

**INSTITUTIONAL ENVIRONMENT, POLITICAL  
CONNECTION AND FINANCIAL CONSTRAINTS:  
EVIDENCE FROM PRIVATE LISTED ENTERPRISES  
IN CHINA**

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**DOCTOR OF PHILOSOPHY  
UNIVERSITI UTARA MALAYSIA  
November 2012**

**INSTITUTIONAL ENVIRONMENT, POLITICAL CONNECTION AND  
FINANCIAL CONSTRAINTS: EVIDENCE FROM PRIVATE LISTED  
ENTERPRISES IN CHINA**

**By**

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**Thesis Submitted to  
Othman Yeop Abudullah Graduate School of Business,  
Universiti Utara Malaysia,  
In Fulfillment of the Requirements for the Degree of Doctor of Philosophy**

OTHMAN YEOP ABDULLAH GRADUATE SCHOOL OF BUSINESS  
Universiti Utara Malaysia



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Tajuk Tesis/Dissertation  
(Title of the Thesis/ Dissertation) : Institutional Environment, Political Connection and Financial Constraints: Evidence from Private Listed Enterprises in China

Program Pengajian  
(Programme of Study) : Doctor of Philosophy

Nama Penyelia/Penyelia-penyelia  
(Name of Supervisor/Supervisors) : Prof. Dr. Abdul Razak bin Chik



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## ABSTRACT

Political connection is one of the hotly debated global issues in financial economics in recent years. However, very few studies have focused on political connection and financial constraints in enterprises operating in different institutional environments. China is known for its unique institutional environment and unbalanced regional economic growth. China's economy is in transition to market economy. The transition is led by the Chinese government. It is important to examine how political connection plays its role in enterprises to reduce financial constraints especially for their business expansion in China. Hence, this study examines the relationship between institutional environment, political connection and financial constraints of private listed enterprises in China. This study uses a sample of 3,911 private listed enterprises in Shanghai and Shenzhen Stock Exchange Market. The data is obtained from WIND and CSMAR database for the period of 2008-2011. Multiple regression models are used to provide answers to the research questions developed in this study. The results show the existence of political connection and strength of such connection has significant influence on reducing enterprises' financial constraints. Political connection helps private listed enterprises access to bank credits, reduce their financial constraints, expand their business enterprises and promote private economic development in China. The findings also show that institutional environment has a significant positive effect in reducing financial constraints. In addition, institutional environment is found to have a moderating effect on the relationship between political connection and financial constraints. The most important contribution of this study is it expands current knowledge on the effect of institutional environment and political connection on private enterprises' financial constraints. This has policy implications for future government initiatives in strengthening the regulations to restrict political connection in order to achieve transformation of government governance, development of financial market and improving the legal system in China.

**Keywords:** Institutional Environment, Political Connection, Financial Constraints, Private Enterprises

## ABSTRAK

Sejak kebelakangan ini, hubungan politik menjadi salah satu isu global dalam bidang ekonomi kewangan. Walau bagaimanapun, hanya sedikit kajian yang menumpu ke atas hubungan politik dengan kekangan kewangan bagi firma-firma beroperasi di dalam persekitaran institusi yang berbeza. Negara China adalah terkenal dengan persekitaran institusinya yang unik dan pertumbuhan ekonomi wilayahnya yang tidak seimbang. Negara China adalah dalam transisi ke ekonomi pasaran. Transisi ini adalah dipimpin oleh kerajaan. Dalam konteks ini, adalah penting untuk mengkaji bagaimana hubungan politik membantu firma mengurangkan kekangan kewangan bagi perkembangan perniagaannya di negara China. Maka, kajian ke atas hubungan antara persekitaran institusi, hubungan politik dan kekangan kewangan adalah penting serta mempunyai sumbangan yang signifikan kepada polisi dan teori. Tesis ini menggunakan sampel yang terdiri daripada 3,911 firma swasta yang disenaraikan dalam pasaran saham di Shanghai dan Shenzhen. Data ini adalah diperolehi daripada pengkalan data WIND dan CSMAR bagi tempoh 2008-2011. Model regresi berbilang digunakan untuk menjawab persoalan kajian yang dibangunkan dalam kajian ini. Hasil dapatan kajian ini menunjukkan bahawa kewujudan dan kekuatan hubungan politik mempunyai kesan signifikan dalam mengurangkan kekangan kewangan sesebuah firma. Hubungan politik membantu firma swasta memperoleh kredit bank, mengurangkan kekangan kewangan, mengembangkan perniagaan mereka dan menggalakkan pembangunan ekonomi swasta di negara China. Hasil kajian ini juga menunjukkan bahawa persekitaran institusi mempunyai kesan positif yang signifikan dalam mengurangkan kekangan kewangan. Tambahan pula, persekitaran institusi juga didapati berupaya mempengaruhi hubungan antara kekangan kewangan dan hubungan politik. Sumbangan terpenting kajian ini adalah ia mengembangkan pengetahuan sedia ada yang berkenaan dengan kesan persekitaran institusi dan hubungan politik ke atas kekangan kewangan firma swasta. Dapatan ini mempunyai implikasi polisi masa depan kerajaan yang bertujuan untuk memperkukuhkan regulasi-regulasi bagi menghadkan hubungan politik dalam usaha untuk mencapai transformasi tabdir urus kerajaan, pembangunan pasaran kewangan dan sistem perundangan di negara China.

