THE IMPACT OF POLITICAL UNCERTAINTY ON THE RISK-TAKING BEHAVIOR OF LISTED COMPANIES IN CHINA: THE MODERATING ROLE OF STATE OWNERSHIP

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LIST OF ABBREVIATIONS

CAPM	Capital Asset Pricing Model
CCDI	Central Commission for Discipline Inspection
CMC	Central Military Commission
CPC	Communist Party of China
COSO	Committee of Sponsoring Organizations
CEO	Chief Executive Office
EMH	Effective Markets Hypothesis
ERM	Enterprise Risk Management
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
GLC	Government-Linked Company
M&A	Merger and Acquisition
MPT	Modern Portfolio Theory
NCS	National Commission of Supervision
PRC	People's Republic of China
POE	Private-Owned Enterprise
R&D	Research and Development
RDT	Resource Dependence Theory
SOE	State-Owned Enterprise
TRM	Traditional Risk Management
U.S.	The United States

KESAN KETIDAKPASTIAN POLITIK KE ATAS TINGKAH LAKU MENGAMBIL RISIKO SYARIKAT TERSENARAI DI CHINA: PERANAN PENYEDERHANA PEMILIKAN KERAJAAN

ABSTRAK

Kajian ini menyiasat kesan ketidakpastian politik terhadap pengambilan risiko syarikat tersenarai di China. Ketidakpastian politik merujuk kepada perubahan rasmi tempatan dalam kerajaan bandar peringkat perbandaran, dan ketidakpastian politik dibahagikan kepada tiga jenis yang berbeza, iaitu, (i) pusing ganti Datuk Bandar; (ii) pusing ganti setiausaha jawatankuasa perbandaran Parti Komunis China (PKC); (iii) pusing ganti sama ada Datuk Bandar atau setiausaha PKC, untuk melihat sama ada kesan ketidaktentuan politik terhadap pengambilan risiko korporat berkaitan dengan jenis pegawai. Selain itu, kajian ini juga menyiasat kesan penyederhanaan hubungan pemilikan negeri. Rangka sampel untuk kajian ini adalah dari 2012-2024 meliputi 1470 syarikat bukan tersenarai kewangan di China. Perolehan rasmi kerajaan tempatan, yang merangkumi 214 kes bandar peringkat perbandaran, dikumpul dengan tangan, manakala maklumat kewangan peringkat firma diperoleh daripada laporan tahunan dalam laman web rasmi sampel. Kajian ini menggunakan regresi panel kesan tetap. Keputusan menunjukkan bahawa: (i) apabila ketidakpastian politik diuji sebagai pembolehubah palsu tunggal, ia mempunyai kesan negatif yang ketara terhadap leverage kewangan dan urus niaga M&A, tetapi positif ke atas perbelanjaan R&D.

Keputusan menunjukkan apabila firma hadir dalam konteks perolehan rasmi tempatan, ketidaktentuan politik memburukkan lagi asimetri maklumat antara kerajaan dan firma, menjadikan pengambilan risiko korporat cenderung menjadi lebih lemah. (ii) Apabila ketidakpastian politik dibahagikan kepada dua jenis berbeza, pusing ganti setiausaha CPC mempunyai kesan yang lebih tinggi ke atas perbelanjaan R&D dan urus niaga M&A berbanding perolehan Datuk Bandar, tetapi lebih rendah pada leverage kewangan. Keputusan menunjukkan bahawa tidak semua pusing ganti pegawai tempatan mendorong ketidakpastian politik yang mencukupi untuk menjejaskan pengambilan risiko korporat. (iii) Hubungan pemilikan negeri melemahkan kesan ketidaktentuan politik ke atas leverage kewangan, dan ke atas urus niaga M&A, tetapi bukan ke atas perbelanjaan R&D. Keputusan menunjukkan hubungan pemilikan boleh membantu firma berkongsi lebih banyak sumber dan maklumat daripada kerajaan, yang mungkin melemahkan hubungan antara ketidaktentuan politik dan pengambilan risiko korporat. Secara keseluruhannya, dapatan kajian ini memberikan bukti bahawa ketidaktentuan politik boleh memberi impak yang ketara ke atas pengambilan risiko korporat yang memberi manfaat kepada firma dalam menangani risiko politik di bawah persekitaran yang tidak menentu.

