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Trust and the provision of trade credit

Wenfeng Wu [a], Michael Firth [b,*], Oliver M. Rui [c]

[a] Antai College of Economics and Management, Shanghai Jiao Tong University, Shanghai, China
[b] Department of Finance and Insurance, Lingnan University, Hong Kong
[c] China Europe International Business School (CEIBS), Shanghai, China

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ABSTRACT

State-controlled listed firms in China receive preferential treatment when borrowing from commercial banks; in contrast, private controlled firms rely on informal finance and on trade credit. We argue for and find evidence that private firms located in higher social trust regions use more trade credit from suppliers, extend more trade credit to customers, and collect receivables and pay payables more quickly. These findings are enhanced for firms located in provinces with weak protection of property rights. Our results are robust to different measures of social trust, legal environment, and endogeneity. Overall, our results show that social trust helps private firms overcome institutional difficulties in financing their activities.

1. Introduction

A growing body of research has shown that social trust has played an important role in explaining regional differences in economic and institutional (e.g., government and large organizations) performance (North, 1990; Putnam, 1993; Fukuyama, 1995; La Porta et al., 1997; Knack and Keefer, 1997; Ostrom, 1998; Zak and Knack, 2001; Guiso et al., 2004, 2009). As "an important lubricant of a social system" (Arrow, 1974), social trust is viewed as the propensity of people within one organization to cooperate to produce efficient outcomes thus promoting economic and institutional performance.

Prior literature has demonstrated several mechanisms through which social trust affects economic growth, including creating human capital (Coleman, 1988; Putnam, 2001), enhancing the quality of governance of institutions (Putnam, 1993; Knack, 2002), and increasing investment or trade (Zak and Knack, 2001). However, most of these studies examine the macro-effect of social trust and there are relatively few studies that investigate the impact of social trust at the micro-level or firm level. In this study, we study the micro-effect of social trust from the firm level perspective. The granting and receiving of trade credit is an important type of informal financing (Fisman and Love, 2003) and is an area where trust would seem to be important. Thus, we examine the effect of social trust on the trade credit received and offered by firms.

When trade credit takes place, the suppliers deliver goods to customers and the customers do not pay immediately, but promise to pay later. This promise represents a credit, or an implicit financing contract. In the (implicit) contract, the financiers (suppliers) take on the risk that the financed (customers) will not pay in the future. Typically, there is no collateral standing behind the transaction and no guarantees from third parties or financial intermediaries. As Guiso et al. (2004) point out, whether trade credit is extended depends on not only the legal enforceability of the contract, but also on the extent to which the suppliers trust customers. Hence, trust plays an important role in trade credit.

Since social trust represents the general trust level within one community as a whole, we argue that it will affect trade credits in that business community. In intensive-social-trust regions, firms are more likely to trust each other. Hence, if a firm is located in an intensive-social-trust region it will be viewed as being more trustworthy and will receive more trade credit from its suppliers. At the same time, a firm located in an intensive-social-trust region will be more likely to trust other firms in the same region, so it will extend more trade credit to its local customers. Therefore, a high level of social trust will result in firms using and offering more trade credit.

* Corresponding author. Address: Department of Finance and Insurance, Lingnan University, 8 Castle Peak Road, Tuen Mun, NT, Hong Kong. Tel.: +852 2616 8950; fax: +852 2462 1073.

E-mail addresses: wfwu@sjtu.edu.cn (W. Wu), mafirth@ln.edu.hk (M. Firth), oliver@ceibs.edu (O.M. Rui).

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Social trust is more likely to be important in explaining trade credit in those countries with relatively weak or capricious enforcement of contracts and where there is discrimination in bank lending (formal financing). As China is characterized as having both weak legal enforcement and biased lending policies, and because it has highly disparate levels of trust across its various regions (Zhang and Ke, 2002; Ang et al., 2012), we argue that it is an ideal setting for us to study social trust and trade credit. The uneven level of social trust across regions makes China a natural laboratory for a cross-sectional investigation of whether and how social trust affects trade credit. An intra-country study enables us to abstract away from differences in national laws, taxes, economic policies, codes of corporate governance, and so on. We also examine how provincial differences in the practice or effectiveness of law affect the sensitivity of trade credit to social trust.

