



JURNAL EKONOMI DAN BISNIS

Journal homepage: www.ejournal.uksw.edu/jeb

ISSN 1979-6471 E-ISSN 2528-0147

The effect of political connections on firms' performance: The moderating role of leverage

Supatmi Supatmi^{a*}

^a Faculty of Economics and Business, Universitas Kristen Satya Wacana, Salatiga, Indonesia;
supatmi.supatmi@uksw.edu*

ARTICLE INFO

Article History:

Received 11-20-2020

Revised 05-04-2021

Accepted 06-02-2022

Kata Kunci:

Koneksi politik, leverage, kinerja perusahaan, teori agensi

Keywords:

Political connection, leverage, firm performance, agency theory

ABSTRAK

Tujuan penelitian ini adalah menguji pengaruh koneksi politik terhadap kinerja perusahaan dan untuk menyelidiki leverage sebagai moderator dari hubungan kausal tersebut. Indonesia sebagai salah satu negara berkembang memberikan setting penelitian yang sesuai untuk penelitian ini. Penelitian menggunakan sampel 471 perusahaan Indonesia yang terdaftar di Bursa Efek Indonesia untuk tahun 2014-2017 dengan observasi 1.884 tahun perusahaan. Kinerja perusahaan terbagi menjadi dua indikator, yaitu ROA sebagai proksi kinerja akuntansi dan Tobins'Q sebagai proksi kinerja pasar. Pengukuran koneksi politik dihitung dengan jumlah pejabat yang terkoneksi secara politik di sebuah perusahaan. Leverage dihitung total kewajiban pada akhir tahun dibagi total aset pada akhir tahun. Hasil penelitian berdasarkan uji regresi data panel menunjukkan bahwa koneksi politik menurunkan kinerja pasar dan akuntansi perusahaan. Lebih lanjut, hasil secara empiris menunjukkan bahwa leverage memperkuat dampak koneksi politik terhadap kinerja perusahaan. Studi ini memberikan kontribusi dengan menambahkan bukti empiris tentang penerapan teori keagenan untuk menyelidiki pengaruh koneksi politik terhadap kinerja perusahaan dalam konteks Indonesia sebagai negara berkembang.

ABSTRACT

This study seeks to examine the impact of political connections on firms' performance and the moderating role of leverage on this causal relationship. As an emerging country, Indonesia offers an interesting research setting for this research. Our sample is 471 Indonesian publicly listed firms in 2014–2017, yielding 1,884 firm-year observations. This study uses two indicators as the proxies for firms' performance: accounting (ROA) and market performance (Tobins'Q). We operationalize political connections with the number of politically connected officials in a firm. Leveraged is measured by dividing total liabilities by total assets at the end of the year. Based on the panel data regression test, our

*Corresponding Author

results demonstrate that political connections decrease firms' market and accounting performance. Further, the results empirically show that leverage strengthens the effect of political connections on firms' performance. This study contributes to the literature by adding empirical evidence on applying the agency theory to investigate the impact of political connections on firm performance in an emerging country like Indonesia. Furthermore, Indonesia's multi-party political system offers a research context distinct from other countries.

INTRODUCTION

Various factors explain firms' performance, including political connections. Political connections are arguably crucial (Chen *et al.*, 2013) and considered valuable resources for most firms (Fisman, 2001). Chen *et al.* (2013) argue that firms' political connections affect various firms' behaviors and outcomes, including rent-seeking behaviors, related lending, control and values, entrenchment, connected credit channels, financial pressures, and project creation and selection.

Politically connected firms enjoy various facilities and benefits in engaging in transactions (Faccio, 2006). However, according to Cheung *et al.* (2005), political connections may be beneficial (helping hand) or detrimental (grabbing hand) for firms. In a similar vein, Belghitar *et al.* (2019) reveal that political connections are arguably firms' valuable resources but also incur higher agency problems for firms.

From the resource dependence theory perspective, politically connected boards reduce firms' external risks (especially those from governments), increase firms' resilience, and facilitate easier business transactions (Hillman, 2005). Hence, more politically connected boards increase firms' performance. This argument is consistent with Tao *et al.* (2017) who document that financially distressed and politically connected firms receive greater government subsidies and eventually improve their performance (Wang *et al.*, 2019; Wong & Hooy, 2018).

