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Government connections and financial constraints: Evidence from a large representative sample of Chinese firms[☆]

Robert Cull [a,*], Wei Li [b], Bo Sun [c], Lixin Colin Xu [a]

[a] *World Bank, United States*
[b] *Cheung Kong Graduate School of Business, China*
[c] *Guanghua School of Management, Peking University, China*

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ABSTRACT

We examine the role of firms' government connections, defined by government intervention in CEO appointment and the status of state ownership, in determining the severity of financial constraints faced by Chinese firms. We demonstrate that government connections are associated with substantially less severe financial constraints (i.e., less reliance on internal cash flows to fund investment), and that the sensitivity of investment to internal cash flows is higher for firms that report greater obstacles to obtaining external funds. We also find that those large non-state firms with weak government connections, likely the engine for innovation in the coming years in China, are especially financially constrained, due perhaps to the formidable hold that their state rivals have on financial resources after the 'grabbing-the-big-and-letting-go-the-small' privatization program in China. Our empirical results suggest that government connections play an important role in explaining Chinese firms' financing conditions, and provide further evidence on the nature of the misallocation of credit by China's dominant state-owned banks.

1. Introduction

The presence of financial constraints and its effects on firms' investment decisions have received intense interest in the corporate finance literature. There is considerable evidence that financing constraints are an impediment to the investment and growth of firms in developed economies (Hubbard, 1998; Stein, 2003), while less work has been done to further our knowledge about financial constraints in developing countries that have different institutional structures. Firms in developing countries tend to face more severe financial constraints than those in developed countries, and their owners typically name financial constraints as one of their primary obstacles to investment (Dethier et al., 2011). Moreover, the governments of these countries tend to play a larger role in directing financial resources than in developed countries and tend to favor state-owned firms and firms that have stronger ties with the state in the allocation of capital (Ayyagari et al., 2012).

Credit allocation in China has been characterized by government intervention and has been biased towards state-owned enterprises,[1] and insufficient financial support may impose difficulties in the development of firms that lack government

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* Corresponding author at: MC 3-307, World Bank, 1818 H Street, N.W., Washington, DC 20433, United States. Tel.: +1 202 473 6365; fax: +1 202 522 1155.
E-mail address: rcull@worldbank.org (R. Cull).
[1] See Brandt and Li (2003), Huang (2003), Bai et al. (2006), Li et al. (2008), Cull et al. (2009), and Gordon and Li (2011).

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connections.[2] Employing the World Bank's Enterprise Survey of manufacturing firms in 120 Chinese cities conducted in 2005, we study whether and how firms with differential government connections are financially constrained in China and how that affects their investment patterns. We compare not only state-owned enterprises (SOEs) to non-state firms (both foreign and domestic), but also examine whether CEOs' governmental connections explain financial constraints within the subset of non-state firms.

We consider two forms of government connections: state ownership and the role of government in CEO appointment. A firm is classified as state-owned if it is registered as such based on the level of government shareholding. While state-owned firms have been corporatized and have their own boards of directors, they maintain close ties with their government supervisory entities and owners, and therefore have strong government connections. Firms can also gain and maintain government connections via personnel appointments and personal ties. Specifically, when a firm's CEO is appointed by a government agency, it indicates the firm's institutional ties or its CEO's personal ties to the government. A government-appointed CEO could have achieved this coveted position because the firm under his or her management is state-owned, or formerly state-owned. In our sample, about 8.3% of the non-state-owned firms have government-appointed CEOs. Government intervention in CEO appointment therefore also serves as an indicator of the extent of the firms' connections to the government for our empirical analysis.

Our empirical results show that the investment rates of sample firms are sensitive to internal cash flows and are also jointly sensitive to access to external finance — bank loans, trade credit and the size of unpledged collateralizable assets (henceforth "UCA"). The finding that the cash flow variable is still significant when we control for various measures of access to external financing suggests that internal financing is crucial for investment. In addition, we find that investment cash flow sensitivity tends to be higher for firms that perceive themselves to be more financially constrained — that is, when firms report that they face more severe financial constraints in both financial access and financing costs, when firms report having greater difficulty in obtaining loans after the financial crunch in 2003 in China, when firms report less confidence that their property rights will be protected, and when firms are younger.