We focus on non-state firms (i.e., private firms) because prior literature documents that the Chinese private sector experiences discrimination in borrowing from banks. China has maintained a state-dominated financial system that favors State-Owned Enterprises (SOEs), particularly large-scale SOEs engaged in state-preferred industries, in the allocation of bank loans (Firth et al., 2009). Non-state firms, especially private firms, have a restricted access to bank loans from the state-controlled banking system (Allen et al., 2005). According to statistics from the China National Statistics Bureau, which show the loan distribution of state-controlled banks to firms of different ownership types, only 7% of loans were allocated to non-state firms in 2005. Thus, the state-dominated banking sector of China has favored SOEs. Although its share of China's total GDP has surpassed 60%, the private sector has received less than 20% of the formal bank credit in most of the last decade, and the other 80% has all gone to the state sector (Garnaut et al., 2005). Lin, 2007 documents that less than 0.5 million of over 40 million small and medium enterprises (SMEs) were able to obtain bank loans in 2006. In China, banks give preferential treatment to SOEs and discriminate against non-SOEs for various reasons. For example, the government often requires banks to issue "policy lending" to SOEs because the major banks are controlled by the government (Cull and Xu, 2003). In comparison to the favoritism shown to SOEs, the non-state sector relies more on informal mechanisms to overcome discrimination in bank lending (Allen et al., 2005).

Using data from Chinese non-state listed firms over the period 2003–2008, we find that firms located in higher social trust regions receive more trade credit from their suppliers than do firms located in lower social trust regions. At the same time, these firms also extend more trade credit to their customers than do their counterparts in the lower trust regions. Moreover, these firms collect accounts receivables more efficiently from their customers, along with paying accounts payables more promptly to their suppliers. Our results suggest that social trust plays an important role in informal financing. Specifically, social trust increases firms' propensities to use and offer trade credit. Our conclusion also holds when we use a large dataset of non-listed private firms covering more than 80,000 separate business entities.

We find that social trust exerts an even stronger influence on trade credit for firms located in regions with poor legal environments (that is, those provinces that have a relative lack of respect for property rights and have poor enforcement of contracts). Thus, social trust is a substitute for weak legal and institutional systems. In addition, we find that the effect of social trust on the use of trade credit is stronger in firms with a lower bank loan ratio, lower fixed assets ratio, and higher growth rate, whereas the effect of social trust on extending trade credit is stronger in firms with a higher growth rate. It is usually difficult for these types of firms to seek formal financing by way of bank loans and so they resort to the use of trade credit. Thus, social trust plays a more important role in the trade credit financing of those firms that face discrimination from banks and financial institutions.

Our study contributes to the literature in several ways. First, it extends the research on social capital or social trust by examining its role in a firm-level financing context. We show that social trust can help explain firms' use of trade credit. Furthermore, our results provide evidence that social trust can mitigate the effect of weak legal institutions on the granting and receiving of trade credit.[1]

Second, we enrich existing studies on trade credit. Most of the prior literature on trade credit focuses on the influences of the characteristics of firms and goods (Petersen and Rajan, 1997; Nilsen, 2002; Cunat, 2007; Giannetti et al., 2011). However, in this study we examine the effects of social trust on trade credit. Our results show that the "informal institution" of social trust plays an important role in the granting and use of trade credit.

Third, our study complements the literature on the mechanisms that help firms to mitigate the institutional difficulties in accessing finance. The existing literature documents that informal institutions, such as governance mechanisms based on reputation and relationships, and/or alternative financing channels, such as trade credit, enable firms to overcome institutional barriers to sources of funding (Fisman and Love, 2003; Allen et al., 2005; Cull et al., 2009). Our study shows that the use of trade credit by private firms that invariably face restrictions in formal financing, depends critically on the level of social trust.

2. The link between social trust and trade credit

China is a very diverse country with major differences in ethnicity, history, language, and philosophy across its many provinces. Moreover, at various times throughout its history, China has been split up into smaller independent countries, which has aided and abetted the unique characteristics of today's provinces. The social trust characteristics of provinces have also been shaped by the religious beliefs of its people. Although communist rule has increased agnosticism, major religious beliefs (e.g., Buddhism, Christianity, Islam, and Taoism) still hold sway today and they impact on social trust across China's provinces. Ang et al. (2012) shows that there are more cultural differences across China's provinces than there are cultural differences across Europe. This diversity in cultural norms has spawned different levels of social trust across the country. While there is within-province homogeneity in trust, there are substantial differences in trust across provinces (Ang et al., 2012). This substantial heterogeneity in trust across the different provinces allows China to be an excellent laboratory for our research.

Trade credit is typically regarded as a short-term informal financing instrument. Like the suppliers of institutional finance (usually banks), the suppliers of the trade credit face the future default risk of customers. While banks can diversify their risks through a large customer base, the suppliers of trade credit only have a comparatively small number of customers and cannot easily diversify their risks. Therefore, customer relationship plays an important role in offering trade credit (Petersen and Rajan, 1994).

Because of differences in cultural norms and historical development, the level of social trust is likely to vary across regions and countries. Therefore, the use of trade credit will vary across regions and countries, depending on the social trust within a region or country. Firms are more trustworthy in the intensive-social-trust regions, and thus they will receive more trade credit from suppliers. Likewise, suppliers in more intensive-social-trust regions will be more likely to trust other firms that are from the same region

[1] Conceptually, social trust and legal and institutional development could be substitutes or complements (Stiglitz 1999).