



Social capital and corporate cash holdings



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ABSTRACT

In this paper we investigate the impact of regional social capital on corporate cash holdings. We also examine the possible channels through which social capital may affect cash holdings. Using US data, this study shows that firms from a high social capital county hold significantly less cash than firms from a low social capital county. We also confirm that social capital reduces cash holdings via the financial constraints and financial reporting quality channels, while it increases cash holdings via the systematic and idiosyncratic risk channels. Additional analysis reveals that, the effect of social capital on cash holdings is more pronounced for less geographically dispersed firms. These results are robust to alternative specifications of cash holdings and social capital, and to the use of a two-stage least squares (2SLS) analysis to alleviate the endogeneity concern. Overall, our findings suggest that regional social capital plays an important role in determining corporate cash holdings.

1. Introduction

In this paper we investigate whether regional social capital impacts corporate cash holdings in the USA. We also identify and examine four channels (financial constraints, financial reporting quality, systematic risk and idiosyncratic risk) through which social capital may explain cash holdings. Social capital can be perceived as the existence of a set of values or norms that facilitate cooperation among members (Fukuyama, 1997; Guiso, Sapienza, & Zingales, 2004). Extant research has examined the impact of social capital on corruption, crime, and transaction costs associated with financial exchanges (LaPorta, Lopez-De-Silanes, Shleifer, & Vishny, 1997; Buonanno, Montolio, & Vanin, 2009). We consider a hitherto unexplored effect of social capital on managers' propensity to hoard cash.

The amounts of cash holdings of public U.S. firms are economically significant, and have been growing steadily over time (Bates, Kahle, & Stulz, 2009).¹ A fundamental question is: why do firms hold cash, despite the agency and opportunity costs associated with cash holdings? A plethora of research has investigated the determinants and consequences of corporate cash holdings including financial constraints (Denis & Sibilkov, 2009), refinancing risk (Harford, Klasa, & Maxwell, 2014), product market threats (Hoberg, Phillips, & Prabhala, 2014), customer concentration (Itzkowitz, 2013), creditor rights (Yung & Nafar, 2014), national culture (Chen, Dou, Rhee, Truong, & Veeraraghavan, 2015), ownership and control structure of firms (Kuan, Li, & Liu, 2012), and a host of other firm-specific variables (Amess, Banerji, & Lampousis, 2015). Our study adds to this literature by exploring the role of social capital, an important dimension that has been missing from the extant literature.

Extant literature has offered a number of motives for explaining corporate cash holdings. First, the transaction motive for cash holdings suggests that managers hold cash to make payments without liquidating assets or seeking external financing (e.g., Miller & Orr,

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¹ The average cash-to-book assets ratio in our sample exhibits a monotonic increase from 20% in 1997 to 26% in 2015.

1966; Mulligan, 1997). Miller and Orr (1966) derive the optimal demand for cash when a firm incurs transaction costs associated with converting a noncash financial asset into cash, and uses cash for payments. The precautionary motive for holding cash considers capital market frictions, and proposes that firms hold cash to cope better with adverse shocks in the presence of costly external financing (e.g., Han & Qiu, 2007; Almeida, Campello, and Weisbach (2004). The agency motive for cash holdings posits that entrenched managers squander away cash, e.g. through overinvestment, despite poor investment opportunities (e.g., Jensen, 1986). Harford (1999) shows that firms with larger cash holdings engage in more acquisitions and these acquisitions are value decreasing. Finally, Foley, Hartzell, Titman, and Twite (2007) show that the tax consequences associated with repatriating foreign earnings motivates U.S. firms to hold more cash.

The above theories highlight the motives of hoarding cash, but do not take into consideration the impact of social capital, which is likely to shape many of the incentives for hoarding cash. Social capital is characterized by the presence of a certain set of informal values, norms, and networks fostering cooperation and facilitating collective action (Fukuyama, 1997; Woolcock, 2010), and by the existence of a mutual level of trust (Guiso et al., 2004). The strength of cooperative norms and the density of social networks fosters honest behavior and enhances the punishment for deviant behavior (Coleman, 1994; Spagnolo, 1999). Human beings, including managers, develop a set of ideas following the prevalent social norms, and take into account the costs associated with deviating from the accepted norms (Cialdini, Kallgren, & Reno, 1991; Milgram, Bickman, & Berkowitz, 1969). Such norms might include efficient utilization of financing proceeds, i.e., cash and cash resources.²