On the other hand, the agency theory perspective considers that political connections incur higher agency costs (Belghitar *et al.*, 2018). Politically connected firms are arguably risk-takers (Ling *et al.*, 2016) and more likely to experience business failure (Johnson & Mitton, 2003). Politically connected firms perform worse when they have more politically connected boards due to increased blockholder rent appropriation (Sun *et al.*, 2016).

Prior studies on the effect of political connections on firms' performance are inconclusive likely because of firms' leverage. This argument is consistent with Keefe (2019) who argues that the lender-borrower relationships explain the financial performance effect of political connections. Further, politically connected borrowers with greater takeover risk from lenders tend to exhibit lower financial performance. This model is relevant for highly leveraged firms in countries with lower law enforcement quality (Keefe, 2019) like Malaysia (Bliss & Gul, 2012) and Indonesia

(Leuz & Oberholzergee, 2006). According to the agency theory, principals can use high leverage levels to prevent agents from acting opportunistically. However, highly leveraged public firms incur greater risks in honoring their financial obligations (Akhbar, 2017).

This study seeks to empirically demonstrate the effect of political connections on firms' performance and the role of leverage in explaining the causal relationship. Business owners and politicians have maintained close relationships since the Old Order (Suryo, 2014). Many top business owners join the politics in the post-Soeharto era because the Indonesian parliament holds greater political power in the reformation era, enabling political elites to act as rent-seeking agents (Fukuoka, 2013). Faccio (2006) documents that about 22 percent of Indonesian publicly listed firms exhibit political connections, higher than Malaysia, Thailand, and Singapura. This study predicts the negative effect of political connections on firms' accounting and market performance, and this effect is arguably stronger for highly leveraged firms.

We use 1,884 firm-year observations from 471 Indonesian publicly listed firms in 2014-2017. Our panel data regression tests empirically reveal the negative impact of political connections on firms' accounting and market performance, and firms' leverage amplifies the negative effect.

This study contributes to the literature by providing additional empirical evidence on the agency perspective of the impact of political connections on Indonesian firms' performance. Ours also contributes to the literature using emerging markets as the research context, especially in Asia. Indonesian firms are typically family-owned (Habib *et al.*, 2017; Habib & Muhammadi, 2018) with weaker investor protection (Leuz & Oberholzergee, 2006). Additionally, Indonesia's multi-party system offers a distinct research context from other countries. Lastly, this study also empirically demonstrates the moderating role of leverage on the causal relationship between political connections and firm performance, a research issue that arguably remains understudied.

LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

Political Connections

Close relationships between business owners and politicians have been pervasive in Indonesia since the Old Order. The phenomenon is also common in more developed areas like Europe or the US (Suryo, 2014). Many business owners have entered politics since the post-Soeharto era, enabling the Indonesian parliament to acquire greater political power and political elites to act as rent-seeking agents (Fukuoka, 2013). Further, many parliament members and political elites hold firms' top management teams to secure government contracts.

Firms' political connections are closely related to the close relationships

between board members or firm owners with government/ state heads or parliament members, either directly or indirectly (Faccio, 2006). According to Faccio (2006); Faccio *et al.* (2006), a firm is considered politically connected when at least one of its top management team or large shareholders (holding more than 10% of outstanding shares) is head of state or government (president, king, prime minister), a government minister, or a national parliament member. Such political connections are considered direct ones. Meanwhile, indirect political connections refer to when one of the firm's top management team or large shareholders has familial ties (indicated by the same family name) with the head of state/ government or minister. Further, political connections also exist when firms' top management teams or large shareholders are closely related to political elites like political parties' leaders, heads of state/ government, ministers, or parliament members. Firms with direct government or state ownership exhibit direct political connections or firms with former politicians as their board members or top managers (Ang *et al.*, 2011; Fu *et al.*, 2017; Pérez *et al.*, 2015).

Meanwhile, Indonesia has employed a multi-party political system since the post-New Order era. Hence, firms are considered politically connected not only because they are related to the presidents or their close families but also politicians, political parties, parliament, government ministries, military, local governments, and their close families (Habib *et al.*, 2017). According to Wu *et al.* (2012), firms may also acquire political connections through board members or firm owners who are former senior officers in government ministries and other government agencies.

