# Non-Electoral Political Uncertainty and Cash Management Policy: Evidence from East Asia

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**Abstract**

This paper documents new evidence that political uncertainty from non-electoral incidents have causal effects on corporate cash holdings. The use of non-electoral incidents instead of elections provides better identification of political uncertainty and sets a strong natural experimental framework for causal interpretations. On average, firms increase cash levels by 5.2% in the year incidents occur, subsequently attenuating cash increases as uncertainty subsides. Variations in cash policy responses are driven by structural differences in political governance, shareholder protection levels, and industry sensitivity to politics. These findings provide support for the precautionary motive of holding cash during periods of political uncertainty.

*JEL classification:* G32; D72; D74

*Keywords:* Political uncertainty; Non-electoral incidents; Corporate cash holdings

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# 1 Introduction

In imperfect capital markets, holding liquid assets is necessary for two reasons. First, it can be costly for firms to convert cash substitutes into cash or to raise external financing should there be unexpected shortfalls in cash flow. Second, information asymmetries in markets can deter firms from raising external financing at the moment when cash is required because securities will have to be issued at a discount. Keynes (1936) describe the above two reasons as the transaction cost motive and the precautionary motive for holding cash, respectively. Both explanations advocate that liquidity management is in itself an important aspect of corporate financial policy, and is neither an auxiliary nor mechanical outcome of other corporate decisions such as investments. While a large number of theoretical and empirical studies have expounded on the determinants of cash holdings (see for example, Bates, Kahle, & Stulz, 2009; Baumol, 1952; Denis & Sibilkov, 2010; Dittmar & Mahrt-Smith, 2007; Miller & Orr, 1966; Opler, Pinkowitz, Stulz, & Williamson, 1999; Whalen, 1966), we have limited knowledge of how cash management decisions are made in a world where market imperfections are exacerbated by political uncertainty.

Research in political economics show that politics exerts significant influence over the business environment. On one hand, political influence can effect positive outcomes. For example, firms with strong political connections have easier access to debt capital (Faccio, 2006), are more likely to receive government bailouts during crisis (Faccio, Masulis, & McConnell, 2006), and are better able to secure preferential subsidies (Johnson & Mitton, 2003), etc. But, politics can also lead to negative consequences. Several studies show that uncertainty in the political climate deters dividend payment (Huang, Wu, Yu, &

Zhang, 2015), and leads firms to cut capital expenditures (Julio & Yook, 2012; Pindyck & Solimano, 1993; Rodrik, 1991). Evidently, political uncertainty can have profound impacts on corporate finance decisions.

The connection between political uncertainty and corporate cash holdings is best explained by the precautionary motive for holding cash. Since political uncertainty channels through to the aggregate economy by increasing unpredictability in policies and outcomes, it follows that uncertainty distorts the expected distribution of net cash disbursements of firms such that it increases the risk of illiquidity when raising external financing is costly. Consequently, firm managers should respond to adverse shocks from political uncertainty by increasing cash contingencies, which is consistent with the precautionary motive view of holding cash. An important theory supporting this hypothesis stems from the model in Stanhouse (1982), which shows a positive relationship between the amount of information demanded by decision makers and the optimal level of precautionary cash firms should hold. If one argues that political uncertainty intensifies information asymmetry problems in the markets, then firm managers should demand more information to make sound decisions, and the equilibrium outcome is an increase in cash balance. The precautionary motive for holding cash is also supported by Myers and Majluf (1984) who show that firms can avoid difficulties in raising external funds due to asymmetric information by building-up liquid assets.

In this paper, I hand-collect a unique cross-country dataset of non-electoral incidents in East Asia that cause political uncertainty and investigate corporate cash holdings policy during the occurrence of these incidents. Based on the assumption made by Alesina and Perotti (1996) that "policy changes relevant for economic decisions can occur only when

governments change", the non-electoral incidents must consist threats to the stability of incumbent governments such that they cause uncertainty over the governments' continuity. Thus, I define non-electoral political incidents as large-scale demonstrations against the government, coups *d'état*, assassinations on the head of government, political scandals involving the head of government, and states of emergency of a political nature. The choice of utilizing non-electoral incidents instead of national elections as a proxy for political uncertainty offers several advantages. First, non-electoral incidents occur mostly randomly with very little forewarning. Thus, political uncertainty from these incidents acts as strong exogenous shocks to firm economics. This is unlike the majority of elections around the world, which occur in predictable cycles mandated by the constitutions of countries. As such, firms are able to preemptively formulate corporate policies in anticipation of changes in economic policies based on electoral outcomes, which implies that the causal effects of political uncertainty from elections on firm behavior are severely diminished. Second, the outcomes of non-electoral incidents are more difficult to predict than outcomes of elections. For instance, it is much harder to foresee whether an attempted military coup would successfully topple the incumbent government than to forecast which party would win the elections and form the government. In fact, there are several democracies with a dominant ruling party and very little political-party fragmentation such that it is highly improbable for elections to result in a change of government. Therefore, non-electoral incidents provide a better identification of political uncertainty than elections.

East Asia is an interesting and appropriate setting for the purpose of this study because democratic countries in this region frequently experience political instability of a non-electoral nature. This provides a rich dataset of exogenous political shocks to conduct

a natural experiment investigating the effects of political uncertainty on cash management decisions. Consequently, causal inferences can be made from the results of the analysis in this study, unlike studies that only use elections as a proxy for political uncertainty. Moreover, there are conspicuous structural differences in political governance and legal frameworks across countries in East Asia, which allows me to exploit the variations in country political characteristics and examine the differential effects of political uncertainty on cash holdings.

I document robust evidence that political uncertainty from non-electoral incidents causes firms to increase cash balances. After controlling for firm and industry-specific characteristics, cash balances increase by an average of 5.2% in years when non-electoral incidents occur. Additionally, the results show that there is no statistically significant change to cash holdings around national elections. The baseline evidence provides two key implications. First, the determinants of corporate cash holdings go beyond firm characteristics; political uncertainty is another significant factor that impacts cash management decisions. Second, national elections do not appear to be a good identification of political uncertainty. The predictability of election cycles and the endogenous relationship between the call for elections and economic performance[1] dampens the degree of uncertainty created by elections. While Julio and Yook (2012) do show that cash holdings increase during elections, the results in this paper prove that when non-electoral incidents causing political uncertainty are also considered, national elections lack power as a proxy for uncertainty in determining cash holdings.

To further illuminate the effects of non-electoral political uncertainty on cash holdings,

[1]Julio and Yook (2012) document that approximately 55% of elections held between 1980 and 2005 in 48 countries were called opportunistically during periods of high economic growth.

I examine cash policy response after the first occurrence of a non-electoral incident. The intuition for this line of inquiry is based on the expectation that political uncertainty can lead to unstable or suboptimal economic policies that require time to stabilize or improve. This implies that uncertainty can persist, and firm managers need to continually structure cash policy responses accordingly until such time when the uncertainty is resolved. I find that managers continue to increase cash holdings in response to non-electoral political uncertainty up to two years after the incidents occur. The estimation results also show a step-down in cash holdings increases from 4.4% in the year incidents occur, to 2.2% one year after, and finally to 1.9% two years on. The results suggest that there are persistence effects in political uncertainty from non-electoral incidents, but the uncertainty subsides after two years on average. And, firm managers respond rationally by adjusting cash management policy according to the degree of uncertainty. Within countries, I also find variations in cash policy responses. Firms operating in industries considered sensitive to political changes increase cash holdings more so than other firms whenever there is political uncertainty.

In cross-country analysis, I find that differences in inherent political governance characteristics of countries can either attenuate or intensify the uncertainty caused by non-electoral incidents and lead to variations in cash policy responses. Using six measures for the quality and performance of governments obtained from the Worldwide Governance Indicators database, I find evidence suggesting that political uncertainty is mitigated in countries with better political and legal frameworks such as high government effectiveness and stronger adherence to govern by the rule of law. And consequently, firms in such countries increase cash holdings less than that of firms in poor political governance

countries in response to non-electoral political uncertainty. I also conduct tests to examine whether political uncertainty from a particular country spills over to its closest neighboring country and how firms respond. I find evidence that firm managers also consider political uncertainty from abroad to potentially lead to domestic uncertainty, and increase cash holdings when non-electoral incidents occur overseas. But, cash holdings increase less in response to overseas incidents than domestic incidents, which is consistent with the notion that foreign political uncertainty should cause less severe shocks to cash disbursements relative to domestic political uncertainty.

I also address a concern that the precautionary motive for holding cash as a result of political uncertainty may diminish in explanatory power when one also considers the alternative view that corporate governance may be a more significant determinant of cash holdings. This alternative view is termed the agency cost motive of holding cash, and originates from Jensen (1986) who argues that conflicting interests in principal-agent relationships can lead firm managers to hold more cash than optimal for maximizing shareholder wealth. After controlling for country-level corporate governance measured by the level of shareholder protection, I find that the precautionary motive continues to be a significant explanation for holding cash when there is political uncertainty caused by non-electoral incidents.

Two other tests show that the increase in average cash holdings caused by political uncertainty from non-electoral incidents is not a mechanical outcome of other corporate policy responses to uncertainty. First, I show that both debt and equity security issuances decline when non-electoral incidents occur. This proves that the increase in cash holdings during periods of political uncertainty is not a consequence of an increase in external

financing. Second, I find that the unconditional mean investment rates decline by 3.0% during years when non-electoral incidents occur relative to years without incidents occurring. In multivariate tests, investment rates drop by an average of 2.0% during incident years. Conversely, I do not find any statistically significant changes to investment rates during elections. Comparing the changes in cash holdings and investment rates during incident years, I find that the magnitude of investment rate decline is less than the 5.2% increase in cash holdings. Clearly, the findings suggests that one cannot systematically ascribe increases in cash holdings during periods of political uncertainty to purely a consequence of investment cuts. The additional 3.2% increase in cash levels lends strong support to the precautionary motive view that managers build up cash contingencies in response to political uncertainty.

The remainder of the paper proceeds as follows. In Section 2, I develop the key hypothesis. Section 3 presents a brief historical account of politics in East Asia from 1990 to 2014. Section 4 discusses the process of collecting data related to non-electoral incidents causing political uncertainty, and summarizes key statistics of the main variables. Section 5 presents empirical results from baseline tests of cash policy responses when non-electoral incidents occur, cross-country analyses, comprehensive robustness checks, and tests of security issuances and investment rates under political uncertainty. Section 6 concludes.

# 2 Hypothesis Development

Keynesian economics presents a clear argument connecting politics with economics; in *laissez-faire* capitalist systems, decentralized economic activities may lead to suboptimal

outcomes, which can be resolved through government interventions. Based on this proposition, it follows that if governments play an integral role in effecting intended economic outcomes, then any uncertainty over the stability of governments can cast doubt over the predictability of future economic states. Pástor and Veronesi (2013) show how uncertainty over the government's future actions upsets economic equilibrium, and leads to higher stock market volatility. Their theory is supported by empirical evidence, which shows that political uncertainty commands a risk premium, and contributes to market return volatility (see for example, Boutchkova, Doshi, Durnev, & Molchanov, 2012; Mei & Guo, 2004). There is also substantial evidence showing significant relationships between political instability and corporate financial policies. For instance, Julio and Yook (2012) document that managers delay investment in reaction to political uncertainty and resume plans only after the resolution of that uncertainty.[2] The findings in these studies support the identification of political uncertainty as an explicit explanatory variable in the determination of asset prices and corporate finance decisions.

In the context of corporate cash management decisions, managers should not ignore political uncertainty because it can translate to uncertainty over the firm's distribution of cash payments and receipts, potentially inducing incidents of illiquidity whenever payments exceed receipts. Now, absent capital market frictions, firms can easily raise external funds if receipts are deficient relative to payments, and risks of illiquidity will no longer be of concern. However, if there exists explicit and implicit costs for firms to obtain cash when it is needed, then holding cash becomes necessary because it can help firms avert illiquidity. Keynes (1936) elaborate that there are two main motives for firms

[2]Julio and Yook also show very briefly that corporate cash holdings increase during national elections.

to hold cash. First, when transaction costs associated with liquidating assets or issuing securities to raise cash outweigh the opportunity cost of holding cash, then firms have the incentive to build-up cash reserves. This is known as the transaction costs motive for holding cash. Second, when there are information asymmetries, external financing may become a prohibitively expensive source of funds such that firms are better-off not issuing securities, which implies that firms need to hold cash as a contingency against such situations. This motivation is known as the precautionary motive for holding cash.

