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Institutional development, state ownership, and corporate cash holdings: Evidence from China☆

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ABSTRACT

This study examines how institutional development and state ownership influence corporate cash holdings among Chinese firms. The empirical results reveal that firms in provinces with more developed institutions (non-state-controlled firms) hold more (less) cash reserves than those in provinces with less developed institutions (state-controlled firms). Moreover, the positive effect between institutional development and cash holdings is more prominent for non-state-controlled firms. These findings are consistent with the hypothesis that more developed institutions mitigate the threat of political extraction for non-state-controlled firms, resulting in larger cash holdings among these firms. Subsequent analyses demonstrate that the impact of institutional development on cash holdings is weakened for non-state-controlled firms which have established political connections. Therefore, this study identifies one vital channel through which political connections are beneficial for non-state-controlled firms in terms of mitigating the threat of political extraction.

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1. Introduction

Despite the rapid growth and development of China's economy in the past two decades, the legal environment in China is still far from ideal (Allen, Qian, & Qian, 2005; Yao & Yueh, 2009). The weak enforcement of property rights has given rise to rampant rent-seeking activities by government bureaucrats, as highlighted by a large body of anecdotal evidence and academic studies in recent years (Fan, Rui, & Zhao, 2008; Chen, Li, Su, & Sun, 2011; Chen, Sun, Tang, & Wu, 2011). Moreover, prior studies indicate the existence of regulatory discrimination between state-owned and non-state-controlled firms, to the extent that the private sector is often the subject of state predation (Brandt & Li, 2003; Johnson, Kaufmann, McMillan, & Woodruff, 2000). This problem is exacerbated by the variation in economic and legal institutions across different provinces in China.

In spite of the work of researchers in this field, very little is known about managerial actions taken to protect their firm's assets from the threat of political extraction by government officials in China. Cash and cash equivalents is the most liquid asset and thus is arguably most vulnerable to political extraction (Myers & Rajan, 1998). The first objective of this study is to investigate which of the two competing theories–the political extraction or the precautionary motive hypothesis–can better explain the pattern of cash holdings for Chinese firms. This study employs three provincial indices from Fan, Wang, & Zhu (2011) and the Central Bureau of Statistics which have been widely used as proxies for the institutional development in China (*e.g.*, Jian & Wong, 2010; Li, Meng, Wang, & Zhou, 2008; Wang, Wong, & Xia, 2008), and a dummy variable representing non-state-controlled firms. The main findings are that firms in provinces with more developed institutions (non-state-controlled firms) hold more (less) cash reserves than those in provinces with less developed institutions (state-controlled firms). Furthermore, the positive relationship between institutional development and cash holdings is more prominent for non-state-controlled firms. The results are consistent with the political extraction theory and suggest that non-state-controlled firms hold less cash reserves (and invest more) as a strategic response to counter the threat of political extraction and that the presence of developed institutions mitigates the threat of political extraction for these firms.

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The second objective of this study is to examine the role of political connections as another channel in mitigating the threat of political extraction for non-state-controlled firms in China. The finding is that the impact of institutional development on the cash holdings of non-state-controlled firms is also attenuated as these firms become politically connected.

This study provides two contributions to the existing literature. First, this paper shows that the threat of political extraction lowers firms' incentives to hold cash, which complements recent findings on the determinants of cash holdings (Chen & Chuang, 2009; Dittmar, Mahrt-Smith, & Servaes, 2003; Harford, Mansi, & Maxwell, 2008; Kalcheva & Lins, 2007; Kuan, Li, & Chu, 2011; Opler, Pinkowitz, Stulz, & Williamson, 1999) and in particular the political extraction hypothesis proposed in the cross-country study by Caprio, Faccio, & McConnell (2013). The single-country setting in this study offers advantages over Caprio et al. (2013) as is relatively free from the omitted variable problem often encountered in cross-country studies. Moreover, the co-existence of state-controlled and non-state-controlled firms and the importance of political-connections to Chinese firms facilitate interesting extensions to merely investigating how economic and legal institutions affect corporate cash holdings in China. Neither issue is examined previously in Caprio et al. (2013).

Second, this study also advances the understanding of the economic role of political connections in China. Prior studies have shown that firms around the world have incentives to build political connections and that political connections bring various benefits to connected firms such as preferential access to capital, government bailouts in the event of financial distress, and lighter taxation (Faccio, Masulis, & McConnell, 2006; Fan et al., 2008). More importantly, this study complements the studies of Chen, Sun, Tang, & Wu (2011) and Wu, Wu, & Rui (2012) in demonstrating that the benefits derived from political connections are largely concentrated in non-state-controlled firms. In particular, political connections help non-state-controlled firms mitigate the threat of political extraction and thus to maintain cash reserves at a relatively efficient level to support future investment opportunities.

