiated an economic stimulus package of RMB four trillion (US$ 586.68 billion) in 2008. Compared with the 30 trillion yuan GDP of China in 2008, the magnitude of the stimulus plan was quite large. This was also the largest economic stimulus plan in the world during the financial crisis, equal to three times the size of the US efforts (Wong, 2011). Different from the case in the US, where the government bailed out financial institutions to provide more liquidity to the market, the four trillion yuan were used to promote investment in priority areas such as housing, rural infrastructure, transportation, health and education, environment, industry, disaster rebuilding, income-building, tax cuts, and finance.[2]

The 2008 economic stimulus package in China provided an exogenous shock to firms' investment environment. The ESP may affect firm's investment behavior in the following ways. Firstly, the government invested directly in priority areas under the program, thus creating demand for the upstream and downstream enterprises, which would affect the firms' investments. Secondly, China's government initiated an accommodative monetary policy regime under the economic stimulus program. The central bank reduced the interest rate five times to encourage firms to borrow money from banks. As a result, firms would enjoy easier access to bank credits with a lower interest rate, which provided ample funding for firms' investments. Moreover, the government sharply enlarged the size of credit to enterprises from commercial banks, making firms more easily obtain bank loans to support their investments. Thirdly, the government encouraged firms to invest in key areas by offering tax reduction and subsidies with the support of the stimulus plan. This provided motivation for firms to increase investments. Finally, the government could utilize political power to exercise control over SOEs and require SOEs to invest directly in specific areas. For non-SOEs, government intervention may have taken effect via politically connected top executives.

Since the financial crisis and the subsequent economic stimulus package were not expected,[3] it is unlikely that the government changed its intervention in anticipation of the ESP. Therefore, with the exogenous shock to the investment environment, it is interesting to investigate how the world's largest government-led stimulus program affected firms' investment behavior and, more importantly, how the effect of the stimulus program on corporate investment differed with different levels of government intervention.

In China, the government can intervene in firms in several ways. The most effective method of intervention is direct ownership control, which makes the firms SOEs. Such ownership may be used by politicians to interfere in SOEs to support the economy (Fan et al., 2011). The other indirect method of intervention is conducted through informal networks such as politically connected executives. This kind of intervention usually works in private firms which have a natural disadvantage compared with SOEs. So private firms need to utilize political connections to pursue political rents and in turn, these firms have to adjust decisions in order to cater to the government's goals.

With the above institutional settings and following prior research (Chen et al., 2011), we identify two instruments of government intervention with state ownership and political connections. According to the degree of intervention, we first classify SOEs as one type of intervened firms. Private firms with politically connected executives are classified as the other type of intervened firms (PC firms). The literature has shown that political connection to central government may have a different impact from connections with local government (Wu et al., 2012), and that central government has great resources to allocate in implementing stimulus plans, so we further focus on a subset of PC firms which have a political connection with central government (CC firms). Following related research on political connection (Fan et al., 2007; Fisman and Wang, 2015; Zheng et al., 2015), a private firm is politically connected if the Chairman or CEO of the firm is a current or former government official or a military officer or has taken a position on key political committees such as the National People's Congress, the People's Political Consultative Conference or the Congress of the Chinese Communist Party.[4]

We hypothesize that the effect of economic stimulus package on firms' investment behavior varies with different degree of government intervention. Specifically, the economic stimulus package provides positive shock to the supply of external finance, together with the presence of government intervention, might promote investments. Moreover, such effects should be more significant in firms facing more government intervention such as SOEs, PC and CC firms. Meanwhile, it is less clear-cut how firms' investment efficiency may be affected. In theory, positive shocks to external finance supply make financial constrained firms enable to fund profitable projects, which had to be ignored before. If this is the case, investment efficiency should be increased. However, under the unprecedented magnitude and great sense of urgency of the economic stimulus package, firms may be provided more capital than they needed in the short term, which leads to overinvestment and the effect should be more significant in

[1] The predominant view has attributed the decline of firm investment to the sharp decrease in the supply of external capital such as bank lending (Ivashina and Scharfstein, 2010; Duchin et al., 2010).

[2] "China plans 10 major steps to spark growth as fiscal, monetary policies ease". News.xinhuanet.com. Retrieved 2012-05-20.

[3] See Naughton (2009) for a detailed discussion of how urgent the economic stimulus package was initiated and implemented since it was unexpected.

[4] These positions are crucial instruments for entrepreneurs in private firms to build their political connections, because they are the only way to engage in the process of political decision-making in central and local government. Additionally, these positions are a reflection of social recognition, which helps to build a larger social network.

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