“Characteristics of politically connected firms in Indonesia”

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CHARACTERISTICS OF POLITICALLY CONNECTED FIRMS IN INDONESIA

Abstract

This study investigates the types and characteristics of firms with politically connected directors in the boards of the company. The study uses data from all firms listed in Indonesia Stock Exchange spanning from 2004 to 2006. This study employs univariate analyses to address the research questions. The finding shows that firms with political connections are prevalence in chemical, infrastructure, investment, and miscellaneous industry. Furthermore, firm size is the only variable which significantly affects the probability of being politically connected firms. Specifically, larger firms are more likely to be politically connected. This study implies that the size of the firms is an important determinant in establishing political connections in Indonesia.

Keywords rent seeking, political economy, industry studies, firm size, value of the firms

JEL Classification D72, P16, L70, L25, G32

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INTRODUCTION

Prior studies find that firms with political connections in emerging countries receive some special benefits from their connections (Faccio, 2006). Other studies have also found that political connections will affect the firms' decision-making process and outcomes. Leuz and Oberholzer-Gee (2006) find that the changes of the political power map influence the proportion and source of debt of politically connected firms. Fisman (2001) shows that politically connected firms share price is affected by the health issue/news of the connected politicians.

Despite the significant impact of being politically connected for the companies, however, only a few studies discuss the industrial distribution and characteristics of politically connected firms in specific countries (Agrawal & Knoeber, 2001; Gray, Harymawan, & Nowland, 2016). This study examine the distributions and characteristics of politically connected firms in Indonesia. We employ political connections data from Faccio (2006) to measure political connections in Indonesia. We are particularly interested in investigating this issue using these data, because this database was widely used in international publications. The study period covered in this study is spanning from 2004 to 2006 and employ simple firm characteristics analysis to address the hypothesis. The software used for data processing is STATA.

This study finds that around 9.4 percent of firms-year observations are politically connected. Interestingly, connected firms are more

pronounced in chemical, infrastructure, investment, and miscellaneous industry. Furthermore, the results show that larger firms are significantly and positively associated with politically connected firms. This result implies that in Indonesia, larger firms are more likely to establish political connections to support their business. However, we find no significant association between political connections to firm performance, debt structure, and firm's liquidity. The results of this study further enhance our knowledge on the distributions and characteristics of politically connected firms in Indonesia.

1. LITERATURE REVIEW

In the developing countries, prior research finds there are some costs and benefits of being politically connected firms. From the benefits perspective, previous studies which found that firms with politically connected directors are by Wu, Wu, Zhou, and Wu (2012) who look at the impact of political connections on tax benefits and firm performance in China. Their results show that firms with politically connected managers are more likely to have better firm performance and enjoy tax benefits. Minggui, Yafu, and Hongbo (2010) find that connected firms in China earn more fiscal subsidies than the counterparts. Li, Meng, Wang, and Zhou (2008) find that private firms that join membership of party in China will have better performance and more access to loan.

From the cost point of view, prior findings reveal that firms with political connections are more likely to appoint a high quality of auditor and pay higher audit fees. Gul (2006) investigates the relations between political connections and audit fees. He found that connected firms in Malaysia pay higher audit fee than non-connected ones. He argues that the auditor needs to provide higher effort when auditing connected firms, since these firms have a higher risk of financial misstatements. Interestingly, he also found that the audit fee charged by the auditor will decline when the government introduced capital controls to assist the connected firms. Another study from Aswadi Abdul Wahab, Zain, and James (2011) examines the effect of political connections on the relationship between corporate governance and audit fees. Their results show that connected firms with better corporate governance pay higher audit fees than other firms. Bliss and Gul (2012) find that connected firms in Malaysia are more likely to have higher leverage, higher likelihood of reporting a loss, and higher likelihood to having negative equity. They argue that these situation are associated that connected firms in Malaysia are perceived as being of higher risk by the market and the auditor.

Political connections research on the developed countries shows the mixed findings. Correia (2014) finds that connected firms in United States are less likely to be involved on SEC enforcement actions. She also found that the connected firms have lower penalties when they are prosecuted by the SEC. Blau, Brough, and Thomas (2013) find that connected firms in United States are more likely to receive more and earlier support from the government when they face financial problem. Interestingly, Gray, Harymawan, and Nowland (2016) finds that the appointment of politically connected directors for firms in Australia is associated with negative market reactions.

Furthermore, being politically connected firms also affect the decision making and outcomes of the firms. Fisman (2001) finds that in Indonesia, the share price of firms connected to Soeharto (former president of Indonesia) is influenced by the health issues of the President. When there is a good news related to the health of the President, the share price of the connected firms will increase significantly. Leuz and Oberholzer-Gee (2006) extended the study from Fisman (2001) by investigating the relations between the financing strategy of the firms connected to Soeharto. They found that connected firms are less likely to have publicly traded foreign securities. Interestingly, after Soeharto stepped down, the connected firms are more likely to increase their foreign financing. Chaney, Faccio, and Parsley (2011) show that firms with political connections are more opaque than non-con-

nected ones. Harymawan and Nowland (2016) also found that some country indicators (i.e., government effectiveness and political stability) could affect the association between political connections and earnings quality of connected firms in Indonesia.

