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Do property rights matter? Evidence from a property law enactment ☆

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ABSTRACT

This paper considers a property law enactment that gave creditors more rights over the assets underlying their secured loans to private firms and gave private firms more protections against the potential expropriation of their assets. We find that this property law enactment led to a significant increase in firm value. We also find that the law's impact on value was more profound for firms with more tangible assets, lower internal cash flows, and stronger growth opportunities, and less profound for politically connected firms. Taken together, our findings confirm the importance of property rights protection in enhancing firm value.

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1. Introduction

Property rights are a fundamental concept in economics and finance. As Levine, 2005, p. 61) points out, "the security of property rights... is not a natural occurrence; rather it is an outcome of policy choices and social institutions." Given the importance of the topic, recent literature has explored how cross-country differences in colonial origins and natural endowments shape property rights which, in turn, cause long-run country-level growth (La Porta, López de Silanes, Shleifer, and Vishny, 1998; Acemoglu, Johnson, and Robinson, 2001; Shleifer and Wolfenzon, 2002; Beck, Demirgüç-Kunt, and Levine, 2003; Beck and Levine, 2005; Levine, 2005). At the firm level, Beck, Demirgüç-Kunt, and Maksimovic (2005) and La Porta, López de Silanes, Shleifer, and Vishny (2002) also show that legal institutions that provide property rights protections enhance firm value and growth.

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Existing theories suggest that property rights protections should enhance firm value because of their impact on both firm-level investment and financing decisions and on the willingness of creditors to make external finance available. A firm is at risk of getting poor returns on its investments if its government can easily grab private assets and if its government does not provide fundamental protections of property rights (e.g., Shleifer and Vishny, 2002). Firms operating in an environment with insecure property rights are uncertain about their ability to keep the fruits of their efforts and as a consequence, decrease their investment activities (North, 1990; Cull and Xu, 2005) and have a lower market valuation. And, creditors limit their supply of finance when their rights to seize collateral from a firm that is in default on a loan or to receive compensation from a firm that degrades its collateral are weak (Djankov, Hart, McLiesh, and Shleifer, 2008) Furthermore, creditors are less willing to make loans to firms whose assets can be easily expropriated. A firm thus has weak access to external finance for investment and a lower market valuation when creditor rights over the assets underlying its secured loans are weak and when the firm's property rights protections over its assets are weak.

Despite the importance of property rights, evidence of their impact *at the firm level* is limited. Using cross-sectional enterprise survey data, Johnson, McMillan, and Woodruff (2002) and Cull and Xu (2005) find that property rights affect a firm's incentives to reinvest retained profits. In this paper we analyze China's 2007 Property Law in order to understand the effects of property rights on firm value. The 2007 Property Law contained provisions that broadly strengthened property rights for private firms and for their creditors (primarily banks). The law checked the power of local government to expropriate assets from private firms. The law also gave creditors the right to seize their collateral if a private firm defaulted on a loan; moreover, secured creditors would get paid first out of the proceeds of the liquidation and creditors were also given assurances that they would be fully compensated if a borrower damaged the collateral underlying a loan. Thus, because the property law significantly strengthened property rights for private firms, its enactment should have given private firms a greater incentive both to invest in potentially profitable projects and to seek access to external finance for funding these projects. Moreover, because the law also strengthened creditor rights and the protection of a creditors' collateral, its enactment should have enabled firms to have better access to external finance. In sum, because of the incentives the law gave to both private firms and to their creditors, we should observe that its enactment led to an improvement in firm value.

We also use China's 2007 Property Law to understand how asset tangibility, growth opportunities and political connections influence the relation between the enactment of the law and firm value. The idea is that the impact of the property law on firm value should be more profound when, before the enactment, a private firm is more likely to use its assets that are at risk of being expropriated as collateral and also when a private firm is facing more limited access to external finance. On the contrary, the impact of the property law should be less profound for a private firm that, before the enactment, has alternative ways of shielding itself from potential expropriation and of gaining access to external finance.

Prior to the enactment, the way Chinese firms accessed external finance is somewhat typical for firms in economies with underdeveloped financial markets. Highly tangible assets including property, plant, and equipment could be collateralized for securing a loan; however, assets such as inventories, accounts receivables, and intangibles were generally not used as collateral (Cousin, 2007; Ayyagari, Demirgu-Kunt, and Maksimovic, 2010). Political connections[1] for firms also served as an informal type of collateral for gaining favorable access to external finance (see for example, Firth, Lin, Liu, and Wong, 2009; Li, Meng, Wang, and Zhou, 2008). However, stock market investors could expect that private tangible assets were less likely to be expropriated in the post-enactment period and, therefore, could become a more valuable form of collateral. Therefore, the beneficial effect of the law on firm value should have been more profound for firms that had a large share of tangible assets compared to firms that had a small share of tangible assets before the enactment: In other words, firms with a large share of tangible assets should be more affected by the property law. Moreover, stock market investors could expect that the relatively high expropriation risks for politically unconnected firms would fall and the relatively poor access to finance for these firms would improve in the post-enactment period. Therefore, the beneficial impact of the law on firm value should have been more profound for firms lacking political connections versus politically connected firms pre-enactment.

Our empirical analysis contains a strong confirmation of these predictions. We show that the proposed strengthening of property rights around the time when the law was announced had a significant effect on firm value. Furthermore, consistent with our expectations, the beneficial effects of the law on firm value during the event window were larger for firms that, pre-enactment, had a relatively large share of tangible assets and did not have political connections.

In the next section, we argue that the Property Law was effectively approved for enactment on December 29, 2006 when it was passed as a draft by the 25th Session of the 10th Standing Committee of the National People's Congress (NPC). In order to make sure that this is a valid setting for our empirical analysis, we check whether the stock market reacted strongly to the news that the draft of the property law was passed. We document that both the overall stock market return and the cross-sectional variance of firm-level returns were much higher on December 29, 2006 (and for several event windows surrounding December 29, 2006) than the other trading days during December 2006. For example, while weighted average stock increased by 3.95% on the event date, the average daily return on stocks on all other trading days during 2006 was 0.41%; and, the cross-sectional standard deviation of weighted firm-level returns on the event date was 31% higher than the average cross-sectional standard deviation of returns for the other trading days in 2006. These differences in means and standard deviation are both statistically significant at the 1% level. This pattern is robust when we compare event windows surrounding December 29, 2006

[1] The term "political connections" will be precisely defined in Section 4 of this paper.

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