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The determinants of capital structure: Evidence from China

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Abstract

This paper employs a new database containing the market and accounting data (from 1994 to 2003) from more than 1200 Chinese-listed companies to document their capital structure characteristics. As in other countries, leverage in Chinese firms increases with firm size and fixed assets, and decreases with profitability, non-debt tax shields, growth opportunity, managerial shareholdings and correlates with industries. We also find that state ownership or institutional ownership has no significant impact on capital structure and Chinese companies consider tax effect in long-term debt financing. Different from those in other countries, Chinese firms tend to have much lower long-term debt.
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This paper documents the determinants of capital structure in Chinese-listed companies and investigates whether firms in the largest developing and transition economy of the

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world entertain any unique features. Specifically we try to answer the following two questions:

1. Are corporate financial leverage decisions made in Chinese-listed firms different from those made in firms in economies where private property right is more popular and market mechanisms have been the rule for years?
2. Do the factors that affect cross-sectional variability of capital structure in other countries have similar effects on Chinese firms' capital structure? These factors have been identified by theoretical studies and by previous empirical studies on data from other countries including both developed and developing countries.

The institutional environment for Chinese firms has two salient features: (1) China is in transition from a command economy to a market economy, and (2) Most Chinese-listed companies were state-owned enterprises (SOEs) before—the state still maintains its controlling right after the firms go public. It is not difficult to understand that China has institutional structures different from developed as well as many developing countries. For example, in the world of Modigliani and Miller, tax should have no effect on firms' capital structure in a command economy. This is because in China the government or state is the owner of firms and banks, as well as the beneficiary of tax. Similarly, it is widely acknowledged that non-listed SOEs are not value-maximisers; their size (proxy for bankruptcy cost), tangible assets (collateral) and even profitability may have no effect on their capital structure. Also, because the state is the controlling shareholder for most listed companies, if it does not change its behavior towards the firms, the firms are less likely to run into financial crisis than are their counterparts whose controlling shareholders are individuals or private institutes. The proxies for financial crisis cost (size and volatility) in Chinese firms may have less or no effects on capital structure. As a result, the answers to the two questions will also tell us, to a great extent, whether these companies, which claim to be shareholders' wealth maximisers, really are.

Since Modigliani and Miller published their seminal paper in 1958, the issue of capital structure has generated great interest among financial researchers (see an excellent survey by Harris & Raviv, 1991, and another survey covering new development after 1990 by Myers, 2003). With respect to the theoretical studies, there are two widely acknowledged competitive models of capital structure: the static tradeoff model and the pecking order hypothesis.

According to static tradeoff models, the optimal capital structure does exist. A firm is regarded as setting a target debt level and gradually moving towards it. The firm's optimal capital structure will involve the tradeoff among the effects of corporate and personal taxes, bankruptcy costs and agency costs, etc. Both tax-based and agency-cost-based models belong to the static tradeoff models, such as Bradley, Jarrel, and Kim (1984), Chang (1999), Diamond (1989), Grossman and Hart (1982), Harris and Raviv (1990), Jensen (1986), Jensen and Meckling (1976)Kim (1978), Kraus and Litzenberger (1973), Miller (1977), Modigliani and Miller (1958, 1963), and Stulz (1990).

On the other hand, the pecking order hypothesis, first suggested by Myers and Majluf (1984), states that there is no well-defined target debt ratio. Firms are said to prefer retained earnings (available liquid assets) as their main source of funds for investment.

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