It is necessary to clarify that the precautionary motive view in Keynes (1936) original definition in essence explains that managers hold cash to provide for *unpredictable* circumstances particularly related to meeting liabilities or funding investments. This is the critical point of departure from the transaction costs motive explanation. In classical models of the transactions demand for cash, Baumol (1952) assumes that a particular firm's "transactions are perfectly foreseen and occur in a steady stream". In addition, Miller and Orr (1966) assume that there is no "lead time" required to convert non-cash assets into cash, which implies that firms do not need to accumulate cash to guard against shortfalls. Both models eliminate consideration for *uncertainty* perturbing the expected distribution of a particular firm's cash inflows and outflows, and the impact of asymmetric information on raising funds externally. Therefore, the transaction cost motive by design, cannot be an appropriate explanation for changes in corporate cash holdings under political uncertainty, which leaves the precautionary motive as the only viable explanation. Empirically, Opler et al. (1999) find convincing evidence for the precautionary motive for holding cash in a sample of non-financial U.S. firms.

The primary difficulty of establishing a relationship between the precautionary motive

for holding cash and political uncertainty is a possibly endogenous relationship between economic outcomes and government instability. Many extant studies use national elections as a proxy for political uncertainty (see for example, Boutchkova et al., 2012; Julio & Yook, 2012; Mei & Guo, 2004; Pantzalis, Stangeland, & Turtle, 2000), which does not resolve the endogeneity issue. While it is conceivable that elections may generate uncertainty due to a possible regime shift in policies affecting economic outcomes, elections are prone to various characteristics that may in fact exacerbate the endogeneity problem. First, although some elections held in regular cycles[3] occur outside the control of firms and state of the economy, management can still structure corporate policies in anticipation of upcoming elections. Arguably, this implies that any uncertainty associated with the elections can be preempted and one cannot definitively conclude that political uncertainty causes certain firm outcomes. Second, elections held outside of regular cycles, also known as snap elections, usually coincide with good economic states since rational incumbent governments standing for reelection tend to use economic performance as a political tool to garner votes. Therefore, snap elections are perceivably endogenous to firm economics. Finally, the call for elections can in fact indicate a resolution of uncertainty especially in countries characterized by fledging democratic systems fraught with political unrests. Elections can definitively select which party has the popular mandate to form the government and put to rest any political instability. For all these reasons outlined, national elections appear to be a poor identification of political uncertainty, and the use of which in studies examining effects on corporate outcomes may produce biased inferences.

On the other hand, non-electoral incidents causing political uncertainty overcome

[3]Alesina, Cohen, and Roubini (1992) call such elections as having "exogenous" timing because the cycles are written in constitution and independent from economic performances.

endogeneity concerns because such incidents occur unexpectedly with hard to predict outcomes. As such, non-electoral incidents can act as strong exogenous political shocks on the economy to allow for causal inferences from tests of political uncertainty on firm outcomes. I define non-electoral political incidents as having the ability to assail the foundation of government stability and create political impediments to the government's normal functioning, sometimes to the extent of causing outright collapse. This is in line with Alesina and Perotti (1996) who explain that the essence of political uncertainty should contain threats to government change based on the assumption that only political turnover can create policy changes relevant for economic decisions. Huang et al. (2015) use an alternative definition of political uncertainty: "disruptive interactions between two or more nations, which may lead to a heightened probability of military hostilities...and challenge the structure of an international system.". This definition, termed "political crisis", is problematic for two reasons. First, it wholly excludes uncertainty from domestic politics, which should have a larger and more direct impact on local firm outcomes than political uncertainty from foreign nations. Second, there are confounding sources of uncertainty encapsulated in that definition, which are not necessarily of a political nature in a strict sense. Military action could be reactions to national security threats such as terrorist activities or incursions on geographic sovereignty.

The empirical strategy of this paper uses the exogenous non-electoral incidents as a natural experimental setting to investigate the effects of political uncertainty on corporate cash management policies. This will effectively mitigate any endogeneity concerns between political uncertainty and changes to cash holdings, and allows for unbiased causal inferences. Based on the precautionary motive for holding cash, when faced with political uncertainty,

firm managers are expected to increase cash levels to guard against the heightened risk of illiquidity since the uncertainty casts doubt over a particular firm's future cash disbursements. I formalize the central hypothesis of this paper as follows:

**Hypothesis** *Non-electoral political uncertainty causes firms to increase their cash levels on a precautionary basis because the uncertainty is perceived to amplify the variability of net disbursements.*

When countries experience incidents of non-electoral political uncertainty, the magnitude of the resulting economic impact should depend on the political characteristics of the incumbent government. This is because the strength of the overall political structure of a country determines whether political institutions can withstand uncertainty and counter its adverse effects on the business environment. It follows that if there is heterogeneity in the competence and performance of governments, then there should also be variations in firm policy responses across countries when incidents of political uncertainty occur. I expect firms in countries with higher quality governments to perceive the risk of illiquidity as a result of political uncertainty to be lower, and consequently increase their precautionary cash balances by less than firms in countries with lower quality governments. I also investigate whether there are any spillover effects of domestic political uncertainty to other countries. Given the close economic ties and geographic proximities of countries in East Asia, I hypothesize that firms perceive political uncertainty from neighboring countries to have a destabilizing effect on the region's commercial activities and also react by increasing cash holdings.

# 3 A Brief History of Political Uncertainty in East Asia

In this section, I provide an overview of the political climate in East Asia, and describe key non-electoral events leading to political uncertainty that happened in the last quarter century in each of the six countries/territories in this study's final sample.

Post-modern era politics in many East Asian countries can be characterized by complex dynamics involving the inertia to completely eradicate legacy systems of monarchism and authoritarianism, and the struggle to govern by the rule of law based on principles of democracy. When Marxist ideologies started to significantly permeate East Asia after the second World War, several countries succumbed to its influence and installed communism as a more palatable solution. Where democracy has succeeded, in the sense that some form of "free and fair" elections are held to select leaders of government, few are consistently stable.

Often, the nascent democratic systems in East Asia are interrupted by periods of military coups where elections are suspended or dominated by pseudo-democratic autocracies where the outcome of elections have little bearing on the selection of government. Therefore, the primary source of political uncertainty in East Asia stems not from elections per se, but from widespread incidents of political unrests aimed at unseating incumbent governments. Some of these incidents emerge because governments are perceived to have usurped upon democratic principles through manipulating political institutions to preserve control. Such incidents of political unrests are often manifested as mass pro-democracy rallies, which have profound adverse implications for political and economic stability.

*Hong Kong*—Although Hong Kong continues to hold legislative elections after returning to Chinese rule in 1997 as a Special Administrative Region, political power is held by the chief executive of Hong Kong. He or she has the authority to decide socio-economic policies and introduce legislation in strict consultation with the Chinese government. Consequently, the outcomes of legislative elections hardly introduce any political uncertainty in Hong Kong. The major source of political uncertainty comes from demonstrations initiated by pro-democracy supporters who vehemently oppose any legislation or policy perceived to infringe upon the democratic rights of Hong Kong residents. In 2002, when *Basic Law Article 23*, a broad-spectrum legislation prohibiting subversive acts against the Chinese government was passed, massive protests against China's authoritarian rule took place. The protests continued into 2004, and at one point more than 700,000 people took to the streets. Thus, began a series of large-scale protests calling for universal suffrage in Hong Kong. The most significant one occurred in 2014, colloquially called the *Umbrella Movement* or *Umbrella Revolution*, when opponents of China's decision to reform Hong Kong's electoral system such that candidates for chief executive must be pre-selected by the Chinese Communist Party staged public demonstrations. The intensity of this movement escalated rapidly to the point that there were over a 100,000 protesters at any given time blockading key business districts and government buildings. The authorities' inability to quell the protests, which eventually lasted four months, added to the uncertainty of Hong Kong's political and economic future. As commerce and trade were severely interrupted during this period, losses in revenue particularly in retail and tourism were estimated at US$5 billion.

*Indonesia*—While Indonesia has had democratic elections under a presidential repre-

sentative framework since 1955, there was an extended period during which the Indonesian government functioned more like a military dictatorship. This occurred when Suharto, a commander of the Indonesian Armed Forces, ousted the founding president, Sukarno, in 1967 and declared himself president. Although legislative elections were held regularly, control of government resided with President Suharto until his forced resignation in 1998. Therefore, from an electoral viewpoint there was hardly any political uncertainty. Leading up to the 1997 legislative elections, a confrontation between supporters of the opposition *Partai Demokrasi Indonesia*, the Indonesian Democratic Party, led by Megawati, the daughter of Sukarno, and government agents escalated into violent riots. The ruling *Golkar* party considered Megawati a major threat and sent soldiers and police to crush opposition supporters. After the elections, in which *Golkar* won a landslide majority of 74 percent of the votes, protests spread to campuses with students alleging vote rigging and calling for political reforms. By 1998, the riots not only spread to other cities, but also evolved into a civil armed conflict that became racially motivated. Chinese-owned homes, businesses, and establishments were looted and destroyed; property damage alone was estimated at US$238 million. Suharto eventually relinquished control after 32 years in power.

*Malaysia*—Since independence from British rule in 1963, Malaysia has been ruled by right-wing *Barisan Nasional*(BN), which translates to The National Front party. The constitution of Malaysia requires general elections at the federal level to be held at least once every five years. Consistently, BN has won the majority of 222 seats in parliament at every election and retained control. However, the party's share of popular vote has been declining since the late 2000's. This trend has its origin in an increasing dissatisfaction by

electors over how the government oppresses opposition and political dissent even from within its own party. When former prime minister Mahathir Mohamad sacked his deputy, Anwar Ibrahim in 1998 on alleged charges of corruption and sodomy, the incident sparked a widespread protest movement coined *Reformasi* aimed at ousting PM Mahathir Mohamad on the allegation that he propagated a culture of corruption and cronyism in Malaysian politics. Over the next decade, several large-scale demonstrations known as *Bersih Rally* calling for electoral reforms after alleged discrepancies in elections favoring the ruling party were held. These rallies sometimes turned violent and caused the shutdown of major commercial districts in Kuala Lumpur.

*Philippines*—After The Philippines officially became an independent republic in 1946 when the U.S. ended its colonial rule, democratic elections are held regularly to choose the president, members of congress, and other public officials under a framework very similar to that of the U.S. However, Filipino politics is plagued by an insalubrious relationship between politicians and family wealth. Very often, the Filipino electorate selects populist presidents who are from well-known and highly-regarded families. Therefore, whenever there are high-profile presidential candidates, there is very little uncertainty regarding election outcomes. For instance, in the 1998 presidential elections with six contestants, Joseph Estrada won nearly 40 percent of the popular vote. Similar to other burgeoning democracies in Asia, much of the political uncertainty in The Philippines revolve around protests and corruption scandals. In 2000, impeachment proceedings started against President Estrada under the allegation he had plundered public funds. And, when the impeachment court ceased proceedings in 2001, it led to a political protest called the *EDSA Revolution II* aimed at removing President Estrada from office, which turned out

to be successful. This protest was essentially a *de facto* coup and the lack of regard for political due process threw Filipino politics into chaos. In 2005, known as the *Hello Graci* scandal, President Gloria Arroyo was alleged to have rigged the 2004 elections in her favor. A state of emergency was subsequently declared in 2006 and martial law was imposed after President Arroyo claimed there was an attempted coup against her government. The frequent occurrence of such political scandals undermines political stability and has impeded the economic progress of The Philippines.

