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ABSTRACT

This study examines how political connections influence the value of cash holdings in an international setting. The main finding reveals that political connections are not associated with the value of cash holdings in the overall sample. However, further analysis demonstrates that political connections are negatively associated with the value of cash holdings for firms in emerging markets and in countries with high levels of corruption. Moreover, the negative valuation of cash holdings is driven by firms that are connected through large shareholders. Overall, the findings provide new insights into the value relevance of cash holdings, especially for politically connected firms.

1. Introduction

Recent studies in corporate finance have emphasized the importance of corporate liquidity policies, including the issue of how shareholders value a company's cash holdings. Having sufficient internal cash serves shareholders' interests, as it can act as a buffer to protect the firm against any cash shortfalls; however, as Myers and Rajan (1998) argue, cash is perhaps the asset that is most vulnerable to expropriation by managers. In particular, managers may hoard cash to engage in activities that are damaging to minority shareholders' interests, such as overinvestment.

Using market-to-book equity as a measure of firm value, Pinkowitz et al. (2006) document that country-level institutional environment plays an important role in influencing how cash holdings are valued. Interestingly, they find an asymmetry in the value implications of cash holdings. Specifically, cash holdings are valued at a premium for firms in countries with strong investor protection, whereas they are valued at a discount for firms in countries with weak legal protection of investors. Other studies (such as Dittmar and Mahrt-Smith, 2007; Kalcheva and Lins, 2007; Fresard and Salva, 2010) demonstrate similar findings using firm-level governance mechanisms.

There are a growing number of studies examining the value of political connections around the world. Studies such as Faccio (2006) and Goldman et al. (2009) find that politically connected firms have higher firm values than their non-connected counterparts. Recent studies have focused on the costs of political connections, which include higher audit fees (Gul, 2006), lower accuracy of earnings forecasts made by analysts (Chen et al., 2010), lower quality accounting information (Chaney et al., 2011), higher incidence of tunnelling or self-dealing activities (Peng et al., 2011), higher incentives to take on risky projects (Boubakri et al., 2013), lower return on assets due to overinvestments (Ling et al., 2016) and lower incentives for banks to obtain information about connected firms' projects (Banerji et al., 2018).

The mixed results in the literature suggest that further research is needed to determine the value relevance of political connections and cash holdings. This study tests how political connections affect the value of cash holdings in an international setting, which is an interesting empirical question that has not been examined. Using data from 8373 firms across 24 countries, this study finds that

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political connections do not affect the value of cash holdings in the overall sample. However, further cross-sectional analysis demonstrates that political connections are negatively associated with the value of cash holdings for firms in emerging markets and for those in countries with high levels of corruption. Moreover, the negative valuation of cash holdings in these countries is driven by firms that are politically connected through large shareholders, rather than those that are connected through directorship.

Overall, the findings in this study contribute to the literature by providing additional insights into how investors value the cash holdings of politically connected firms. The findings also complement existing studies (such as Chen et al., 2010; Boubakri et al., 2013; Pinkowitz et al., 2006) by demonstrating that country-level institutions influence whether political connections and/or cash holdings are value relevant for international firms.

2. Data and variable construction

A dummy variable, *CONNECT*, is used to represent firms that have established close ties to politicians or governments. The data on connected listed firms around the world are first obtained from Faccio (2006). Her raw dataset consists of a list of 541 connected firms from 35 countries. According to Faccio (2006), a firm is classified as politically connected if, during the 1997 to 2001 period, at least one of its largest shareholders (those with ownership of at least 10% of the voting shares) or one of its top directors (CEO, president, vice-president, chairman or secretary) is a leader of the country (king, president, prime minister or premier), a minister, a member of parliament, or a close relative of a politician or a political party.

As Faccio's (2006) dataset on political connections covers the 1997 to 2001 period, the data on connected and unconnected firms are matched with firm-level financial data as of 2001 from Worldscope. To be consistent with previous studies, firms with missing firm-year observations on financial variables, financial firms (i.e. firms with SIC codes between 6000 and 6999), small firms (i.e. firms with a book value of total assets of less than US$10 million) and countries with zero connected firms are excluded from the sample. The screening process results in a final sample of 8373 firms from 24 countries. Among them, 227 are connected firms. The first two columns of Table 1 present the distributions of all of the firms and of the connected firms for each of the countries in the final sample.