Also, some international studies on political connections also provide interesting findings. Boubakri, Cosset, and Saffar (2008) examine the impact of political connections in privatized firms. They found that newly privatized firms are associated with higher leverage and more pronounced in the regulated industry. Boubakri, Cosset, and Saffar (2012) investigate the firm's operating performance and financing decision of politically connected firms. Their finding shows that connected firms enjoy a benefit on easier access to credit and their connections can help them to increase their performance. Faccio, Masulis, and McConnell (2006) find that connected firms are more likely to be bailed out when the home country of the firm's headquarters received aid from the International Monetary Fund or the World Bank.

2. HYPOTHESES DEVELOPMENT

According to Goldman, Rocholl, and So (2013), the politically connected firms have easier access to get the government contract. This means that the firms use their political connections to win the tender for the contract of the government's project, for example, in infrastructure. The industry from infrastructure sectors which have a political background on their board of directors will use their connections to make the firm get easier access to the project in infrastructure.

Moreover, Krueger (1974) stated that the firm uses their political connections to get access to regulation on export import license. In Indonesia, mining and agriculture are the examples of industry sectors that conduct the export-import activities. From that standpoint, we argue that the political connections are more pronounced in that industry. Because, the firm will use their connections to make the regulation regarding export-import license, which can make the firm easier to get profit and facilitate the export-import activities. Therefore, hypothesis 1 is as follows:

H1: The politically connected firms are more pronounced in agriculture, mining, and infrastructure sector.

Although the politically connected firms are easier to win the contract, but to make sure that the government project regarding infrastructure is running well and the output is satisfied, the government will have some consideration in choosing the firms to conduct the project. The government will choose the big firm which expected to give the best result for the project. Furthermore, we argue that leverage, ROA, and liquidity ratio also become the consideration for the government to choose the firm. Based on the findings from Faccio (2010), the result shows that the politically connected firms have a larger size and higher leverage than non-connected ones. From that standpoint, hypotheses 2 are as follows:

H2a: The politically connected firms have bigger firm size than non-connected firms.

H2b: The politically connected firms have higher leverage than non-connected firms.

H2c: The politically connected firms have a higher liquidity ratio than non-connected firms.

H2d: The politically connected firms have a lower return on assets than non-connected firms.

3. DATA AND VARIABLE MEASUREMENT

3.1. Sample and data sources

This study uses 759 firm-year observations which consist of all firms listed in Indonesia Stock Exchange for the period 2004–2006. All financial data used in this study are obtained from the Indonesia Stock Exchange (IDX) websites. For political connections measurement, this study uses the list of politically connected firms in Indonesia from Faccio (2006).

There are 72 firm-year observations matched with the list of politically connected firms from Faccio (2006), which means that the firm has political connections. This result will leave 687 firms as non-politically connected firms. All of the politically connected firms in our sample are connected through ownership or the directors by a minister, police officer, army, members of political parties or someone related to them.

3.2. Variable measurement

The variable of political connections is labeled as PCON. The value for this variable is 0 and 1. The value of 1 indicates that the firm is categorized as politically connected firms, which match with the list of politically connected firms from Faccio (2006). The value of 0 means that the firms is categorized as non-politically connected firms.

The variable of firm size, which is labeled as SIZE, is calculated by the natural logarithm (Ln) of total assets. Leverage ratio (LEV) is calculated as the ratio of total debt to total assets. Return on Assets (ROA) calculated as the ratio of net income for the current year to total assets. Liquidity ratio (CASH) calculated as the ratio of cash holdings to total assets.

4. EMPIRICAL RESULT

4.1. Firm distribution with political connection

Politically connected firms distribution for firm listed in Indonesia Stock Exchange's per industry.

Table 1. Firm distribution

Sector	Firms	% of connection
Agriculture		
No connection	26	100
connections	0	0
Total	26	100
Mining		
No connection	55	100
Connections	0	0
Total	55	100
Basic industry and chemicals		
No connection	119	86.86
Connections	18	13.13
Total	137	100
Miscellaneous industries		
No connection	80	81.63
Connections	18	18.36
Total	98	100
Consumer goods industry		
No connection	83	93.26
Connections	6	6.74
Total	89	100
Property, real estate, and building		
No connection	78	92.86
Connections	6	7.14
Total	84	100
Infrastructure, utilities and transportation		
No connection	55	90.16
Connections	6	9.84
Total	61	100
Finance		
No connection	6	100
Connections	0	0
Total	6	100
Trade, service, and investment		
No connection	185	91.13
Connections	18	8.87
Total	203	100
Total		
No connection	687	90.51
Connections	72	9.49
Total	759	100

Table 1 represents the number of politically connected firms in each industry sector for the firms listed in Indonesia Stock Exchange for the period 2004–2006. The largest number of politically connected firms come from the industry sector of basic industry and chemical, miscellaneous industry, and trade, service and investment with 18 politically connected firms for each industry. Followed by the industry sector of consumer goods industry; property, real estate and building and infrastructure, utilities and transportation with six politically connected firms in each sector.

