This paper uses the industry-level panel data from 1975-2005 and estimates Wurgler's $\eta$, the elasticity of industry investment to value-added, for each of Japan's 47 prefectures. Exploiting cross-prefecture variation in Wurgler's $\eta$, we then examine the impact of government loans on capital allocation efficiency. We address the endogeneity of government loans by using the exogenous variation in the share of government loans that is correlated with the intensity of political support for the Liberal Democratic Party (LDP), the dominant political party. We find that the share of government loans is strongly and negatively correlated with the quality of capital allocation, and that this negative correlation is more pronounced in declining industries than growing industries. Moreover, the results show that the share of government loans is negatively correlated with total factor productivity growth but positively correlated with investment-to-output ratio. Taken as a whole, Japan's government financial institutions might have propped up declining industries in the LDP strongholds with overall negative effects on capital allocation efficiency and technical progress.