Belghitar *et al.* (2019) establish that political connections pose a dilemma for firms. On the one hand, political connections are firms' crucial resources; on the other hand, these connections lead to higher agency costs. According to the resource dependence theory, politically connected boards reduce transaction costs, improve firms' resilience, and facilitate easier business transactions (Hillman, 2005). Financially distressed Chinese firms receive more government subsidies that improve their values (Tao *et al.*, 2017).

Conversely, the agency theory argues that politically connected boards exacerbate expropriation by majority shareholders against minority shareholders (Sun *et al.*, 2016). For firms with greater principal-principal agency problems, like in Indonesia, politically connected boards enable majority shareholders to extract more resources at the expense of minority shareholders' interests and firms' performance (Sun *et al.*, 2016).

Political connections and firms' performance

According to the agency theory, politically connected firms are risk takers that tend to make excessively risky investments (Ling *et al.*, 2016) and exploit their political influences to acquire soft loan facilities from their governments (Wahab *et al.*, 2011). They can then use the soft loans to mitigate their financial problems, which explains why politically connected firms incur higher business failure risks (Johnson

& Mitton, 2003). These firms also tend to invest excessively, especially on less profitable projects that will deteriorate their returns (Keefe, 2019).

Based on the agency theory, political connections are more detrimental than beneficial for firms. Several studies observe the negative impacts of firms' political connections, including lower productivity (Domadenik *et al.*, 2016), increased blockholders' rent appropriation (Sun *et al.*, 2016), and higher reliance on external financing (Leuz & Oberholzergee, 2006). Politically connected firms also exhibit lower long-term performance (Deng *et al.*, 2012; Leuz & Oberholzergee, 2006), higher leverage levels, greater long-term liabilities and cash holdings, and lower financial reporting quality (Belghitar *et al.*, 2019). Based on the above arguments, we propose the following hypothesis:

H1: Political connections negatively affect firms' performance.

Political connections, leverage, and financial performance

Leverage measures a firm's ability to pay its liabilities with its assets. Higher leverage levels indicate higher risks because firms are less able to fulfill their financial obligations with their assets. Highly leveraged public firms are also subject to greater public attention. Habib *et al.* (2017) document that highly leveraged firms tend to underperform.

This study predicts that leverage affects the causal relationship between political connections and firms' performance. Based on the agency theory, politically connected firms likely incur higher risks and underperform. Their risks become arguably higher when they are highly leveraged. This argument is consistent with Keefe (2019) who documents the role of lender-borrower relations in explaining the effect of political connections on financial performance. Politically connected firms that incur greater takeover risks by their lenders tend to exhibit lower financial performance, especially highly leveraged ones in countries with lower law enforcement quality. They are also subject to more intense public scrutiny (especially creditors and investors) on their ability to pay their financial obligations timely. These firms are also less likely to exhibit better accounting performance because higher leverage levels lead to higher interest costs, implying lower financial performance. In other words, higher leverage levels increase the negative impact of political connections on firms' performance. Based on the argument, we propose the following hypothesis:

H2: Leverage strengthens the negative effect of political connections on firms' performance.

RESEARCH METHODS

Our population is the entire Indonesian publicly listed firms in 2014-2017. We select the research sample with the purposive sampling technique with the following criteria: firms that publish their annual reports consecutively during the research period, firms with December 31 as their end of the fiscal year, and firms that have complete information on closing share prices and board of executive and supervisory members' profiles. The criteria yield 471 sample firms and 1,884 firm-year observations in nine industries. We rely on firms' annual reports as the main data source through the www.idx.co.id website and other websites to verify politically connected boards.

We use two proxies to operationalize firms' performance (FP) as the dependent variable: accounting performance (ROA) and market performance (Tobins' Q). ROA is measured by dividing net income by end-of-year total assets. Tobins' Q is operationalized by dividing the market value of a firm's end-of-year assets (book value of debt plus the market value of outstanding equity) with the book value of its end-of-year assets (Al-Matari *et al.*, 2014).

We measure political connections (PC) with the number of politically connected individuals in a firm. This study follows and adds Supatmi *et al.* (2019) and other studies Faccio (2006); Faccio *et al.* (2006); Habib *et al.* (2017) and Wu *et al.* (2012) in defining politically connected individuals. Prior studies, like Fisman (2001) and Leuz & Oberholzergee (2006), demonstrate that firms with the additional criteria exhibit political connections. Firms that do not meet the criteria score 0, indicating that they are not politically connected.