The industry sector, which doesn't have politically connected firms come from agriculture, mining and finance sector. From 759 firm-year observations, 72 are politically connected firms, and the rest of 687 firm-year observations are non-politically connected firms.

4.2. Descriptive statistics

Table 2. Descriptive statistics

Variable	Mean	Median	Standard deviation	Minimum	Maximum
SIZE	11.140	11.054	1.649	7.529	15.380
LEV	0.339	0.270	0.364	0.000	2.302
ROA	0.016	0.021	0.113	–0.568	0.306
CASH	0.074	0.046	0.081	0.001	0.365

Note: Descriptive statistics for 759 firm-year observations from firm listed in Indonesia Stock Exchange for the period 2004–2006.

Table 2 represents the descriptive statistics for the variable used in this study. The mean statistics of firm-size (SIZE) is 11.140. It means that on average, the size of the firm used in this research is relatively big. The leverage ratio on average has the debt of 0.339 to the total assets, which is calculated in LEV variable. The mean of ROA variable and CASH variable in this study is 0.016 and 0.074, respectively.

4.3. Pearson correlation

Table 3. Pearson correlation

Variable	PCON	SIZE	LEV	ROA	CASH
PCON	1.000	–	–	–	–
SIZE	0.143***	1.000	–	–	–
	(0.000)	–	–	–	–
LEV	0.016	0.056	1.000	–	–
	(0.665)	(0.126)	–	–	–
ROA	–0.002	0.281***	–0.348***	1.000	–
	(0.959)	(0.000)	(0.000)	–	–
CASH	0.036	0.099***	–0.253***	0.329***	1.000
	(0.324)	(0.007)	(0.000)	(0.000)	–

Note: Pearson correlation for 759 firm-year observations from firm listed in Indonesia Stock Exchange for the period 2004–2006. Significance level at * 10%, ** 5%, *** 1%.

Table 3 represents the correlation coefficient and the significance level of correlation between the variables used in this study. As expected, the correlation between PCON and SIZE is positive and significant, indicating that politically connected firms are associated with high firm size. It indicates that the firm size of politically connected firms is bigger than non-politically connected firms.

In contrast, there is no significant relationship between PCON with LEV, ROA, and CASH. It means that the politically connected firms and non-politically connected firms for firms listed in Indonesia Stock Exchange for the period 2004–2006 relatively have the same characteristics with regards to their leverage ratio, return on assets and liquidity ratio.

4.4. Firm characteristics

Table 4. Firm characteristics

Variable	Connection	No Connection	Coef.	t-value
	N = 72	N = 687		
SIZE	11.867	11.063	0.804***	3.974
LEV	0.357	0.337	0.020	0.433
ROA	0.015	0.016	–0.001	–0.051
CASH	0.083	0.073	0.010	0.986

Note: Independent t-test for 759 firm-year observations from firm listed in Indonesia Stock Exchange for the period 2004–2006. Significance level at * 10%, ** 5%, *** 1%.

Table 4 presents the firm characteristics between politically connected and non-politically connected firms. This independent t-test used 759 year-firms as the samples to determine if there are differences between politically connected firms and non-politically connected firms. We divide into two groups: connection and no connection groups, which has 72 and 687 firm-year observations, respectively. Based on the table above, the mean value of SIZE for politically connected firms is 11.867 with the total of observations are 72 year-firms. For non-politically connected firms which consist of 687 firm-year observations, the mean value from t-test above is 11.063. The coefficient of SIZE is 0.804 and significant at the 1% level. This result indicates that the firm size of politically connected firms is significantly different and bigger than non-politically connected firms.

On the other hand, the result shows that there are no significant differences between politically connected and non-politically connected firms with regards to LEV, ROA, and CASH for the firms listed in Indonesia Stock Exchange for the period 2004–2006. It means that the firm characteristics of politically connected firms and non-politically connected firms are relatively same with regards to their leverage, return on assets and liquidity ratio. On the other hand, the result shows that there are no significant differences between politically connected and non-politically connected firms with regards to LEV, ROA, and CASH for the firms listed in Indonesia Stock Exchange for the period 2004–2006. It indicates that the firm characteristics of politically connected firms and non-politically connected firms are relatively same with regards to their leverage, return on assets and liquidity ratio.

CONCLUSION

This study investigates the distributions and characteristics of politically connected firms in Indonesia, a country with strong political influence in business. This study uses the list of politically connected firms from Faccio (2006) to measure political connections and all of the firms listed in Indonesia Stock Exchange for the period 2004–2006 as the observations. The initial results shows that the connected firms in Indonesia are more pronounced in chemical, infrastructure, investment, and miscellaneous industry. This study also shows that political connections have a positive and significant relationship with firm size. This finding indicates that the politically connected firms are associated with larger size of the firms. In contrast, flip with prior findings, there is no significant relationship between political connections and leverage, return on assets and liquidity ratio. Hence, there is no difference on the characteristics between politically connected firms and non-connected firms in regards to leverage, return on assets and liquidity ratio. The results of this study further enhance our knowledge on the distibutions and characteristics of politically connected firms in Indonesia.

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