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Political uncertainty and firms' information environment: Evidence from China☆

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ABSTRACT

How political uncertainty affects the supply of value relevant information about a firm is an important but unresolved question. Using an emerging market setting where political leaders are expected to exert significant influence on economic activities, we examine the effect of political uncertainty caused by turnovers of local government leaders on a firm's information environment. We find that during periods of political uncertainty, the total amount of idiosyncratic information about a firm that is available to the market is reduced. The adverse effect on information supply is manifest in firms that are more politically dependent and stronger when uncertainty is more severe. Further, we provide evidence suggesting that firms react to political uncertainty by reducing the amount and the quality of information provided to investors. We find that information intermediaries such as financial analysts and the media have a moderating effect on the information environment as they increase the production of information during periods of political uncertainty. However, these intermediaries do not negate the net loss of information.

1. Introduction

Recent finance literature has documented the adverse effect of political uncertainty on financial activities and firm value (e.g. Pastor and Veronesi, 2012, 2013, Boutchkova et al., 2012; Brogaard and Detzel, 2015). The market volatilities around the Brexit vote in the U.K. and the U.S. presidential election in 2016 are just two latest examples of such an effect. However, less is known about how political uncertainty affects the supply of value relevant information about a firm. This is an important question because the availability of information is a key factor in the efficient allocation of productive resources and essential for investors' optimal investment decisions (e.g., Myers and Majluf, 1984; Bushman and Smith, 2001; Biddle et al., 2009; Piotroski and Wong, 2013). In this

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paper, we define information environment as the total amount of idiosyncratic information about a firm that is made available to investors[1] and examine how political uncertainty affects a firm's information environment.[2]

Political uncertainty could affect a firm’s information environment in both directions. On the one hand, it could worsen the information environment by reducing the amount of information firms make available to the market. Firms concerned about increased political scrutiny (Watts and Zimmerman, 1986; Piotroski and Wong, 2013) could choose to reduce or obfuscate information disclosure. Political uncertainty also subjects the firms to more uncertain future cash flow streams. As a result, the option value of delaying decisions becomes higher (Dixit and Pindyck, 1994) which in turn causes firms to withhold disclosure of relevant information. On the other hand, the loss of information provided by the firm could be compensated by increased information production by other participants. Since investors likely demand more information during periods of political uncertainty, information intermediaries such as the media and financial analysts could increase the supply of information about the firms.[3] Therefore, the net effect of political uncertainty on a firm's information environment is an empirical question.

In this study, we examine the relationship between the information environment and political uncertainty in an emerging market setting. Specifically, we use turnover of municipal level government leaders in China as a measure of political uncertainty. Compared with the U.S. and other rule-of-law countries which form the backdrop of many studies[4], the Chinese setting is more suitable for an examination of the effect of political uncertainty for several reasons. First, politics and politicians have a much stronger influence on businesses in China than in a market based economy such as the U.S. China is ruled by one political party that has no term limits, does not answer to an electorate, and is not “checked and balanced” by other legal or political institutions. Bushman and Piotroski (2006) argue that a country's legal system and political economy influence the behavior of businesses, investors, and other market participants. While a U.S. firm is protected by permanent legal institutions and therefore insulated to a large extent against direct meddling from transient elected politicians, a Chinese firm is at the mercy of its political leaders. It is essential for Chinese businesses to cultivate and maintain political connections (*guanxi*) with government officials. Compared with U.S. firms, managing political risks is of paramount, not peripheral, importance to Chinese firms, and political concerns likely exert a primary, rather than a secondary, effect on business decisions, including decisions about information disclosure. Second, municipal leadership turnover in China creates an ideal experimental setting for our study. Chinese municipalities are large jurisdictions that govern millions, often tens of millions, in population. The Chinese political governance system leaves local municipalities as semi-autonomous economic regions, and the highest ranking municipal officials wield such vast power in their jurisdictions that they are often called “local emperors.” Despite their powers in all local matters, municipal officials' tenures are exclusively dictated by the upper level government in secret deliberations and typically last about three years. As such, Chinese firms are subject to frequent, but unanticipated changes in their political leaders, which creates significant uncertainties to their welfare. Therefore, compared with fixed calendar election cycles in democratic countries that change political leaders, municipal leadership turnovers in China provide a relatively randomized sample of external political shocks.[5] Third, the information environment of the Chinese market is found to be one of the most opaque in the world (Morck et al., 2000; Jin and Myers, 2006; Piotroski et al., 2015). As the second largest economy of the world, and the largest emerging market, an examination of a possible adverse effect on its information environment is economically meaningful.

We examine all non-financial Chinese firms listed on its two main stock exchanges from 2000 to 2014. Using market based measures of stock price synchronicity and idiosyncratic volatility for information environment,[6] we find that municipal leadership turnover is positively associated with price synchronicity and negatively associated with idiosyncratic volatility after controlling for other factors. Our evidence supports the notion that political uncertainty adversely affects the information environment of firms by reducing the amount of value relevant information available to the market. Our results are robust to a battery of tests that include: matched sample approach and alternative measures of the dependent and main independent variables.

We also conduct cross-sectional analysis to ascertain whether a firm’s information environment is more affected when the uncertainty is more pronounced. We posit that the following four conditions indicate a more severe degree of uncertainty: multiple changes in municipal leadership, changes in both party secretary and mayoral positions[7], abnormal turnover defined as top municipal leaders being demoted, fired, arrested or forced to resign, and new leader(s) without prior local connections. As predicted, we find that higher degree of political uncertainty is associated with a more adverse effect on the information environment.

If the reduction in firm specific information is indeed caused by political uncertainty, firms that are more reliant on political favors and/or susceptible to political influences ought to be more negatively affected by political uncertainty. To ascertain such a cross-sectional effect, we separate our samples by their political dependencies. Specifically, we compare state owned enterprises with

[1] We focus on idiosyncratic information about the firm and not public information about macro economic conditions, industry trends and competitors that also may be used by investors. While both types of information may be relevant, idiosyncratic information has unique values because it may inform investors about firm risks that are not diversifiable.

[2] Since it is not feasible to directly quantify idiosyncratic information about the firm, we use two price based measures, stock synchronicity (R^2) and idiosyncratic volatility, to infer the amount of information available to market participants. This practice is consistent with prior literature (e.g. Morck et al., 2000; Jin and Myers, 2006; Piotroski et al., 2015; Liao et al., 2016). We discuss this in detail in Section 3.

[3] The benefits to the information intermediaries could be increased viewership for the media and increased subscription and reputation for analysts.

[4] For example, Julio and Yook (2012), Gao and Qi, (2012), Pastor and Veronesi, (2013), and Dai and Ngo (2015), among others.

[5] Another advantage of this setting is that it gives researchers a much larger data set because there are hundreds of municipalities in China that experience leadership turnovers every few years.

[6] Li et al. (2014), among others, suggest that the R^2 and idiosyncratic volatility measures may contain noises and recommend using additional measures to triangulate results. Accordingly, we use trading volume and stock turnover as supplemental measures of information environment. The logic is that the amount and intensity of trading should be positively associated with the amount of information disseminated in the market. Our results are robust to these alternative measures.

[7] In the Chinese political system, the communist party secretary and the mayor are the number one and number two leaders, respectively, in a municipality.