THE IMPACT OF POLITICAL UNCERTAINTY ON THE RISK-TAKING BEHAVIOR OF LISTED COMPANIES IN CHINA: THE MODERATING ROLE OF STATE OWNERSHIP

ABSTRACT

This study investigates the impact of political uncertainty on the risk-taking of listed companies in China. Political uncertainty refers to the local official changes in the municipal-level city government, and political uncertainty is divided into three different types, i.e., (i) turnover of mayor; (ii) turnover of the secretary of Communist Party of China (CPC) municipal committee; (iii) turnovers of either mayor or CPC secretary, to see whether the impact of political uncertainty on corporate risk-taking is related to the type of official. Additionally, this study also investigates the moderating effect of state ownership ties. The sample frame for this study is from 2012-2024 covering 1470 non-financial listed companies in China. The local government official turnover, which include 214 municipal-level city cases, are hand-collected, while the firm-level financial information is obtained from the annual reports in the official website of the sample. This study uses the fixed effect panel regression. The results show that: (i) when political uncertainty is tested as a single dummy variable, it has a significantly negative effect on financial leverage and M&A deals, but positive on R&D expenditure. The results show when firms are present in the context of local official turnover, political uncertainty exacerbates information asymmetry between governments and firms, making corporates' risk-taking tend to become weaker. (ii) When political uncertainty is divided into two different types, the turnover of CPC secretary has a higher effect on R&D expenditure and M&A deals than the turnover of mayor, but lower on financial leverage. The results show that not all local officials' turnover induces sufficient political uncertainty to affect corporate risk-taking. (iii) State ownership ties attenuate the effect of political uncertainty on financial leverage, and on M&A deals, but not on R&D expenditure. The results show ownership ties can help firms share more resources and information from the governments, which may weaken the linkage between political uncertainty and corporate risk-taking. Overall, the finding of this study provides evidence that political uncertainty can have a significant impact on corporate risk-taking which benefit firms in dealing with political risk under an uncertainty environment.

CHAPTER 1

INTRODUCTION

1.1 National Governance Structure of China

The political system plays an important promoting role in China's economic growth, especially after the Chinese government implementing the reform and opening-up (Xu, 2011). The People's Republic of China (PRC) adopts a top-down national governance structure in which the central government as the chief executive and the local governments as policy implementers (Allen, Qian, & Qian, 2005; Calomiris, Fisman, & Wang, 2010). As a unitary country, the bureaucratic hierarchy in Chinese government is broadly composed by five levels of national administration, namely: the central, provincial-level, municipal-level, county-level, and township-level. The last four levels are defined as the local/ subnational governments (Xu, 2011). The Communist Party of China (CPC), is at the center of this political system, and is the sole ruling party without any effective political competitor. The General Secretary of the CPC Central Committee, who is not only the supreme leader of the CPC, but also serves concurrently as the President of PRC and the Chairman of the Central Military Commission. The core decision-making body of the PRC is the Standing Committee of the Politburo, which is also controlled by the CPC, and it leads the pyramid of power that governs every workplace and village in this country.

Although China has a similar political election cycle in both central and local levels just same with other countries, no the national-level (i.e., Presidential) elections uncertainty. These unique political backgrounds lead to the differences in research on Western countries and China. In Western countries, the most uncertainty occurs immediately before the period of appointment or election. As Çolak, Durnev, & Qian (2017) argue that political uncertainty is related to possible changes in political leadership and/or in government policies, such as the uncertainty about who will win an election prior to the actual election. In China, the uncertainty about who will win any election is small even not exist at all for firms and citizens. The greatest uncertainty occurs during and after the year of the new local government official appointment. For example, An, Chen, Luo, & Zhang (2016) argue that uncertainties will arise when new local government officials bring changes to existing local policies. During periods of political instability, the possibility of changes in government policies and macroeconomic conditions significantly increases perceived risks for capital market participants (e.g., Pástor & Veronesi, 2012; 2013). Local firms must wait and learn the new rules of the game. Therefore, political uncertainty surrounding local government turnover exists whenever new officials are appointed or elected in China (Cheng, Guo, Jin, & Geng, 2021). In other words, the definition of political uncertainty is often related to the official changes in local government levels in China (Niu & Zhou, 2023).

