



Political connection, government policy, and investor trading: Evidence from an emerging market



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ABSTRACT

This study investigates whether political connection (PC), government policy (GP), or both affect stock returns before and after the Taiwanese 2008 presidential election. We also examine whether the two effects influence the five types of investor trading during the election. Past studies have separately focused on either the PC or the GP effect, whereas this study considers both effects. Specifically, we consider five types of investors, namely, foreign investors, security investment trust companies (INVTRUSTs), security dealers, board of directors and supervisors, and individual investors. We find that firms connecting only with the winning party exhibit positive abnormal returns, and only INVTRUSTs increase the shareholdings of these firms (PC effect). Our results do not support the GP effect alone. Instead, we identify that firms with joint PC and GP effects have the abnormal returns during election periods.

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1. Introduction

An increasing number of studies have been devoted to the investigation of politics and finance. Political topics include political events, such as elections, government policy (GP), political connection (PC), political intervention, and corruption. Among the studies related to politics, [Belo, Gala, and Li \(2013\)](#) focus on the influence of the GP on government spending on the stock returns of firms, whereas [Goldman, Rocholl, and So \(2009\)](#) and [Cooper, Gulen, and Ovtchinnikov \(2010\)](#) consider the PC effect on the stock market during the presidential election. However, given that both GP and PC may affect stock returns during the presidential election, considering only one of them may cause inaccuracies in the findings of the effects of the two factors.

PC denotes that the chief executive officer (CEO) or board of directors of firms either serves in the central committee (e.g., [Li, Meng, Wang, & Zhou, 2008](#)) or financially donates to a political party (e.g., [Claessens, Feijen, & Laeven, 2008](#); [Cooper et al., 2010](#)). Firms connected with politics are typically referred to as PC firms. Investors subsequently expect PC firms to obtain preferential treatment when applying for loans, to be informed in advance of future policy directions, and to be the first to be bailed out, among many advantages.

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For example, using data on firm applications for capital under the Troubled Asset Relief Program (TARP),¹ Duchin and Sosyura (2012) show that PC firms are more likely to be funded than other types of firms. Accordingly, the “PC effect” denotes that stock returns and shares trading of these firms tend to increase because investors purchase shares of firms with PCs with the winning party. This effect has been confirmed by studies, such as those by Ferguson and Voth (2008) based on German data, Claessens et al. (2008) on Brazilian data, and Goldman et al. (2009), Cooper et al. (2010), and Kim, Pantzalis, and Park (2012) on U.S. data.

GP denotes that given the political goals of each political party, investors are more likely to buy shares of firms whose businesses may benefit from the policy, despite the lack of PCs of firms to the government (Pástor & Veronesi, 2012). For example, in the United States, the Democratic Party focuses significantly on the minimum-wage policy, health-care reform, and income inequality, whereas the Republican Party encourages laissez-faire economics, fiscal conservatism, and the elimination of government-run welfare programs. The business of a firm must match the policies to obtain the desired benefits. Belo et al. (2013) report that firms with high level of industry exposure to government spending experience higher cash flows and stock returns during Democratic presidencies. Therefore, the “GP effect” denotes that stock returns and shares trading of these firms tend to increase, because investors purchase shares of firms whose businesses are consistent with the policies of the winning party in the election.

Both GP and PC affect the values of firms, but differ in their influence channels. The GP effect requires the business operations of firms to be consistent with the policy direction without establishing a PC with the ruling party. By contrast, the PC effect focuses on firms that connect with politicians, especially those from the winning party, without their businesses being necessarily integrated with GP. An example is a company with a good relationship with politicians but whose business is not directed to favor established policies. Firms may exhibit both GP and PC effects, indicating that their businesses are consistent with the policy direction and they have PC with the winning party in the election. At the same time, firms may also exhibit neither of the two effects. GP and PC effects have been examined separately in the past, but their effect may jointly influence the stock returns and trading shares. To the best of our knowledge, no study has investigated the simultaneous GP and PC effects.