In addition, two country-level institutional factors are used in the cross-sectional analysis. Following previous studies (e.g., Fernandes and Ferreira, 2009), 16 countries in the sample are classified as developed markets and the remaining 8 countries are

Table 1
Sample distribution and country-level variables.

Country	All firms	Connected firms	*CORRUPT*
Panel A: Developed countries			
Austria	62	1	1.93
Belgium	81	1	1.36
Denmark	99	3	2.36
Finland	111	2	2.54
France	526	11	1.46
Germany	475	3	1.72
Hong Kong	374	2	1.44
Ireland	31	1	1.55
Israel	22	1	1.25
Italy	162	7	0.89
Japan	2494	22	1.38
Singapore	279	8	2.5
Spain	96	1	1.66
Sweden	161	2	2.48
Switzerland	161	3	2.22
U.K.	994	66	2.17
Panel B: Emerging markets			
India	252	6	0.21
Indonesia	178	19	−1.09
Malaysia	476	39	0.18
Mexico	72	6	−0.39
Philippines	73	2	−0.49
South Korea	569	4	0.45
Taiwan	375	5	0.72
Thailand	250	12	−0.34
TOTAL	8373	227	
Mean	349	9	1.16
Std Dev	510	15	1.08

Note: This table presents the distribution of all firms (both connected and non-connected firms) for each country in year 2001 and the country-level variable *CORRUPT* as described in Appendix A.

classified as emerging markets. *CORRUPT* is the corruption index from Transparency International, with a lower number indicating a higher level of corruption.[1]

In addition to *CONNECT*, the following firm-level variables used in this study: cash holdings (*CASH*), excess cash holdings (*EXCASH*), total assets (*ASSET*), firm size (*SIZE*), firm value (*VALUE*), cash flow (*CF*), leverage (*LEV*), capital investment (*CAPX*) and a dividend dummy (*DIVD*). All of the control variables (except for *DIVD*) are winsorised at the 1% and 99% levels to make sure that the results are not attributed to outliers in the data. The definitions of all of the firm-level and country-level variables are provided in the Appendix A.

The summary statistics for the measure of firm-level political connections (*CONNECT*) and the financial variables are reported in Table 2. On average, connected firms make up 2.7% of the sample. The mean and median of *CASH* are about 0.13 and 0.09, respectively, and the standard deviation is 0.13. The mean and median of *EXCASH* are about 0.00 and -0.02, respectively, and the standard deviation is 0.11.

3. Empirical results

3.1. Political connections and the value of cash holding

Eq. (1) is estimated to examine the effect of political connections on the value of cash holdings, using a regression model that controls for both industry fixed effects (using the industry classification from Fama and French (1997)) and country fixed effects:

$$VALUE_i = a_0 + \beta_1 CONNECT_i + \beta_2 CASH_i + \beta_3 (CONNECT_i \times CASH_i) + \beta_4 SIZE_i + \beta_5 CF_i + \beta_6 LEV_i + \beta_7 CAPEX_i + \beta_8 DIVD_i + \sum c_j Country_i^j + \sum c_k Industry_i^k + u_i, \quad (1)$$

where the dependent variable is *VALUE*. All of the other variables are as defined in Appendix A.

If political connections and cash holdings are valuable to a firm, both the coefficients on political connections (β_1) and cash holdings (β_2) are expected to be positive. Moreover, the interaction term (*CONNECT* × *CASH*) captures the incremental effect of political connections on the value of cash holdings. Column (1) of Table 3 presents the results using the level of cash holdings (*CASH*). The results demonstrate that the coefficient on *CASH* is positive and significant at the 1% level for the overall sample, which highlights the value relevance of cash holdings. In addition, although the coefficient on *CONNECT* is positive and the coefficient on the interaction term (*CONNECT* × *CASH*) is negative, neither of them are statistically significant.