As the moderating variable, leverage is measured by dividing total liabilities with total assets at ending figures. We employ several control variables: blockholder ownership, firms' size, and audit quality. Blockholder ownership (BLOCK) is measured by the percentage of share ownership held by a firm's largest shareholder (Sun *et al.*, 2016). Firms' size (SIZE) is operationalized with the natural logarithmic of the market capitalization value of a firm's shares. Audit quality (AUD) is a dummy variable that equals one if the firm's financial statements are audited by Big-4 audit firms and zero otherwise.

We test our hypotheses with the following panel data regression analysis:

Model 1

$$FP = \alpha + \alpha_1 PC + \alpha_2 LEV + \alpha_3 BLOCK + \alpha_4 SIZE + \alpha_5 AUD + \varepsilon \dots\dots\dots 1$$

Model 2

$$FP = \beta + \beta_1 PC + \beta_2 LEV + \beta_3 PC \times LEV + \beta_4 BLOCK + \beta_5 SIZE + \beta_6 AUD + \varepsilon \dots\dots\dots 2$$

Model 1 tests the first hypothesis, while the second hypothesis is tested with staged analysis (Hair *et al.*, 2014) by comparing model 1 (no moderation) with model 2 (with moderation). The first hypothesis is statistically supported if $\alpha_1 < 0$ while the second hypothesis is supported if $\beta_3 \neq 0$, and the adjusted R^2 value in model 2 (with moderation) is greater than in model 1 (without moderation). We also run an additional analysis as the sensitivity test by dividing the sample into two subsamples (financial and nonfinancial industries) to investigate the effect of industry on the main results.

ANALYSIS AND DISCUSSIONS

Table 1 below presents the descriptive statistics of our research variables:

Table 1
Descriptive Statistics

Research Variable	Max	Min	Mean	Standard Deviation
TOBIN	37.231	0.123	1.821	2.696
ROA	2.192	-2.084	0.021	0.148
PC	12	0	1.489	1.863
LEV	20.714	0.001	0.591	0.769
BLOCK	0.999	0.050	0.508	0.220
SIZE	33.941	20.669	28.076	2.013
Research Variable			Observations	Proportion
Audit Quality (AUD)				
Big-4 audit firms (1)			704	37.37%
Non big-4 audit firms (0)			1,180	62.63%
Political connection				
Exists (1)			1,167	61.94%
Does not exist (0)			717	38.06%

Note:

ROA: Return on assets, TOBIN: Tobins'Q, PC: Political connection, LEV: Leverage, BLOCK: Blockholder ownership, SIZE: firms' size, AUD: Audit quality

Table 1 indicates that our sample firms exhibit relatively good performance with a positive average ROA, implying that the sample firms can generate net income with their assets. The average value of Tobin's q is greater than one, indicating that investors overvalue these firms. The mean value of POLCON is 1.489, suggesting that, on average, there are 1-2 politically connected individuals in each firm. A considerable minority of firms (38.06 percent) do not have a single politically connected individual. In contrast, Lippo Karawaci Tbk. (LPKR), has 12 politically connected individuals (the highest among the sample firms), with four of them being former ministers in prior cabinets. In general, politically connected individuals within a firm will also hold senior positions in other firms within the same business group, like those in Lippo Group, Sinar Mas Group, Bakrie Group, and Astra Group. The findings confirm that concentrated ownership dominates Indonesian firms, with ownership held by certain groups or families (Habib *et al.*, 2017).

Table 1 also demonstrates that our sample firms are highly leveraged (59.1

percent), implying that more than 50 percent of firms' assets are financed by debts. The average value of blockholders ownership indicates that 50.8 percent of sample firms' outstanding shares are owned by one of their largest shareholders (institutional or individual). Lastly, the mean value of SIZE is 28.08 percent, and most observations (62.63 percent) are audited by non-big-4 audit firms (62.63 percent).

