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Cost of government and firm value

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ABSTRACT

Do high expenditures incurred in running the government benefit or hurt firms? Using Chinese data between 1999 and 2006, we find that higher administrative expenditures in provincial governments are associated with lower firm value, lower stock and financial performance, and lower labor productivity. Local governments that spend more on public administration tend to collect more fees from companies and spend less on social welfare and infrastructures. Our evidence is consistent with the “grabbing hand” hypothesis and has important policy implications.

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1. Introduction

Since 2005 China has consistently ranked among the heaviest taxed countries in the world in terms of the Forbes Tax Misery Index. According to some estimates, the overall tax burden in China runs as high as 34.5% if all types of taxes are accounted for (Wei, 2011). While the precise tax burden is disputed by the Chinese authorities, they nevertheless justify the rising tax burden on grounds of a fast-growing economy and, consequently, rapidly rising public expenditures which must be funded (Xiao, 2010). Other reasons often cited for rapidly rising public expenditures and total tax burden include a rapidly expanding government work force (Zhou, 2009), the use of the amount of taxes collected by local officials as a performance indicator, and, in some cases, the linking of officials' bonuses and perks to the taxes collected (Wei, 2011).

In contrast to the vast literature on how government spending affects aggregate consumption, saving and investment (e.g., Blanchard and Perotti, 2002; Cohen et al., 2010; Fisher and Peters, 2010), there is only limited research on how the costs of public administration and corporate taxation affect individual firms' value and performance. Thus, we are left with an unresolved question: Do high expenditures incurred in running the government enhance or erode firm value and performance? If public expenditures serve to improve overall government efficiency, for example, by attracting better qualified public sector workers, one would expect a positive impact on firms through higher quality public services, lower corruption, and reduced bureaucracy

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among other benefits. If, on the other hand, government spending is mainly self-serving, then the high cost of government not only may reflect low efficiency, but also may entrench local government bureaucrats and even lead to political extraction (for example, excessive fee charges to finance government expenditures) or reduced spending on social welfare and infrastructures, which, in turn, worsens the business environment and hurts both enterprises and citizens.²

This paper is motivated by the lack of empirical evidence on the relationship between the cost of government and firm value, and the important policy implications of such a relationship. Specifically, we empirically examine whether, and how, the level of administrative expenditures (that is, government spending on administration, including salaries and fringe benefits for public sector workers) at the local government level affects the valuation and performance of local listed firms. Using provincial level data in China during the period 1999–2006, we find that a higher cost of government is associated with lower firm value, lower stock and financial performance, and lower labor productivity. We further find that provincial governments that incur higher administrative expenditures tend to collect more taxes and fees from companies, and spend less on social welfare and infrastructures. Thus, excessive administrative expenditures erode firm value and performance mainly because of local governments' grabbing hand working through the collection of excessive fees and other taxes. Apart from identifying the link (that is, the total tax burden) between cost of government and firm value/performance and thus identifying the direction of causality, we also address potential endogeneity between firm value/performance and cost of government by controlling for observable factors that may affect these variables, and by using an instrumental variable approach to explicitly tackle the potential endogeneity issue. Our results are found to be robust.

Our empirical evidence, in conjunction with a large Chinese and English literature (e.g., Gordon and Li, 2011; Lin, 2005; Xu, 2011; Zhou, 2009) as well as anecdotal evidence, suggests that the negative association between cost of government and firm value and performance is caused by government expropriation, which is perpetuated by a number of imperfections, including the lack of democratic institutions, the absence of labor and firm mobility, a fiscal system which gives local governments strong incentives to collect excessive fees from enterprises, and inadequate oversight by the central government over local governments. Our findings are broadly consistent with the conclusions in recent studies which suggest that property rights institutions are significantly related to firm performance (Claessens and Laeven, 2003; Cull and Xu, 2005; Johnson et al., 2002), and that both tax burdens and corruption tend to lower foreign direct investment, firm growth, and the returns to investors (Cai et al., 2011; Fisman and Svensson, 2007; Xu, 2011). Our evidence based on a single country further adds to the growing literature (e.g., Choy et al., 2011; Pagano and Volpin, 2005) which indicates that a country's political system affects corporate finance and governance outcomes, and the stream of literature which indicates that fiscal policies (e.g., taxation) affect corporate valuation and behavior (e.g., Alzahrani and Lasfer, 2012; An, 2012; Doidge and Dyck, 2011).³

Although we examine the relations between cost of government and firm value in the context of China's transitional economy, we believe that the results have broader implications. For instance, without transparency or political accountability, higher administrative expenditures at the local government level may not result in higher efficiency in the provision of public services, and, worse still, may divert scarce resources away from much needed social welfare programs and hurt private firms and citizens. Our China evidence on the adverse impacts of excessive government spending (coupled with a lack of accountability and poor protection of property rights) is consistent with the cross-country evidence in Choy et al. (2011), among others, which indicates that a country's electoral system and extent of government involvement in the economy impact agency costs and consequently different aspects of corporate finance. The adverse impacts of excessive government spending (funded by taxation and/or borrowing) are corroborated by the highly publicized social and economic problems experienced most recently by several major developed economies due to large long-lasting government budget deficits. Our results may thus prompt academics and other key stakeholders to rethink the public finance system (including government expenditures and taxation), the role of government in business, and the relationship between federal/central government and state/local governments (see Glaeser, 2012 for a review of this literature).

We contribute to the literature in two major ways. First, we establish the empirical relations between the cost of public administration and firm value and performance. In doing so, we extend the literature on the effects of government spending and taxes on the private sector and economic efficiency. Second, we shed light on the specific mechanisms (that is, taxation and fees collection) through which excessive government expenditures erode firm profitability and productivity. Thus, we add to a growing body of research relating the political economy to the stock market.⁴

The remainder of the paper is structured as follows. Section 2 provides some background information on local government financing in China. Section 3 reviews the literature and formulates the hypotheses to be tested, Section 4 discusses the sample data and the empirical methodology, and Section 5 presents the empirical results. Section 6 provides a summary and concludes.

² According to Zhou (2009), many of China's government workers spend most of their time on administering approvals, licenses, registrations and the like rather than providing vital public services; the government workers are supported in part by the fiscal budget and in part by fees and fines collected; and relative to China's GDP per capita, the government work force is far too large and their financial support is a great burden for the country. The net results include a negative impact on entrepreneurship and creation of employment opportunities, widespread corruption, and political rent seeking. The problems are especially serious at the local government level.

³ Glaeser (2012) discusses the advantages of conducting country-specific studies of urban public finance, especially in the developing countries. Specifically, he points out that local government institutions differ significantly across the world, and it is unlikely that institutions have a homogenous impact throughout the world (e.g., more decentralization is likely to be beneficial in some areas and less so in others). Thus it is beneficial to focus on one or two countries, so as to adequately describe the rich institutional details necessary for a proper understanding of how urban political institutions (e.g., functions and powers of local governments) affect economic outcomes.

⁴ Belo et al. (2013) and Croce et al. (2012) provide a review of the literature on the relations between fiscal policies and asset prices. Bardhan and Mookherjee (2006) examine the effects of decentralization and accountability on local government public service volumes, efficiency and equity.

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