Chinese local government officials can be divided into two categories, namely CPC (Party) officials and Government officials. Both the Party and the Government have organs at each level of China's political hierarchy (Li & Zhou, 2005). In each local governments, all positioned two leaders (Xu, 2011), namely: the secretary of the CPC (coresponding level) committee (hereafter, CPC secretary), and the Government chief executives (e.g., Governor/Mayor), who also serve as the deputy secretary of the CPC (coresponding level) committee. Due to the power of each local government is concentrated in the local Party committee, the local CPC secretary is thus in charge of the local government. The local government chief executive is a member of the local party organization and is subject to the leadership of the local party committee (Wu, Li, & Li, 2020). Therefore, the local CPC secretary is the first leader in local politics, and the local government chief executive is the second leader (Chen, Chen, Wang, & Zheng, 2018). Specific in each local bureaucratic structure, the duty of CPC secretary not only responsible for local economic development affairs and policy formulating, but also hold powerful authority over the political promotion careers of the lower-level local officials. The government chief executive, would be more focus on running the daily government affairs and conducting of various policies. Such the dual administrative structure means any changes in the CPC secretary and Government chief executive could have an impact on the local economy and businesses (Zhou, 2017).

Since the Xi Jinping elected as the President of the PRC and the General Secretary of CPC on China's "18th National Congress" in December 2012, the new Chinese central government is official launched a largest anti-corruption campaign in this country (Lin, Morck, Yeung, & Zhao, 2023). Since then, many corrupt senior officials have been “investigated” by the Central Commission for Discipline Inspection (CCDI) of the CPC & the National Commission of Supervision (NCS) of the PRC. Basically, these officials whom involved in the “investigation scandals” are followed by removal or even arrest (Tang & Zhang, 2024). Each scandal means that the anti-corruption campaign is not over yet, and warns officials to be careful in what they say and do. According to the official statistics issued by the CCDI & NCS in the year of 2019, more than 600 both from central and local government officials have been investigated. Obviously, any corruption investigations related to the government senior officials undoubtedly signal the increased political uncertainty. Because these political anti-corruption activities have largely been seen as a traumatic and random accident for some local government leaders since 2012, as these activities may arouse situations that result in frequent official turnover, discontinuity in terms of policy and abandoned projects (Tang & Zhang, 2024).

1.2 Motivation of the Study

Politician turnover is a crucial dimension of the institutional environment, becoming surprisingly prevalent in the field of corporate strategic management research (Dong, Huang, & Liu, 2022; Zhong, Lin, Gao, & Yang, 2019; Boubakri, Cosset, & Saffar, 2013). Existing studies have investigated the role of national elections in economic development and corporate's risk behavior and outcomes worldwide (Dong et al., 2022; Wu, Licht, & Wolford, 2021; Smales, 2020). Findings suggest that politician turnover tends to trigger political uncertainty (Chen, 2022), as the change of politician in the government may bring uncertainty, that is, the discontinuity of governmental policies and projects. However, most existing studies have examined the political uncertainty in the Western developed countries, especially by the event of Presidential election, on corporate's risk-related decisions-making, while there are fewer studies explored that in the one-party rule countries like China, which political uncertainty is generally related to official changes in local government levels. In fact, given the country's distinct socioeconomic structure and political bureaucracy, political uncertainly perhaps plays a more profound role in China than in the Western.

First, unlike the market-economy system in the Western, in which the government uses the so-called "invisible hand" to allocate wealth and resources, the socio-economic structure in China is more like a mixture of market-based economy and government-planed system (Luo, Chen, & Wu, 2017). Due to the Chinese government prefers directly to control resources and allocate wealth by use the “visible hand”, which in turn create uncertainties to firms and volatilities in financial markets (Chen, Mao, & Feng, 2020). Second, the Chinese central government adopts a model with political centralization and fiscal decentralization to manage this country (Xu, 2011). On the one hand, the central government has the ultimate authority to promote or demote local government officials. On the other hand, this model also authorized local governments substantial autonomy and equips them with effective tools to allocate economic resources independently and are responsible for economic development in their regions. By established a GDP-based official promotion evaluation system, the Chinese central government successfully created a competition among the local officials (Zhuravskaya, 2000), which is widely believed to have greatly contributed to China's economic success during the past four decades.