As an alternative method for mitigating the issue of endogeneity as it relates to cash holdings, a two-stage least square (2SLS) regression is used to estimate the value of excess cash holdings. The excess cash holdings for each firm are computed as follows. First, *CASH* is regressed against the control variables that have been found to determine corporate cash holdings (such as *SIZE, LEV, CAPEX* and *DIVD*). The estimated coefficients are then used to predict the optimal level of cash holdings for each firm. Excess cash holdings (*EXCASH*) are computed as the residual from the regression and it is found that 42% of the sample firms have positive excess cash holdings. Eq. (1) is re-estimated by replacing *CASH* with *EXCASH*. The results, presented in Column (2) of Table 3, are similar to those presented in Column (1), except that the coefficient on *CONNECT* is now positive and statistically significant at the 10% level. Likewise, the coefficient on the interaction term (*CONNECT* × *CASH*) is negative but not significant. These results suggest that the presence of political connections is not associated with the value of cash holdings for the overall sample.

3.2. Country-level institutions, political connections and the value of holding cash

Next, it is important to examine whether the strength of country-level institutions affect the association between political connections and the value of holding cash. The sample is classified into two subsamples (low and high) based on market development and the level of corruption. In particular, countries with *CORRUPT* values that are below the mean (1.16) are classified as High corruption countries and countries with *CORRUPT* values that are above the mean are classified as Low corruption countries. Eq. (1) is re-estimated for each subsample using a regression model that controls for both the industry and country fixed effects.

Table 4 presents the estimation results of Eq. (1) using the level of cash holdings (*CASH*). Interestingly, the coefficient on the interaction term (*CONNECT* × *CASH*) is now found to be negative and statistically significant only for the subsamples of firms located in emerging markets (Column (2), coefficient = -1.308) and in countries with high levels of corruption (Column (4), coefficient = −1.171). The findings suggest that investors significantly discount the value of cash holdings for politically connected firms, especially in emerging markets or in countries with a greater tendency towards corruption. The asymmetry in the observed results is consistent with the findings in past studies (such as Chen et al., 2010; Boubakri et al., 2013; Pinkowitz et al., 2006) and highlights the important role of country-level institutions in determining the value relevance of political connections and cash holdings.

Table 5 presents the estimation results of Eq. (1) using excess cash holdings (*EXCASH*). The findings are similar to those presented in Table 4, as the interaction coefficient continues to be negatively significant only for the subsample of firms located in emerging markets (Column (2), coefficient = -0.669) and those in countries with high levels of corruption (Column (4), coefficient = -0.612).

[1] The website of Transparency International is http://www.transparency.org and it aims to "work with governments, businesses and citizens to stop the abuse of power, bribery and secret deals."

Table 2
Descriptive statistics.

Variables	N	Mean	Median	Std Dev	Min	Max
CONNECT	8373	0.027	0.000	0.162	0.000	1.000
CASH	8373	0.133	0.090	0.132	0.000	0.643
EXCASH	8373	−0.000	−0.018	0.109	−0.194	0.374
CF	8373	0.070	0.082	0.127	−0.423	0.403
LEV	8373	0.259	0.239	0.201	0.000	0.822
CAPX	8373	0.050	0.034	0.052	0.000	0.317
DIVD	8373	0.687	1.000	0.464	0.000	1.000
VALUE	8373	1.245	1.017	0.784	0.495	5.750
ASSET	8373	1130	175.45	3509	12.02	26,992

Note: This table presents the descriptive statistics for the measure of firm-level political connections and control variables. The definition of the variables are as described in Appendix A.

Table 3
Political connections and the value of cash holding.