Table 2
Correlation Test

		ROA	TOBIN	PC	LEV	SIZE	BLOCK	AUD
ROA	Pearson	1	0.056*	0.005	-0.386**	0.239**	0.093**	0.109**
	Correlation							
	Sig. (2-tailed)		0.015	0.816	0.000	0.000	0.000	0.000
	N	1884	1884	1884	1884	1884	1884	1884
TOBIN	Pearson	0.056*	1	-0.002	0.272**	0.261**	-0.006	-0.016
	Correlation							
	Sig. (2-tailed)	0.015		0.937	0.000	0.000	0.793	0.485
	N	1884	1884	1884	1884	1884	1884	1884
PC	Pearson	0.005	-0.002	1	0.044	0.416**	0.020	0.194**
	Correlation							
	Sig. (2-tailed)	0.816	0.937		0.059	0.000	0.387	0.000
	N	1884	1884	1884	1884	1884	1884	1884
LEV	Pearson	-0.386**	0.272**	0.044	1	-0.079**	-0.037	-0.026
	Correlation							
	Sig. (2-tailed)	0.000	0.000	0.059		0.001	0.105	0.254
	N	1884	1884	1884	1884	1884	1884	1884
SIZE	Pearson	0.239**	0.261**	0.416**	-0.079**	1	0.089**	0.391**
	Correlation							
	Sig. (2-tailed)	0.000	0.000	0.000	0.001		0.000	0.000
	N	1884	1884	1884	1884	1884	1884	1884
BLOCK	Pearson	0.093**	-0.006	0.020	-0.037	0.089**	1	0.176**
	Correlation							
	Sig. (2-tailed)	0.000	0.793	0.387	0.105	0.000		0.000
	N	1884	1884	1884	1884	1884	1884	1884
AUD	Pearson	0.109**	-0.016	0.194**	-0.026	0.391**	0.176**	1
	Correlation							
	Sig. (2-tailed)	0.000	0.485	0.000	0.254	0.000	0.000	
	N	1884	1884	1884	1884	1884	1884	1884

Note:

a) *, **, ***) indicate significance at 10%, 5%, 1%, respectively

b) Please see Table 1 for variable definition

Table 2 above displays the correlation test results between the research variables. It indicates that political connections are not correlated with firms' accounting and market performance.

We use panel data that combines the cross-section and time-series data. This study employs the F test (Chow test), Hausman test, and Breusch-Pagan Lagrange Multiplier (LM) test to determine the estimation technique of the data panel regression data. The results demonstrate that the random effect model is the appropriate estimation technique for the panel data regression model for all the research hypothesis tests. Besides, our panel data has more observations (N) than observation periods (T) that better fit with the random effect (Gujarati & Porter, 2015). Table 3 presents the

results of the panel data regression tests for all hypotheses:

Table 3
Hypothesis Testing

Research Variable	Accounting Performance (ROA)		Market Performance (TOBIN)	
	Model 1	Model 2	Model 1	Model 2
Constant	-0.432***	-0.479***	-14.637***	-15.133***
PC	-0.006**	0.003	-0.141***	-0.080**
LEV	-0.073***	-0.037***	1.279***	1.556***
PC*LEV		-0.015***		-0.104***
BLOCK	0.044**	0.040**	-0.266	-0.243
SIZE	0.018***	0.019***	0.581***	0.593***
AUD	0.002	0.000	-0.495***	-0.501***
Year effect	Yes	Yes	Yes	Yes
R ²	0.168	0.191	0.298	0.303
Adjusted R ²	0.166	0.188	0.296	0.301
F-statistic	63.492***	63.191***	132.767***	116.771***

Note:

a) *, **, *** indicate significance at 10%, 5%, 1% levels, respectively

b) Please see Table 1 for variable definition

Table 3 model 1 reveals that the regression coefficient values for PC are -0.006 dan -0.141 (significant at 5% and 1% levels, respectively). The findings indicate that political connections negatively affect firms' accounting (ROA) and market (Tobin's Q) performance. Thus, firms with more politically connected individuals exhibit lower performance to generate net income from their assets and are valued lower by their investors. In sum, our first hypothesis predicting the negative effect of political connections on performance is empirically supported.

Our results document that politically connected firms are considered riskier, as suggested by the agency theory. This theory argues that politically connected firms are risk takers (Ling *et al.*, 2016) and are more likely to fail during a crisis (Johnson & Mitton, 2003). Consequently, investors react negatively to political connections, as indicated by these firms' lower share prices. These firms' politically connected individuals are considered to exacerbate conflicts of interests and not as firms' political strategies. Politically connected individuals not only increase firms' operating costs but also facilitate majority shareholders to expropriate minority shareholders (Sun *et al.*, 2016). Thus, blockholder rent appropriation is more likely when firms have more politically connected individuals, leading to lower performance.

