



Political uncertainty and cash holdings: Evidence from China



Nianhang Xu^a, Qinyuan Chen^{a,*}, Yan Xu^{a,*}, Kam C. Chan^b

^a School of Business, Renmin University of China, Beijing 100872, China

^b Department of Finance, Gordon Ford College of Business, Western Kentucky University, Bowling Green, KY 42101, USA

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ABSTRACT

We examine the relation between political uncertainty and cash holdings for firms in China. We document that, during the first year of a new city government official's appointment, a firm, on average, holds less cash, which is consistent with the grabbing hand hypothesis of politician. Our results are robust to alternative measures of cash holdings, instrumental variable estimation, sub-samples without firms in four major cities, a matched sample approach, and placebo tests. In addition, our additional analyses suggest that a firm holds significantly less cash if: (a) the newly appointed official is from a different city relative to that from the same city, (b) it faces high political extraction risk, and (c) it has strong twin agency conflicts. Lastly, our extended results suggest that the market value of cash holdings is significantly negative during periods of political uncertainty and firms hide their cash by moving it to related firms via related party transactions.

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1. Introduction

Political connections play an important role in many economic activities. While they are not necessarily good for an economy, they are sometimes very good for a firm. A firm can use political connections to enhance its operations and increase its value (Fisman, 2001; Faccio, 2006; Faccio et al., 2006; Bunkanwanicha and Wiwattanakantang, 2009). Specifically, emerging market studies, such as those on China, document that a firm's political connections are critical for favorable decisions in corporate litigation (Firth et al., 2011), the approval and promotion of initial public offerings (Liu et al., 2013; Piotroski and Zhang, 2014), and family firm succession (Xu et al., 2015), among other things. These studies suggest that political connections can be helpful and play the role of a helping hand to a firm.

In contrast, political connections can sometimes harm a firm, especially in emerging markets with weak formal institutions and high levels of corruption. The literature (e.g., Frye and Shleifer, 1997; Shleifer and Vishny, 2002) generally describes a grabbing hand phenomenon, in which government officials extract resources from a firm for personal gain through user fees, taxes, regulations, and bribery or even seizing all assets via nationalization. Stulz (2005) shows that, facing expropriation by officials, firm owners will structure corporate assets to minimize the likelihood of loss from political extraction. Studying 109 countries and using firm cash holdings in 2005 as the dependent variable, Caprio et al. (2013) report that when a country's corruption level is high, a firm's cash holdings, on average, are low and vice versa. The authors contend that cash is the most liquid asset and government officials often target cash-rich firms for political extraction via corruption. Hence, a firm holds less cash to minimize the risk of political extraction. While the findings of Stulz (2005) and Caprio et al. (2013) are insightful, they focus on expropriation by corrupt officials, which is the undesirable outcome of the grabbing hands process of officials. The role of the

* Corresponding authors.

E-mail addresses: nhxu@ruc.edu.cn (N. Xu), garfieldchan@ruc.edu.cn (Q. Chen), blesxuyan@163.com (Y. Xu), johnny.chan@wku.edu (K.C. Chan).

helping hand perspective of political connections regarding a firm's cash holdings is unclear. In addition, the literature primarily examines the impact of having political connections, not changes in political connections, on firm value and cash holdings. A change in political connections due to political turnover creates political uncertainty. The political uncertainty is a shock that enhances or weakens the firm's existing political connections and subsequently affects its cash holding decisions.

The objective of our study is to examine the relation between cash holdings and political uncertainty in China. Using political uncertainty created by political turnover in a city in which a firm located, we examine the competing helping and grabbing hand hypotheses of politicians on cash holdings. We argue that a firm has two possible reactions to political uncertainty in its city. Under the helping hand hypothesis, a firm considers politicians helpful. Political uncertainty means opportunity for the firm because the new official can help the firm to enhance its value. Hence, the firm needs to respond aggressively to a newly appointed official's initiatives and policies to secure the official's help or government resources. For instance, a newly appointed official might want to expand a city's economic development. It is then in the best interest of a firm to respond positively and promptly to such an initiative to take advantage of government subsidies in the name of economic development. By doing so, the firm will be able to obtain the government's help and, more importantly, can maintain or exceed its political connections established in the previous political regime to enhance the firm's future value. Accordingly, the firm opportunistically needs more cash in a period of political uncertainty to respond quickly to the newly appointed official, which is similar to the speculative motive for holding cash (Almeida et al., 2004; Francis et al., 2014). Moreover, a newly appointed official, while very friendly and helpful to local firms, may take time to materialize help to firms in terms of financing. That is, a helpful hand takes time to be effective. Thus, it is in a firm's best interest to maintain more cash to ease temporary financial constraints due to political uncertainty. This is a precautionary motive for holding cash (e.g., D'Mello et al., 2008; Bates et al., 2009). Therefore, during a new political appointee's first year in a city, political uncertainty leads to more cash holdings for local firms.