*Taiwan*—Before 1996, Taiwan did not hold any direct elections to select the President, who is both the head of state and government. The ruling *Kuomintang*, The Nationalist Party, would select a leader from among its political ranks to govern. When Lee Teng-hui became the first directly elected president of Taiwan in 1996, China reacted by launching missiles close to the Taiwanese border as a warning against any pro-independence agenda.[4] The primary opposition party, *The Democratic Progressive Party* (DPP), did not take control of the presidency until 2001 when its candidate, Chen Shui-bian won the elections. Traditionally, the DPP, especially during Chen's presidency, took a stronger pro-independence stance than the *Kuomintang*, which rattles the Chinese government. It is therefore tempting to argue that presidential elections in Taiwan create political uncertainty because if the DPP were to win, one could expect adverse reactions from China that would threaten Taiwan's security and economy. However, regardless which party forms the government, the probability of adverse reaction from China remains because of the tenuous relationship. Thus, the more important question is what are the other unanticipated events that add to the political uncertainty of Taiwan. These

[4]The Chinese government regards Taiwan as a renegade province that must eventually be reunited with mainland China by force, if necessary.

events include an assassination attempt on President Chen Shui-bian in 2004 when he was campaigning for reelection, a protest in 2006 by Chen's opponents against a failed attempt to remove him from office under allegations of corruption, another protest in 2008 against President Ma Ying-jeou's pro-China policies, and a large-scale demonstration termed *The Sunflower Movement* against the signing of a trade agreement with China widely seen as damaging to Taiwan's economy and an implicit acceptance of China's influence over Taiwanese politics. All these events heightened the political uncertainty facing Taiwan.

*Thailand*—In the last 25 years, Thailand's military has overthrown the elected government and seized control three times with two coups occurring in the last decade alone. The most recent coup happened in 2014 when the military placed former PM Yingluck Shinawatra under house arrest, dissolved parliament, and established a military junta. Interestingly, this coup is closely related to the previous coup in 2006 when PM Thaksin Shinawatra, who is in fact Yingluck Shinawatra's elder brother, was also ousted by the military. After winning the general elections in 2001, Thaksin's term as PM was riddled with controversies especially conflicts of interest in connection with his multi-billion dollar family business, the Shin Corporation. When Thaksin won his second term in 2005, widespread protests calling for his resignation ensued, culminating in a military coup. These protests are frequently violent and accompanied by bloody military crackdowns, the most infamous of which is the "red shirts vs. yellow shirts" protest, which precipitated into a state of emergency in Bangkok in 2008. Similarly, the 2014 coup was accompanied by violent anti-government protests described as *Operation Occupy Bangkok*. The uncertainty revolving around the resolution of these unrests had severe repercussions on Thailand's economy. For instance, foreign investors withdrew an estimated US$3 billion in capital

since the latest series of protests began in 2013. The tourism industry, which is a key contributor to the Thai economy, also experienced sharp downturns.

# 4 Data

## 4.1 Incidents of Non-Electoral Political Uncertainty

I hand-collect all non-electoral incidents that lead to political uncertainty occurring in Hong Kong, Indonesia, Japan, Korea, Malaysia, Philippines, Singapore, Taiwan, and Thailand from 1990 to 2014. I define these incidents as (1) peaceful or violent widespread political demonstrations, (2) attempted or successful coups *d'état*, (3) attempted or successful assassinations on the head of government, (4) political scandals of which the head of government is under investigation for or found guilty of corrupt practices (not restricted to a financial sense), and (5) declarations of a state of emergency or impositions of martial law in response to any of the above incidents. I exclude resignations of the head of government, and dissolutions of parliament from the definition because these incidents are usually soon followed by the call for elections. This implies that it would be difficult to disentangle the resulting political uncertainty between the incidents and the elections.

I start with web scraping Factiva using a text "grepping" technique to find all news articles fitting the definition of non-electoral political uncertainty by searching for terms and their variations or constituent words such as "political protests", "anti-government demonstrations", "pro-democracy rallies", "military coups", "political scandals", "assassination attempts", and "state of emergency". I then read through each article to determine whether the cause of the incident fits the definition. Next, I carefully verify the authenticity

of the news report through several steps. If the article is published by a news agency with a local-centric readership (for example, *The South China Morning Post* from Hong Kong; *New Straits Times* from Malaysia; *Bangkok Post* from Thailand, etc.), I use Google's search engine to find a corresponding article published by internationally-renowned news agencies. The international news agencies include, but are not limited to, *Associated Press* (AP), *British Broadcasting Corporation* (BBC), *Cable News Network* (CNN), *Wall Street Journal* (WSJ), *Reuters*, and *The New York Times*. The purpose of this step is to ensure that the content of the local news report has not been adulterated as a result of undue censorship from the government or biasness from the local journalists. And, the fact that the local news article can be independently-verified by international news agencies connotes the significance of the reported incident of political uncertainty. Once the article from the international news agency verifies the content of the local article, I conduct a second search for a corresponding article from another international news agency so that I can verify the consistency of the content to ensure that there are no conflicting accounts of the cause or circumstance of the political incident, and the incident continues to fit the definition of political uncertainty in this study. News articles that do not pass the verification steps are omitted from the data.

The final dataset consists of 37 non-electoral political incidents from 6 countries. I omit

Japan[5], Korea[6], and Singapore[7] from the dataset because none of the defined incidents of political uncertainty occurred in these three countries during the sample period. Of the 37 incidents, 27 are political demonstrations, 3 are military coups, 5 are political scandals, 1 is an assassination attempt, and 1 is a declaration of a state of emergency in response to an attempted coup *d'état*. Since one of the key strengths of this study is the separate identification of political uncertainty from non-electoral events and from elections, it is critical for the identified incidents to have a low correlation with elections. I check whether each of the 37 incidents occurred in the same year as elections were held, and find a total of 10 such incidents. 7 of the incidents are political protests, 2 are political scandals, and the remaining 1 is the assassination attempt. Only 3 of the 10 incidents are closely-related to elections that occurred either before or after the incidents happened. The remaining incidents that coincide with elections called in the same year are not direct causes or consequences of the elections or their outcomes. In robustness checks, I exclude these

[5]It is very common in Japan for the prime minister to resign before his term ends. From 1990 to 2014, there were eight changes in the prime minister, five of which occurred from 2006 to 2011. The most common reason for resignation is to accept responsibility for the party's poor approval ratings. For instance, the current PM of Japan, Shinzo Abe, was actually appointed PM in 2006 by the ruling Liberal Democratic Party after PM Junichiro Koizumi resigned. Abe subsequently resigned in 2007 citing poor health and low approval ratings. This consistent and frequent pattern of change in head of government has become mainstream in Japanese politics to the point that it hardly introduces any political uncertainty especially since the new PM is always selected from among the ruling party ranks who continues the previous PM's policies. Snap elections are also called soon after a change in PM.

[6]In March 2004, President Roh Moo-hyun openly endorsed the Uri Party ahead of national elections. He had formed the Uri Party in 2003 after leaving his original political party, the Millennium Democratic Party. This endorsement constituted a technical violation of required political impartiality by the sitting President, and opposition lawmakers moved to impeach Roh. Two months later, the Korean Constitutional Court overturned the impeachment motion. I would have considered the impeachment incident as a political scandal, but since the impeachment decision was reversed and very short-lived, I exclude this observation from the dataset. Other than this incident, most of Korea's uncertainty stems from military tensions with North Korea, which falls outside the definition of political uncertainty in this study.

[7]Singapore is perhaps the most politically-stable country in Asia. Since the formation of an independent republic in 1965, the founding political party, the People's Action Party, has won every general election and forms the government. There was a riot in 1969, but it was due to racial tensions between the ethnic Chinese majority and the Malay minority. No other similar incidents of a political nature has occurred in Singapore. From a electoral and non-electoral viewpoint, Singapore hardly experiences any form of political uncertainty.

three incidents from empirical tests and find no appreciable change in the results.

## 4.2 Country-Level Data and Variables

In the empirical tests that follow, I control for political uncertainty arising from national elections that determine the head of government. Indonesia, Philippines, and Taiwan conduct presidential elections to select the head of government. Malaysia and Thailand adopt the parliamentary system and hold legislative elections to decide which political party has the popular mandate to form the government; the winning party chooses a prime minister to become the head of government. In Hong Kong, elections are held to select the chief executive, who is the head of government.[8] I collect data from The Database of Political Institutions[9](DPI) on presidential elections for countries with a presidential system[10], and legislative elections for countries with the parliamentary system. I rely on various internet sources for election data on Hong Kong since this data is unavailable in DPI. For the purpose of this study, only the years when elections were held are required. The variables DATELEG and DATEEXEC in DPI show the month and year of presidential and parliamentary elections, respectively.

I further collect measures of governance standards for each country and use them to control for variations in political characteristics across countries. The Worldwide Governance Indicators (WGI)[11] is a database that reports six indicators of quality and performance of

[8]But unlike elections in the other five countries, only the Election Committee consisting of 1,200 members can vote to select Hong Kong's chief executive. Eligible candidates for the chief executive position must have received at least 150 nominations from the Election Committee before they can run for office.

[9]This database is maintained by the Development Research Group at The World Bank and can be found at http://go.worldbank.org/2EAGGLRZ40.

[10]Indonesia, Philippines, and Taiwan also conduct legislative elections, but these do not determine the head of government.

[11]WGI is an initiative of The World Bank. The data can be excessed at www.govindicators.org.

the government in 215 countries and territories from 1996 to 2014. The six governance indicators (variable names italicized in parentheses) are Voice and Accountability (*VA*), Political Stability and Absence of Violence/Terrorism ($PV$), Government Effectiveness ($GE$), Regulatory Quality ($RQ$), Rule of Law ($RL$), and Control of Corruption ($CC$). The indicators are reported in standard normal units ranging from -2.5 to 2.5 with higher units indicating better quality or performance. For details on the methodology, see Kaufmann, Kraay, and Mastruzzi (2010). Panel A of Table 1 presents summary statistics for all the country-level variables.

## 4.3 Firm-Level Data and Variables

I collect firm-level data from Thomson Reuters Worldscope database for firms listed on the stock exchanges of the six countries in this study's sample from 1990 to 2014. I exclude financial and utility firms with SIC codes ranging from 6000 to 6999, and from 4900 to 4949. Firm-year observations with negative book values of assets, cash, or shareholder's equity are considered erroneous data and removed from the sample. In the analyses that follow, the main variables are *Cash*, Tobin's *Q*, *Cash Flow*, firm *Size*, *Leverage*, and *Capex*. Firm-year observations with missing values for these variables are also removed from the sample. Panel B of Table 1 shows the summary statistics of the main firm-level variables. The Appendix provides details on variable definitions and construction.

[Insert Table 1: Descriptive Statistics]

# 5 Empirical Results

The first set of results show changes in corporate cash holdings during the occurrence of non-electoral incidents and elections. The evidence aims to prove that political uncertainty causes changes in cash holdings, and that non-electoral incidents are a better identification of political uncertainty. Next, I conduct cross-country analyses to show how better political governance can mitigate the effects of non-electoral political uncertainty, and the spillover effects to neighboring countries. The third set of results from robustness and additional tests addresses concerns over specifications and alternative explanations. In the final set of results, I show how non-electoral political uncertainty affects security issuances and capital expenditures.

## 5.1 Baseline Analysis

Panel C of Table 1 provides the first piece of evidence showing the increase in cash holdings during years when non-electoral political incidents occur. The mean and median cash levels measured by cash scaled by assets during non-incident years are 0.1536 and 0.1049, respectively. They increase to a mean and median of 0.1577 and 0.1091, respectively, during years when incidents occur. The difference in the mean cash levels represents a 2.7% increase during incident years and statistically significant at the 1% level.

Next, I investigate the effects of political uncertainty on cash holdings in a regression framework. For all subsequent tests, cash holdings is defined as the natural log of cash scaled by book value of assets, unless otherwise stated. In univariate tests, I separately examine effects of the two sources of political uncertainty; non-electoral political incidents (*Incident*), which takes a value of 1 in years when incidents occur and 0 otherwise, and

national elections (*Election*), which takes a value of 1 in years when elections are held and 0 otherwise. And in bivariate tests, I include both *Incident* and *Election* in the regression. Columns (1) to (3) of Table 2 show results from OLS regressions without any fixed effects. And, columns (4) to (6) show results from panel regressions, which include firm and year fixed effects. Consistently, the variable *Incident* has a positive coefficient significant at the 1% level. This shows that managers increase their firms' cash balances during years when there is political uncertainty from non-electoral incidents. Conversely, coefficients on the variable *Election* not only have inconsistent signs, they are also not significant. The univariate results show that national elections per se do not seem to induce any cash policy changes in firms. In fact, from the results of bivariate tests, when non-electoral political incidents and elections occur in the same year, only the incidents causes increases in cash balances.