Our results are in line with Deng *et al.* (2012); Domadenik *et al.* (2016) and Leuz & Oberholzergee (2006) who find that politically connected firms tend to underperform and incur greater risks. On average, politically connected firms are more leveraged (61.86 percent) than non-politically connected ones (54.69 percent). The result indicates that politically connected firms incur higher interest costs that hurt their net income and ROA. The findings also support Belghitar *et al.* (2019); Bliss & Gul (2012); Ling *et al.* (2016) and Sun *et al.* (2016) who observe that politically connected firms are highly leveraged and risky that explain their lower performance (Deng *et al.*, 2012).

Table 3 also presents that leverage moderates the causal relationship between political connections with firms' performance. Model 1 (without moderation) shows that both political connections and leverage affect firms' performance. Model 2 (with moderation) reveals that the regression coefficients of the interaction between political connections and leverage (PC*LEV) are -0.015 and -0.104, respectively (significant at one percent level). In this respect, leverage fully (partially) moderates the effect of political connections on accounting (market) performance because the political connection variable remains significant in the market performance analysis.

The adjusted R^2 values in model 2 (with moderation) are greater than in model 1 (without moderation). The interaction between political connections and leverage increases our model's ability to explain firms' performance, implying that leverage strengthens the effect of political connections on firms' performance. Thus, the second hypothesis predicting that leverage intensifies the effect of political connections on firms' performance is empirically supported.

Our results document that firms with more politically connected individuals tend to underperform, and the effect is stronger for more leveraged politically connected firms. Firms with more politically connected individuals are considered to incur greater risks because of greater blockholder rent appropriation opportunities. Hence, highly leveraged firms are riskier, leading to lower accounting and market performance. The findings support the argument that political connections are considered to incur greater conflicts of interest (the agency theory perspective) and not as a corporate political strategy (the resource dependence theory perspective) due to weak investor protection and the pervasiveness of family ownership, and Indonesia's multi-party political system.

We run additional tests by dividing the sample into two subsamples (financial and nonfinancial industries) to investigate the industry's effect on the test results.

Table 4 demonstrates the different results for the financial and nonfinancial industries. In particular, political connections negatively affect nonfinancial firms' accounting and market performance but only financial firms' market performance. Political connections even positively affect financial firms' accounting performance in model 2. However, leverage moderates the effect of political connections on firms' performance in both industries. The inclusion of leverage as the moderating variable also increases the adjusted R^2 values, implying that political connections intensify the impact of political connections on firms' performance.

Table 4
The Sensitivity Test Results

Research Variable	Accounting Performance (ROA)		Market Performance (TOBIN)	
	Model 1	Model 2	Model 1	Model 2
Nonfinancial industry				
Constant	-0.49***	-0.56***	-15.72***	-16.34***
PC	-0.01**	0.00	-0.13***	-0.07
LEV	-0.07***	-0.03***	1.30***	1.59***
PC*LEV		-0.02***		-0.11***
BLOCK	0.05**	0.05**	0.01	0.04
SIZE	0.02***	0.02***	0.62***	0.63***
AUD	0.00	0.00	-0.41**	-0.42***
Year effect	Yes	Yes	Yes	Yes
R ²	0.17	0.20	0.34	0.35
Adj. R ²	0.17	0.20	0.34	0.34
F-statistic	53.59***	54.89***	130.56***	115.33***
Financial Industry				
Constant	-0.09	-0.10	-8.19***	-8.19***
PC	0.00	0.03**	-0.16**	0.78**
LEV	-0.14***	-0.12***	0.12	0.95**
PC*LEV		-0.03**		-1.16***
BLOCK	0.00	0.00	-1.45**	-1.37**
SIZE	0.01**	0.01**	0.38***	0.36***
AUD	0.01	0.01	-0.65**	-0.62**
Year effect	Yes	Yes	Yes	Yes
R ²	0.26	0.27	0.12	0.15
Adj. R ²	0.25	0.26	0.10	0.13
F-statistic	19.93***	18.31***	7.72***	8.43***

Note:

a) *, **, *** indicate significance at 10%, 5%, 1% levels, respectively

b) Please see Table 1 for variable definition

CONCLUSIONS, IMPLICATIONS, AND LIMITATIONS

Conclusions

This study seeks to empirically demonstrate the impact of political connections on firms' performance and the role of leverage in moderating the causal relationship. We document that political connections negatively affect firms' accounting and market performance, and the effects are stronger when firms are more leveraged. Thus, our findings provide additional empirical evidence of the agency theory application in explaining the effect of political connections on firms' performance in the Indonesian setting. Indonesia's multi-party political system causes firms with more politically connected individuals to be considered riskier.