This study examines PC and GP effects during the 2008 presidential election in Taiwan. We examine these phenomena through the following research questions: Does the influence of PC and GP effects generate abnormal stock returns during the election period? Does the influence of PC and GP effects motivate investors to increase their stock holdings? What types of traders are most likely to be affected by PC and GP effects? Do strategies of PC and GP bring profit?

These four issues differ from those examined in past studies in terms of two aspects. First, early studies did not distinguish PC and GP effects.² Therefore, the increasing stock returns or superior accounting performance of specific firms may be attributed to PC (GP) effects when in fact they emerge from the PC (GP) effect during the election. Second, past studies implicitly assume that all types of investor experiences have the same share-trading patterns (Goldman et al., 2009). The different types of investors may plausibly have different priorities in terms of returns and risk, knowledge accumulation and information collection, trading experience, and the ability to use public information in evaluating the election outcomes and GPs. Thus, trading patterns may vary among different types of traders in response to PC and GP effects. We consider the assumption of the same trading styles by classifying investors into five types, namely, foreign investors (FIs), security investment trust companies (INVTUSTs), security dealers (DEALERS), insiders, such as board of directors and supervisors (BOARDS), and outsiders, such as individual investors (INDINVs).³ With no theoretical and empirical guidance, we have limited knowledge on which investor type exhibits a trading pattern in line with PC and GP effects *ex ante*. Therefore, the topic remains an empirical issue.

The use of the data on Taiwan is influenced by three unique features. First, the two major political parties in Taiwan, the Kuomintang Party (KMT) and the Democratic Progressive Party (DPP) have significantly different economic policies, which aim to provide an ideal environment for the identification of the consistency or inconsistency of business operations of firms with GP. According to Ross (2006) and Imai and Shelton (2011), KMT has adopted the trading policies of China and emphasizes the importance of the Chinese market, whereas DPP prefers trading with other countries or regions and expresses that the Chinese market is less important than it appears to be. These two strikingly different policies easily allow us to identify the GP effect. Second, the exact and detailed trading data by the five types of traders are rarely accessible in other developing countries. We collected the necessary data on these investors from the Taiwan Stock Exchange (TWSE), which allows us to investigate this issue. Finally, Taiwan maintains data on political donations since 2005 under the Sunshine Law. Thus, we can clearly distinguish PC from non-PC firms. Donation data are unusually available in other developing countries.

With the surveys indicating that 75% of voters believe that KMT will win the elections, the theoretical PC effect suggests that investors will purchase the shares of PC firms connected with KMT (KMT firms hereafter) and sell the shares of PC firms connected with DPP (DPP firms) even prior to the elections. We examine the effects 40 days before and 5 days after the elections. By contrast, the GP effect indicates that investors will buy the shares of firms with strong links to China. Hence, stock returns and shares trading of PC firms connected with KMT (PC effect), as well as those of firms with businesses linked to China (GP effect) will increase.

Our empirical evidence modifies the traditional PC effect by finding that the joint effects of PC and GP are more significantly positive in the measure of cumulated abnormal results (CAR) during the 2008 presidential election in Taiwan. During the election, investors buy the shares of KMT firms to earn potential profit, and they sell the shares of DPP firms to avoid future losses. Hence, KMT and DPP firms have positive and negative CAR, respectively, which are fully consistent with the expected PC effect. Second, we find that the

¹ TARP is a program of the U.S. government signed into law by President George W. Bush on October 3, 2008. The program purchases assets and equity from financial institutions to strengthen the financial system.

² Ferguson and Voth (2008), Claessens et al. (2008), Goldman et al. (2009), Cooper et al. (2010), and Kim et al. (2012) all confirm the PC effect during elections.

³ The Financial Supervisory Commission (FSC) is the official authority of the Banking, Securities, Derivatives, and Insurance of Taiwan; it requires all institutional investors to report daily firm-level trading information, providing us with rich trading data for this research.

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