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Chenyu Cui , Kose John , Jiaren Pang , Haibin Wu

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Chenyu Cui
School of Economics and Management, Tsinghua University

Kose John
Leonard N. Stern School of Business, New York University

Jiaren Pang
School of Economics and Management, Tsinghua University

Haibin Wu
College of Business, City University of Hong Kong

Abstract

Employment protection increases labor adjustment costs and hence the expected costs of financial distress for labor-intensive firms. It follows that these firms are likely to increase their cash holdings to reduce the risk of financial distress when employment protection is strengthened. Consistent with this prediction, we find that labor-intensive firms in China significantly increase their cash holdings following the enactment of China's Labor Contract Law; other contemporaneous shocks do not seem to drive the finding. We also find that two events prior to the enactment that increase the likelihood of enacting the law have a similar effect. Further analysis shows that the impact of the law is concentrated on areas with strict law enforcement, state-owned enterprises, and industries that employ large numbers of migrant workers.

JEL classification: G32; G34; K31

Keywords: Cash holdings; employment protection; labor adjustment costs

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Contact information: Chenyu Cui, cuichy.14@sem.tsinghua.edu.cn; Kose John, kjohn@stern.nyu.edu; Jiaren Pang (corresponding author), pangjr@sem.tsinghua.edu.cn; Haibin Wu, haibinwu@cityu.edu.hk.