Research Implications

Our study implies that investors need to consider firms' political connections and leverage in their investment decisions. Further, managers need to consider the number and composition of board members, especially politically connected ones. The findings also recommend that the Indonesian Financial Service Authority (*OJK*) and

other policy-making institutions regulate firms' governance, especially the composition of firms' boards that have not accommodated the political connection aspect.

Limitations and Suggestions

We only measure political connections based on the number of politically connected individuals and have not accounted for the political connection levels based on politically connected individuals' different political positions. This study also assumes that macroeconomic conditions, including the inflation rate, remain constant. Thus, we advise future studies further to analyze politically connected individuals' different political positions to investigate the impact of political connection levels better.

REFERENCES

- Akhbar, T. (2017). Simultaneous effect on debt and managerial ownership: Agency theory framework. *KINERJA*, 21(2), 201–213. <https://doi.org/10.24002/kinerja.v21i2.1276>
- Al-Matari, E. M., Al-Swidi, A. K., & Fadzil, F. H. B. (2014). The measurements of firm performance's dimensions. *Asian Journal of Finance & Accounting*, 6(1), 24–49. <https://doi.org/10.5296/ajfa.v6i1.4761>
- Ang, J. S., Ding, D. K., & Thong, T. Y. (2011). Political connection and firm value. *Massey U. College of Business Research Paper No. 31, May*. <https://doi.org/10.2139/ssrn.1934346>
- Belghitar, Y., Clark, E., & Saeed, A. (2019). Political connections and corporate financial decision making. *Review of Quantitative Finance and Accounting*, 53(4), 1099–1133. <https://doi.org/10.1007/s11156-018-0776-8>
- Bliss, M. A., & Gul, F. A. (2012). Political connection and cost of debt: Some Malaysian evidence. *Journal of Banking & Finance*, 36(5), 1520–1527. <https://doi.org/10.1016/j.jbankfin.2011.12.011>
- Chen, C.-M., Ariff, M., Hassan, T., & Mohamad, S. (2013). Does a firm's political connection to government have economic value? *Journal of the Asia Pacific Economy*, 18(3), 477–501. <https://doi.org/10.1080/13547860.2012.742674>
- Cheung, S. Y.-L., Jing, L., Rau, P. R., & Stouraitis, A. (2005). Guanxi, political connections, and expropriation: The dark side of state ownership in Chinese listed companies. *SSRN Electronic Journal*. <https://doi.org/10.2139/ssrn.683726>
- Deng, X., Tian, Z., Li, J., & Abrar, M. (2012). The diversification effects of a firm's political connection and its performance implications. *Chinese Management Studies*, 6(3), 462–487. <https://doi.org/10.1108/17506141211259140>
- Domadenik, P., Prašnikar, J., & Svejnar, J. (2016). Political connectedness, corporate governance, and firm performance. *Journal of Business Ethics*, 139(2), 411–428. <https://doi.org/10.1007/s10551-015-2675-4>