To control for firm-specific characteristics, I perform multivariate regressions of the following model:

$$\begin{aligned} Cash_{ijk,t} = \beta_0 &+ \beta_1 Incident_{j,t} + \beta_2 Election_{j,t} + \beta_3 Q_{ijk,t-1} + \beta_4 CF_{ijk,t} + \beta_5 Size_{ijk,t-1} \\ &+ \beta_6 Lev_{ijk,t-1} + \beta_7 Capex_{ijk,t} + \beta_8 IndVol_{k,t} \\ &+ \beta_9 Div_{ijk,t} + \eta_i + \tau_t + \varepsilon_{ijk,t}, \end{aligned} \tag{1}$$

where $i$ indexes firm, $j$ indexes country, $k$ indexes industry, and $t$ indexes year. $Q$ is Tobin's Q defined as the ratio of market value of assets to book value of assets. Market value of assets is the sum of book value of assets and market value of common equity less the sum of deferred taxes and book value of common equity. $CF$ is cash flow defined as the sum

of net income before extraordinary items and depreciation scaled by beginning-of-period book value of assets. *Size* measures firm size calculated as the natural log of the book value of assets. *Lev* is the ratio of total debt to book value of assets. $Capex$ is net capital expenditures scaled by beginning-of-period book value of assets. $IndVol$ is the cash flow volatility of two-digit SIC industry computed as the standard deviation of industry cash flows over the past four years. *Div* is a dummy variable equals to 1 if a firm pays cash dividend in year $t$, and 0 otherwise. $\eta_i$, $\tau_t$, and $\varepsilon_{ijk,t}$ denote firm fixed effects, year fixed effects, and residuals, respectively.

[Insert Table 2: Baseline Results]

Columns (7) to (9) of Table 2 presents the results. Once again, the coefficient on *Incident* is positive and statistically significant while *Election* remains an insignificant determinant of changes to cash holdings. The evidence here corroborates the descriptive evidence, and supports the hypothesis that political uncertainty from non-electoral incidents causes firm managers to increase cash contingencies. Notice however, that none of the coefficients on *Election* in all tests show up as statistically significant. Moreover, the coefficients signs are also unstable. This evidence suggests that national elections per se are unreliable proxies for political uncertainty.

### 5.1.1 Persistence Effects

As an extension to the baseline analysis, I examine whether the effects of political uncertainty on cash management policies persist. I rely on a general prior from the policy sciences literature postulating how unstable political systems often result in policy outcomes that may require extended periods to reverse or correct. This implies that it is

possible for firm managers to maintain cash management policies in response to events introducing political uncertainty over a length of time after the first occurrences of these events. While the persistence effects argument is reasonable, there is however, a lack of an a priori expectation of how long such persistence should last. Notwithstanding this limitation, I use the 1-year and 2-year lags of *Incident* to test whether cash holdings change in response to non-electoral political incidents one and two years after their first occurrences. This should shed some light on the persistence effects of political uncertainty on cash policy within the limitation discussed. Table 3 presents interesting results. In columns (1) and (2), the results show that cash levels continue to increase in response to incidents that occurred one year and two years ago, respectively.[12] Additionally, note that the magnitude of the response differs. Firms increase their cash holdings more one year after the incident occurred than two years later. This suggests that the effects of political uncertainty wane as time progresses and firms alter their cash policy responses accordingly. In columns (3) to (5) I explore various combinations of contemporaneous and lagged *Incident*. And, in column (6) I use contemporaneous and lags of *Incident* in the same regression and the results show a step-down in increases of cash levels from 0.0435 to 0.0187. The evidence suggests two interesting facts; (1) political uncertainty from non-electoral incidents persist for a period of time, and (2) managers continue to remain cautious after uncertainty first permeates the political climate, but they conscientiously attenuate cash policy responses as uncertainty subsides.

[Insert Table 3: Persistence Effects of Political Uncertainty from Non-Electoral Incidents]

[12] In unreported results, coefficients of further lags of *Incident* included in the regressions show no statistical significance in causing changes to cash holdings.

## 5.2 Cross-Country Analysis

### 5.2.1 Political Governance Variations

It is reasonable to expect that some inherent characteristics of a particular country's political system can determine whether the effects of political uncertainty are mitigated or exacerbated. Proceeding with this line of inquiry, I interact *Incident* with various measures of the one-year lag of political governance characteristics (*PolGov*). The signs of the coefficients on the interaction term *Incident* $\times$ *PolGov* will show the differential effects of non-electoral political uncertainty on cash holdings given variations in political governance standards. Firms in countries with better political governance should respond less severely to political uncertainty under the assumption that stronger governments are more capable at restoring normal functioning to political and economic institutions should there be any disruptions. Therefore, conditional on the occurrence of a non-electoral political incident, all else equal, firms in countries with better political governance at the beginning of the period should increase their cash holdings by less as a precaution against political uncertainty compared to firms in countries with poorer political governance standards.

[Insert Table 4: Cross-Country Political Variations]

Columns (1) to (6) of Table 4 shows the results when each of the six proxies for political governance characteristics is interacted with the occurrence of a non-electoral political incident. The six proxies capture three broad aspects of political governance standards, and I quote the definitions directly from Kaufmann et al. (2010); (1) *VA* and *PV* measure "the process by which governments are selected, monitored, and replaced", (2) *GE* and

*RQ* measure "the capacity of the government to effectively formulate and implement sound policies", and (3) *RL* and *CC* measure "the respect of citizens and the state for the institutions that govern economic and social interactions". All the six measures are continuous variables with higher values indicating better governance standards. The advantage of using these governance variables is they vary with time, which allows for better examination of effects from variations in country-political characteristics. This approach supersedes using indicator variables for legal origin (common law vs. civil law) and political systems (parliamentary vs. presidential) as these remain static.

The explanatory variable of interest is the interaction term $Incident \times PolGov$, which has a negative coefficient for each of the six measures of governance. The evidence is consistent with the prediction that better political governance can mitigate uncertainty caused by non-electoral incidents, and consequently firms respond by increasing their precautionary cash balances less. The mean of the coefficients on the interaction term shows that cash holdings is 4.2% lower for firms in countries with higher quality governments given political uncertainty. It is also interesting to note that some coefficients of the variable *PolGov* are negative and significant. This implies that absent political uncertainty, firms in countries with governments that are more effective, have higher regulatory quality, and follow the rule of law tend to hold less cash. The key implications of the evidence presented thus far are (1) politics does effect changes to economic outcomes through the channel of uncertainty, and (2) the "strength" of the uncertainty channel is not consistent across countries and time; it depends significantly on the state of political governance within countries.

### 5.2.2 Spillover Effects

In the next set of cross-country analysis, I explore whether political uncertainty from non-electoral incidents in a particular country affects precautionary cash holdings of firms in a neighboring country. I construct an indicator variable *Spillover*, which takes a value of 1 if the closest neighboring country by geographical distance experiences a non-electoral political incident in year $t$, and 0 otherwise. Now, the closest neighbor is not necessarily a pair-wise relationship. I identify the closest neighbor (in parenthesis) for each country in the sample as follows: Hong Kong (Taiwan); Indonesia (Malaysia); Malaysia (Thailand); Philippines (Hong Kong); Taiwan (Hong Kong); and Thailand (Malaysia). I then include *Spillover* in the baseline model specification to examine its effect.

[Insert Table 5: Spillover Effects of Political Uncertainty]

Table 5 shows the results. In columns (1) to (3), I exclude firm-specific controls to show the effects solely from the political indicator variables *Spillover*, *Incident*, and *Election*. And in columns (4) to (6), control variables are included in the regressions. All tests include firm and year fixed effects. The coefficients on *Spillover* are positive and significant in all tests even when political uncertainty from domestic non-electoral incidents and national elections are included as additional controls. This shows that firm managers also consider political uncertainty from neighboring countries to heighten the risk of illiquidity, and they take precautionary steps against this risk by increasing cash balances. But, note that the magnitude of the coefficients on *Spillover* are smaller than that on *Incident* implying that firm cash holdings increase less in response to political incidents occurring overseas compared to incidents occurring locally. This result makes sense because political uncertainty from foreign nations should have less bearing on the prospect of domestic

government turnover and associated economic policy changes than uncertainty originating locally. Now undoubtedly, there will be some correlation between the occurrence of political incidents at home and those abroad. For instance, it is generally believed that the *Umbrella Movement* of 2014 in Hong Kong partially inspired the pro-democracy rallies in Taiwan also occurring in 2014. The Pearson correlation coefficient between *Spillover* and *Incident* is 0.084 significant at the 1% level. Unfortunately, without a strong prior it is difficult to ascertain whether this correlation level is too high. Hence, I rely on the general principle that correlations less than or equal to 10% is sufficiently low, and thus allow for separate interpretations of *Spillover* and *Incident* without causing severe econometric concerns.

## 5.3 Robustness and Additional Tests

### 5.3.1 Reduced-Form Model

According to the static tradeoff theory, firms target an optimal capital structure by adjusting debt levels, cash holdings, and capital expenditures simultaneously. The theory suggests that the relationships between cash holdings and leverage, and cash holdings and investments are endogenous. Opler et al. (1999) find strong evidence that cash holdings in U.S. firms can be explained by the static tradeoff theory, which raises the concern about including the variables *Leverage*, *Capex*, and *Div* in the baseline model. To mitigate this concern, I perform regressions on a reduced-form of Equation (1) by omitting the supposedly endogenous variables.

[Insert Table 6: Robustness]

Columns (1) and (2) of Table 6 show the results. Consistent with the baseline results,

the explanatory variable of interest, *Incident* continues to have positive and significant coefficients. Also note that the coefficients on *Q*, *Cash Flow*, *Size*, and *IndVol* retain the same signs and have very similar magnitudes as the coefficients on these variables in the baseline results shown in Table 2. The results here suggest that endogeneity concerns in relation to the control variables in the baseline specification are unwarranted.

### 5.3.2 Macroeconomic Variations

Another concern deals with omitted explicit controls for macroeconomic factors that have been shown to also perturb the normal pattern of cash management policies.[13] For example, Baum, Caglayan, Ozkan, and Talavera (2006) find that the cross-sectional variation in cash levels for a sample of non-financial U.S. firms decline when measures of macroeconomic uncertainty increase. And, Almeida, Campello, and Weisbach (2004) find that the sign of the relationship between the sensitivity of cash holdings to cash flows and macroeconomic shocks depends on the constraint status of the firm. Consistently, change in GDP is shown to be a significant determinant of firm decision-making because it indicates the general prospect of a particular economy, which helps managers formulate firm policies. In the context of cash management, one should expect firms to hold less cash during periods of high GDP growth since positive economic growth entails higher capital flows, which lowers liquidity risk. Hence, managers should hold less precautionary cash with positive GDP growth.

I construct the variable *GDP Growth* as the annual percentage change in a country's current GDP in U.S. dollars to proxy for the economic state of a country and include it as a

[13]Many studies simply control for macroeconomic variations on cash holdings with time fixed effects in empirical models (see for example, Bigelli & Sánchez-Vidal, 2012; Pinkowitz & Williamson, 2001)

macroeconomic control variable in all subsequent tests in this section. I obtain GDP data from the World Development Indicators database from The World Bank, supplemented by data from the Asian Development Bank, and Thomson Reuters Worldscope database. I then reestimate Equation (1) with the one year lag of *GDP Growth*. The results are shown in columns (3) and (4) of Table 6. The coefficients on *Incident* remain positive and significant at the 1% level with no appreciable difference in magnitudes to the ones from the baseline results. This indicates that the effect of political uncertainty from non-electoral incidents on cash holdings is robust to controlling for economic conditions. And, as expected, the coefficients on *GDP Growth* have negative signs, which implies that positive GDP growth is associated with lower precautionary cash balances.

### 5.3.3 Alternative Variable Construction

I explore alternative constructions of the dependent variable, cash holdings, and test them in the baseline model. First, there could be a concern regarding variations in accounting practices across countries, which lead to different methods of recording book value of assets. Flower and Ebbers (2002) explain this issue as arising from differences in accounting conservatism, which is the level of strictness applied when it comes to recognizing assets and liabilities. This implies that the cash to book assets ratio across countries may not be a standardized measure of cash holdings. Sales figures, on the other hand, are less subject to accounting conservatism than assets. Therefore, using sales as a deflator of cash balances might be a more consistent measure across countries. I then take the natural log of cash over sales and use this as the dependent variable in Equation (1) and rerun the regressions.