Although many Chinese literatures emphasized that such a personnel control and incentive system has greatly contributed to the rapid economic development in China, it also led to an unintended consequence which is the potential political instability in the local government levels. Typically, a tenure of an official in Chinese local governments is five years and can be re-elected for two consecutive terms (i.e., 10 year) in legal. To ensure the effectiveness of the personnel control and incentive system, especially to make the promise of promotion convincing, the turnover rate of Chinese local government main leaders kept at a high level (Yao & Zhang, 2015). Such as, Wu et al. (2020) showed the statistic information during the sample period of 1983 to 2012, there were 2,172 CPC secretaries and 2,387 mayors in 283 municipal-level cities, the average lengths are 3.7 years for CPC secretaries and 3.3 years for mayors. Due to Chinese local government officials are usually appointed by higher-level CPC officials rather than being elected by local constituents (An et al., 2016), the decisions to replace local officials tend to be sudden and unexpected for either political or legal reasons (Xu, Chen, Xu, & Chan, 2016). Thus, the tenure term for a local government official is largely unpredictable (Earle & Gehlbach, 2015), and managing political uncertainty is a priority task for most local market participant (Qian, Wang, Zhang, & Zhong, 2024).

Political uncertainty affects corporate risk-taking mainly through two main channels in China. At first, political turnover directly influences the top managers' decisions-making regrading resource allocation and strategic adjustments, which subsequently shapes their corporates' risk-taking. The "promotion tournament model" incentivize local officials to foster local economic growth to increase their likelihood of promotion (Li & Zhou, 2005). When these local officials to pursue their social and political objectives, they frequently exercise power to support those specific or potential business programs or policies that will benefit their further political achievement (Chen et al., 2020). If local officials are promoted or replaced, however, these policies or programs that they have implemented may be changed or even abolished during their successors' terms, which may result in policy instability and discontinuity and thereby have a significant impact on the local economy (Hu & Kong, 2021). As Wu (2023) indicates that although China is not constitutionally a federal state, in many important economic issues, Chinese local governments are more powerful than their counterparts in federal countries around the world because they are responsible for much broader regional matters than simply fiscal issues. Therefore, when political turnover occurs, firms located in the affected jurisdictions may inevitably postpone making operational decisions and thereby affecting their risk-taking until part or all of the policy risk is resolved.

The second, political turnover also disrupts or dismantles the firm's existing political connections, which affects the top managers' operational decisions. Prior research across various countries has demonstrated that political connections significantly enhance firm operations, providing access to critical resources and increasing firm value. Similarly, given the China's unique socioeconomic structure, which blends market mechanisms with centralized government planning, political actors and officeholders exert substantial influence over the economic and business operations. Firms often need to cultivate and maintain a close relationship with local government officials in order to secure favorable policies, regulatory advantages, and economic benefits (Pham, 2019). This reliance on political connections creates an environment where firms must closely monitor and adapt to changes in political uncertainty to protect their interests (Xu et al., 2016). Consequently, when political turnover occurs, top managers tend to adopt a cautious approach, delaying expansion plans and conserving resources until they can establish relationships with incoming leaders or gain clarity on their policy priorities (Pan, Zhang, & Zhang, 2022). This strategic hesitation, driven by the need to navigate political uncertainty, often leads to an impact in corporate risk-taking.

Hence, motivated by the growing number of studies on the environmental determinants of corporate risk-taking and the role of political uncertainty on firm-specific operate decisions, this study want to investigate how political uncertainty caused by local government official turnover affects corporate risk-taking in China.

1.3 Problem Statement

Political uncertainty is commonly regarded as reconstructing the relationship between government, enterprise, and resource allocation patterns in the local area. The turnover of officials destabilizes the political environment and leads to political risk and information asymmetry, which could have an influence on the corporate behavior, because the bargaining power is imbalanced between different firms and the government (Cai, Boateng, & Guney, 2019). A political system of localized management has existed for a long time in China, the local party committees mainly obtain a high level of power to determine local policies, rules, regulations, and governmental contracting, so the local politicians in China, especially the leaders of local governments, have greater control and influence (Liu et al., 2021). Thus, local government official turnover tends to result in inconsistent policies, as incumbent politicians may have different views on interpreting and implementing regulations and policies (Yung & Root, 2019), which makes firms more difficult to effective in strategic decision-making and thus their risk-taking and performances may be affected.

