



Does State Ownership Really Matter in Determining Access to Bank Loans? Evidence from China's Partial Privatization

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ABSTRACT

Prior studies have reported a positive relationship between state ownership and access to bank loans. Using a sample of 702,300 firm-year observations over the 1998–2007 period, we find consistent evidence that long-term debt ratios are significantly higher for firms with state ownership in the cross-section. However, once the unobservable difference across firms is controlled, the positive relationship becomes weaker. When the possible mechanical debt ratio reduction associated with the partial privatization in China is further controlled, the positive relationship between state ownership and access to bank loans completely disappears. Our findings suggest that state ownership does not necessarily lead to better access to bank loans in China, which is contrary to the common expectation.

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1. Introduction

Does state ownership matter for access to bank loans? This question is important given the role of the formal financial system in supporting faster economic growth than informal systems do (Ayyagari et al., 2010). On one hand, state ownership can provide an implicit guarantee that the firm will not default on its payment. As a result, banks—and especially state-owned banks—are more likely to grant loans to firms with state ownership. Consistent with this view, the privatization literature (see Megginson et al., 1994; Megginson and Netter, 2001; Shleifer, 1998) shows that state-owned enterprises (SOEs) tend to have higher debt ratios in the pre-privatization periods; moreover, their debt ratios tend to decrease post privatization. On the other hand, however, state ownership can also bring adverse “grabbing hand” effects to a firm's daily operations, such as maintaining excessive employment (Shleifer and Vishny, 1994, 1998). Due to these concerns, well-functioning banks might not be willing to provide state-owned firms with better access to bank credit. Empirically, estimating the net effect of state ownership can be difficult; it is even more challenging due to an inherent selection bias associated with the decision on ownership retained by the state. However, without a sufficient understanding of this decision, one cannot evaluate the effect of state ownership on access to bank credits appropriately.

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We explore this important issue in the Chinese context for two reasons. First, China has experienced large-scale privatization over the past three decades. This test setting provides a large number of firm observations over a long time period that can help to elucidate the relationship between state ownership and access to bank loans. Second, like other test settings, the decision on state ownership is outside the remit of the firm. Selling or transferring state ownership is a decision made by the government, and firms cannot strategically choose to increase or decrease their state ownership to achieve more or less access to bank loans. Hence, we do not have to worry about firm-level characteristics *ex ante*. However, unlike other test settings, the decision on state ownership made at the state level is well delineated in the Chinese government's privatization policy over our sample period. This unique institutional feature facilitates a better and sharper test for estimating the impact of state ownership and addressing the endogeneity or mechanical debt reduction associated with the decision on it.

Prior studies based on ordinary least squares (OLS) regressions report a positive cross-sectional relationship between state ownership and long-term debt ratios, which seems to suggest that state ownership *per se* is the cause of improved access to bank loans. We cast doubts on this positive relationship for the following three reasons:

- 1) The banking sector in China has gone through a series of reforms, including partial privatization, since the late 1990s. Banks have become more responsible for their own profits and losses; thus, the loan decisions they make are increasingly based on the risk–return analysis. Banks claim that they give equal treatments to all borrowers if they have the same credibility;
- 2) Almost all SOEs in China are corporatized with limited liabilities. Even if the government is the residual owner, SOEs can still go bankrupt. In fact, the government has let many of its SOEs go bankrupt since the passage of the bankruptcy law in 1986.¹ All Chinese banks know this well; thus, it is unreasonable to argue that banks perceive that the government will pick up the bill when an SOE defaults on its debt repayments; and
- 3) This positive relationship between state ownership and long-term debt ratios can be a manifestation of a hand-in-hand decrease both in state ownership and in long-term debt ratios due to partial privatization. This is the case for share issue privatization (SIP). As pointed out by Sun and Tong (2003), the proceeds obtained from SIP in China are retained by the issuing firms, which increases both the equity and the total assets of the firm; thus, it mechanically reduces the debt ratio. This is largely the case even for partially privatized firms that do not go public. For a firm to be partially privatized, it usually engages in a restructuring process, which often involves some asset (including cash) injections by the new shareholder. The government may also help to write off some debts for the firm using taxpayers' money. All of these factors lead to a mechanical reduction of the debt ratio.

The objective of this paper is to reexamine the relationship between state ownership and the long-term borrowing of a firm after taking into account the mechanical debt reduction or endogeneity problem. Our sample consists of 702,300 firm-year observations from 165,816 unique Chinese manufacturing firms operating in the unlisted sector over the 1998–2007 period. We define long-term debt (*LTD*) ratios as the long-term debts over total assets, and state ownership as the proportion of state holdings in the firm. First, our simple pooled OLS regression analysis suggests that after controlling for observable firm characteristics, as well as the legal and market environments, long-term debt ratios are still 3.12 percentage points higher for firms with state ownership. Given that the average long-term debt ratio for all firm-years is 6.02%, this difference is not only statistically but also economically significant. Second, our results for firm fixed-effects estimation show that the coefficient on state ownership has plummeted by almost 90% in relative terms, from 3.12% to 0.48%, but it is still statistically significant. Third, the positive relationship still holds even when we use the propensity score matching (PSM) method to match the firms with and without state ownership. Again, the coefficient of state ownership is smaller than that obtained from the simple pooled regression without matching (2.3% vs. 3.12%). These findings suggest that once omitted firm-specific variables are controlled for or firms are better matched, the positive relationship between state ownership and the long-term debt ratio becomes weaker. Fourth, we try to control for the endogeneity problem wherein the positive relationship between long-term debt ratios and the fraction of state ownership is mechanically associated with partial privatization using two-stage least squares (2SLS) estimation. More specifically, we construct two instrumental variables in the spirit of the government privatization policy known as *zhuada fangxiao*, which means “grasping the large and letting go of the small” in Chinese, as follows: the fraction of total assets in book value owned by a particular firm to its industry total assets and the fraction of the number of employees in a particular firm to the employed population in the same two-digit industry. The aim in doing so is to capture the political importance of a particular firm relative to the industry in which it operates. We find robust evidence that once the partial privatization effect is controlled for, the positive relationship between *LTD* and state ownership disappears. In fact, it turns out to be negative and statistically significant. Finally, we use first-difference regressions to confirm that partial privatization is indeed associated with a reduction in *LTD*. Particularly, we find that the positive relationship between state ownership and the access to loans only exists when the change in state ownership is negative (partial privatization); the relationship turns to be negative when the change in state ownership is positive.

The existing literature reports mixed evidence on the relationship between state ownership and access to bank loans. For example, Li et al. (2009) and Qian et al. (2009) find that state ownership is positively related to capital structure, but Huang and Song (2006) and Firth et al. (2008) do not find similar empirical evidence. Our paper contributes to the literature by exploring a wide range of alternative explanations for an observed positive association between state ownership and long-term borrowing. After adjusting for the potential impacts of unobservable factors outside and within the firm, particularly the mechanical debt

¹ The Bankruptcy Law of the People's Republic of China was first adopted in December 1986. The law was revised in June 2007. Statistics shows that of all 40,483 bankruptcy cases over the 2003–2012 period, about 55% are state-owned enterprises. See more details at http://www.legaldaily.com.cn/zbzk/content/2014-03/26/content_5401182.htm.

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