Columns (5) and (6) of Table 6 report the results. The coefficients on *Incident* are still positive, albeit smaller in magnitudes and have lower significance levels compared to the ones in Table 2. Notwithstanding, the overall interpretation does not change; firms increase their cash balances in response to political uncertainty from non-electoral incidents. It is interesting to note however, that the coefficient on *Election* is significant, which is not the case in any of the baseline results. But, the coefficient is negative indicating a reduction in cash holdings during elections. This appears to suggest that elections could in fact be a resolution of political uncertainty, not a contributor, and therefore should not be used solely in empirical studies examining the effects of political uncertainty on firm outcomes. As a further robustness check, instead of taking the log of cash over assets, I simply use the cash over assets ratio as the dependent variable. The results in columns (7) and (8) of Table 6 do not change previous conclusions.

### 5.3.4 Corporate Governance and Cash Holdings

I investigate an additional explanation of cash holdings, which stems from the agency cost motive. Jensen (1986) theorize that in an agency relationship, managers may implement policies that benefit only themselves at the expense of shareholders, which implies that managers have the incentive to hold more cash than optimal for maximizing shareholder wealth because the excess cash increases managerial discretion. Thus, the theory predicts that firms will hold more cash where agency problems are more pronounced. This is supported by empirical evidence from Kalcheva and Lins (2007) who show that weak shareholder protection is associated with higher cash holdings, which leads to lower firm values. Also, Dittmar and Mahrt-Smith (2007) show that firm value is reduced when

poorly-governed firms hold too much cash.

To explicitly account for variations in corporate governance across countries, I follow Dittmar, Mahrt-Smith, and Servaes (2003) and use shareholder protection as a proxy for country-level corporate governance and include it in the baseline model. La Porta, Lopez-de Silanes, Shleifer, and Vishny (1998) (henceforth, LLSV (1998)) measure the strength of shareholder protection as the number of antidirector rights, out of six categories, available to minority shareholders to protect them against exploitation by large shareholders. From Table 2 of LLSV (1998), the number of antidirector rights, in parenthesis, for the countries in this study are as follows: Hong Kong (5); Indonesia (2); Malaysia (4); Philippines (3); Taiwan (3); and Thailand (2). As in Dittmar et al. (2003), I employ a random effects framework to allow for variations in industry effects within a country as well as variations in country effects. In other words, the random effects are for each country–industry pair. Columns (1) and (2) of Table 7 report the estimation results without firm-specific control variables while columns (3) and (4) report results with the controls. Two key findings emerge. First, the evidence suggests that corporate governance has significant effects on cash holdings. The negative coefficients on the level of shareholder rights imply that in countries where agency problems are less severe, firms tend to have lower cash balances. Second, even after accounting for corporate governance, political uncertainty continues to be a significant determinant of cash holdings; firm managers increase cash when non-electoral incidents occur. An implication of the results here is while the agency cost motive is significant, one cannot ignore the precautionary motive in response to political uncertainty as also an important explanation for corporate cash holdings.

[Insert Table 7: Additional Tests]

### 5.3.5 Politically-sensitive Industries

In the final additional test, I examine variations in cash policy response to political uncertainty across firms within a country. To conduct this examination, I exploit variations in industry sensitivity to policy swings. According to Herron, Lavin, Cram, and Silver (1999), industries in the U.S. react differently to presidential election outcomes due to expected government partisanship. This implies that uncertainty over government turnover may have differential impacts on firm cash policy across industries because the operations, and ultimately performances of certain industries are more dependent on the political and economic objectives of the government than others, which could change when the administration changes. It follows that firms in politically-sensitive industries are likely to increase precautionary cash balances more so than others whenever there is political uncertainty.

Herron et al. (1999) identify 15 industry sectors whose stock performances are significantly dependent on which candidate wins the 1992 U.S. presidential elections, and suggest that these sectors are politically-sensitive. Obviously, one cannot expect all other countries to have the same set of politically-sensitive industries as in the U.S. But, since there is an absence of a clear theory to identify sensitive industries, I am left with the option to use the same industries from Herron et al. and code them as politically-sensitive for the countries in this study.

I introduce a dummy variable *Sensitive*, which takes on a value of 1 if the firm operates in a politically-sensitive industry, and 0 otherwise. I then interact *Sensitive* with *Incident* and *Election* to test the differential effects on cash holdings across firms when there is

political uncertainty. The general model specification is as follows:

$$Cash_{ijk,t} = \beta_0 + \beta_1 Uncertainty_{j,t} \times Sensitive_k + \beta_2 Uncertainty_{j,t} + \beta_3 Sensitive_k + \beta_4 \mathbf{X}_{ijk,t} + \beta_5 \mathbf{Z}_{ijk,t-1} + \beta_6 GDP\_Growth_{j,t-1} + \gamma_j + \tau_t + \varepsilon_{ijk,t}, \quad (2)$$

where $i$ indexes firm, $j$ indexes country, $k$ indexes industry, and $t$ indexes year. $Uncertainty_{j,t}$ is either $Incident_{j,t}$ or $Election_{j,t}$ in separate regressions. $\mathbf{X}$ is a vector of firm-specific variables measured at time $t$. $\mathbf{Z}$ is a vector of firm-specific variables measured at time $t-1$. $\gamma_j$, $\tau_t$, and $\varepsilon_{ijk,t}$ denote country fixed effects, year fixed effects, and residuals, respectively.

The estimation results of Equation (2) are shown in columns (5) to (8) of Table 7. The positive coefficients on *Sensitive* show that firms in industries that are politically-sensitive tend to hold between 20.2% to 26.3%, depending on the specification, more cash than other firms. Also, the positive coefficients on the interaction terms $Incident \times Sensitive$ and $Election \times Sensitive$ support the prediction that when there is political uncertainty, either from non-electoral incidents or national elections, firms in sensitive industries increase their cash holdings even more. The evidence suggests that variations in cash management response to political uncertainty can in part be explained by variations in industry sensitivity to government turnover.

## 5.4 Security Issuances

The empirical analysis in this section investigates how the issuance of debt and equity securities are affected by political uncertainty. Firms raise external financing to meet working capital needs and to fund investment expenditures. But, besides firm-level factors,

the ability to raise external capital is also dependent on the legal and political framework, and financial development of a country (La Porta, Lopez-De-Silanes, Shleifer, & Vishny, 1997). Yet, political uncertainty can significantly impair polity and the financial sector (Qi, Roth, & Wald, 2010; Roe & Siegel, 2011), which engenders an impediment to external capital raising. Hence, controlling for firm characteristics, one would expect firms to raise less external capital during periods of political uncertainty.

To test this conjecture, I regress net debt and net equity issuances (in separate regressions) on *Incident* and *Election* with contemporaneous *Cash Flow*, and the one-year lag of Tobin's *Q*, firm *Size*, and *Lev*. The firm-specific control variables included in the regressions follow the general specification from Almeida and Campello (2010). The dependent variable *Debt Issuance* is constructed as the difference between long term debt borrowings and reduction in long term debt scaled by book assets. The dependent variable *Equity Issuance* is the ratio of net proceeds from the sale of common and preferred stock to book assets. I obtain the data from Thomson Reuters Worldscope database.

[Insert Table 8: Security Issuances]

Table 8 reports the results. The negative and statistically significant coefficients on *Incident* shows that both debt and equity security issuances decrease during non-electoral political incidents. *Election* on the other hand, show no significant effect on external capital raising. The evidence demonstrates that non-electoral political uncertainty very likely disrupted normal capital flows of economies such that it becomes more difficult for firms to issue securities relative to periods without political uncertainty. It is also likely that security issuances are lower during periods of political uncertainty because firms make fewer investments, and therefore require less external capital. I explore this in the

next subsection.

## 5.5 Investment Rates

Several theoretical models show that political uncertainty exerts significant influence over investment decisions in that uncertainty raises the firm's expected returns on projects such that the opportunity set becomes smaller, and consequently fewer investments are made (Pindyck & Solimano, 1993; Rodrik, 1991). Julio and Yook (2012) provide a preponderance of empirical evidence proving that firms reduce investments during national elections. However, as noted earlier in the paper, elections may not be a good proxy for political uncertainty because (1) outcomes could be consistent and do not cause government turnovers, (2) elections can actually be resolutions to uncertainty in some cases, and (3) the majority of elections occur in predictable cycles, which weakens exogeneity conditions in econometric models. Therefore, the key dataset of non-electoral incidents leading to political uncertainty developed in this study is a better identification of political uncertainty, and can provide us with a clearer understanding of investment behavior under uncertainty.

I employ the investment-Q model from Hayashi (1982) to test the effect of political uncertainty on investments. *Invest* is defined as capital expenditures scaled by beginning-of-period book assets. The general model specification is

$$Invest_{ij,t} = \beta_0 + \beta_1 Incident_{j,t} + \beta_2 Q_{ij,t-1} + \beta_3 CF_{ij,t} + \eta_i + \tau_t + \varepsilon_{ij,t}, \tag{3}$$

where $i$ indexes firm, $j$ indexes country, and $t$ indexes time. All variables are as previously

defined. In alternate specifications, I include *Election*, firm *Size*, *Lev*, and *GDP Growth* as additional control variables.

[Insert Table 9: Comparison of Investment Rates]

Panels A and B of Table 9 show the descriptive statistics of investment rates during incident and non-incident years, and during election and non-election years, respectively. The unconditional mean investment rate during years when non-electoral political incidents occur is 0.0019 lower than in non-incident years, which represents a 3% decline, statistically significant at the 1% level. Notice also, that the median investment rate during incident years is lower than that in non-incident years. When comparing the investment rates between election years and non-election years, Panel B of Table 9 show that the mean and median investment rates are actually *higher* during years when elections are held. And, the difference in unconditional means is significant at the 1% level.

[Insert Table 10: Investment Rates]

Next, I perform regression analysis with variations of Equation (3). The univariate results in columns (1) and (2) of Table 10 show a negative and significant coefficient on *Incident*, and a positive but not significant coefficient on *Election*, respectively. In columns (3) to (6) I include various firm-specific controls, and consistently, the results show that investments decline during non-electoral incidents. But, no conclusive results can be said for the effect of national elections on investment rates. In columns (7) and (8) of Table 10, both *Incident* and *Election* are included in the same regressions. And, the results support earlier findings that firms cut investments in response to political uncertainty only from non-electoral incidents, but not from elections. Yet again, the evidence suggests

that national elections do not appear to induce significant political uncertainty when more exogenous and pertinent sources of uncertainty from non-electoral incidents are considered.

Additionally, results from the full specification model in column (8) of Table 10 shows investment rates decline by 0.0013 on average in the year where non-electoral political incidents occur, which translates to a 2.0% drop in investment rates compared to the investment rate in an average year without incidents occurring. Now, revisiting column (9) of Table 2, the full specification model shows a 5.2% increase in actual cash levels on average in the year where non-electoral incidents occur relative to the cash levels in an average year without incidents occurring. Clearly, the increase in average cash levels in years with political incidents occurring cannot be completely attributed to a cut in investment rates. And, recall that results from Table 8 show a drop in security issuances, which shows that the increase in cash levels cannot be explained by external financing. Therefore, the additional 3.2% increase in cash levels in an average year where non-electoral political incidents occur strongly supports the notion that managers are taking a precautionary stance by building up cash contingencies to guard against political uncertainty.

# 6 Conclusion

This paper contributes to the political economics and corporate finance literatures by providing comprehensive evidence that political uncertainty causes managers to increase cash holdings as a precautionary measure. However, unlike many extant studies (see for example, Boutchkova et al., 2012; Durnev, 2010; Julio & Yook, 2012; Mei & Guo, 2004;

Pantzalis et al., 2000), this paper uses political incidents of a non-electoral nature instead of national elections as a proxy for political uncertainty. Because non-electoral incidents occur more randomly and with less predictable outcomes than elections (of which the majority are called in regular cycles as required by constitutional law, while the rest tend to coincide with economic performance), the incidents provide true exogenous shocks to examine the effects of political uncertainty on cash management policies, and allows causal inferences to be made from the findings of this paper.

