



Government intervention and corporate policies: Evidence from China^{☆,☆☆}



Yingying Shao^a, Rodrigo Hernández^{b,1}, Pu Liu^{c,*}

^a Department of Finance, College of Business and Economics, Towson University, USA

^b Department of Accounting, Finance and Business Law, College of Business and Economics, Radford University, USA

^c Department of Finance, Sam M. Walton College of Business, University of Arkansas, USA

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ABSTRACT

This study examines two channels through which Chinese government intervenes in business activities: direct intervention via government ownership and indirect intervention via strategic development plans in selected areas. The findings show that these interventions affect corporate policies differently and have opposite effects on financing policies: while firms with higher level of government ownership tend to use higher leverage, more long-term debt and hold less cash, and such effects are more pronounced with central government ownership, reverse effect is related with strategic development plans. In addition, the study shows that indirect intervention alleviates the impact of direct intervention on firms' financing policy. In terms of investment policies, both forms of intervention are related to higher investment expenditures and poorer performance. The effect of government ownership on firms' leverage has become less significant after the establishment of corporate bond market in China.

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1. Introduction

Government intervention can have a significant impact on an economy and the effect is particularly profound in emerging countries where the financial markets are more opaque, credit and financing are more difficult to receive, bureaucracies are more severe, and government intervention is more prevalent than in developed countries. In China, after three decades of economic reforms, the government still maintains substantial influences in business activities through different forms of intervention. This paper focuses on two forms of government intervention and examines how they affect corporate financing decisions including financial leverage, the use of long-term debt, and cash holdings. In

addition, this study investigates the effect of government intervention on firms' investment decisions and performance, respectively.

The first form of intervention is Chinese government's ownership of corporate firms. Studies examining the effect of government ownership have reported that high level of government ownership is often associated with pursuit of political and social objectives (Shleifer & Vishny, 1994), and that state-owned banks often make lending decisions based on social and political goals including providing jobs to the society and/or bailing out financially distressed firms (Cull & Xu, 2003; La Porta, Lopez de Silanes, & Shleifer, 2002). In China, a distinctive feature about government ownership is that the government is often the majority owner of both corporate firms and large banks, also known as dual ownership. The Chinese government owns many large banks including the largest four banks: Industrial and Commercial Bank of China, Agricultural Bank of China, China Construction Bank, and Bank of China, which in total provide more than 80% of commercial and industrial loans to corporations. This provides a unique institutional setting to examine how government ownership affects firms' corporate decisions because dual ownership structure allows the government to instruct the banks it owns to make preferential loans to firms it owns. Even though many of the state-owned enterprises (SOEs) are now partially privatized, they are still under the strong control of the government and still carry the goals of providing social and economic stability in addition to generating profits.

The study posits that Chinese firms with higher government ownership may take the advantage of government dual ownership to gain easier access to bank loans. Consequently, these firms tend to have higher leverage, use more long-term debt, and hold less cash. Because these firms can obtain bank loans more easily, they tend to make

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* Corresponding author. Tel.: +1 479 575 6095.

E-mail addresses: yshao@towson.edu (Y. Shao), rjhernand@radford.edu (R. Hernández), pliu@walton.uark.edu (P. Liu).

¹ Tel.: +1 540 831 6454.

more capital investment or even undertake value-reducing projects mandated by the government and thus experience relatively poor performance. The results in the study confirm the hypotheses and further reveal that the effect is more pronounced when firms are owned by central government compared to being owned by local government.

The second form of government intervention in this study is Chinese government's decision to strategically select some special "economic development areas" (to be referred to as EDAs henceforth). During the economic reforms, China has strategically established four EDAs: Yangtze River Delta Economic Area, Pearl River Delta Economic Area, Beijing–Tianjin–Hebei Economic Area, and Chengdu–Chongqing Economic Area. The government has implemented a number of preferential policies in these areas to create more favorable economic, technical and industrial opportunities so that the developments in these areas can serve as an economic engine to drive the economy in the rest of the nation. While the establishment of these EDAs was successful in boosting the national economy, it also produced unintended consequences such as creating severe economic disparities across regions. According to the China Statistics Yearbook, the average GDP growth rate is about 18% in EDAs compared to 5% in other areas, and the GDP in EDAs represents more than 40% of the total GDP in China.

