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THOUGHT LEADERSHIP BRIEF

Expropriation Risk and Investment: What Policy Makers can Learn from a Natural Experiment in China

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KEY POINTS

- Property rights institutions govern the ownership and usage of economic resources.
- Strong property rights institutions help enforce contracts between the government and private entities and constrain a government's arbitrary behavior and expropriation activities, the threat of which lowers firms' expected returns from investments.
- Our research shows that firms increase investments, especially those that result in tangible assets. when they perceive lower risk of expropriation activities.
- Local governments should consider implementing rules and regulations that lower private companies' explicit and implicit expropriation risks to stimulate investments.

ISSUE

Legal institutions strongly influence economic development and corporate policy. Usually, legal institutions can be dissected into two deeply intertwined yet distinct clusters: contracting institutions and property rights institutions. The former oversees the rules and regulations that govern transactions among private and public entities. Stronger contracting institutions can lower uncertainty in the enactment and enforcement of contracts between parties. Property rights institutions, on the other hand, govern the ownership and usage of economic resources and include the rules and regulations that protect private entities against infringement from other parties, such as individuals, private organizations, or the government.

Strong property rights institutions help enforce contracts between the government and private entities and constrain a government's arbitrary behavior and expropriation activities. The threat of expropriation lowers firms' expected returns from investments. Thus, lowering firms' expropriation risk by strengthening property rights protection should increase firms' willingness to invest.

However, despite the intuitive appeal of this prediction, there is no conclusive evidence that strengthening property rights protection indeed leads to higher investments. Although we observe different levels of property rights protection across different countries, these differences cannot answer the question for a few reasons. First, a country's property rights are deeply intertwined with other important factors that influence economic outcomes, such as contracting institutions and the political economy, making it challenging to identify the effect of property rights. Second, property rights institutions are largely shaped by pre-determined factors, such as natural endowments and colonial origins, so it is unclear whether attempts to strengthen property rights can sufficiently alleviate expropriation risk and lead to economically meaningful differences in real outcomes. Indeed, property rights reforms in developing countries often fail because powerful groups alter or exploit the reforms to maintain their economic dominance. Third, property rights reforms are rare, and often associated with other types of institutional changes, making it difficult to attribute the benefits only to property rights reforms.

Using surveys on companies to investigate the relation between managers' perception of property rights protection and their firms' decision suffers from the same drawbacks. That is, surveys usually still rely on differences across geographical areas, and cannot rule out that other factors, such as political economy, are driving investments. Furthermore, survey questions typically focus on bribes and informal payments, thus the results could be due to firms reducing investment to retain liquid assets for making these payments.

Property rights protection is especially important to private firms because they are subject to higher expropriation risk than publicly traded ones. Indeed, local governments are less likely to expropriate from publicly listed firms due to their greater visibility and deeper connections to the State.

In sum, expropriation risks are often of first-order importance to entrepreneurs and private companies. Whether property rights reforms in emerging economy can effectively lower managers' perception of expropriation risk and lead to meaningful increase in investments is an open question, whose answer has implications for emerging economies' legislators and regulators.

ASSESSMENT

In 2007, China passed the Property Law of the People's Republic of China (hereafter, the Law). Prior to the Law, private property owners were entitled only to an "administrative review" in response to local government expropriation. This administrative review, which entailed assessments of the owners' and local government's claims and of the compensation provided by the local government, was conducted by the local government itself. After the law, owners can challenge expropriations in a court, which creates a check on the local government. As the Law reduces firms' perceived government expropriation risk without materially changing the efficacy of contracting institutions, it is an ideal setting to examine the effects of a property rights reform on private companies' investment.

However, the change in private companies' investments during the Law may be due to time trends or other contemporaneous events. We thus take advantage of differences in property rights protection prior to the Law to strengthen our analyses. Specifically, prior to the Law, firms' property rights protection varied by region. We use this variation to sort firms into treatment and control groups. As the Law formalizes property rights protection for all provinces, we expect that provinces with weaker pre-Law property rights protection (i.e., higher expropriation risk) will experience greater improvement than those with stronger pre-Law protection. We use the China National Economic Research Institute's provincial-level government expropriation risk measures. We label the five provinces with the lowest expropriation risk, namely Shanghai, Beijing, Guangdong, Zhejiang, and Jiangsu, as the control provinces and firms headquartered in those provinces as control firms. We label the remaining 26 provinces as treatment provinces and firms headquartered in them as treatment firms. To control for differences in characteristics between treatment and control firms that may influence investment, we match each treatment firm with a control firm based on their economic fundamentals, including size, liabilities, and profitability in 2006 (i.e., the year prior to the Law).