The results show that firms increase cash levels by 5.2% on average in response to political uncertainty only from non-electoral incidents, but there are no statistically significant changes to cash during elections. The results are robust to alternative empirical specifications and variable constructions, including GDP growth as a control for macroeconomic states, controlling for country-level corporate governance measured by shareholder protection levels, and adding a dummy variable for politically-sensitive industries to account for variations in inherent industry reactions to political uncertainty. Moreover, I find evidence that managers remain cautious after the first occurrence of non-electoral incidents and continue to increase cash holdings, albeit with a step-down as the uncertainty subsides. Across countries, firms operating in countries with poorer political governance standards on average increase cash holdings by 4.2% more than firms in countries with higher quality political and legal institutions in response to political uncertainty. I also find that political uncertainty from non-electoral incidents occurring in a particular country can spillover to neighboring countries and cause managers to respond accordingly. Finally, an investigation of security issuances and investment rates when non-electoral incidents occur show that less external funds are raised, and cash levels increase more so than cuts

to investments. The findings provide strong support for the precautionary motive for holding cash as caused by political uncertainty, and that cash management decisions are made with deliberation and not as a by-product of other corporate finance decisions.

The key implications for this paper are as follows. First, uncertainty from politics influence cash management policy in that the occurrence of non-electoral political incidents raises overall risk of illiquidity and causes managers to increase cash contingencies as a precaution. Second, national elections are a poor identification of political uncertainty. Studies examining causal effects of political uncertainty on firm outcomes should consider using clear exogenous shocks of a political nature such as non-electoral political incidents.

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**Appendix: Variable Descriptions**

| Variable | Description |
|---|---|
| *Panel A: Country-Level Variables* | |
| Political Incident (*Incident*) | Indicator variable that takes a value of 1 if a non-electoral political incident occurs in year $t$, and 0 otherwise. |
| National Election (*Election*) | Indicator variable that takes a value of 1 if a national election occurs in year $t$, and 0 otherwise. |
| Spillover Political Incident (*Spillover*) | Indicator variable that takes a value of 1 if a non-electoral political incident occurs in the closest neighboring country by geographical distance in year $t$, and 0 otherwise. |
| Voice and Accountability ($VA$) | Continuous variable from -2.5 to 2.5 indicating ability of citizens to select their government, and overall freedom of expression. This data is obtained from Kaufmann et al. (2010). |
| Political Stability and Absence of Violence/Terrorism ($PV$) | Continuous variable from -2.5 to 2.5 indicating perceptions on the probability of government turnover or destabilization via illegal means such as a coup *d'état*. This data is obtained from Kaufmann et al. (2010). |
| Government Effectiveness ($GE$) | Continuous variable from -2.5 to 2.5 indicating perceptions on the quality of public sector services and government policies, and ability of governments to withstand undue political pressures. This data is obtained from Kaufmann et al. (2010). |
| Regulatory Quality ($RQ$) | Continuous variable from -2.5 to 2.5 indicating perceptions on the ability of governments to administer policies that foster private sector development. This data is obtained from Kaufmann et al. (2010). |
| Rule of Law ($RL$) | Continuous variable from -2.5 to 2.5 indicating perceptions on the adherence to due process especially in terms of honoring contracts and the protection of property rights. This data is obtained from Kaufmann et al. (2010). |
| Control of Corruption ($CC$) | Continuous variable from -2.5 to 2.5 indicating perceptions on the prevention of public officials from abusing power to advance private interests. This data is obtained from Kaufmann et al. (2010). |

*(continued)*

**Appendix**—*Continued*

| Variable | Description |
|---|---|
| Shareholder Rights Level (*Shr. Rights*) | A discrete variable that takes an integer value from 0 to 6 indicating the number of antidirector rights available in a particular country's law to protect minority shareholders. This data is obtained from LLSV (1998). |
| GDP Growth | The annual percentage change in current gross domestic product (GDP) measured in U.S. dollars. |
| *Panel B: Industry-Level Variables* | |
| Industry Cash Flow Volatility (*IndVol*) | The standard deviation of two-digit SIC industry cash flows over the previous four years. |
| Politically-sensitive Industry (*Sensitive*) | A dummy variable that takes the value of 1 if the industry is politically-sensitive, and 0 otherwise. This data is obtained from Herron et al. (1999). |
| *Panel C: Firm-Level Variables* | |
| Cash Holdings (*Cash*) | The natural log of cash and cash equivalents scaled by book value of total assets. |
| Tobin's Q ($Q$) | The ratio of market value of assets to book value of assets. Market value of assets is the sum of book value of assets and market value of common equity less the sum of deferred taxes and book value of common equity. |
| Cash Flow ($CF$) | The sum of net income before extraordinary items and depreciation scaled by beginning-of-year book value of total assets. |
| Firm Size (*Size*) | The natural log of book value of total assets. |
| Leverage (*Lev*) | The ratio of book value of total debt to book value of total assets. |
| Investment Rate (*Capex*) | Capital expenditures scaled by beginning-of-year book value of total assets. |
| Cash Dividend (*Div*) | A dummy variable that takes the value of 1 if a firm pays cash dividends to common and preferred stock holders in year $t$, and 0 otherwise. |

*(continued)*

**Appendix**—*Continued*

| Variable | Description |
|---|---|
| Log Cash/Sales | The natural log of cash and cash equivalents scaled by sales. |
| Cash Holdings Level | Cash and cash equivalents scaled by book value of total assets. |
| Debt Issuance | The difference between long term debt borrowings and reduction in long term debt in year $t$ scaled by book value of total assets. |
| Equity Issuance | The net proceeds from the sale of common and preferred stock in year $t$ scaled by book value of total assets. |

**Table 1: Descriptive Statistics**

Panel A reports descriptive statistics for non-electoral political incidents, national elections, and six measures of political governance from 1990 to 2014. The political governance measures are Voice and Accountability ($VA$), Political Stability and Absence of Violence/Terrorism ($PV$), Government Effectiveness ($GE$), Regulatory Quality ($RQ$), Rule of Law ($RL$), and Corruption Control ($CC$). Panel B reports descriptive statistics for the main firm-level variables used in this study. Panel C reports descriptive statistics for cash holdings level in years when non-electoral political incidents occur and compares it to the level in years when no incidents occur. Cash holdings level is defined as cash and cash equivalents scaled by book value of total assets. See the Appendix for details of variable descriptions.

| Panel A: Country Characteristics | | | |
|---|---|---|---|
| | Mean | Median | Std. Dev. |
| Incidents/year | 1·7 | 2·0 | 1·0 |
| Elections/year | 1·8 | 1·0 | 1·5 |
| VA | 0·1469 | 0·1179 | 0·5097 |
| PV | 0·1476 | 0·4679 | 0·9021 |
| GE | 0·8640 | 1·0505 | 0·6866 |
| RQ | 0·8738 | 0·8366 | 0·7984 |
| RL | 0·5759 | 0·6406 | 0·7260 |
| CC | 0·5404 | 0·5129 | 0·9142 |
| **Panel B: Firm Characteristics** | | | |
| | N | Mean | Median | Std. Dev. |
| Cash | 47,930 | 0·1549 | 0·1063 | 0·1542 |
| Q | 47,930 | 0·6819 | 0·7727 | 0·3682 |
| Cash Flow | 47,930 | 0·0727 | 0·0749 | 0·1542 |
| Size | 47,930 | 15·1888 | 14·6730 | 2·8799 |
| Leverage | 47,930 | 0·2532 | 0·2083 | 0·2512 |
| Investment | 47,930 | 0·0630 | 0·0316 | 0·0883 |
| **Panel C: Cash Holdings in Incident Years vs. Non-Incident Years** | | | |
| Incident Years | | 0·1577 | 0·1091 | 0·1548 |
| Non-Incident Years | | 0·1536 | 0·1049 | 0·1539 |
| Difference | | 0·0041 | | |
| $t$-stat | | 3·1822 | | |

**Table 2: Baseline Results**

The table reports estimation results from variations of the main cash holdings regressions specified in Equation (4) examining the effects of political uncertainty from non-electoral incidents and national elections on cash levels. The dependent variable is the natural log of cash and cash equivalents scaled by book value of total assets. $Incident_t$ is an indicator variable taking on a value of 1 if a non-electoral political incident occurs, and 0 otherwise. $Election_t$ is an indicator variable taking on a value of 1 if a national election occurs, and 0 otherwise. Cash flow (*CF*), investment rates (*Capex*), industry cash flow volatility (*IndVol*), and cash dividends (*Div*) are measured contemporaneously, while Tobin's Q (*Q*), firm size (*Size*), leverage (*Lev*) are lagged by one year. See the Appendix for details of variable definitions. Standard errors are clustered by firm. *t*-statistics are reported in parentheses. Coefficients marked with ***, **, and * are statistically significant at the 1%, 5%, and 10% level, respectively.

| | (1) | (2) | (3) | (4) | (5) | (6) | (7) | (8) | (9) |
|---|---|---|---|---|---|---|---|---|---|
| $\text{Incident}_t$ | 0·0409*** | | 0·0409*** | 0·0629*** | | 0·0634*** | 0·0514*** | | 0·0516*** |
| | (3·2254) | | (3·2206) | (6·6138) | | (6·6254) | (5·4801) | | (5·4639) |
| $\text{Election}_t$ | | −0·0024 | 0·0004 | | −0·0028 | 0·0051 | | −0·0047 | 0·0016 |
| | | (−0·1792) | (0·0292) | | (−0·2598) | (0·4720) | | (−0·4457) | (0·1521) |
| Q | | | | | | | 0·0758*** | 0·0791*** | 0·0758*** |
| | | | | | | | (3·9485) | (4·1223) | (3·9476) |
| CF | | | | | | | 0·8451*** | 0·8416*** | 0·8451*** |
| | | | | | | | (24·5509) | (24·4468) | (24·5511) |
| Size | | | | | | | −0·1703*** | −0·1739*** | −0·1703*** |
| | | | | | | | (−21·4161) | (−21·9418) | (−21·4114) |
| Lev | | | | | | | −0·4977*** | −0·4979*** | −0·4977*** |
| | | | | | | | (−20·2121) | (−20·2162) | (−20·2121) |
| Capex | | | | | | | −0·4715*** | −0·4745*** | −0·4715*** |
| | | | | | | | (−7·6981) | (−7·7448) | (−7·6982) |
| IndVol | | | | | | | 0·0815*** | 0·0760*** | 0·0814*** |
| | | | | | | | (4·6975) | (4·3852) | (4·6890) |
| Div | | | | | | | −0·0754 | −0·0783 | −0·0754 |
| | | | | | | | (−1·1508) | (−1·1934) | (−1·1496) |
| Fixed Effects | None | None | None | Firm Year | Firm Year | Firm Year | Firm Year | Firm Year | Firm Year |
| Observations | 47,930 | 47,930 | 47,930 | 47,930 | 47,930 | 47,930 | 47,930 | 47,930 | 47,930 |
| $R^2$ | 0.0002 | 0.0000 | 0.0002 | 0.0320 | 0.0311 | 0.0320 | 0.0679 | 0.0673 | 0.0679 |

**Table 3: Persistence Effects of Political Uncertainty from Non-Electoral Incidents**

The table reports estimation results from regressions examining cash holdings of firms after the first occurrence of a non-electoral political incident. The dependent variable is the natural log of cash and cash equivalents scaled by book value of total assets. $Incident_{t-1}$ and $Incident_{t-2}$ are indicator variables, which take a value of 1 if $Incident_t = 1$, and 0 otherwise. Cash flow ($CF$), investment rates ($Capex$), industry cash flow volatility ($IndVol$), and cash dividends ($Div$) are measured contemporaneously, while Tobin's Q ($Q$), firm size ($Size$), leverage ($Lev$) are lagged by one year. See the Appendix for details of variable definitions. All specifications include firm and year fixed effects. Standard errors are clustered by firm. $t$-statistics are reported in parentheses. Coefficients marked with ***, **, and * are statistically significant at the 1%, 5%, and 10% level, respectively.

