

# Patient Capital and the Governance of Inefficient Investment and Overcapacity: A Factor Allocation Perspective

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## ABSTRACT

Inefficient investment and persistent overcapacity remain central concerns in modern economies, particularly in contexts where capital markets and corporate governance structures are imperfect. This paper examines the role of patient capital in mitigating these problems from the perspective of factor allocation. Rather than treating inefficient investment as a purely behavioral or agency-driven phenomenon, the analysis situates it within a broader framework of resource misallocation within firms. Patient capital, characterized by long investment horizons and tolerance for delayed returns, is argued to influence firms not only by alleviating financing constraints but also by reshaping internal allocation mechanisms and governance structures. Building on existing empirical and theoretical insights, the paper develops a mediation framework in which factor allocation efficiency serves as the transmission channel linking patient capital to investment outcomes. The analysis suggests that patient capital reduces both overinvestment and underinvestment by stabilizing expectations and altering the criteria through which resources are deployed. The findings contribute to the literature by integrating capital structure, governance, and allocation efficiency into a unified analytical perspective.

## KEYWORDS

Patient capital; Inefficient investment; Overcapacity; Factor allocation; Corporate governance

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## 1. INTRODUCTION

The persistence of inefficient investment and overcapacity has long been recognized as a structural issue in both emerging and developed economies. Firms frequently deviate from optimal investment levels, either allocating excessive resources to low-return projects or failing to invest in profitable opportunities. These distortions are not only detrimental at the firm level but also aggregate into broader inefficiencies in resource allocation, thereby constraining productivity growth and economic development.

Traditional explanations have largely focused on agency conflicts and financing constraints. The seminal work of Jensen [1] attributes overinvestment to managerial incentives under conditions of free cash flow, while subsequent research emphasizes the role of financial frictions in generating underinvestment. Although these perspectives offer valuable insights, they tend to treat inefficient investment as a direct outcome of governance failures or capital market imperfections, without fully accounting for the underlying allocation processes within firms.

In parallel, the concept of patient capital has gained increasing attention in both academic and policy discussions. Patient capital refers to long-term investment that is willing to accept delayed returns and tolerate short-term fluctuations in performance. Unlike short-term oriented capital, which often

prioritizes immediate financial outcomes, patient capital is associated with a longer evaluative horizon and a greater emphasis on sustainable value creation [2]. This temporal dimension of capital introduces a distinct mechanism through which investment behavior may be shaped.

This paper seeks to bridge these two strands of literature by examining how patient capital influences inefficient investment and overcapacity through the lens of factor allocation. The central argument is that inefficient investment is not merely a result of distorted incentives, but also a manifestation of misaligned resource allocation within firms. Patient capital, by altering the temporal structure of decision-making and stabilizing financing conditions, reshapes how firms allocate capital, labor, and technological resources.

The remainder of the paper proceeds as follows. Section 2 reviews the relevant literature on inefficient investment, factor allocation, and patient capital. Section 3 develops the theoretical framework linking these concepts. Section 4 elaborates the mechanisms through which patient capital operates. Section 5 outlines an empirical strategy and discusses the mediating role of factor allocation efficiency. Section 6 considers broader implications, and Section 7 concludes.

## **2. LITERATURE REVIEW**

### **2.1. Inefficient Investment and Corporate Behavior**

The literature on investment efficiency has consistently emphasized the role of agency conflicts in shaping firm behavior. Jensen [1] argues that managers with access to abundant internal funds may pursue expansion strategies that do not maximize shareholder value. This tendency toward overinvestment reflects the divergence between managerial incentives and firm-level objectives. Conversely, when firms face external financing constraints, profitable investment opportunities may be forgone, resulting in underinvestment.

Subsequent research has refined these insights by incorporating the role of information asymmetry and financial reporting quality. Chen et al. [3] show that higher-quality financial reporting reduces both overinvestment and underinvestment by improving the information environment in which capital allocation decisions are made. Similarly, Biddle et al. [4] demonstrate that transparency enhances investment efficiency by facilitating better monitoring and reducing uncertainty.

