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Political uncertainty and firm risk in China☆

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Abstract

The political uncertainty surrounded by the turnover of government officials has a major impact on local economies and local firms. This paper investigates the relationship between the turnover of prefecture-city officials and the inherent risk faced by local firms in China. Using data from 1999 to 2012, we find that prefecture-city official turnovers significantly increased firm risk. Our results show that the political risk was mitigated when new prefecture-city officials were well connected with their provincial leaders. In addition, the impact of political uncertainty was more pronounced for regulated firms and firms residing in provinces with low market openness.

Keywords: Government official turnovers; Political uncertainty; Firm risk; China

1. Introduction

In the finance literature, it has been well documented that political uncertainty is an important factor affecting firm risk and performance. For example, Nippani and Medlin (2002), Nippani and Arize (2005), Li and Born (2006), He et al. (2009), Jones and Banning (2009), Sy and Al-Zaman (2011), Goodell and Bodey (2012), and Goodell and Vähämaa (2013) investigate the effects of U.S. Presidential election on stock market and report a negative relation between the election uncertainty and stock market volatility. Pantzalis et al. (2000) use a broad sample of countries and show the existence of influence of election cycles.

Recently, a number of studies further use election as an exogenous shock to examine how policy uncertainty and political connections affect stock returns and firms' risk-taking behavior. For instance, Pastor and Veronesi (2012) show that changes in government policy increase volatility and risk premia. Kim et al. (2012) document that political geography has a pervasive effect on the cross-section of stock returns. Gulen and Ion (2016) find a strong negative relationship between firm and industry-level capital investment and the aggregate level of uncertainty associated with future policy and regulatory outcomes. Jens (2017) provides the evidence that firm investment declines 5% before elections and firms delay equity and debt issuances tied to investment before elections. Akey and Lewellen (2017) use a sample of U.S. Congressional elections to show that policy-sensitive firms donate more to candidates for elected office than less-sensitive firms.

However, most existing studies have examined the political uncertainty, especially from the event of Presidential election, in developed countries, but very few have explored that in developing countries. The purpose of this paper is to extend the current literature by investigating the impact of political uncertainty in China. Two perspectives motivate our study. First, political uncertainly plays a more profound role in China than in developed countries because of China's unique socioeconomic system and political bureaucracy. Unlike the market-economy system in the U.S. and other developed countries whose governments use the so-called "invisible hand" to allocate resources and wealth, the socioeconomic structure in China is a mixture of market economy and government-planning systems. As a result, the Chinese government often uses the "visible hand" to directly control resources and allocate wealth, which in turn create uncertainties to firms and volatilities in financial markets.

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Second, China still maintains a centralized government with one-party rule. Even though there is a similar political election cycle in China just like in other countries, there is no national election uncertainty because the Chairman of the Communist Party automatically becomes the president. However, the political uncertainty in China is unequivocally associated with the election and turnover of government officials at local levels, such as provincial Party Secretaries and Governors, and prefecture-city Party Secretaries and Mayors. Li and Zhou (2005), employing the turnover data of top provincial leaders in China between 1979 and 1995, find that the likelihood of promotion (termination) of provincial leaders increases (decreases) with their economic performance. They interpret their findings as evidence that China uses personnel control to induce desirable economic outcomes. Similarly, under the decentralized economic reform, local officials have more authority and incentives to design and implement policies that could help them move up the political ladder. Therefore, any top local leadership change will trickle down to local economic policy changes. The resulting instability and discontinuity of the incumbent's economic development will inevitably enhance the operating risk encountered by local firms.

There are several studies in the literature about local government's impact on firms in China. For example, Qian (1995, 1996) argues that local governments use firms to serve political and social objectives, and therefore they have a negative impact on firm performance. On the other hand, they also show that local governments can help firms to get access to scarce resources and create friendly environments, which lead to a positive impact on firm performance. Chang and Wong (2004) investigate the local political control of decision making in Chinese firms, and show that the existing level of local Party control is excessive and is negatively associated with firm performance.