| | (1) | (2) | (3) | (4) | (5) | (6) |
|---|---|---|---|---|---|---|
| $\text{Incident}_{t}$ | | | 0·0444*** | 0·0476*** | | 0·0435*** |
| | | | (3·7817) | (3·8132) | | (4·5007) |
| $\text{Incident}_{t-1}$ | 0·0367*** | | 0·0272** | | 0·0300*** | 0·0217** |
| | (3·0051) | | (2·5030) | | (2·6919) | (2·2432) |
| $\text{Incident}_{t-2}$ | | 0·0298*** | | 0·0227** | 0·0235** | 0·0187** |
| | | (2·5975) | | (2·0727) | (2·2863) | (1·9606) |
| Q | 0·0761* | 0·0747* | 0·0742* | 0·0724* | 0·0721* | 0·0707*** |
| | (1·7990) | (1·7670) | (1·7580) | (1·7167) | (1·7080) | (3·6861) |
| CF | 0·8365*** | 0·8308*** | 0·8400*** | 0·8343*** | 0·8295*** | 0·8331*** |
| | (13·1400) | (13·0672) | (13·2116) | (13·1430) | (13·0523) | (24·2642) |
| Size | −0·1718*** | −0·1722*** | −0·1694*** | −0·1694*** | −0·1702*** | −0·1682*** |
| | (−9·5523) | (−9·5970) | (−9·4015) | (−9·4197) | (−9·4677) | (−21·0566) |
| Lev | −0·4951*** | −0·4897*** | −0·4948*** | −0·4895*** | −0·4900*** | −0·4897*** |
| | (−9·4465) | (−9·3696) | (−9·4410) | (−9·3661) | (−9·3765) | (−19·9028) |
| Capex | −0·4746*** | −0·4632*** | −0·4729*** | −0·4611*** | −0·4611*** | −0·4597*** |
| | (−4·9800) | (−4·8743) | (−4·9618) | (−4·8518) | (−4·8519) | (−7·4960) |
| IndVol | 0·0723** | 0·0726** | 0·0784*** | 0·0794*** | 0·0702** | 0·0770*** |
| | (2·5039) | (2·5180) | (2·7114) | (2·7494) | (2·4254) | (4·4179) |
| Div | −0·0752 | −0·0789 | −0·0737 | −0·0761 | −0·0764 | −0·0746 |
| | (−0·9670) | (−1·0155) | (−0·9486) | (−0·9820) | (−0·9834) | (−1·1420) |
| Fixed Effects | Firm | Firm | Firm | Firm | Firm | Firm |
| | Year | Year | Year | Year | Year | Year |
| Observations | 47,838 | 47,689 | 47,838 | 47,689 | 47,689 | 47,689 |
| $R^2$ | 0.0677 | 0.0673 | 0.0681 | 0.0678 | 0.0675 | 0.0679 |

**Table 4: Cross-Country Political Variations**

The table reports estimation results from regressions examining the differential effects of non-electoral political uncertainty on cash holdings from cross-country variations in political governance. The dependent variable is the natural log of cash and cash equivalents scaled by book value of total assets. The explanatory variable of interest is the interaction of *Incident* and political governance (*PolGov*). *PolGov* represents each one of the six political governance measures in separate columns, which are Voice and Accountability (*VA*), Political Stability and Absence of Violence/Terrorism (*PV*), Government Effectiveness (*GE*), Regulatory Quality (*RQ*), Rule of Law (*RL*), and Corruption Control (*CC*). Cash flow (*CF*), investment rates (*Capex*), industry cash flow volatility (*IndVol*), and cash dividends (*Div*) are measured contemporaneously, while political governance (*PolGov*), Tobin's Q (*Q*), firm size (*Size*), leverage (*Lev*) are lagged by one year. See the Appendix for details of variable definitions. All specifications include firm and year fixed effects. Standard errors are clustered by firm. *t*-statistics are reported in parentheses. Coefficients marked with ***, **, and * are statistically significant at the 1%, 5%, and 10% level, respectively.

| | VA | PV | GE | RQ | RL | CC |
|---|---|---|---|---|---|---|
| | (1) | (2) | (3) | (4) | (5) | (6) |
| $\text{Incident}_{t}$ | 0·0484*** | 0·0556*** | 0·1011*** | 0·0696*** | 0·1001*** | 0·0614*** |
| | (3·8366) | (4·3771) | (3·7706) | (3·1192) | (5·1868) | (3·8547) |
| $\text{Incident}_{t}$ × | −0·0519*** | −0·0340** | −0·0501** | −0·0243* | −0·0678*** | −0·0220** |
| PolGov | (−2·7667) | (−2·2933) | (−2·1934) | (−1·8414) | (−3·1503) | (−2·0449) |
| PolGov | −0·0127 | 0·0242 | −0·3581*** | −0·1171** | −0·2152*** | 0·0395 |
| | (−0·3035) | (0·9077) | (−4·9082) | (−2·0559) | (−4·2041) | (1·4169) |
| Q | 0·0594*** | 0·0594*** | 0·0518*** | 0·0579*** | 0·0565*** | 0·0591*** |
| | (3·1140) | (3·1129) | (2·7137) | (3·0336) | (2·9619) | (3·0927) |
| CF | 0·7903*** | 0·7897*** | 0·7910*** | 0·7890*** | 0·7971*** | 0·7886*** |
| | (23·3203) | (23·2990) | (23·3426) | (23·2778) | (23·5247) | (23·2625) |
| Size | −0·1742*** | −0·1753*** | −0·1745*** | −0·1742*** | −0·1758*** | −0·1751*** |
| | (−21·5388) | (−21·7044) | (−21·6178) | (−21·5414) | (−21·7811) | (−21·6534) |
| Lev | −0·4509*** | −0·4530*** | −0·4615*** | −0·4515*** | −0·4641*** | −0·4519*** |
| | (−18·3876) | (−18·4839) | (−18·8233) | (−18·4179) | (−18·9159) | (−18·4221) |
| Capex | −0·4303*** | −0·4313*** | −0·4287*** | −0·4334*** | −0·4331*** | −0·4308*** |
| | (−6·7975) | (−6·8108) | (−6·7771) | (−6·8425) | (−6·8458) | (−6·8011) |
| IndVol | 0·0847*** | 0·0790*** | 0·0583*** | 0·0771*** | 0·0593*** | 0·0792*** |
| | (4·9365) | (4·6115) | (3·3743) | (4·5009) | (3·4371) | (4·6204) |
| Div | −0·0684 | −0·0687 | −0·0671 | −0·0665 | −0·0691 | −0·0672 |
| | (−1·0737) | (−1·0777) | (−1·0546) | (−1·0434) | (−1·0861) | (−1·0557) |
| Fixed Effects | Firm<br>Year | Firm<br>Year | Firm<br>Year | Firm<br>Year | Firm<br>Year | Firm<br>Year |
| Observations | 45,848 | 45,848 | 45,848 | 45,848 | 45,848 | 45,848 |
| $R^2$ | 0.0675 | 0.0675 | 0.2620 | 0.0675 | 0.0688 | 0.0674 |

**Table 5: Spillover Effects of Political Uncertainty**

The table reports estimation results from regressions examining the spillover effects of political uncertainty from non-electoral incidents on cash holdings. The dependent variable is the natural log of cash and cash equivalents scaled by book value of total assets. A "spillover" occurs when a non-electoral political incident occurs in the nearest neighboring country by geographical distance. Thus, $Spillover_t$ is an indicator variable taking a value of 1 if $Incident_t = 1$ in the nearest neighboring country, and 0 otherwise. Cash flow ($CF$), investment rates ($Capex$), industry cash flow volatility ($IndVol$), and cash dividends ($Div$) are measured contemporaneously, while Tobin's Q ($Q$), firm size ($Size$), leverage ($Lev$) are lagged by one year. See the Appendix for details of variable definitions. All specifications include firm and year fixed effects. Standard errors are clustered by firm. $t$-statistics are reported in parentheses. Coefficients marked with ***, **, and * are statistically significant at the 1%, 5%, and 10% level, respectively.

| | (1) | (2) | (3) | (4) | (5) | (6) |
|---|---|---|---|---|---|---|
| $\text{Spillover}_t$ | 0·0391*** | 0·0324*** | 0·0336*** | 0·0301*** | 0·0224*** | 0·0235*** |
| | (3·7403) | (3·1567) | (3·2626) | (3·6413) | (2·6692) | (2·8065) |
| $\text{Incident}_t$ | | 0·0437*** | 0·0413*** | | 0·0499*** | 0·0477*** |
| | | (3·9307) | (3·6862) | | (5·7627) | (5·4956) |
| $\text{Election}_t$ | | | −0·0346*** | | | −0·0307*** |
| | | | (−4·6538) | | | (−3·5596) |
| Q | | | | 0·1203*** | 0·1214*** | 0·1192*** |
| | | | | (6·4239) | (6·4809) | (6·3613) |
| CF | | | | 0·8708*** | 0·8754*** | 0·8740*** |
| | | | | (25·0460) | (25·1808) | (25·1422) |
| Size | | | | −0·0128* | −0·0115* | −0·0128* |
| | | | | (−1·8807) | (−1·6956) | (−1·8896) |
| Lev | | | | −0·6065*** | −0·6054*** | −0·6047*** |
| | | | | (−24·5873) | (−24·5513) | (−24·5271) |
| Capex | | | | −0·6700*** | −0·6685*** | −0·6632*** |
| | | | | (−10·9173) | (−10·8967) | (−10·8076) |
| IndVol | | | | 0·1647*** | 0·1680*** | 0·1691*** |
| | | | | (9·6237) | (9·8129) | (9·8784) |
| Div | | | | −0·0547 | −0·0538 | −0·0554 |
| | | | | (−0·8205) | (−0·8075) | (−0·8311) |
| Fixed Effects | Firm | Firm | Firm | Firm | Firm | Firm |
| | Year | Year | Year | Year | Year | Year |
| Observations | 47,930 | 47,930 | 47,930 | 47,930 | 47,930 | 47,930 |
| $R^2$ | 0.0005 | 0.0011 | 0.0014 | 0.0345 | 0.0352 | 0.0355 |

**Table 6: Robustness**

The table reports estimation results from several robustness tests. *GDP Growth* is included as a macroeconomic control variable, computed as the annual percentage change in current GDP in USD for each country and lagged by one year in the tests. Columns (1) to (4) report results from regressions where the dependent variable is the natural log of cash and cash equivalents scaled by book value of total assets. The dependent variable *Log Cash/Sales* is the natural log of cash and cash equivalents scaled by sales. The dependent variable *Cash Holdings Level* is cash and cash equivalents scaled by book value of total assets. Cash flow (*CF*), investment rates (*Capex*), industry cash flow volatility (*IndVol*), and cash dividends (*Div*) are measured contemporaneously, while Tobin's Q (*Q*), firm size (*Size*), leverage (*Lev*) are lagged by one year. See the Appendix for details of variable definitions. All specifications include firm and year fixed effects. Standard errors are clustered by firm. *t*-statistics are reported in parentheses. Coefficients marked with ***, **, and * are statistically significant at the 1%, 5%, and 10% level, respectively.

