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Government integrity and corporate investment efficiency

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ABSTRACT

We explore the relation between government integrity and firms' investment efficiency in the context of China's deepening reforms and its strengthening the social credit system. We find that government integrity is positively associated with the investment efficiency of listed companies in China. Government integrity is negatively related to corporate underinvestment, but insignificantly related to corporate overinvestment. Higher government integrity reduces underinvestment in non-state-owned firms, but this relation is not significant in state-owned firms. Furthermore, we find that the negative relation between government integrity and underinvestment is only significant for firms in industries that receive supportive government policies. This study enriches research on corporate investment by adopting the perspective of government integrity, and supplements the literature on government integrity and its economic consequences. Our study also provides micro-level empirical evidence that strengthening government integrity will promote the economic transformation of China.

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1. Introduction

In recent years, as China has developed economically, integrity has become increasingly important in the social value system and of increasing interest to researchers and policy makers. The report of the Eighteenth National Congress of the Communist Party of China (CPC) points out that education and governance are

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needed to address serious ethical problems, and that it is essential to enhance government integrity, business integrity, social integrity and judiciary credibility. In addition, the Third Plenary Session of the Eighteenth CPC Central Committee called on the public and government to establish a sound social credit system to encourage ethical behavior, punish dishonesty, promote the transformation of government, greatly reduce administrative examination and approval, make government's decision-making more reasonable, and strive for a transparent government. Chinese Premier Keqiang Li emphasized in the State Council Executive Meeting that "a promise is a promise for the government." It is important for the government to keep its word, because foreign investors and citizens will choose to invest in local areas only if they believe in the government's policies and regard the government as trustworthy (Zhang, 2015). A government with integrity contributes to a good investment environment, which is essential for local economic development. To optimize the investment environment for private capital investment, the Chinese government has focused on speeding up the transformation of government function and on improving the efficiency of government operations; however, several problems still exist. For example, some of the government's policies are opaque or change frequently, and favorable promises made by the government are not always fulfilled. These problems threaten the government's image, and make enterprises less enthusiastic about investments.

Some studies have discussed the relations between enterprises' investment behavior and formal institutions such as the legal, government control or official assessment systems (e.g., Shleifer and Vishny, 1994; La Porta et al., 1998; Li and Zhou, 2005; Yang and Hu, 2007). However, as Chen et al. (2013) emphasize, researchers who focus on the formal system should note that countries with similar legal systems may have great differences in areas such as social and economic development, which are not determined by the formal system. In countries undergoing economic transformation or countries with unsound formal systems, attention should be paid to the influence of the informal system (Greif, 1994; North, 2005). Given China's economic transformation, researchers limiting themselves to studying the formal system, as absorbed and improved by China, will not understand China's social and economic issues well (Allen et al., 2005; Chen et al., 2013). They should consider the informal systems that have been shaped over thousands of years and have a far-reaching influence on Chinese society (Allen et al., 2005; Chen et al., 2013). Today, as China works to strengthen government integrity and strives to construct a transparent government, government integrity,¹ as an informal system that plays an important role in the development of China, is attracting growing attention from researchers.

In the political principal-agent relationship between the public and the government, the latter makes a commitment to protect the public's interests the moment it accepts the public's commission to exercise power. As an important aspect of a responsible government in a modern democratic society, government integrity is the cornerstone and the soul of social integrity, and governments play an important role in leading and promoting the construction of the social integrity system. In China, the government plays a double role: participant and regulator (Zou, 2004). Due to the government's monopoly and authority, government integrity is, undoubtedly, the core of social integrity in China (Zou, 2004). If the level of government integrity is high, it has a positive influence on social integrity (Du, 2010), and thus contributes to both market integrity and local comprehensive competitiveness (Wang, 2003). In contrast, if the level of government integrity is low, it is likely to lead to unfair practices between the government and the enterprises it manages (Wang, 2003). These unfair practices include official corruption, as demonstrated by the government's illegal possession of personal assets (Wang, 2003). Such occurrences damage the government's authority and create a credibility gap between the government and the market. In this situation, the lawful rights and interests of enterprises are barely guaranteed and the whole market-oriented economy becomes chaotic. Therefore, it is essential for the government to strengthen the integrity of the administrative process.

¹ Narrowly defined, integrity is a behavioral characteristic. However, more generally, integrity is part of the process of people's long-term social interactions. The definition of integrity as a core value of Chinese socialism is "integrity is honesty and trustworthiness. It is a moral norm which is passed down for hundreds of years. Integrity is the main part of socialist morality, and focuses on working honestly, keeping promises and treating everyone sincerely." This definition of integrity is general. Zhang (2002) argues that the informal system includes social norms, business culture and all parts of the social organization system. North (1990) points out that the informal system includes conventions, regulations and codes of conduct. Therefore, as a type of value or moral norm, integrity belongs to the informal system.

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