Independent variables	(1)	(2)
CONNECT	0.072	0.040*
	(0.077)	(0.023)
CASH	1.210***	
	(0.150)	
CONNECT × CASH	−0.342	
	(0.745)	
EXCASH		1.109***
		(0.154)
CONNECT × EXCASH		−0.561
		(0.579)
SIZE	0.008	0.001
	(0.011)	(0.011)
CF	1.228***	1.165***
	(0.288)	(0.290)
LEV	0.221**	−0.079
	(0.103)	(0.098)
CAPX	0.995***	0.774**
	(0.298)	(0.294)
DIVD	−0.110**	−0.126***
	(0.039)	(0.039)
Country FE	YES	YES
Industry FE	YES	YES
N	8373	8373
Adj. R^2	0.196	0.189

Note: This table presents the regression results of firm value (*VALUE*) on political connections (*CONNECT*) and the various measures of cash holdings. *CASH* is the level of cash holdings and *EXCASH* is excess cash holdings. The definition of the variables are as described in Appendix A. Robust standard errors (clustered by country) are reported in parentheses. *, **, *** denote statistical significance at the 10%, 5%, and 1% levels, respectively.

3.3. Different types of political connections and the value of holding cash

Prior studies (Faccio, 2006, 2010; Boubakri et al., 2012) have demonstrated the relevance of different types of political connections. In this aspect, two dummy variables are constructed to represent firms that are politically connected through large shareholders (*CONNECT_OWNER*) and through directorship (*CONNECT_DIR*), respectively.

Panel A of Table 6 reports that the mean values of *CONNECT_OWNER* (about 3.3%) are higher than that of *CONNECT_DIR* (about 1.1%) in emerging markets and in high corruption countries; and the difference is statistically significant at the 1% level. This finding reveals the higher prevalence of politically connected firms through large shareholders in these markets.[2]

Subsequently, Eq. (2) is estimated to examine the effect of different types of political connections on the value of cash holdings for firms in emerging markets and in high corruption countries:

[2] The overall mean values of *CONNECT_OWNER* and *CONNECT_DIR* are 1.1% and 1.7%, respectively.

Table 4
Country-level institutions, political connections and the value of cash holding.

Independent variables	(1) *Developed markets*	(2) *Emerging markets*	(3) *Low corruption*	(4) *High corruption*
CONNECT	0.028	0.201***	0.035	0.181***
	(0.129)	(0.041)	(0.132)	(0.045)
CASH	1.051***	1.797***	1.105***	1.581***
	(0.168)	(0.201)	(0.161)	(0.278)
CONNECT × *CASH*	0.071	−1.308**	0.107	−1.171**
	(1.121)	(0.412)	(1.176)	(0.395)
SIZE	0.018	−0.040**	0.019*	−0.038**
	(0.010)	(0.016)	(0.010)	(0.015)
CF	1.347***	0.786	1.369***	0.765
	(0.312)	(0.615)	(0.318)	(0.568)
LEV	0.048	0.542**	0.066	0.490**
	(0.083)	(0.168)	(0.079)	(0.165)
CAPX	1.138***	0.876***	1.173***	0.815***
	(0.317)	(0.230)	(0.320)	(0.241)
DIVD	−0.123**	−0.074	−0.119**	−0.074
	(0.053)	(0.060)	(0.054)	(0.054)
Country FE	YES	YES	YES	YES
Industry FE	YES	YES	YES	YES
N	6106	2267	5944	2429
Adj. R^2	0.196	0.229	0.199	0.225

Note: This table presents the regression results of the role of country-level institutions on the relationship between firm value (*VALUE*), political connections (*CONNECT*), and cash holdings (*CASH*). The definition of the variables are as described in Appendix A. Robust standard errors (clustered by country) are reported in parentheses. *, **, *** denote statistical significance at the 10%, 5%, and 1% levels, respectively.

Table 5
Country-level institutions, political connections and the value of excess cash holding.