While these studies highlight important determinants of investment behavior, they tend to conceptualize inefficiency as a deviation from optimal investment levels without explicitly linking it to the broader issue of resource allocation across different uses within the firm.

### **2.2. Factor Allocation and Misallocation**

A growing body of research has shifted attention toward the role of factor allocation in determining productivity and efficiency. Hsieh and Klenow [5] show that distortions in the allocation of capital and labor across firms can lead to substantial losses in aggregate productivity. These distortions arise from a variety of sources, including financial frictions, policy interventions, and institutional constraints.

At the firm level, misallocation manifests in the form of inefficient deployment of resources across projects. When capital is directed toward low-productivity activities or withheld from high-return opportunities, the resulting allocation is suboptimal. This perspective suggests that inefficient investment is not merely an outcome of managerial bias or financing limitations, but also a reflection of deeper structural issues in how resources are distributed within firms.

## **2.3. Patient Capital and Long-Term Investment Orientation**

The notion of patient capital introduces a temporal dimension to the analysis of investment behavior. Ivashina [6] characterizes patient capital as investment that is committed for extended periods and is less sensitive to short-term performance fluctuations. This form of capital is typically associated with institutional investors such as pension funds and sovereign wealth funds, which have long-term liabilities and investment horizons.

Empirical work increasingly points to the role of long-term investors in shaping corporate outcomes. Bushee [7] finds that firms with a higher proportion of transient investors are more likely to cut research and development expenditures to meet short-term earnings targets, whereas long-term investors are associated with more stable investment policies. Similarly, Graham et al. [8] document that managerial decisions are often influenced by capital market pressures, suggesting that the nature of investor expectations can have a direct impact on corporate behavior.

Rather than operating through a single channel, patient capital appears to influence firms through a combination of financing stability, innovation incentives, and governance engagement. These effects are interrelated and unfold over time, making it necessary to adopt an integrated analytical framework.

## **3. THEORETICAL FRAMEWORK**

The central premise of this paper is that the governance effect of patient capital can be understood as a process that operates through changes in factor allocation within the firm. This perspective requires moving beyond a direct causal relationship between capital structure and investment outcomes, and instead examining the intermediate mechanisms through which capital influences decision-making.

From an agency theory perspective, patient capital reduces the pressure on managers to deliver short-term performance, thereby mitigating incentives for opportunistic behavior. When investors adopt a long-term orientation, managers are less likely to engage in value-destroying expansion or to underinvest in projects with delayed returns.

From the standpoint of financing constraints, patient capital provides a stable source of funding that reduces dependence on volatile external financing. This stability allows firms to smooth investment over time and avoid abrupt adjustments that may lead to inefficiencies.

However, these explanations remain incomplete without considering how resources are actually allocated within the firm. The key contribution of this paper is to highlight factor allocation efficiency as the mechanism through which patient capital exerts its influence. By altering the criteria and constraints governing resource deployment, patient capital reshapes the internal allocation process, leading to more efficient investment outcomes.

## **4. MECHANISMS OF INFLUENCE**

### **4.1. Stabilization of Financing Conditions**

One of the most immediate ways in which patient capital reshapes firm behavior lies in its effect on financing conditions. Firms with access to long-term oriented investors are less dependent on short-term funding cycles and are therefore less vulnerable to liquidity shocks or refinancing pressures. This distinction is particularly relevant in environments where external financing is volatile or costly, as firms without stable capital backing often adjust investment in a procyclical manner, expanding during periods of abundant liquidity and contracting sharply when conditions tighten.

The presence of patient capital moderates this dynamic by providing a more predictable funding base. Instead of reacting to fluctuations in capital markets, firms are able to smooth investment over time,

which reduces the likelihood that profitable projects are abandoned due to temporary financing constraints. At the same time, the reduced sensitivity to short-term performance metrics weakens incentives for expansion that is primarily driven by market expectations rather than underlying productivity.