In contrast, under the grabbing hand hypothesis, firms expect politicians to extract resources from them. When a political turnover occurs, a firm perceives the political uncertainty as just another opportunity for the newly appointed official to extract its assets. The firm considers the new official's initiatives and policies only as means of political extraction. Under political uncertainty and the grabbing hand assumption, it is safer for a firm to hide its assets, especially liquid assets such as cash, to minimize loss from political extraction. The firm will then reduce cash holdings in a period of political uncertainty. The grabbing hand hypothesis under political uncertainty echoes the argument of Stulz (2005) and Caprio et al. (2013) that a firm holds less cash when facing a highly corrupt government. Hence, in the first year of a new political appointee in a city, the cash holdings of local firms are lower. All things considered, whether firms will keep more or less cash in a period of political uncertainty is an empirical question.

Our paper is interesting for two reasons. First, the cross-country study of Caprio et al. (2013) specifically examines cash holdings and corruption and does not directly study cash holdings and political uncertainty. Thus, the authors assume the grabbing hand nature of politicians and an adverse impact of political connections (in the context of corruption) rather than political uncertainty. Our paper fills this gap by examining political uncertainty and considers both the helping and grabbing hand hypotheses. Second, the widely different cultural and economic development among the 109 countries studied by Caprio et al. (2013) naturally allows for only highly aggregated data in their analysis. By focusing on China, we are able to include more firm-level control variables and moderating factors, such as politically connected executives, firm scale, changes in corporate debt, and local fiscal deficits to examine the relation between cash holdings and political uncertainty. That is, by using a single-country study, we are able to control for differences in cultural and economic impacts across the country and provide additional insights on moderating factors on the relation between political uncertainty and cash holdings.

China's environment is particularly suitable for examining the helping versus the grabbing hand hypothesis of politician and cash holdings for several reasons. First, unlike other countries, China has rich data for analysis. It has undergone frequent political turnover because the Chinese government has a policy of appointing new political leaders in a city every several years to empower career politicians and prevent local officials from building up too much power. Both officials and firms are used to the political uncertainty created by government official turnover. Second, the compensation of Chinese officials is generally low relative to that in other countries and relative to private industry in China.¹ It is natural for officials to seek alternative compensation in monetary and non-monetary forms. The helping hand hypothesis suggests that officials enjoy helping firms for non-monetary rewards, such as *guanxi* (personal connections) and/or better political advancement opportunities to supplement their low monetary compensation. Alternatively, the grabbing hand hypothesis explains that officials use their political power to engage in political extraction to enhance their low monetary compensation. Both helping and grabbing hand phenomena are possible. Hence, China is a good testing ground for examining political uncertainty and cash holdings. Third, China is a relational economy. *Guanxi* is important for anyone to achieve a goal or task in China (Xin and Pearce, 1996; Tsang, 1998). Among the different kinds of *guanxi*, political connections are among the most important. Recent evidence from Firth et al. (2011), Liu et al. (2013), and Piotroski and Zhang (2014) illustrates the importance of political connections. When there is political uncertainty due to government official turnover, a firm's political connections become uncertain or even disappear. Naturally, firms pay special attention to political uncertainty and position themselves accordingly. Depending on whether the newly appointed official plays the role of a helping or a grabbing hand, firms react differently in terms of cash holdings. These characteristics make China a good environment for examining the impact of political uncertainty on cash holdings.

¹ On April 29, 2013, the *International Business Times* reported that Xi Jinping, China's president, made US\$19,000 a year (compared to US President Barack Obama's US\$400,000 a year). Jiang Jianqing, Chairman of the Industrial and Commercial Bank of China, made US\$185,000 a year, which is almost 10 times as much as Xi (<http://www.ibtimes.com/chinas-high-ranking-officials-businessmen-salaries-still-too-high-critics-1223295>, accessed October 29, 2015).

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