Our findings on the association between institutional development and corporate cash holdings are consistent with the findings of Caprio et al. (2013). However, our findings appear to be opposite from those of a concurrent working paper by Chen, Li, Xiao, & Zou (2012). Chen et al. (2012) find that the presence of good government reduces cash holding for Chinese firms, which is consistent with the financial constraint mitigation (instead of the political extraction) hypothesis. The differences between the findings in the two studies could be attributed to two aspects. First, the proxies for government quality in Chen et al. (2012) are city-level indices which are obtained from companies' subjective responses to the World Bank (2006), while the measures of institutional development in this study are provincial-level indices. The majority of published papers in the accounting and finance journals examining listed companies in China use provincial-level data. Examples include Wang et al. (2008), Chen, Firth, & Xu (2009), Firth, Lin, Liu, & Wong (2009), Jian & Wong (2010), Chen, Li, Su, & Sun (2011), and Wu et al. (2012). So far, only two papers use city-level data similar to Chen et al. (2012), Cull & Xu (2005) and Lin, Lin, & Song (2010). Cull & Xu (2005) examine the effect of regional institutional factors on the profit-reinvestment decision by non-listed, small private firms (as opposed to large, listed companies) in China. Therefore, the evidences provided in the existing literature demonstrate that provincial-level institutional development could be more appropriate than city-level measures in examining the economic impact of institutional development on listed company behavior. Second, the sample in Chen et al. (2012) contains only listed companies headquartered in those cities covered by the World Bank Survey and in the period from 2005 to 2007, while this study includes all non-financial listed companies from 1999 to 2007.

The remainder of the paper is organized as follows. Section 2 reviews the related literature and develops testable hypotheses. Section 3 describes the source of data and defines the variables. Section 4 presents the main empirical results. Section 5 concludes the paper.

2. Literature review and hypothesis development

2.1. Institutional development, state ownership, and cash holdings

Opler et al. (1999) conduct a comprehensive analysis of the costs and benefits of cash holdings. The cost of holding cash is the low rate of return earned by these assets. On the other hand, holding cash brings two main benefits to the firm. First, the firm saves on transaction costs that would otherwise be incurred in raising funds and does not have to liquidate assets to make payments. Second, the firm can use cash to finance its investment activities if other sources of funding are not available or are very costly.

The above discussion assumes no divergence in the interests of managers and shareholders. However, managers may take actions that benefit themselves at the expense of shareholders. For example, managers may divert cash for personal consumption or overinvest in pet projects. More recent studies focus on the association between cash holdings and corporate governance (Chen & Chuang, 2009; Dittmar et al., 2003; Harford et al., 2008; Kalcheva & Lins, 2007; Kuan et al., 2011).

Myers & Rajan (1998) and Caprio et al. (2013) identify another potential cost of holding cash: cash is the most liquid asset and thus is the asset most susceptible to extraction by politicians. At the same time, politicians incur no costs in converting cash for personal consumption. Therefore, to protect their firm's assets from being extracted by politicians, managers may have incentives to reduce the firm's cash holdings (and increase investments in fixed assets which are harder to be extracted). This incentive should be stronger for firms that are more vulnerable to political extraction.

Using country-level corruption indices to measure the threat of political extraction, Caprio et al. (2013) find that firms in countries where the corruption level (and the threat of extraction) is high tend to hold less cash and divert the cash to investments in fixed assets than firms in countries where the corruption level is low. Prior research finds that there is a great disparity in the development of institutions across regions in China (Fan, Wong, & Zhang, 2007). Anecdotal evidences further suggest that because of the variation in local institutions, the degree of expropriation differs to a great extent across Chinese provinces. Following the argument by Caprio et al. (2013), firms located in provinces with more developed institutions face a lower threat of extraction and these firms could afford to hold more cash. Hence, under the political extraction hypothesis, the first part of the first hypothesis is stated as follows:

H1a. Firms in provinces with more developed institutions have *larger* cash holdings than firms in provinces with less developed institutions.

In addition, China hosts both firms controlled by the government and those controlled by private entrepreneurs. Non-state-controlled firms are also more likely to be the subject of political extraction than are state-controlled firms. For example, Johnson et al. (2000) and Brandt & Li (2003) document that non-state-controlled firms are often disadvantaged by higher tax rates and their inability to obtain bank loans. Based on the above arguments, non-state-controlled firms have more of an incentive to hold lower cash reserves than state-controlled firms as a means of protecting their assets from being extracted. The second part of the first hypothesis is stated as follows:

H1b. Non-state-controlled firms have *smaller* cash holdings than state-controlled firms.

Combining these two sub-hypotheses, the effect of institutional development on cash holdings will be expected to vary across the sample of state-controlled and non-state-controlled firms. In particular, since

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