**Katakunci:** Persekitaran Institusi, Hubungan Politik, Kekangan Kewangan, Firma Swasta

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## ABBREVIATIONS

<b>AIC</b>	Association of Industry and Commerce
<b>CEO</b>	Chief Executive Officer
<b>CF</b>	Cash Flow
<b>CMRI</b>	China Marketization Relative Index
<b>CPI</b>	Consumer Price Index
<b>CPPCC</b>	Chinese People's Political Consultative Conference
<b>CSM</b>	China Stock Market
<b>CSMAR</b>	China Stock Market Accounting Research
<b>CSRC</b>	China Securities Regulatory Commission
<b>EBIT</b>	Earnings before Interest and Taxes
<b>ECD</b>	Enterprise Characteristics Database
<b>FC</b>	Reduction of Financial Constraint
<b>GDP</b>	Gross Domestic Product
<b>GOV</b>	Government Governance Index
<b>HSEM</b>	Shanghai Stock Exchange Market
<b>IE</b>	Institutional Environment
<b>IED</b>	Institutional Environment Database
<b>LEG</b>	Legal System Index
<b>LLSV</b>	La. P., Lopez-de-Silanes, Shleifer, A. and Vishny, R. W.
<b>MF</b>	Financial Market Index
<b>MM</b>	Modigliani and Miller
<b>NAIC</b>	National Association of Industry and Commerce
<b>NPC</b>	National People's Congress

<b>NPV</b>	Net Present Value
<b>NYSE</b>	New York Stock Exchange
<b>PC</b>	Political Connection
<b>PCLE</b>	Political Connection Loan Effects
<b>PCstrength</b>	Political Connection Strength
<b>SSEM</b>	Shenzhen Stock Exchange Market
<b>WIND</b>	Wind Information Limited Company

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## CHAPTER ONE: INTRODUCTION

### 1.1 Background of Study

Many researchers have conducted studies in the field of financial economics related to law and finance. For example, Allen, Qian and Qian (2005) put forward the theories of financial theory and economic growth. This theory is about the relationships among legal system, financial development and economic growth. It proposes that the legal system is one of the decisive factors for financial development and economic growth. However, this proposition is not completely correct in the case of China.

Allen et al. (2005) argue that while economic growth in China is relatively rapid, but its legal system is still not perfect. Thus, this situation is not in line with Allen's economic growth theory. Chinese economic growth should be at a slower rate. However, China's annual average economic growth has experienced double-digits growth since year 2003. The crucial question is why does China's economic growth remain rapid although the legal system and financial institutions are underdeveloped? Such situation has been highlighted by Murrell (2005) as the "Chinese Puzzle".

Allen et al. (2005) provide an explanation on how China could achieve high economic growth under the condition of insufficient legal protection. According to them, the key was the existence of an alternative mechanism in China. They believed that reputation and relationship are the most important alternative mechanisms. Sun, Liu and Li (2005) have pointed out that political connection is

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could not be performed. It is important to note the impact of political connection in the long run could be significantly different from the present study. Future study should explore this dynamic impact of political connection.

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