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Political promotion and labor investment efficiency☆

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ABSTRACT

This study investigates the effect of political promotion incentives on the labor investment efficiency of firms by focusing on human capital misallocation. We show that 1) promotion incentives of local politicians significantly increase firm-level employment growth and decrease labor investment efficiency. 2) Causality is established using the number of death toll in local mining accidents to isolate exogenous shocks on the promotion incentives of local politicians, and placebo tests further confirm the causality. 3) For under-hiring firms, promotion incentives only increase the employment of low human capital, thus distorting human capital structure and decreasing labor investment efficiency. 4) Our findings are robust to alternative specifications. Overall, we highlight the political economy channel of human capital misallocation from the perspective of career concerns of local politicians.

1. Introduction

Considering that human capital is the most important factor that determines firm productivity (Erosa, Koreshkova, & Restuccia, 2010; Lazear, 2009; Moretti, 2004), investment efficiency of human capital is essential for a firm sustaining competitive advantage and high productivity level. However, there has been a great deal of literature on the factors affecting the capital market investment, such as information asymmetry in capital markets affects firm investment decisions and often results in inefficiencies in the form of over- and under-investment (Hubbard, 1998; Stein, 2001). Probably due to the data unavailability, prior studies mainly focus on the investment efficiency of capital expenditure,[1] and there is surprisingly little empirical evidence examining the determinants of labor investment efficiency (Pindyck, 1988; Koeniger & Leonardi, 2007; Pinnuck & Lillis, 2007; Jung, Lee, & Weber, 2014; Alesina, Battisti, & Zeira, 2018; Ben-Nasr & Alshwer, 2016; Ghaly, Dang, & Stathopoulos, 2015).

This study attempts to fill the above gap in the literature. In particular, we investigate the determinants of labor investment efficiency from a novel channel, i.e., promotion incentives of politicians. This investigation is economically significant because labor costs typically represent roughly two-thirds of economy-wide value added (Jung et al. (2014)), and labor investments are more

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[1] For example, Hayashi and Inoue (1991); Hubbard (1998); Walker (2005); Richardson (2006); Biddle, Hilary, and Verdi (2009); Liang and Wen (2007); Erickson and Whited (2000); Nan and Wen (2014); Chari and Henry (2008) and Hall (2016).

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flexible and reversible than capital investments (Pinnuck and Lillis (2007); Hall (2016)). For example, the U.S. Census Bureau's Annual Survey of Manufacturers reports that the payroll and employee benefits in the manufacturing sector totaled $829 billion in 2015 but capital expenditures only amounted to $263 billion.[2] In China, the labor adjustment is costly. For example, in January 2008, China adopted a new "Labor Contract Law of the People's Republic of China". The law requires employer to provide employees with written contracts that contain the term of employment, wages, social insurance, labor protections and so on. This new law includes not only employment contract viscosity, but also the minimum wage and the broad pay more of the economic compensation when firms dismiss employees. That means China's labor adjustment is very costly because it has legal barrier. Some related studies discuss on relevant issues. For example, Cooper et al. (2012) demonstrate that one of the most economically important provisions is the requirement of severance payment, and the severance is twice the amount (the basic amount specified in the law) if a contract is terminated unlawfully. They also point that in China, increased severance payments lead to a reduction in productivity, since reallocation is very costly. Chen and Funke (2009) claim that the improvements design to protect workers from casualization and arbitrary firings would raise costs for employers by raising requirements for severance pay, and they view the law as the twilight of the age of cheap labor in China.

Meanwhile, the economic consequence of incentives from political promotion on labor investments has yet to be investigated.