Linking the concept of social capital with the incentives for hoarding cash as mentioned above is important. Individuals from a high-social capital region are expected to have a high degree of altruism, a community-centric attitude, a high propensity to honor obligations, and a high degree of mutual trust (Portes, 1998). These regions are also characterized as having a dense network conducive to information sharing. The perceptions by outsiders that individuals, including corporate executives, from high social capital regions are honest and trustworthy, allow firms to access external finance easily and at a cheaper cost, thereby lessening the need for holding cash. This view, therefore, is consistent with the 'precautionary motive' for holding cash. Extant studies also provide evidence that better relations with stakeholders stemming from strong networks reduce firms' exposure to idiosyncratic risk and market-wide risk (Ferris, Javakhadze, & Rajkovic, 2017; Hasan & Habib, 2017) which, in turn, reduces the need to maintain cash holdings at high level (Bates et al., 2009). The idea that firms in high social capital regions hold less cash, can also be related to the agency motive. Opportunistic managerial behavior (managerial entrenchment) with respect to cash management is perceived as socially deviant behavior in high social capital regions, and imposes significant social costs on managers. Mutual trustworthiness, as embedded in high social capital regions, constraints managers from squandering away cash. This allows firms headquartered in high social capital regions to access external financing easily and, again, lessens the need for holding cash.

The preceding discussion, however, did not incorporate the possible channels through which social capital might reduce corporate cash holdings. We identify and examine four channels through which social capital might affect cash holdings. They are the financial constraints, financial reporting quality, systematic risk and idiosyncratic risk channels. Firms with greater frictions in raising outside financing save a greater portion of their cash flow as cash than do those with fewer frictions (Almeida et al., 2004). Since the prevalent social norms facilitate honest behavior by managers (Fukuyama, 1997), and dense networks foster an environment that limits opportunistic behavior (Coleman, 1988), one would expect firms from high social capital regions to face lower financing restrictions (Javakhadze, Ferris, & French, 2016). This in turn reduces the need to maintain cash holdings at high levels for firms incorporating in high social capital regions. Regarding the financial reporting quality channel, prior research has established that high quality financial reporting reduces the negative effects of information asymmetries and adverse selection costs, allowing firms to reduce their cash holdings (García-Teruel, Martínez-Solano, & Sánchez-Ballesta, 2009). Since firms from high social capital regions exhibit better financial reporting quality (Jha, 2017), we expect cash holdings to be at low levels for firms from high social capital regions.

In terms of the systematic risk channel, recent study shows that social capital reduces firms' sensitivity to systematic risk (Ferris et al., 2017). Literature suggests competing views about the relation between systematic risk and cash holdings. One the one hand, firms with low systematic risk may hold less cash because of a lowered transaction motive for holding cash (Palazzo, 2012). On the other hand, since firms with low systematic risk tend to have a shorter debt maturity structure, these firms are likely to hold more cash to mitigate any refinancing risk (Harford et al., 2014). Thus, social capital reduces systematic risk, which may increase or decrease cash holdings. Finally, strong network stemming from social capital helps firms to establish and maintain better relationships with stakeholders, providing insurance-like protection from firm-specific risk (Hasan & Habib, 2017). Since firms with less-firm specific risk do not need to hold cash for precautionary motives (Bates et al., 2009), we expect firms from high social capital regions to hold less cash.

Using a comprehensive sample of 67,493 firm-year observations during the period 1997–2015, we document a negative and statistically significant effect of social capital on cash holdings after controlling for firm characteristics, year, industry and county effects. Our results are economically meaningful as well. A one standard deviation increase in social capital is associated with a 2.71 percent decrease in corporate cash holdings (CASH/NA). Given that the mean value of cash holdings for our sample is \$147.59 million, the implied decrease in annual cash holdings amounts to \$4.0 million for an average firm. We also confirm that social capital reduces cash

² It is important to note that the definition of social capital as formulated here incorporates norms, values, networks, and trust. The well-accepted definition by Fukuyama (1997) includes norms, values, as well as network densities, as constructs of social capital. However, network-based definition of social capital has also been proposed in the literature. For example, Burt (2005, p. 5), defines social capital as '[t]he advantage created by a person's location in a structure of relationships'. Nahapiet and Ghoshal (1998, p.243) defines individual's social capital as 'the sum of actual and potential sources embedded within, available through, and derived from, the network of relationships possessed by that individual'. We consider the definition proposed by Fukuyama (1997), as we believe that social norms of honest behavior in regions with high social capital foster a stable network of relationships, beneficial for organizational outcomes. We argue that misuse of cash and cash proceeds by managers in firms in high social capital regions goes against the social norm of honoring obligations towards the stakeholders.

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