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Government expropriation and Chinese-style firm diversification

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ABSTRACT

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Firm diversification across unrelated businesses is prevalent in many emerging economies, in contrast to the practices in developed economies. A fundamental difference between these two types of economies concerns with the existence of sound economic institutions including in particular the institutions constraining government expropriation of private properties. In this paper, using a survey data set of private enterprises in China, we find that severer government expropriation in the form of higher informal levies, extralegal payments, and entertainment fees causes firms to diversify. We then provide two case studies to highlight the extra costs that China's private entrepreneurs need to bear for doing businesses, and how they can subsequently leverage their relations with government bureaucrats to diversify into various businesses. *Journal of Comparative Economics* **43** (1) (2015) 155–169. Chinese University of Hong Kong, Shatin, N.T., Hong Kong; National University of Singapore, 1 Arts Link, 117570, Singapore; School of Business, University of Hong Kong, Pokfulam, Hong Kong.

1. Introduction

Diversified firms are found to be prevalent in emerging economies such as China, India, Mexico, and Russia. And studies have shown that firm diversification leads to better performance in those emerging economies (e.g., Khanna and Palepu, 2000a; Khanna and Yafeh, 2005).[1] This is in contrast to the trend in developed economies where there exist diversification discounts in corporate valuation and as a result firms adopt focused strategies for their businesses.[2] What accounts for the contrasting patterns in firm diversification between emerging economies and developed economies? A fundamental difference

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[1] See Keister (2000), Khanna and Palepu (1996), Camp (1989), and Blasi et al. (1997) for the case of China, India, Mexico, and Russia, respectively. For a comprehensive review, see for example Ghemawat and Khanna (1998), Khanna and Yafeh (2007).

[2] For a recent survey, see Martin and Sayrak (2003).

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between these two types of economies is that there exist sound economic institutions (particularly, the institutions constraining government expropriation of private properties) in developed economies but not in developing ones.

Emerging economies are characterized with pervasive and severe government expropriation of private properties. It has been suggested that private entrepreneurs in those economies may diversify their businesses in response to government expropriation (Khanna and Palepu, 1997; Ghemawat and Khanna, 1998). Albeit a reasonable conjecture, there is little rigorous empirical work on the relationship between government expropriation and firm diversification. Part of the empirical challenge lies in data limitation, particularly in cross-country studies for which comparable measures of government expropriation are difficult to come by. In addition, empirical investigation has to address various endogeneity issues. In this paper, we fill in the void by using data from the largest emerging economy, China, and carefully addressing the identification problems.

The data used in this study come from a survey of China's private enterprises conducted in 2000. Unlike their state-owned counterparts, who are the favorite kids of the socialist government of China, private enterprises are the so-called adopted kids facing systematic discriminations and substantial constraints in business entries and subsequent operations. In particular, to meet various government regulations of business entry and ongoing operations, private enterprises are subject to heavy expropriations from the government, which maintains a significant role in the economy vis- à-vis the market in regulating business entry decisions and in adjudicating commercial disputes (Du et al., 2014). Thus, the business strategy of private firms can reflect most clearly the impact of government expropriation on firm diversification. Moreover, China provides a good setting to study the effects of government quality on firm diversification strategy. Despite the fact that China is a unitary state with unified laws and political system, there exist substantial variations in the de facto protection of private property rights across its regions (e.g., Cull and Xu, 2005; Du et al., 2008; World Bank, 2008), which allows us to identify the impacts of government expropriation on firm diversification.[3]

To capture the extent of government expropriation, we combine three different measures used by Johnson et al. (2002) and Cai et al. (2011), specifically, extra-legal payments (*Tan Pai* in Chinese), informal levies (*Za Fei* in Chinese), and entertainment fees (*Zhao Dai Fei* in Chinese).

We find that firms reporting more severe government expropriation are more diversified. Specifically, a one-standard-deviation increase in government expropriation leads to a 0.10-standard-deviation increase in firm diversification. These results remain robust when the regression models are modified to address typical technical concerns in empirical studies, including alternative estimation methods (Probit vs. linear probability model), instrumental variable estimation, alternative measures of firm diversification and government expropriation, controls for other types of institutions, and different subsamples.

To shed light on how in China government expropriation leads to diversification of private enterprises, in case studies contained in Section 4, we highlight some extra costs that China's private entrepreneurs need to bear for doing businesses. First, China's private entrepreneurs generally need to go through complicated and characteristically opaque business entry regulations to get their businesses started. Second, even after setting up their businesses, those entrepreneurs would still be constantly disturbed with ongoing levies on business operations imposed by governments, often in the name of fulfilling corporate social responsibility.

Those two types of costs point to interesting interactions between China's private entrepreneurs and its government bureaucrats, who are in charge of both entry approvals and ongoing business regulations. Private entrepreneurs have to spend much time to first get acquainted with those bureaucrats, and then build up personal trust with them. Private entrepreneurs need to make financial contributions to relieve the regional fiscal burden and help build up bureaucrats' signature projects. Furthermore, private entrepreneurs may need to nurture close relationships with those bureaucrats and/or their family members through gifts and favors.

Only after private entrepreneurs establish relations and build trust with relevant bureaucrats can they obtain licenses to do business in the regions and industries administered by those bureaucrats. However, those private entrepreneurs can then leverage the relationship-specific capital that they build up with relevant bureaucrats in entering new profitable industries upon their emergence and bidding for government procurement contracts often in new business lines, both of which result in diversification into often unrelated businesses.[4] In Section 4, we argue that diversification across unrelated businesses within a region (industrial diversification) is often a more viable strategy for private firms than expanding their existing business lines across regions (geographical diversification). This Chinese-style corporate diversification is obviously due to the power of the state vis-à-vis the market in the economy on one hand and the systematic discriminations against private enterprises on the other hand. In regions with severer government discriminations against private enterprises and hence higher government expropriations, government bureaucrats typically have more discretion over business regulations. Consequently, the relationship-specific capital that private entrepreneurs build up with relevant bureaucrats will be more

[3] Compared with cross-country studies, our cross-region study has two advantages: first, comparable data (say, for government expropriation) are more readily available for sub-national units; and second, it avoids the difficulty of controlling for differences in culture, political system, legal system, and religion across countries in international studies so that we could minimize the impact of various confounding factors.

[4] Consistent with the findings in the literature on economic institutions, government expropriation clearly dampens firm investment incentive. For example, high one-time setup costs deter firm entry, while high levies reduce profit-maximizing scale and hence the equilibrium investment. However, what we are concerned in this paper is the impact of government expropriation on firm diversification given the size of investment.