Prior research demonstrates political uncertainty affects the risk preference and risk-taking propensity of a firm, but the empirical evidences are mixed and inconclusive. One strand of literature predicts that political uncertainty is associated with lower corporate risk-taking. This stream of studies argue that political uncertainty may increase firm cash flow volatility due to the disruption of established policy directions and industry preferences, and the escalating political uncertainty exacerbates information asymmetry between creditors and firms (Yu, Nahm, & Song, 2020; Dai & Zhang, 2019; Brogaard & Detzel, 2015). Thus, firm top managers are less likely to take risks as the cost of external financing rises (Chen et al., 2020; Boubakri et al., 2013). Additionally, political uncertainty can reduce firm production and innovation, which in turn negatively impacts borrowers' ability to repay debts (Bhattacharya, Hsu, & Tian, 2017; Bachmann, Elstner, & Sims, 2013). Firms may inevitably postpone making operational decisions and thereby affecting their risk-taking until part or all of the political risk is resolved (Chen, 2022).

However, another strand of literature predicts that top managers of firms have higher willingness to take risk. This stream of studies argues that political uncertainty can improve competition in the local industrial market due to politician turnover break firms' existing special government connections, enhancing market fairness and transparency (Zhang, Yuan, Li, Chen, & Luo, 2024; Niu & Zhou, 2022). However, some other studies (Hassan, Hollander, van Lent, & Tahoun, 2019; Akey & Lewellen, 2017) also suggest that firms subject to political uncertainty are likely to engage in lobbying to gain access to policymakers. During periods of high political uncertainty, such firms will have political access, and as a result, they can get informational advantage regarding future political events and how they might affect the company. This suggests that the future is less uncertain for those firm managers, and thus, they may take more risk activities (Timbate, Kim, Asrat, & Sungjun, 2024). Therefore, it becomes a controversial issue whether a firm should increase or decrease its risk-taking in order to encounter political uncertainty. This becomes the first research interest of this study.

Moreover, building on Julio & Yook (2012), politician turnover is widely used as a measure of political uncertainty. Some studies use the national elections worldwide as a proxy for uncertainty in multiple countries (Cao, Li, & Liu, 2019; Kim, 2019; Çolak, Gungoraydinoglu, & Öztekin, 2018; Gungoraydinoglu, Çolak, & Öztekin, 2017). Others use the local elections/local official turnover to measure local uncertainty, focusing on U.S. gubernatorial elections (Dai & Ngo, 2021; Jens, 2017). However, little attention is paid to a more fundamental question, which is do all political turnover affect corporate risk-taking? The premise underlying the above-cited studies is that uncertainty arises when new politicians change policies, which motivates firms to act. If a certain type of political turnover does not lead to substantial policy uncertainty, it may have little or no impact on corporate risk-taking. China provides a unique setting for studying this issue by the dual administrative structure. However, although a few current studies examined the political uncertainty resulting from the turnover of local officials, most studies either focus on one type of local official (An et al., 2016; Cao, 2013), or consider the two types in combination (Liu, Sisto, & Li, 2021; Chen et al., 2020; Chen et al., 2018), little attention is paid to the types of these local officials, which are their core characteristics. Thus, whether political uncertainty caused by different types of official turnovers has different effects on corporate risk-taking, this becomes the second research interest of this study.

Finally, past literature emphases mainly on how aggregate policy uncertainty affects firms' operations and hence assumes that firms with different ownership structures are homogenous in their response to political uncertainty. This assumption does not seem reasonable. In spite of 30 years of economy reform and privatization, Chinese government still maintains tight control over the country's business and economics (Calomiris et al., 2010). China insists on the fundamental status of state-owned enterprises (SOEs) in the whole economy and supports them with materially beneficial policies (Cull, Li, Sun, & Xu, 2015; Chen, Li, Luo, & Zhang, 2017). However, these preferential treatments are generally not designed to maximize shareholder wealth, but to pursue social welfare (Chen, Sun, Tang, & Wu, 2011). To facilitate the desire for intervention over SOEs, politically connected top managers are appointed by government to ensure that firm goals align with government objectives, rather than for maximizing firm value, and thus they are acknowledged as channels through which the state uses SOEs to pursue its political agenda (Fan, Wong, & Zhang, 2007; Pan, Ning, & Xiao, 2015). State ownership can be seen as a typical proxy for corporate political ties (Maung, Wilson, & Tang, 2016).