Importantly, this stabilization effect is not limited to the quantity of available capital. It also affects how investment decisions are sequenced and evaluated. When financing conditions are stable, firms are less compelled to prioritize projects with immediate payoffs and can instead adopt a more gradual and coordinated approach to capital deployment. This tends to reduce both underinvestment associated with financial frictions and overinvestment driven by cyclical optimism, thereby contributing to a more balanced allocation of resources over time.

#### **4.2. Reconfiguration of Allocation Criteria**

Beyond stabilizing financing conditions, patient capital also reshapes the criteria through which firms allocate resources internally. Under short-term pressure, investment decisions are often influenced by the need to generate visible and immediate returns, which can lead to a bias toward projects that improve near-term financial indicators rather than long-term productivity. In such contexts, capital may be directed toward activities that serve signaling purposes such as rapid expansion or capacity building, even when their marginal returns are uncertain or diminishing.

The introduction of patient capital alters this evaluative framework. Long-term investors tend to assess projects based on their contribution to sustained value creation, placing greater weight on future cash flows and strategic positioning. This shift does not eliminate uncertainty, but it changes the tolerance for it. Projects with longer gestation periods, including those involving technological upgrading or organizational restructuring, become more viable when they are not penalized for short-term underperformance.

As a result, the internal distribution of resources begins to reflect productivity considerations more closely. High-return opportunities are more likely to receive sustained funding, while projects with weak fundamentals are less likely to be continued solely for reputational or signaling reasons. Over time, this leads to a reallocation of capital toward more efficient uses, reducing the dispersion between marginal returns across projects. In this sense, patient capital contributes not only to better investment decisions at the margin, but also to a structural improvement in how firms match resources with productive opportunities.

#### **4.3. Governance Through Temporal Alignment**

The governance implications of patient capital extend beyond conventional monitoring mechanisms and are more closely tied to the temporal alignment between investors and managers. Traditional governance frameworks often emphasize control rights and the ability of shareholders to discipline management through intervention. While such mechanisms remain important, they do not fully capture the role of investor horizons in shaping managerial behavior.

Long-term investors influence firms less through frequent intervention and more through the expectations they establish. When investors are committed over extended periods, managers face less pressure to deliver short-term performance signals and are instead evaluated based on their ability to sustain value over time. This reduces the incentive to engage in actions that improve short-term metrics at the expense of long-term efficiency, such as overexpansion, earnings management, or the postponement of necessary restructuring.

In this sense, governance operates through a form of temporal coordination. Managers and investors share a common horizon, which makes it easier to implement strategies that require sustained commitment and may involve short-term costs. As noted by Shleifer and Vishny [9], the effectiveness of governance depends not only on formal control structures but also on the incentives and time

horizons of those who exercise them. Patient capital, by extending these horizons, creates conditions under which managerial discretion can be exercised in a more disciplined and forward-looking manner.

This form of governance does not eliminate agency problems, but it changes their expression. Instead of being driven by short-term opportunism, managerial decisions are more likely to reflect strategic considerations, with resource allocation becoming increasingly aligned with long-term productivity rather than immediate performance indicators.

## 5. EMPIRICAL STRATEGY AND MEDIATION ANALYSIS

To formalize the relationship between patient capital and investment efficiency, the analysis adopts a mediation framework in which factor allocation efficiency serves as the transmission channel.

The baseline empirical specification relates inefficient investment to the presence of patient capital while controlling for firm characteristics:

$$Inefficiency_{i,t} = \alpha + \beta PatientCapital_{i,t} + \gamma Controls_{i,t} + \varepsilon_{i,t}$$

Inefficient investment can be measured as deviations from expected investment levels based on firm fundamentals, following Richardson [10]. Patient capital may be proxied by measures such as the proportion of long-term institutional ownership or investor turnover rates.