We find that subsequent to the Law, treatment firms significantly increase investment compared to control firms. The result is consistent with treatment firms becoming less concerned about expropriation risk in their investment decisions after enactment of the Law. In economic terms, after the Law, the average treatment firm increases its investment by 0.53% of total assets (6.68% of the pre-Law investment level) or 1 million RMB (equivalent to USD 135,000), relative to the average control firm. We also find that after enactment of the Law, treatment firms invest more in human capital than do control firms, indicating higher employment growth among treatment firms.

Additionally, we separate investments into capital expenditure and R&D because the former is more likely to lead to tangible assets, which are easier to expropriate than are intangible assets from R&D. We indeed find that treatment firms' increased investments are driven by capital investments, lending further supports to the notion that firms' perceiving less expropriation risk is the mechanism driving their investment.

Next, we conduct cross-sectional analyses to provide evidence regarding the mechanism of the Law's effect on investment. Intuitively, if treatment firms increase investment post-Law due to lower perceived expropriation risk, the Law's effects should be stronger among treatment firms facing a high likelihood of expropriation. To measure this likelihood, we use three items from the literature: the local government's deficit, the firm's level of tangible assets, and the distance from the provincial capital. First, larger budget deficits incentivize governments to expropriate. Second, tangible assets are easier to expropriate than intangible assets. Third, courts in rural areas have fewer resources and thus worse institutional quality than those in urban areas, so having access to a high-quality court such as those in provincial capitals reduces expropriation risk. Consistent with these intuitions, we find that the increases in investment of treatment firms relative to control firms are especially strong for firms in cities where local governments had large deficits immediately prior to the Law, for firms with more tangible assets, and for firms in provincial capitals.


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Because property rights affect creditors' ability to repossess collateral when borrowers default, the Law then also improves the pledgeability of real property and increases lenders' willingness to offer credit. Thus, an alternative explanation of our results is that treatment firms increase investment because they have better access to credit. However, we find no difference in the treatment effect between firms with high or low levels of external financing, measured using trade credit and long-term debt. Considering the previous cross-sectional results, these findings suggest that lower expropriation risk, instead of increased financing availability, is the primary driver of treatment firms' post-Law investment increases.

RECOMMENDATION / IMPLICATION

Our research has implications for legislators and regulators. In particular, we document the effect of a change in property rights institutions in an emerging market. Despite the intuitive appeal that strong property rights institutions should stimulate investments because it helps enforce contracts between the government and private entities and constrain a government's arbitrary behavior and expropriation activities, there is no conclusive evidence of whether property rights reform in emerging markets can achieve this effect. Results from our research have policy implications that property rights reform can indeed stimulate private companies' investments, including those in tangible assets and human capital.

Moreover, our research also has implications for firms that are contemplating whether to invest in emerging markets. By documenting the positive effect of property rights protection on local private companies' investments, our results suggest that firms considering investments in an emerging market should carefully evaluate the expropriation risk in the local jurisdiction. Our results also suggest that, in addition to the legal statutes, these firms should evaluate other factors, such as the local government's deficit, the specific type of investment under consideration (whether it is tangible or intangible assets), and the local institutional quality such as access to a high-quality court, when making an investment decision.

Allen Huang is an Associate Professor in the Department of Accounting, the Associate Dean of the School of Business, and Faculty Associate of the IEMS at HKUST. His research has been featured in CFA Digest, CFO, Harvard Business Review, Harvard Law School Forum, Vox and Financial Times, and has won First Paper in MIT Asia Conference in Accounting (twice), IRRC Institute Research Award, and International Centre for Pension Management Research Award. His publications have appeared in top-tier finance, accounting and management journals such as the Journal of Finance, Management Science, The Accounting Review, Journal of Accounting Research, Journal of Accounting and Economics, Review of Accounting Studies, and Contemporary Accounting Research. He is an editor at the Journal of Business, Finance and Accounting.

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Prior to joining HKUST, he worked in the Quantitative Equity Strategy group in Lehman Brothers and Barclays Capital in New York. Allen holds a Ph.D. in Business Administration from Duke University and a B.S. in Electronics from Peking University in China.

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