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

Supatmi Supatmi*

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

A R T I C L E  I N F O
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

A B S T R A K
Tujuan penelitian ini adalah menguji pengaruh koneksi politik terhadap kinerja perusahaan dan untuk meneliti 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 Tobin’s 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 meneliti pengaruh koneksi politik terhadap kinerja perusahaan dalam konteks Indonesia sebagai negara berkembang.

A B S T R A C T
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 (Tobin’s Q). We operationalize political connections with the number of politically connected officials in a firm. Leverage is measured by dividing total liabilities by total assets at the end of the year. Based on the panel data regression test, our
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.
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
\[ FP = \alpha + \alpha_1PC + \alpha_2LEV + \alpha_3BLOCK + \alpha_4SIZE + \alpha_5AUD + \epsilon \]

Model 2
\[ FP = \beta + \beta_1PC + \beta_2LEV + \beta_3PC \times LEV + \beta_4BLOCK + \beta_5SIZE + \beta_6AUD + \epsilon \]
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:

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

| 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                      |
| R²                | 0.168                      | 0.191                     | 0.298                    | 0.303                    |
| Adjusted R²       | 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 and -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 (5469 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 R² 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 R² 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                 |
| R²                | 0.17                        | 0.20                        | 0.34                | 0.35                |
| Adj. R²           | 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                 |
| R²                | 0.26                        | 0.27                        | 0.12                | 0.15                |
| Adj. R²           | 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

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## 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.

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