We conduct our study based on the Chinese stock market, which is an ideal laboratory to investigate the effect of promotion incentives on labor investment efficiency (*LabEff*) for the following reasons:

1) Firm productivity in China is relatively low compared with that in developed markets. Related studies argue that input misallocation can be an important reason for low productivity level (Hsieh and Klenow (2009); Bartelsman, Haltiwanger, and Scarpetta (2013); Restuccia and Rogerson (2013)). Recently, Li, Loyalka, Rozelle, and Wu (2017) argue that future economic growth of China requires higher human capital. As the second largest economy worldwide, Chinese economy has been growing at nearly 10% since it embraced economic reforms more than 30 years ago. Therefore, investigating the labor investment efficiency and human capital misallocation in China is an important research agenda with economic significance.
2) Promoting employment has always been the goal of China's central government, and, thus, local politicians are pressured to increase employment. For example, on September 9, 2014, Chinese premier Keqiang Li responded to Klaus Kleinfeld (CEO and chairman of Alcoa Corporation): "Everyone is concerned about China's economic growth data, but for the Chinese government, the greatest concern is about the employment situation in China." In 2012, the former president of China Jintao Hu also emphasized: "employment is the foundation of people's livelihood, and promoting employment is the top priority for ensuring and improving people's livelihood."[3] Accordingly, in all three versions (2006, 2009, and 2013) of "Comprehensive Appraisal System of the Local Party and Government Leading Bodies and Leading Cadres (for Trial Implementation)," the performance evaluation of politicians (Chapter 6) clearly requires that the evaluation criterions should include the levels of local economy, employment (unemployment rate), and household income. Local firms are greatly incentivized to build "intimate" relationship with the local government because local governments control land, capital, and other important resources and possess approval authority to major investment projects. When the central government requires improving employment rate and controlling unemployment as macroeconomic indicators, local governments will exert/transfer this pressure to local firms. In addition, local firms may also intentionally cater to their political allies by altering their hiring decisions toward the targets of the government in an attempt to obtain future benefits in return,[4] i.e., exchange of favors between politicians and firms.
3) Data in China allow us to identify human capital structure at firm level. To explore the underlying mechanism between promotion incentives and *LabEff*, we hand-collect the educational level of employees at firm level and introduce the human capital structure to investigate whether the hiring behavior of firms distorts labor structure.

Based on the aforementioned arguments, we conjecture that local politicians subject to promotion incentives will transfer political pressure to local firms and further affect the human capital level and *LabEff* of local firms.

To test the above hypothesis, we manually retrieve the turnover of local government officials at city level and define a dummy variable, *Promotion*, to identify years with the highest incentives of promotion for the local politician (Bo (1996); Li and Zhou (2005); Piotroski, Wong, and Zhang (2015); Piotroski and Zhang (2014)). Following Pinnuck and Lillis (2007) and Jung et al. (2014), We use firms' net hiring (percentage change in the number of employees) to measure investment in labor, and then we define investment efficiency by using absolute values of differences between observed (actual) labor investment and expected labor investment, which is predicted and justified by economic fundamentals. A higher deviation of labor investment from its predicted value indicates lower labor investment efficiency. Thus, our measure of abnormal net hiring captures the amount of net hiring not attributable to underlying economic factors.

First, we find that political promotion facilitates inefficient net hiring. By comparing the actual and expected net hiring, we divide the sample into two subgroups: over- and under-hiring firms. For over-hiring firms, impending political promotions decrease (increase) labor investment efficiency (inefficiency), which is straightforward: local politicians are pressured to increase employment at

[2] http://factfinder.census.gov/bkmk/table/1.0/en/ASM/2015/31GS101

[3] Attaching great importance to employment, the Chinese central government formulated a series of policies and measures for increasing employment to maintain the basic stability of the employment situation. China exerts great efforts to increase employment level. For example, the Chinese central government issued "Employment Promotion Law of the People's Republic of China" on August 30, 2007, and "The New Labor Contract Law" became effective on January 1, 2008.

[4] Faccio and Hsu (2017) also find evidence of high job formation at establishments operated by the targets of politically connected firms than those operated by targets of non-connected firms, thus supporting stories about exchange of favors.