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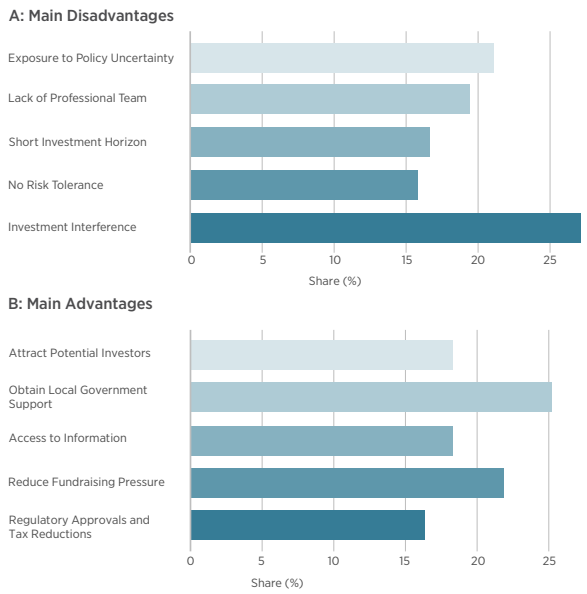
Investing With the Government: A Field Experiment in China

Based on BFI Working Paper 2022-79, "Investing With the Government: A Field Experiment in China," by Emanuele Colonnelli, Chicago Booth; Bo Li, Tsinghua University; and Ernest Liu, Princeton University

The average firm in the venture capital and private equity market in China dislikes investors with government ties, indicating that the benefits of political connections are small compared to the cons of having the government as an investor.

Government participation in the economy, via direct or indirect ownership of private sector firms, is pervasive around the world and is often characterized by two distinct models: the "grabbing hand" model, commonly used to describe Russia and Eastern Europe in the 1990s, where government interference by bureaucrats and politicians represents a key friction to the growth of private businesses; and the "helping hand" model where the government helps private sector firms overcome market failures.

Figure 1 • Survey on Pros and Cons of Government Investors



Notes: This figure shows the distribution of responses from the 2021 surveys, and specifically the shares of each option marked as the most important reason by the respondent. Panel A shows the main advantages of government LPs. Panel B shows the main disadvantages of government LPs.

The authors bring these models to an investigation of China's massive and high-growth economy to determine whether market participants view the government as a grabbing or helping hand, in the context of the multi-trillion-dollar venture capital and private equity (VCPE) market. They combine a field experiment with new administrative and survey data to ask whether—all else equal—firms prefer to receive capital from the government vis-à-vis private investors. Specifically, the authors focus on the matching between capital investors, or Limited Partners (LPs), and profit-seeking firms, that is, the fund managers or General Partners (GPs), that manage invested capital by deploying it to high-growth entrepreneurs.

The authors characterize the role of government in the Chinese VCPE market by matching data on VCPE investments from 2015–2019 with administrative business registration records, through which they can observe the ownership structure of all firms (GPs) and investors (LPs) in the data, to establish four descriptive facts:

- The government—represented by central, provincial, and local government agencies as well as state-owned enterprises (SOEs)—is the leading investor, with the government as a majority owner of about half of LPs, and government LPs significantly larger investors than private LPs.
- The government is also a minority owner of a significant share (about a third) of GPs.
- Government-owned GPs perform worse than private GPs.

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- There is a pattern of assortative matching, with government LPs investing disproportionally more in government-owned GPs.

These facts, while informative, can support many different interpretations, which motivates the authors to estimate actual firm demand for government capital. To do so, they conduct a field experiment in 2019 in collaboration with the leading VCPE industry service provider in China. This collaboration led to an experimental survey of 688 leading GPs in the market (with a response rate of 43 percent), which together manage nearly $1 trillion. GPs are asked to rate 20 profiles of LPs along two main dimensions: (i) how interested they would be in establishing an investment relationship with the LP (under the assumption the LP is interested); and (ii) the likelihood that the LP would be interested in entering an investment relationship with them if they had the chance. Importantly, there is no deception in this survey because GPs know the LP profiles are hypothetical. (Please see the working paper for more details on the survey instrument.)

The authors' novel experimental survey finds the following:

- The negatives of receiving capital that is tied to the government outweigh the positive value GPs may obtain from establishing a link to a government-related politically connected investor.

- This finding is consistent with a "grabbing hand" interpretation of the government's involvement in the market.

- Using both the administrative micro-data and follow-up surveys, and consistent with several anonymous discussions with active VCPE firms, the authors find support for an explanation according to which government connections of the investors lead to interference in decision-making that is due to political, rather than profit-maximizing, incentives.

This work has several implications. On the one hand, by providing direct evidence of the private sector perspective of the advantages and disadvantages of government investors, this research deepens our understanding of the nature of China's model of economic growth grounded on the dominance of state economic actors. On the other hand, this work makes the simple point that the demand for government capital differs across different types of firms. As a result, to the extent that how capital is allocated depends on the agents receiving it, understanding the demand side is important to fully capture the efficiency implications of government participation, an aspect of the debate that the authors believe has been largely neglected but that is crucial for both theory and policy.

READ THE WORKING PAPER

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bfi.uchicago.edu/working-paper/202279

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