In the context of political uncertainty, if a firm is state-owned, it should be able to mitigate the bad risk-taking. For example, Fogel et al. (2008) found that a powerful government may affect firms' tendency to be more rational in their investments to stabilize social benefits, which may increase their risk-taking decisions. These arguments suggest that state ownership may significantly increase the effect of political turnover on corporate risk-taking (Calomiris et al., 2010). The study by Khaw, Liao, Tripe, & Wongchoti (2016) confirmed that the state ownership is indeed an important indicator of corporate risk-taking and that state-owned firms are less willing to take risks. Vo (2018) also reaffirmed that the relationship between the state ownership and corporate risk-taking behavior are of prime importance in transitional economies, such as Vietnam. In return, the private-owned enterprises (POEs) usually may need to undertake too much risk in order to obtain competitive advantage in market, which perhaps due to the changes in external political environment and limited resource. As Zhu & Zhang (2015), they find that POEs need to construct new political relations with local officials constantly when political turnover is high, which in turn hinders firm development and increase operational risks. However, few studies investigated the role of state ownership ties in this relationship between political uncertainty and corporate risk-taking in China. Thus, whether or not state ownership tie will be able to mitigate this relationship between political uncertainty and corporate risk-taking will be the third research interest of this study.

This study hopes to provide a better insight into the aforementioned issues. The next section will outline all the research questions and research objectives identified in order to answer the research interests mentioned in this section.

1.4 Research Questions

Based on the previous discussion in the problem statement, the following research questions are raised:

1) What effect does political uncertainty have on corporate risk-taking?
2) Whether the effect of political uncertainty on corporate risk-taking is related to the type of official?
3) Whether state ownership ties can moderate the effect of political uncertainty on corporate risk-taking?

1.5 Research Objectives

According to the above research questions, this study would like to attain the following research objectives:

1) To examine the effect that political uncertainty has on corporate risk-taking.
2) To examine whether the effect of political uncertainty on corporate risk-taking is related to the type of official.
3) To examine whether state ownership ties can moderate the effect of political uncertainty on corporate risk-taking.

1.6 Significance of the Study

Risk is embedded in every decision making. In the current globalized environment, it has become increasingly important to develop our knowledge on corporate risk-taking. Prior literatures have been emphasized on the corporate risk-taking as a critical aspect of strategic management in improving the market competitive advantage as well as business performance of a firm. This study provides three significances to the study in the area of corporate risk-taking.

First, this study adds to the corporate finance literature by examining the impact of political uncertainty on corporate risk-taking. Recently, the effect of political uncertainty has received increasing attention from academics, but there is still few research on the relationship between political uncertainty and corporate risk taking. Going beyond John, Litov, & Yeung (2008), who established that shareholder rights protection and rule of law affect the extent of risk-taking by corporations around the world, this study shows that official turnover also matters beyond these institutional constraints. In addition, this study also adds to the literature from the perspective of resource dependence theory in explaining the factors which could affect corporate risk-taking, which offers the opportunity a unique and nuanced understanding of how official turnover could influence risk-taking behavior and how political ties moderate this effect could possibly add on or destroy shareholder value (Lewellyn & Muller-Kahle, 2012).

Second, by showing the effect of political uncertainty on corporate decision-making process such as risk-taking, this study allows a firm to match its preferred risk strategies by considering the political uncertainty when making operational decisions, and thus helps managers conduct firm risk management policies more effectively. Furthermore, the government officials may need to undertake the necessary reforms to decrease government predation and extraction in order to encourage investment at the firm level, and hence innovation and overall growth.

Third, this study also adds to the literature by examining the political uncertainty and corporate risk-taking link in a non-U.S. setting, which is China. Our work is motivated on the premise that current findings, are mainly based on U.S. firms, which may not be relevant in countries with diverse institutional and market environments characteristics. There are significant institutional differences between China and the U.S., such as the sources of political uncertainty and official's power and characteristics. These political institutions which assumes will have considerable bearing on corporate risk-taking incentives. A better understanding of the impact of political uncertainty on firms' strategic choices is of particular interest to foreign investors or even multinational companies (MNCs) who are seeking opportunities in China.

