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State Capitalism vs. Private Enterprise

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The key function of an economic system is to allocate scarce resources efficiently. Having proved superior to central planning, Western liberal capitalism, based on markets and private enterprise, was in the ascendant following the collapse of the Soviet Union. More recently, however, state capitalism has won adherents as an alternative to Western capitalism. State capitalism, as practiced in China, Russia, and elsewhere, combines the power of the state with capitalist tools: the state controls access to capital, picks winners, and influences investment decisions, while at the same time listing state firms on domestic or overseas stock markets.

In our research, we ask how efficiently state firms allocate capital. Our focus is on China, the country where state capitalism is perhaps most entrenched. Because China's capital markets are relatively underdeveloped and firms cannot access them without political approval, we focus on firms' internal allocations of capital, the internal capital markets operating inside business groups. As we show, Chinese firms rely more heavily on capital obtained from fellow group members than on external capital markets.

We investigate the efficiency of capital allocation by contrasting how state business groups and privately owned business groups in China allocate capital across

member firms. An efficient internal capital market allocates more capital to units with relatively better investment opportunities. This is exactly how, according to our evidence, private groups in China allocate capital. State groups, in contrast, do the opposite.

Our setting has parallels with studies of internal capital markets at multi-segment firms in the United States, but our focus on state groups is novel. Besides having few state firms, the United States suffers two data handicaps compared to China. First, unlike group member firms in China, business segments in the United States are rarely stock market listed, so standard proxies for their investment opportunities cannot be estimated directly. Second, unlike U.S. firms, Chinese stock market listed firms must disclose detailed data on intra-group capital transfers. These data allow us to test the efficiency of capital allocations by measuring the sensitivity of a firm's capital allocation in the group's internal capital market to that firm's investment opportunities.

Using data on all internal capital transfers among group member firms at 211 state business groups and 76 private business groups from 2004 to 2013, we find startling differences. Private groups allocate more capital to units with better investment opportunities, consistent with maximizing group value. This is despite the fact that

private enterprises in China are often credit-rationed by state banks and face higher interest rates. State groups, by contrast, reallocate capital from good-investment-opportunity to poor-investment-opportunity member firms.

Two pieces of evidence suggest that the perverse response of capital allocations to investment quality in state groups reflects deliberate policy. The first shows that product market competition constrains state groups' tendency to ignore price signals: exogenous increases in product market competition, resulting from tariff reductions, appear to pressure state groups to allocate capital less inefficiently. Conversely, reductions in competition appear to reduce product market discipline on state groups. The second piece of evidence is that state groups divert less capital away from good-investment-opportunity firms over which they have less control, suggesting outside minority investors monitor capital allocation decisions. Even so, minority investors are harmed when state firms with relatively better investment opportunities are allocated relatively less capital.

Our results suggest that state capitalism does a poor job of allocating capital, at least in China's state business groups. This likely reflects the fact that the objective of the Chinese Communist Party (CCP) is not just maximizing profits or shareholder value but also maintaining a "harmonious society." Consistent with this, we document that the chairmen of state groups are rewarded with promotions to higher office not only for raising productivity but also for avoiding large-scale job losses. These aims can be in conflict and over time may be incompatible.

State group chairmen appear to let their career incentives influence their internal capital allocation decisions. Not only do we find that internal capital allocations are used to prop up large and struggling employers with poor prospects, consistent with the policy aims of the CCP. We also find that capital allocations are particularly distorted when group chairmen are up for promotion and cease to be distorted once a group chairman becomes ineligible for promotion under the CCP's rules on mandatory retirement.

Such behavior could in principle be in the CCP's best interest, as it may help avoid layoffs, but a final test suggests that state group chairmen's interests are potentially misaligned. We find that capital allocations are significantly less distorted after crackdowns on corruption among holders of high political offices in the province in

which a state group is headquartered. To the extent that such crackdowns are perceived as exogenous shocks to the risk of being held accountable for self-serving behavior, state group chairmen may prefer to lie low for a while and not misallocate capital for their private ends. Our results are consistent with this interpretation.

Prior literature identifies two sources of inefficiencies at state firms. The "political view" argues that politicians extend a "grabbing hand" to divert public resources for their own benefit. The "social view" argues that the state pursues noncommercial goals, including job creation, regional development, and income redistribution.

Our evidence is consistent with both sources of inefficiency. The influence of group chairmen's career concerns suggests the political view, while favoring struggling group members with poor investment opportunities suggests the social view. Indeed, our results suggest the two sources of inefficiency are interlinked: by pursuing social objectives political appointees at state firms maximize their personal chances of obtaining political benefits.

Our paper also contributes to the literature on business groups, which emphasizes two views of internal capital markets. According to the "bright side" view, divisions compete for corporate resources while group management picks winners based on the quality of investment opportunities. According to the "dark side" view, rent-seeking by divisional managers may lead to inefficient capital allocations. Our evidence suggests that for private groups in China, the "bright side" dominates while for state groups the "dark side" dominates.

Finally, our paper contributes to the growing literature on corporate governance in China. Prior work shows that the presence of outside private investors at state-owned enterprises improves firm value, operating performance, transparency, and pay-for-performance sensitivity. We add to this the finding that outside private investors make it harder for state groups to divert resources away from member firms with good investment opportunities.

NOTE

This research brief is based on "State Capitalism vs. Private Enterprise," by Donghua Chen, Dequan Jiang, Alexander Ljungqvist, Haitian Lu, and Mingming Zhou, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2544246.