Independent variables	(1) *Developed markets*	(2) *Emerging markets*	(3) *Low corruption*	(4) *High corruption*
CONNECT	0.038	0.097**	0.048	0.085*
	(0.030)	(0.040)	(0.028)	(0.040)
EXCASH	0.980***	1.519***	1.038***	1.316***
	(0.176)	(0.237)	(0.168)	(0.300)
CONNECT × *EXCASH*	−0.590	−0.669**	−0.555	−0.612**
	(0.961)	(0.254)	(1.028)	(0.222)
SIZE	0.012	−0.049**	0.012	−0.046**
	(0.010)	(0.015)	(0.010)	(0.015)
CF	1.293***	0.729	1.313***	0.714
	(0.311)	(0.611)	(0.318)	(0.564)
LEV	−0.217**	0.131	−0.212**	0.126
	(0.083)	(0.193)	(0.083)	(0.182)
CAPX	0.948***	0.528*	0.973***	0.508*
	(0.301)	(0.263)	(0.307)	(0.251)
DIVD	−0.138**	−0.087	−0.135**	−0.086
	(0.055)	(0.059)	(0.056)	(0.053)
Country FE	YES	YES	YES	YES
Industry FE	YES	YES	YES	YES
N	6106	2267	5944	2429
Adj. R^2	0.191	0.211	0.194	0.210

Note: This table presents the regression results of the role of country-level institutions on the relationship between firm value (*VALUE*), political connections (*CONNECT*), and excess cash holdings (*EXCASH*). The definition of the variables are as described in Appendix A. Robust standard errors (clustered by country) are reported in parentheses. *, **, *** denote statistical significance at the 10%, 5%, and 1% levels, respectively.

$$VALUE_i = a_0 + \beta_1 CONNECT\_OWNER_i + \beta_2 CONNECT\_DIR_i + \beta_3 CASH_i + \beta_4 (CONNECT\_OWNER_i \times CASH_i) + \beta_5 (CONNECT\_DIR_i \times CASH_i) + \beta_6 SIZE_i + \beta_7 CF_i + \beta_8 LEV_i + \beta_9 CAPEX_i + \beta_{10} DIVD_i + \sum c_j Country_i^j + \sum c_k Industry_i^k + u_i, \quad (2)$$

Panel B of Table 6 presents the estimation results of Eq. (2). Interestingly, only the interaction term (*CONNECT_OWNER* × *CASH*) is negative and statistically significant in Columns (1) and (2). These findings provide additional evidence that value of cash holdings is lower for politically connected firms in emerging markets (coefficient = −1.499) as well as for those in high corruption countries

Table 6
Types of political connections, country-level institutions and the value of cash holding.

Panel A: Distribution of types of political connections

	Emerging markets	*High corruption*
CONNECT_OWN	0.033	0.033
CONNECT_DIR	0.011	0.011
Difference	0.022***	0.0222**
	(0.00)	(0.00)

Panel B: Regression of firm value on different types of political connections and cash holdings

Independent variables	(1) *Emerging markets*	(2) *High corruption*	(3) *Emerging markets*	(4) *High corruption*
CONNECT_OWNER	0.245***	0.231***	0.112*	0.116*
	(0.045)	(0.045)	(0.055)	(0.052)
CONNECT_DIR	0.020	−0.012	0.035	−0.002
	(0.079)	(0.082)	(0.052)	(0.056)
CASH	1.799***	1.582***		
	(0.201)	(0.279)		
CONNECT_OWNER × CASH	−1.499***	−1.333**		
	(0.434)	(0.418)		
CONNECT_DIR × CASH	0.335	0.323		
	(0.657)	(0.527)		
EXCASH			1.519***	1.315***
			(0.237)	(0.301)
CONNECT_OWN × EXCASH			−0.613*	−0.671**
			(0.268)	(0.234)
CONNECT_DIR × EXCASH			−0.773	−0.030
			(1.069)	(1.240)
SIZE	−0.041**	−0.039**	−0.049**	−0.046**
	(0.016)	(0.015)	(0.015)	(0.015)
CF	0.780	0.759	0.727	0.711
	(0.614)	(0.567)	(0.611)	(0.563)
LEV	0.541**	0.490**	0.131	0.126
	(0.168)	(0.165)	(0.192)	(0.182)
CAPX	0.877***	0.816***	0.530*	0.508*
	(0.230)	(0.239)	(0.263)	(0.251)
DIVD	−0.075	−0.074	−0.087	−0.086
	(0.060)	(0.054)	(0.059)	(0.053)
Country FE	YES	YES	YES	YES
Industry FE	YES	YES	YES	YES
N	2267	2429	2267	2429
Adj. R^2	0.229	0.225	0.211	0.209