The evidence therefore suggests that investment cash flow sensitivity may be a reasonable indicator of financial constraints in the Chinese institutional context, although the validity of this methodology is hotly debated based on data and institutions in developed economies (Brown and Petersen, 2009; Fazzari et al., 2000; Kaplan and Zingales, 1997, 2000). Using U.S. data, Chen and Chen (2012) show that investment cash flow sensitivity is no longer a reliable indicator of financial constraints in the U.S. However, for countries with much lower levels of financial development, such as China, our paper and others (e.g. Moshirian and Vadilyev, 2013) offer evidence that this methodology likely remains valid. We therefore take as a working hypothesis that investment cash flow sensitivity is a reasonable indicator of financial constraints for this study.

Our results show how government connections play a key role in explaining firm investment behavior in China. In line with previous studies using different samples and covering different time periods (e.g., Chow and Fung, 1998; Guariglia et al., 2011; Héricourt and Poncet, 2009; Poncet et al., 2010), investment in state-owned enterprises in our sample remains insensitive to cash flows, despite substantial institutional reforms undertaken by the central government.[3] Among non-state and foreign firms, the coefficients for cash flows are positive and significant, indicating that they are financially constrained. However, foreign firms, perhaps because of their greater access to foreign capital, exhibit weaker sensitivities of investment to cash flows than non-state Chinese firms.

Examining the role of government connections via CEO appointments, we find that investment is more sensitive to cash flows in firms with non-government-appointed CEOs than those with government-appointed CEOs. Additional tests are performed to examine the robustness of these results to various measures of firms' financial conditions. In particular, investment by firms with government-appointed CEOs also displays substantially less sensitivity to access to external finance — bank loans, trade credit, and the level of unpledged collateralizable assets (UCA). Even though or perhaps because firms with non-government-appointed CEOs often have less access to external finance, their investment patterns are more closely tied to the available external finance than firms with government-appointed CEOs. It seems to imply that firms with non-government-appointed CEOs face tighter financial constraints due, at least in part, to their inferior political status in the Chinese credit market.

In addition, we find that investments are less sensitive to indicators of growth opportunities in firms with government-appointed CEOs than in firms with non-government-appointed CEOs. Government-appointed CEOs are subject to different promotion criteria, and are presumed to have incentives to maintain stable employment, and use resources that would otherwise be spent on investment to cover firm arrears or seek favors from government officials who have influence over their future career. Our results are thus consistent with the notion that financial resources received by firms with government-appointed CEOs (including, or course, SOEs) could be diverted to other uses than to fund productive investment projects.

We also find that investments by large firms with weaker connections to the government (i.e., owned by non-state entities and/or run by CEOs not appointed by the government) are especially sensitive to the availability of internal funds, a result that is robust to several plausible sensitivity checks. This could be the result of a crowding out effect in external financing faced by large firms without government connections when the government provides privileged access to credit to large firms that are either state-owned or are run by government appointed CEOs.[4] Another plausible interpretation is that for smaller firms, the need for investment funding is commensurately smaller, and thus it is easier to use informal finance such as funding from friends, relatives or trading partners to

[2] Dollar and Wei (2007) also provide evidence that distorted capital allocation had led to persistent dispersion in returns to capital across sectors and geographic areas. Farrell and Lund (2006) report that by 2006 the private sector had produced more than half of China's GDP but received only 27% of total loans.

[3] With specific respect to the banking sector, non-performing assets were removed from the balance sheets of state-owned banks and placed in asset management companies (Hsu and Wan, 2004). State-owned banks have also taken on minority foreign ownership shares, first in smaller banks and later in three of the "Big Four" banks. Evidence indicates that minority foreign ownership was associated with gains in efficiency in the smaller state-owned banks (Berger et al., 2009).

[4] Under recent policies, the government privatized small and medium sized state-owned firms, retaining controlling ownership stakes in large SOEs.

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