1.7 Definition of Key Terms

The key term in this study is listed and defined below:

Term	Definition
Risk	Uncertainty in the outcome of a decision which can be realized in significant and/or disappointing way.
Risk aversion	Inversion of risk tolerance, relates to a person's insistence on favorable chances when the fraction of wealth is at risk.
Corporate risk-taking	Top managers' strategic choices associated with uncertain outcomes.
Political uncertainty	Official changes in Chinese local government levels.
CPC secretary	Secretary of Communist Party of China (corresponding-level) committee.
Local chief executive	Governor or mayor.
Local CPC secretary	Secretary of CPC (corresponding level) committee.

1.8 Organization of Chapters

This thesis is organized into five chapters. Chapter 1 presents the background of study, follow by motivation of the study, problem statement, research questions, research objectives, contribution and significance of study. Chapter 2 discusses the theoretical and empirical literature related to the study and the hypothesis development. Chapter 3 discusses the research design and methodology. Chapter 4 reports the results and provide discussion on the findings. Chapter 5 presents the conclusion and implication of the results. Limitation of the study and suggestion for future are discussed at the end of the chapter.

CHAPTER 2

LITERATURE REVIEW

2.1 Introduction

This chapter provides a structured review of literature related to political uncertainty and corporate risk-taking. Section 2.2 and Section 2.3 provides an overview of development history towards risk from finance to management. Section 2.4 focused on corporate risk-taking by exploring the theoretical risk-taking perspective, firm behaviors that reflecting managerial risk taking and factors that determine the risk-taking behavior and take a close look on individual factors. Section 2.5 introduces the control variable to corporate risk-taking. Section 2.6 introduces the and suggests that resource dependence theory is appropriate in predicting the relationship between political uncertainty and corporate risk-taking. Section 2.7 shows first part hypotheses development in this study. Section 2.8 introduces the and suggests that resource dependence theory is appropriate in the political ties to moderate this relationship between political uncertainty and corporate risk-taking. Section 2.9 shows second part hypotheses development in this study. Section 2.10 shows the framework of this study.

2.2 The Risk in Finance

"One of the most important developments in finance theory in the last decades is the ability to talk about risk in a quantifiable fashion. If we know how to measure and price financial risk correctly, we can properly value risky assets. This in turn leads to better allocation of resources in the economy. Investors can do a better job of allocating their savings to various types of risky securities, and managers can better allocate the funds provided by shareholders and creditors among scarce capital resources." (Copeland, Weston, & Shastri, 2005).

2.2.1 Modern portfolio theory

The history of Modern Portfolio Theory (MPT), also known as modern portfolio management, originates with the seminal academic work of Markowitz (1952, 1959). The MPT mainly introduced the concepts of the risk return trade-off, correlations in returns of different assets, portfolio selection and investment optimization. As a prescriptive rather than a descriptive theory, MPT provides solution for investors by showing what is the best combination of available assets in a portfolio in order to maximize the total expected return for a given amount of risk, or, alternatively, in order to minimize the portfolio risk, for a given level of expected return (Fabozzi, Gupta, & Markowitz, 2002). The risk of an asset is measured as the variance of the return on that asset, where variance is a measure of how returns can deviate from their expected value. The portfolio's return variance then is the sum over all assets of the square of the fraction held in a specific asset (weight) times the asset's return variance (Fatemi & Luft, 2002). If uses a classic sentence to describe it, namely: the eggs cannot be in the same basket.

There are number of critical underlying assumptions of MPT about the behavior of individuals, which are typically and usually implicitly also made about institutional behavior, whatever the problems with that linkage (Ţiţan, 2015). Some of these assumptions are also taken by the efficient market hypothesis (EMH). The first assumption is that all investors are rational. The assumption of rational investor ('homo economicus', that is utility maximizing and calculating) is the basis for the EMH, but it was originally assumed by MPT. The second assumption is that all investors are risk averse and make decision always depended on the axioms of expected utility theorem. In other words, the risk-averse investors prefer the portfolio with the lower overall risk than the one with the higher overall risk when their presented with two different portfolios. A third assumption is that of a monotonic investor always prefer a portfolio with a higher expected return over another portfolio with a lower expected return. Taking these MPT assumptions into account, one can conclude that the overall risk of a portfolio depends on the risk of each asset in the portfolio, the proportion of the portfolio in that asset and the correlations among different assets in the portfolio when considering the pattern of returns (Ţiţan, 2015).