- Faccio, M. (2006). Politically connected firms. *American Economic Review*, 96(1), 369–386. <https://doi.org/10.1257/000282806776157704>
- Faccio, M., Masulis, R. W., & McConnell, J. J. (2006). Political connections and corporate bailouts. *The Journal of Finance*, 61(6), 2597–2635. <https://doi.org/10.1111/j.1540-6261.2006.01000.x>
- Fisman, R. (2001). Estimating the value of political connections. *The American Economic Review*, 91(4), 1095–1102.
- Fu, J., Shimamoto, D., & Todo, Y. (2017). Can firms with political connections borrow more than those without? Evidence from firm-level data for Indonesia. *Journal of Asian Economics*, 52, 45–55. <https://doi.org/10.1016/j.asieco.2017.08.003>
- Fukuoka, Y. (2013). Indonesia's 'democratic transition' revisited: A clientelist model of political transition. *Democratization*, 20(6), 991–1013. <https://doi.org/10.1080/13510347.2012.669894>
- Gujarati, D. N., & Porter, D. C. (2015). *Dasar-dasar ekonometrika* (5th ed.). Jakarta: Salemba Empat.
- Habib, A., & Muhammadi, A. H. (2018). Political connections and audit report lag: Indonesian evidence. *International Journal of Accounting & Information Management*. <https://doi.org/https://doi.org/10.1108/IJAIM-08-2016-0086>
- Habib, A., Muhammadi, A. H., & Jiang, H. (2017). Political connections and related party transactions: Evidence from Indonesia. *The International Journal of Accounting*, 52(1), 45–63. <https://doi.org/10.1016/j.intacc.2017.01.004>
- Hair, J. F., Black, W. C., Babin, B. J., & Anderson, R. E. (2014). *Multivariate data analysis* (7th ed.). Pearson Education Limited.
- Hillman, A. J. (2005). Politicians on the board of directors: Do connections affect the bottom line? *Journal of Management*, 31(3), 464–481. <https://doi.org/10.1177/0149206304272187>
- Johnson, S., & Mitton, T. (2003). Cronyism and capital controls: Evidence from Malaysia. *Journal of Financial Economics*, 67(2), 351–382. [https://doi.org/10.1016/S0304-405X\(02\)00255-6](https://doi.org/10.1016/S0304-405X(02)00255-6)
- Keefe, M. v. (2019). A theory of political connections and financial outcomes. *International Review of Economics & Finance*, 61(April 2018), 108–127. <https://doi.org/10.1016/j.iref.2019.01.009>
- Leuz, C., & Oberholzergee, F. (2006). Political relationships, global financing, and corporate transparency: Evidence from Indonesia. *Journal of Financial Economics*, 81(2), 411–439. <https://doi.org/10.1016/j.jfineco.2005.06.006>
- Ling, L., Zhou, X., Liang, Q., Song, P., & Zeng, H. (2016). Political connections, overinvestments and firm performance: Evidence from Chinese listed real estate firms. *Finance Research Letters*, 18, 328–333. <https://doi.org/10.1016/j.frl.2016.05.009>
- Pérez, S. G., Sánchez, C. B., & Martín, D. J. S. (2015). Politically connected firms in Spain. *BRQ Business Research Quarterly*, 18(4), 230–245. <https://doi.org/10.1016/j.brq.2014.10.002>

- Sun, P., Hu, H. W., & Hillman, A. J. (2016). The dark side of board political capital: Enabling blockholder rent appropriation. *Academy of Management Journal*, 59(5), 1801–1822. <https://doi.org/10.5465/amj.2014.0425>
- Supatmi, M., Sutrisno, T., Saraswati, E., & Purnomosidhi, B. (2019). The effect of related party transactions on firm performance: The moderating role of political connection in Indonesian banking. *Business: Theory and Practice*, 20(20), 81–92. <https://doi.org/10.3846/btp.2019.08>
- Suryo, H. (2014). Konspirasi bisnis (pengusaha) dalam politik praktis. *TRANSFORMASI: Jurnal Ilmu-Ilmu Sosial*, 26(1), 1–51.
- Tao, Q., Sun, Y., Zhu, Y., & Yang, X. (2017). Political connections and government subsidies: Evidence from financially distressed firms in China. *Emerging Markets Finance and Trade*, 53(8), 1854–1868. <https://doi.org/10.1080/1540496X.2017.1332592>
- Wahab, E. A. A., Haron, H., Lee Lok, C., & Yahya, S. (2011). Does corporate governance matter? Evidence from related party transactions in Malaysia. In *International Corporate Governance Advances in Financial Economics* (Vol. 14, pp. 131–164). [https://doi.org/10.1108/S1569-3732\(2011\)0000014009](https://doi.org/10.1108/S1569-3732(2011)0000014009)
- Wang, Y., Yao, C., & Kang, D. (2019). Political connections and firm performance: Evidence from government officials' site visits. *Pacific-Basin Finance Journal*, 57(February), 101021. <https://doi.org/10.1016/j.pacfin.2018.05.003>
- Wong, W., & Hooy, C. (2018). Do types of political connection affect firm performance differently? *Pacific-Basin Finance Journal*, 51(August), 297–317. <https://doi.org/10.1016/j.pacfin.2018.08.009>
- Wu, W., Wu, C., Zhou, C., & Wu, J. (2012). Political connections, tax benefits and firm performance: Evidence from China. *Journal of Accounting and Public Policy*, 31(3), 277–300. <https://doi.org/10.1016/j.jaccpubpol.2011.10.005>