To capture the mediating role of factor allocation, an additional equation is introduced:

$$AllocationEfficiency_{i,t} = \alpha_1 + \delta PatientCapital_{i,t} + Controls + \varepsilon$$

$$Inefficiency_{i,t} = \alpha_2 + \beta' PatientCapital_{i,t} + \theta AllocationEfficiency_{i,t} + Controls + \varepsilon$$

A significant reduction in the coefficient on patient capital after introducing allocation efficiency would indicate a mediating effect. This approach allows the analysis to move beyond correlation and examine the underlying mechanism.

The framework also accommodates heterogeneity across firms. The effect of patient capital is expected to be more pronounced in environments characterized by higher financing constraints or greater capital intensity, where allocation decisions are more sensitive to funding conditions.

## 6. DISCUSSION

The analysis suggests that the impact of patient capital cannot be fully understood without incorporating the temporal dimension of capital into the analytical framework. Short-term and long-term investors differ not only in their return expectations, but also in the way they structure the decision-making environment within firms. By extending the horizon over which performance is assessed, patient capital reshapes both the incentives and the constraints faced by managers, making it possible to sustain investment strategies that would otherwise be difficult to justify under short-term evaluation regimes.

This temporal perspective also invites a reconsideration of how overcapacity is conceptualized. Conventional explanations tend to attribute excess capacity to macroeconomic fluctuations, industrial policy distortions, or demand-side imbalances. While these factors remain important, they do not fully account for the persistence of overcapacity within specific firms and sectors. From a factor allocation standpoint, overcapacity can be understood as the outcome of repeated allocation decisions

that fail to reflect underlying productivity differences. In this sense, it is not merely a cyclical phenomenon, but a cumulative result of misaligned incentives and evaluation criteria at the micro level.

Patient capital intervenes in this process by altering the conditions under which such allocation decisions are made. When firms are less constrained by short-term financing pressures and less exposed to immediate performance scrutiny, they are better positioned to adjust capacity in line with long-term demand and productivity trends. This does not necessarily eliminate excess capacity in the short run, but it reduces the tendency to perpetuate inefficient expansion or delay necessary contraction.

At the same time, the findings underscore the importance of consistency between capital structure and corporate strategy. Firms that rely predominantly on short-term financing may face structural difficulties in maintaining efficient allocation, even when formal governance mechanisms are in place. By contrast, the presence of patient capital provides a complementary foundation for governance reforms, reinforcing strategic coherence and enabling a more stable alignment between resource allocation and long-term value creation.

## **7. CONCLUSION**

This paper has examined the role of patient capital in mitigating inefficient investment and overcapacity from the perspective of factor allocation. Rather than treating these phenomena as isolated outcomes of agency conflicts or financing constraints, the analysis situates them within a broader framework in which resource misallocation within firms plays a central role. By bringing together insights from corporate finance, governance, and allocation theory, the paper develops a more integrated understanding of how the structure and horizon of capital shape firm behavior.

The central argument is that the effect of patient capital does not operate primarily through direct intervention, but through a gradual reconfiguration of the internal allocation process. When investment decisions are evaluated over longer horizons and under more stable financing conditions, the criteria for allocating resources begin to shift. This, in turn, reduces the systematic biases that give rise to both overinvestment and underinvestment. In this sense, factor allocation efficiency emerges not simply as an outcome, but as the mechanism through which capital structure is translated into observable investment behavior.

Viewed from this perspective, the contribution of the paper lies in connecting the temporal structure of capital with micro-level allocation dynamics. It suggests that improving investment efficiency requires more than tightening governance mechanisms or expanding financing access; it also depends on aligning the time horizon of capital with the nature of the investments being undertaken.

Several directions for future research follow from this analysis. One concerns the heterogeneity of patient capital, as different types of long-term investors may vary in their objectives, engagement styles, and influence on firms. Another relates to the institutional context, where legal frameworks and market structures may condition the extent to which patient capital can exert its effects. Exploring these dimensions would further clarify the boundary conditions under which patient capital contributes to more efficient allocation.

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