Sharpe (1964) in an extension to the original work of Markowitz (1952, 1959) introduced the concepts of systematic and idiosyncratic risks, portfolio beta, diversification and the linear relationship between beta as a measure of portfolio/asset risk and the expected return of portfolio/asset (Blake & Moschieri, 2017). Through diversification, an investor can reduce the total risk of his portfolio by choosing different assets the returns to which are not completely correlated. This reduces idiosyncratic risk or asset-specific risk which can be, in theory, diversified away. Systemic risk, on the other hand, is common to all assets, and it cannot be diversified away (Byrnes, Miller, & Schafer, 1999). Consequently, risk-averse investors will prefer a well-diversified portfolio only exposed to systematic risk. Sharpe (1964) also argues the correlation of each asset is critical to a single common underlying factor due to the idiosyncratic risk can be dispersed. If investors all rely on risk and return to choose their portfolios and they also have a same view towards each asset in terms of expected return, risks and correlations. Thus, Sharpe (1991) shows it will be a linear relationship in equilibrium between the expected return of an asset and its sensitivity to the return on the market portfolio. In other words, a most optimized portfolio should be the market portfolio with the best ratio of return to risk, because it is the best diversified of all possible portfolios.

2.2.2 Capital asset pricing model

The concept of risk in financial theory is closely related to the insights of MPT. The most important paradigm of risk is part of a set of results known in the financial economics literature as the Capital Asset Pricing Model (CAPM). The CAPM, based on the works of Treynor (1962), Sharpe (1964) and Lintner (1965), is the first important economic model that explains the relationship between risk and expected return, and it represents an extension and simplification of the standard mean-variance portfolio model by Markowitz's (1952 & 1959). In this model, there is a linear relationship between expected return for a security and the market risk premium. In other words, all efficient portfolios have to lie on the frontiers of mean-variance investment where investors can obtain a higher return only through accepting a higher level of risk (Chatterjee, Lubatkin, Lyon, & Schulze, 1999). Due to the CAPM extends Markowitz's portfolio theory to a situation of equilibrium, the CAPM argues that all investors will hold the same efficient portfolio, that is the so-called market portfolio, regardless of their personal risk performances. As a result, CAPM is able to determine the market price for risk and an appropriate risk measure for a single asset (Copeland et al., 2005).

The CAPM divides the total risk of a firm into two parts. First, the systematic (market) risk, which measures the dependence of a return of asset on fluctuations in the economy as a whole. The systematic risk, which is represented by the beta, is unavoidable and has to be borne by the shareholder for investing in the equity market.

Second, the unsystematic (unique) risk, which is defined as the variance in a security's returns that cannot be explained by movements in the market portfolio. The CAPM assumes that all the firm-specific behaviors are unsystematic (Chatterjee et al., 1999) and thus, the terms of unsystematic risk and firm-specific risks have a same definition in the terminology of CAPM. The examples of such risks specific to a certain business are, for instance, the success of a new production process or a marketing campaign, a technological breakthrough jeopardizing an existing product, or a new competitor entering the current market (Van Horne, 1995; Fenn, Post, & Sharpe, 2002). It is evident from these examples that the unsystematic risk is clearly related to the firm resources and competencies and with the relationship of the environment to the firm (Bettis, 1983). There, the close link of sources of unsystematic risk to the problems and decisions of strategic management becomes apparent.

While under the CAPM, corporate management can create shareholder value by decreasing the total risk of a corporate, applying the equilibrium CAPM to corporate risk management has completely different implications (Chatterjee et al., 1999). Due to the firm-specific risks are not incorporated in the beta measure in the CAPM and thus, not rewarded by the capital market, so firm managers may follow financial theory and ignore such risk factors. From the beginning with the contribution by Bettis (1983), however, the numerous empirical anomalies investigated by the financial economic researches opened a discussion of the usefulness of CAPM for the field of strategic management. Bettis (1983) detects a conundrum regarding the role of risk in the