| | Reduced-Form Model | | Baseline with Econ. Var. | | Log Cash/Sales | | Cash Holdings Level | |
|---|---|---|---|---|---|---|---|---|
| | (1) | (2) | (3) | (4) | (5) | (6) | (7) | (8) |
| $\text{Incident}_{t}$ | 0·0518*** | 0·0521*** | 0·0514*** | 0·0507*** | 0·0167* | 0·0174* | 0·0020** | 0·0018* |
| | (5·4938) | (5·4850) | (5·4797) | (5·3665) | (1·7450) | (1·8193) | (2·0126) | (1·7692) |
| $\text{Election}_{t}$ | | 0·0023 | | −0·0077 | | −0·0471*** | | −0·0036*** |
| | | (0·2188) | | (−0·7137) | | (−4·8944) | | (−3·6525) |
| Q | 0·0762*** | 0·0762*** | 0·0736*** | 0·0735*** | 0·2110*** | 0·1888*** | 0·0171*** | 0·0168*** |
| | (3·9765) | (3·9749) | (3·8310) | (3·8299) | (9·8570) | (8·8309) | (7·8950) | (7·7813) |
| CF | 0·8588*** | 0·8589*** | 0·8439*** | 0·8437*** | 0·1044*** | −0·1449*** | 0·0623*** | 0·0622*** |
| | (25·3147) | (25·3154) | (24·5227) | (24·5161) | (2·6563) | (−3·5396) | (15·5124) | (15·4742) |
| Size | −0·1660*** | −0·1660*** | −0·1693*** | −0·1693*** | −0·0646*** | −0·0666*** | −0·0128*** | −0·0129*** |
| | (−20·9566) | (−20·9509) | (−21·2803) | (−21·2847) | (−8·4871) | (−8·7743) | (−16·3443) | (−16·5138) |
| Lev | | | −0·5011*** | −0·5013*** | −0·5647*** | −0·7302*** | −0·0645*** | −0·0644*** |
| | | | (−20·3335) | (−20·3380) | (−20·1680) | (−25·3520) | (−22·5420) | (−22·5199) |
| Capex | | | −0·4631*** | −0·4628*** | −0·2533*** | −0·0590 | −0·1448*** | −0·1442*** |
| | | | (−7·5585) | (−7·5534) | (−3·6614) | (−0·8578) | (−20·3774) | (−20·2828) |
| IndVol | 0·0654*** | 0·0652*** | 0·0796*** | 0·0800*** | 0·2273*** | 0·2225*** | 0·0199*** | 0·0201*** |
| | (3·7606) | (3·7505) | (4·5912) | (4·6111) | (11·8206) | (11·6079) | (10·0745) | (10·1465) |
| Div | | | −0·0727 | −0·0730 | −0·0799 | −0·0844 | −0·0102 | −0·0104 |
| | | | (−1·1099) | (−1·1138) | (−1·0760) | (−1·1402) | (−1·3277) | (−1·3527) |
| GDP Growth | | | −0·2978*** | −0·3086*** | −0·3856*** | −0·3803*** | −0·0085 | −0·0085 |
| | | | (−4·1457) | (−4·2036) | (−8·1231) | (−8·0517) | (−1·5547) | (−1·5668) |
| Fixed Effects | Firm<br>Year | Firm<br>Year | Firm<br>Year | Firm<br>Year | Firm<br>Year | Firm<br>Year | Firm<br>Year | Firm<br>Year |
| Observations | 48,127 | 48,127 | 47,928 | 47,928 | 47,560 | 47,560 | 47,938 | 47,938 |
| $R^2$ | 0.0576 | 0.0576 | 0.0682 | 0.0682 | 0.0173 | 0.0233 | 0.0355 | 0.0358 |

**Table 7: Additional Tests**

The table reports estimation results from several additional tests. The dependent variable in all tests is the natural log of cash and cash equivalents scaled by book value of total assets. Columns (1) to (4) report results from regressions examining the effects of country-level corporate governance and political uncertainty on cash holdings. The proxy for country-level corporate governance is the shareholder rights (*Shr. Rights*) measure from LLSV (1998). Following Dittmar et al. (2003), random effects for each country-industry pair are used in these regressions. Columns (5) to (8) report results from regressions examining the interactive effect of political uncertainty and politically-sensitive industries (*Sensitive*) on cash holdings. Industries that are politically-sensitive are defined based on the findings in Herron et al. (1999). *Sensitive* is an indicator variable taking a value of 1 if a firm operates in a politically-sensitive industry, and 0 otherwise. Country and year fixed effects are used in these regressions. All regressions include control variables *CF*, *Capex*, *IndVol*, *Div*, *Q*, *Size*, *Lev*, and *GDP Growth*. See the Appendix for details of variable definitions. *t*-statistics are reported in parentheses. Coefficients marked with ***, **, and * are statistically significant at the 1%, 5%, and 10% level, respectively.

| | Shareholder Rights | | | | Sensitive Industries | | | |
|---|---|---|---|---|---|---|---|---|
| | (1) | (2) | (3) | (4) | (5) | (6) | (7) | (8) |
| $\text{Incident}_t$ | 0·0522*** | 0·0498*** | 0·0580*** | 0·0559*** | 0·0766*** | | 0·0795*** | |
| | (6·0328) | (5·7503) | (6·7901) | (6·5352) | (5·5151) | | (6·0234) | |
| $\text{Election}_t$ | | −0·0360*** | | −0·0315*** | | −0·0038 | | −0·0233 |
| | | (−4·1210) | | (−3·6469) | | (−0·2351) | | (−1·5040) |
| Shr. Rights (level) | −0·4996*** | −0·5018*** | −0·5072*** | −0·5119*** | | | | |
| | (−10·4513) | (−10·5246) | (−10·8963) | (−11·0027) | | | | |
| Sensitive | | | | | 0·2298*** | 0·2024*** | 0·2634*** | 0·2349*** |
| | | | | | (9·3109) | (8·4771) | (11·1158) | (10·2276) |
| $\text{Incident}_t \times$ | | | | | 0·2067*** | | 0·2255*** | |
| Sensitive | | | | | (6·0022) | | (6·8683) | |
| $\text{Election}_t \times$ | | | | | | 0·1785*** | | 0·1770*** |
| Sensitive | | | | | | (4·8097) | | (4·9883) |
| Controls | Yes | Yes | Yes | Yes | Yes | Yes | Yes | Yes |
| Random Effects | Country × Industry | Country × Industry | Country × Industry | Country × Industry | | | | |
| Fixed Effects | | | | | Country Year | Country Year | Country Year | Country Year |
| Observations | 47,928 | 47,928 | 47,928 | 47,928 | 47,928 | 47,928 | 47,928 | 47,928 |
| $R^2$ | | | | | 0.1365 | 0.1360 | 0.2257 | 0.2251 |

**Table 8: Security Issuances**

The table reports estimation results from regressions examining the effect of political uncertainty on the issuance of debt and equity securities. Columns (1) to (3) report results from regressions where the dependent variable *Debt Issuance* is the net long term debt borrowings scaled by book value of total assets. Columns (4) to (6) report results from regressions where the dependent variable *Equity Issuance* is the net proceeds from the sale of common and preferred stock scaled by book value of total assets. The firm-specific control variables are cash flow (*CF*), Tobin's Q (*Q*), firm size (*Size*), and leverage (*Lev*). Only *CF* is measured contemporaneously, while the other control variables are lagged by one year. See the Appendix for details of variable definitions. All specifications include firm and year fixed effects. Standard errors are clustered by firm. *t*-statistics are reported in parentheses. Coefficients marked with ***, **, and * are statistically significant at the 1%, 5%, and 10% level, respectively.

| | Debt Issuance | | | Equity Issuance | | |
|---|---|---|---|---|---|---|
| | (1) | (2) | (3) | (4) | (5) | (6) |
| $\text{Incident}_{t}$ | −0·0022*** | | −0·0027*** | −0·0042*** | | −0·0044*** |
| | (−2·6934) | | (−3·3926) | (−5·3961) | | (−5·6708) |
| $\text{Election}_{t}$ | | 0·0002 | −0·0001 | | −0·0002 | −0·0008 |
| | | (0·2702) | (−0·0785) | | (−0·2580) | (−0·9381) |
| CF | −0·0135*** | −0·0134*** | −0·0174*** | −0·0246*** | −0·0243*** | −0·0247*** |
| | (−4·6388) | (−4·5876) | (−6·0358) | (−8·7826) | (−8·6729) | (−8·8368) |
| Q | 0·0297*** | 0·0296*** | 0·1079*** | 0·0068*** | 0·0065*** | 0·0290*** |
| | (19·1034) | (19·0314) | (29·6063) | (4·2938) | (4·1219) | (7·8332) |
| Size | 0·0098*** | 0·0097*** | 0·0123*** | 0·0258*** | 0·0256*** | 0·0269*** |
| | (15·6506) | (15·4786) | (19·6902) | (39·8324) | (39·5163) | (41·5731) |
| Lev | −0·0617*** | −0·0617*** | −0·0659*** | 0·0306*** | 0·0307*** | 0·0289*** |
| | (−29·6686) | (−29·6504) | (−31·9123) | (15·2187) | (15·2363) | (14·2581) |
| Fixed Effects | Firm | Firm | Firm | Firm | Firm | Firm |
| | Year | Year | Year | Year | Year | Year |
| Observations | 43,546 | 43,546 | 43,546 | 47,681 | 47,681 | 47,681 |
| $R^2$ | 0.0526 | 0.0524 | 0.0646 | 0.0553 | 0.0546 | 0.0562 |

**Table 9: Comparison of Investment Rates**

Panel A reports descriptive statistics for investment rates in years when non-electoral political incidents occur and compares it to the investment rates in years when no incidents occur. Panel B reports descriptive statistics for investment rates in years when national elections occur and compares it to the investment rates in years when no elections occur. Investment rate is defined as capital expenditures scaled by beginning-of-period book value of total assets.

| Panel A: Investment Rates in Incident Years vs. Non-Incident Years | | | |
|---|---|---|---|
| | Mean | Median | Std. Dev. |
| Incident Years | 0·0617 | 0·0311 | 0·0872 |
| Non-Incident Years | 0·0636 | 0·0319 | 0·0888 |
| Difference | −0·0019 | | |
| $t$-stat | −2·4983 | | |
| **Panel B: Investment Rates in Election Years vs. Non-Election Years** | | | |
| Election Years | 0·0666 | 0·0333 | 0·0920 |
| Non-Election Years | 0·0615 | 0·0309 | 0·0867 |
| Difference | 0·0051 | | |
| $t$-stat | 6·4536 | | |

**Table 10: Investment Rates**

The table reports estimation results from regressions examining the effect of political uncertainty on investment rates. The dependent variable is investment rate computed as capital expenditures scaled by beginning-of-period book value of total assets. The firm-specific control variables included are cash flow (*CF*), Tobin's Q (*Q*), firm size (*Size*), and leverage (*Lev*). The country-level macroeconomic control variable is the annual percentage change in current GDP in USD (*GDP Growth*). Only *CF* is measured contemporaneously, while the other control variables are lagged by one year. See the Appendix for details of variable definitions. All specifications include firm and year fixed effects. Standard errors are clustered by firm. *t*-statistics are reported in parentheses. Coefficients marked with ***, **, and * are statistically significant at the 1%, 5%, and 10% level, respectively.

| | (1) | (2) | (3) | (4) | (5) | (6) | (7) | (8) |
|---|---|---|---|---|---|---|---|---|
| $\text{Incident}_t$ | −0·0022*** | | −0·0018** | | −0·0015** | | −0·0017** | −0·0013* |
| | (−2·6545) | | (−2·2807) | | (−2·0011) | | (−2·1525) | (−1·8195) |
| $\text{Election}_t$ | | 0·0008 | | 0·0011 | | 0·0014* | 0·0008 | 0·0013 |
| | | (0·7675) | | (1·0520) | | (1·7094) | (0·8265) | (1·4927) |
| CF | | | 0·1176*** | 0·1177*** | 0·0827*** | 0·0829*** | 0·1176*** | 0·0828*** |
| | | | (31·1313) | (31·1817) | (31·1636) | (31·2181) | (31·1445) | (31·1728) |
| Q | | | 0·0136*** | 0·0134*** | 0·0084*** | 0·0083*** | 0·0135*** | 0·0084*** |
| | | | (7·4309) | (7·3171) | (5·6281) | (5·5753) | (7·3888) | (5·6312) |
| Size | | | | | −0·0346*** | −0·0345*** | | −0·0346*** |
| | | | | | (−18·0756) | (−18·0577) | | (−18·0655) |
| Lev | | | | | 0·0147*** | 0·0146*** | | 0·0146*** |
| | | | | | (23·8206) | (23·7364) | | (23·8063) |
| GDP Growth | | | | | 0·0298*** | 0·0318*** | | 0·0316*** |
| | | | | | (5·3285) | (5·5624) | | (5·5225) |
| Fixed Effects | Firm | Firm | Firm | Firm | Firm | Firm | Firm | Firm |
| | Year | Year | Year | Year | Year | Year | Year | Year |
| Observations | 60,588 | 60,588 | 47,973 | 47,973 | 47,967 | 47,967 | 47,973 | 47,967 |
| $R^2$ | 0.0319 | 0.0318 | 0.0906 | 0.0905 | 0.1023 | 0.1023 | 0.0906 | 0.1023 |