Note: Panel A of this table presents the distribution of types of political connections in emerging markets and in high corruption countries. Panel B of this table presents the regression results of firm value (*VALUE*) on different types political connections (*CONNECT_OWN* and *CONNECT_DIR*), and cash (or excess cash) holdings in emerging markets and in high corruption countries. The definition of the variables are as described in Appendix A. Robust standard errors (clustered by country) are reported in parentheses. *, **, *** denote statistical significance at the 10%, 5%, and 1% levels, respectively.

(coefficient = −1.333), only if the connections are established through large shareholders. Connections that are established through directorship do not lead to a decline in the value of cash holdings. These results are consistent with the earlier findings of Boubakri et al. (2012). Columns (3) and (4) of Panel B present the estimation results of Eq. (2) using excess cash holdings (*EXCASH*). Similarly, only the interaction term (*CONNECT_OWNER* × *EXCASH*) remains negatively significant at least at the 10% level.

In general, the findings support the argument that political connections aggravate the potential information asymmetry between managers and shareholders of international firms, especially for firms located in countries with weak country-level institutions. Moreover, the negative valuation of cash holdings in these countries is driven by firms that are politically connected through large shareholders. One potential explanation is that political connections that are established through large shareholders exert stronger influence than those established through directorship. It also implies that these firms are more likely to allocate significant resources (such as higher cash holdings) to maintain the political relationship by engaging in rent-seeking activities (Faccio, 2010). These activities are detrimental to shareholders' interests, therefore resulting in lower firm values.

Alternatively, political connections do not exert a negative influence on the value of cash holdings in the presence of strong institutions (in developed countries and countries with low corruption). One explanation for these findings is that strong institutions help to mitigate the adverse effects of political connections (Wang et al., 2018) and encourage the more efficient use of cash holdings.

4. Conclusions

Using an international sample of politically connected and non-connected firms, this study examines the impact of political connections on the value implications of holding cash. The findings reveal that political connections are not, in general, associated with the value of cash holdings. However, the results of the cross-sectional regressions on the subsamples demonstrate that the relationship between political connections and the value of cash holdings varies across countries with different institutional characteristics. Specifically, the valuation of cash holdings is negative for firms in emerging markets and for in countries with high levels of corruption that are politically connected through substantial shareholders. These results provide additional insights into how investors value the cash holdings of politically connected firms.

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Appendix A

Definitions of variables

Variable name	Description
Firm-level variables	
CONNECT	A connection dummy variable, which equals 1 for politically connected firms, and 0 otherwise.
CONNECT_OWNER	A connection dummy variable, which equals 1 for firms that are politically connected through large shareholders, and 0 otherwise.
CONNECT_DIR	A connection dummy variable, which equals 1 for firms that are politically connected through directorship, and 0 otherwise.
ASSET	Book value of total assets (in million US dollars).
SIZE	Natural logarithm of *ASSET*, used as a proxy for firm size.
CASH	Cash balance, which is cash and cash equivalents divided by total assets.
EXCASH	Excess cash, which is the residual obtained from a regression of cash holdings on financial control variables.
CF	Cash flow, which is income before extraordinary items plus depreciation and amortization divided by total assets.
LEV	Leverage, which is the sum of short-term and long-term debt divided by total assets.
CAPX	Capital investment, which is capital expenditures divided by total assets.
DIVD	A dividend dummy variable, which equals 1 for firms that paid dividends during the financial year, and 0 otherwise.
VALUE	Firm value or Tobin's *Q*, which is measured as market value of equity plus book value of liabilities divided by book value of total assets, used as a proxy for firm value.
Country-level variables	
EMERGING	An emerging market dummy variable, which equals 1 for countries in the emerging markets, and 0 otherwise.
CORRUPT	The corruption index for the year 2001, from Transparency International.

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