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Government ownership and the capital structure of firms: Analysis of an institutional context from China☆

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ABSTRACT

Emerging economies provide interesting scenarios for examining how institutional context influences the financing behavior of firms. In this study, we examine the capital structure of Chinese listed firms following the Split-Share Structure Reform of 2005. This reform allowed a reduction of government ownership by making government shares tradable. We find that the impact of government ownership on leverage is dependent on whether the government is the largest shareholder in a firm and whether the government ownership is through a parent state-owned enterprise. In addition, we document that the largest non-government shareholder positively influences leverage. Overall, our results reveal that the largest controlling shareholder, either government or non-government, has a significant impact on the capital structure of Chinese firms.

1. Introduction

Capital structure decisions are influenced by firm-specific, industry-specific and institutional factors. Rajan and Zingales's (1995) seminal analysis of seven developed countries shows the importance of these three types of factors. Although the variables that influence financing decisions in developed countries are also influential in emerging economies, Booth et al. (2001) show that distinctive institutional features in emerging countries also play important roles. Emerging countries therefore provide interesting scenarios for studying a variety of institutional characteristics.

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Throughout the last decade, academics have become increasingly interested in studying the distinctive institutional context of China—the world's largest emerging economy. Studies of the financing behavior of Chinese firms (Chen, 2004; Allen et al., 2005; Zou and Xiao, 2006; Huang and Song, 2006; Bhabra et al., 2008) report that these firms rely on informal financing channels, prefer short-term finance and use substantially lower amounts of long-term debt than similar firms in developed markets. Ayyagari et al. (2010) document that Chinese firms obtain 20% of their funds from banks and 80% from channels such as retained earnings, informal sources, loans from family and friends, trade credits, investment funds and equity. Chen (2004) and Zou and Xiao (2006) find that the well-documented firm-specific determinants of leverage such as firm size, profitability, growth opportunity and asset tangibility are also relevant in China. Yet, the low explanatory power of these determinants calls for more research into the impact of institutional features on capital structure in China.

A notable institutional context in China is that the ownership of publicly traded firms is highly concentrated, and the government is a major player in corporate financing (Sun and Tong, 2003). Government ownership can induce firms to borrow more through preferential loan policies and loan guarantees and an intention to maintain state control. Alternately, it can lead to less borrowing due to opportunistic managerial behavior and the higher likelihood of approval of equity issues.[1] Among a handful of studies of the effect of government ownership on capital structure, Huang and Song (2006) and Zou and Xiao (2006) observe no impact of government ownership on the leverage of Chinese firms, whereas Bhabra et al. (2008) and Li et al. (2009) document a positive impact on long-term debt. Pessarossi and Weill (2013) show that government ownership facilitates the issuance of corporate bonds.

The Split-Share Structure Reform (hereafter, Reform) was introduced in 2005 to increase privatization in China.[2] The Reform set the stage for reducing the government ownership of Chinese listed firms and allowing government shares to be tradable at market prices. It improved the alignment of interest between the government and other shareholders (Firth et al., 2010; Hou et al., 2012). It also dampened the government's intention to maintain state control. Thus, it is interesting to evaluate the role of government ownership in firms' financing decisions in the post-Reform period. This is the primary contribution of our study.

In discussing the impact of government ownership on capital structure, we consider not only classic capital structure theories like tradeoff theory and pecking order theory, but also supply side theory (Faulkender and Petersen, 2006; Baker, 2009), as it reflects the specific institutional features of China's banking sector. In China, the four dominant national banks that are controlled by the government provide more credit to state-owned enterprises (SOEs) than to non-SOEs.

In the very few studies covering the post-Reform period, information on government ownership is almost always collected from the China Stock Market and Accounting Research (CSMAR) database (Chan et al., 2013; Liu et al., 2011; Yu, 2013). The database reports government ownership as the holdings in the form of non-tradable shares or shares with trading restrictions.[3] The CSMAR database does not identify government holdings of tradable shares, and thus underestimates the actual amount of government ownership of Chinese listed firms. Our study contributes to the literature by correcting this oversight; it considers both tradable and non-tradable shares when measuring government holdings.

Government shares are held by government agencies and SOEs. Parent SOEs tend to use their listed subsidiaries to raise funds from the stock market (Bradford et al., 2013; Ying and Wang, 2013), which they then make available for internal financing. We contribute to the literature by examining the differential impact of government ownership on firms with or without parent SOEs.

In studying the differential impact of government ownership on firm leverage, we find that the impact is dependent on whether the government is the largest shareholder. When the government is the largest shareholder, government ownership is non-linearly associated with leverage; however, when it is not the largest shareholder, this association disappears. Moreover, we observe that when the parent SOE is the largest controlling shareholder, government ownership is associated with lower leverage. When the government is *not*

[1] Equity issues are bureaucratic in China and listed firms are required to obtain approval from the China Securities Regulation Committee (Ying and Wang, 2013).

[2] It is officially named the Non-Tradable Share Reform. In this study, we denote it simply as the Reform.

[3] See the user's manual of China Listed Firm's Shareholders Research Database of CSMAR (version 2013).

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