In this paper, we examine the impact of prefecture-city official turnovers on firm risk and provide new evidence to the literature. The remaining paper is organized as follows. Section 2 presents the development of hypotheses. Data and methodology are discussed in Section 3. Section 4 presents empirical results and Section 5 summarizes the study.

2. Hypotheses development

China's political system is largely centralized with a multidivisional-form hierarchical structure (Maskin et al., 2000). The government administration broadly consists of five layers as shown in Fig. 1. On the top is the central government, followed by the provincial governments (including autonomous regions and provincial-level cities). Prefecture-city, County, and Township governments are third, fourth and fifth levels. The Politburo Standing Committee of the Chinese Communist Party is the head of this "multidivisional system", which ultimately controls and determines policies, operations, and appointments of top government officials.

Under this hierarchical system, the central government sets national economic policies and appoints the leaders of provincial governments, whereas provincial governments set their own goals and develop strategies for their respective provinces, and

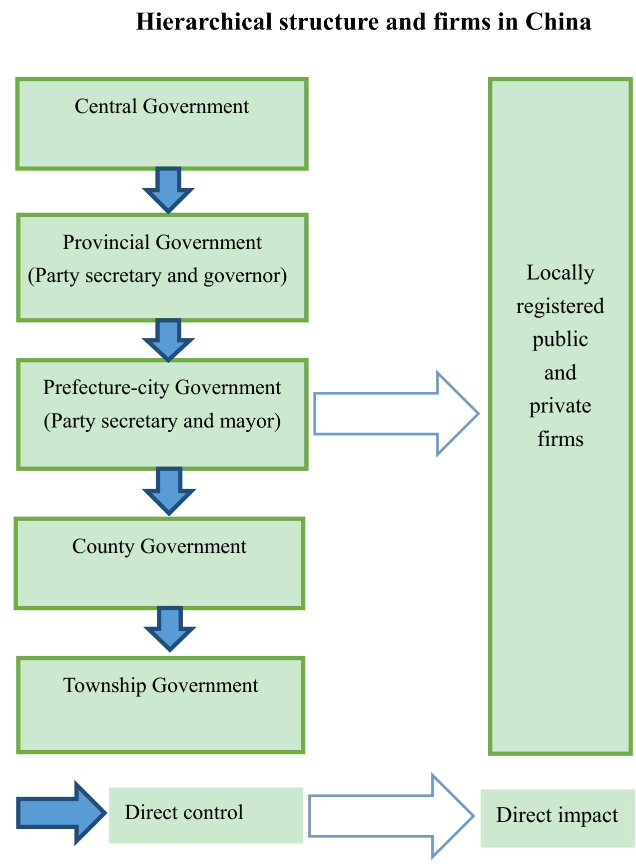

Fig. 1. Hierarchical structure and firms in China.

appoint the leaders of prefecture-city governments. In both province and prefecture-city governments, Party Secretary is the highest-ranking official, followed by the administrative head like Governor or Mayor. This dual Party Secretary/administrative head structure is designed to ensure the Communist Party with full control.

In this study, we define "local government" as the prefecture-city government, which is ranked below province but above county. Several points are worth mentioning. First, prefecture-city governments have substantial and discretionary control of local economic resources. The fiscal decentralization in China allows local governments to share budgetary expenditures and revenues with the central government. They design local economic policies and strategies based on their budget and spending plans. They decide land usage, set up business rules, codes and regulations, and provide investment opportunities and financial credits for local firms. Many of these local policies touch on daily business operations, such as work safety inspections and investment project approval (Gordon and Li, 2012). Therefore, prefecture-city governments have a direct impact on local firms.

Second, the career evaluation and promotion of prefecture-city officials are directly tied to their local economic performance (Wu et al., 2013; Deng et al., 2015). Prefecture-city officials are appointed by the provincial government and are evaluated based on local economic performance, which is heavily dependent on the tax revenues collected in their juris-