Based on the research suggesting that firms' locations play an important role in corporate decisions (Almazan, Motta, Titman, & Uysal, 2010) and that financial slack is needed to fund potential growth opportunities (Myers and Majluf, 1984), this study conjectures that in China, the economic disparities in different areas caused by the government's development strategies and the resultant variation in growth opportunities would lead firms to make different corporate decisions based on their geographical locations. Such differences in corporate decisions between firms in EDAs and firms in other areas are referred to as the effect of *indirect* government intervention because the effect is transferred from the government's influence in the entire economy to individual firms' decisions. In other words, the strategic policies implemented by government in EDAs first cause changes in the macroeconomic environment, which consequently lead to changes in firms' behavior. In contrast, government ownership is referred to as *direct* intervention in the paper. In the literature, few studies have attempted to examine the effect of *indirect* intervention on corporate decisions, particularly in the form of establishing EDAs. Only recently research began to take a step toward this direction. Chen, Khan, Yu, and Zhang (2013) recognize the difference in regional government interventions and they study the relationship between regional government interventions and firms' co-investments as well as the consequent performance due to firms' investment co-movement. However, it is still unclear how EDA, a different form of government intervention, affects firms' financing decisions, investment decisions, and their performance.

The empirical results in this study show that while the direct and indirect interventions have similar effects on firms' investment decisions and performance, their effects on financing decisions are opposite. Firms located in EDAs tend to choose an efficient financial structure as reflected in lower leverage, less use of long-term debt, and more cash holdings than firms in other areas. Also, the investigation on the joint effect of government ownership and locations (in terms of inside or outside EDAs) reveals that the effect of government ownership on financing decisions and performance is less pronounced for firms inside EDAs than that for firms outside EDAs. In sum, this study suggests that while *direct* government intervention via government ownership may have led to inefficient financing policies and poor performance, indirect government intervention through establishing EDAs plays a positive role in mitigating the adverse effect of government ownership on firm's financing decisions.

Lastly the paper examines whether the inception of a new corporate bond market in China in 2007 affects firms' choice of leverage. The participants in bond market, which is free from government intervention,

may behave differently from the state-owned banks. For instance, the lenders in the bond market are more likely to make lending decisions based on borrowers' creditworthiness hence are less willing to lend to poorly performing firms that carry social and political goals. Therefore, we would expect that the inception of the corporate bond market would constrain the ability of government-controlled firms in the increase of financial leverage in order to fulfill the social and political mandates of the government.

This paper, to the best of our knowledge, is the first study using geographical EDA locations to examine how government policies affect corporate decisions and performance. The findings on the relationship between government's selection of EDA and firms' corporate decisions suggest a positive role played by the government in inducing efficient financing decisions. Moreover, the finding that *indirect* government intervention can help mitigate the adverse effect of *direct* intervention is a major contribution to the literature.

The paper also contributes to the literature in the area of government ownership, particularly in the study of China. It provides a comprehensive study on the effect of Chinese government ownership on multiple decisions in financing, investment, and performance, while previous studies tend to focus on the effect of government ownership on one single decision. For instance, Pessarossi and Weill (2013) study how government ownership affects firms' decision on borrowing from bond market vs. syndicated loans. Gul (1999) examines the relationship between government ownership, debt financing, and dividend policies which is only tangentially related to our study in terms of debt financing. In addition, this study complements the existing studies as the findings on the relationship between government ownership and firm performance are largely mixed. Some studies suggest that government ownership may undermine the performance because, in order to fulfill social and political goals, state-owned enterprises may undertake value-reducing investments (Chen, Sun, Tang, & Wu, 2011; Kang & Kim, 2012; Shleifer & Vishny, 1994), while others find that the relationship between government ownership and performance follows an inverted U-shape implying that too little government ownership may not provide SOEs with enough government support during financial distresses, while too much government ownership may lead to too much government interference in operation and management (Sun, Tong, & Tong, 2002). Our study contributes to the literature by suggesting a geographical variation in the effect of government ownership: while government ownership tends to have a negative effect on firm's performance, the negative effect is less pronounced for firms located in EDAs than for firms located in other areas.

Also relatively little is known regarding whether central government affects a firm's decisions differently from local (i.e. provincial, city, and county) government. This study therefore contributes to the literature by documenting a more profound effect of ownership by central government than by local government. In addition, it makes a unique contribution by documenting that the establishment of a new corporate bond market in China weakens the effect of government ownership on firms' leverage as the lenders in bond market are prone to lending based on economic as opposed to social and political considerations.

The remainder of this study is organized as follows. Section 2 discusses previous studies and develops the hypotheses. Section 3 describes sample selection and data. Section 4 presents the empirical results and Section 5 concludes the paper.

2. Hypothesis development

2.1. Government ownership, financing and investment decisions

Agency theory suggests that firms' financial policies are affected by ownership structure due to potential interest conflicts among various stakeholders. In the context of state-owned firms, studies suggest that, in addition to profitability goals, government-owned enterprises often

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