The impact of managerial political ties on corporate governance and debt financing: Evidence from Ghana

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A B S T R A C T

In this study, we draw upon insights from agency theory to examine the impact of managerial political ties on cost of debt and also to explore whether corporate governance mediates this impact. We hypothesize that political ties reduce financial reporting quality, disclosure of non-financial information and board independence, and are therefore associated with higher interest rates. We also hypothesize that the negative effect of political ties on the cost of debt will be stronger if firms borrow from privately-owned banks versus government-owned banks. Using data from Ghana, we find support for our direct and moderation hypotheses; political ties are associated with high interest rates and poor corporate governance. However, we do not find evidence of mediation. Altogether, the findings reveal the dark side of political connections and highlight the cost of political embeddedness in emerging credit markets.

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Introduction

Political strategy researchers have explored the benefits of political ties, defined as the personal and social relationships managers develop and maintain with politicians (Guo et al., 2014; Park and Luo, 2001). Indeed, over the last two decades there has been a proliferation of literature focusing on value of political ties (see Mellahi et al., 2016; Rajwani and Liedong, 2015). Particularly, there is increasing attention on the link between political ties and debt financing. The small body of research focusing on this topic unanimously shows that political ties enable firms to gain access to bank loans (e.g. Saeed et al., 2015; Yeh et al., 2013). However, it is still not clear whether these ties enable firms to get loans at lower interest rates. Although previous studies have examined the impact of political ties on the cost of debt (e.g. Bliss and Gul, 2012; Chen et al., 2014; Houston et al., 2014), the findings are far from conclusive.

Additionally, literature on the impact of corporate political activity (CPA henceforth) on firm performance in general, and on the cost of debt in particular, suffers from an under-examination of mediating mechanisms (see Guo et al., 2014; Mellahi et al., 2016). At best, researchers conjecture mediation to explain their empirical findings. While conjecturing is a good step towards theorization, the lack of empirical verification curtails a deeper understanding of the means or intermediate outcomes through which political ties are translated into value-adding or value-eroding outcomes (Rajwani and Liedong, 2015).

Related to the above, majority of political strategy studies focus on developed markets and a few emerging markets in Asia (e.g. Johnson and Mitton, 2003; Leuz and Oberholzer-Gee, 2006). Thus, there have been calls to extend strategy research to

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Afric (Mellahi and Mol, 2015; Wright et al., 2005) where important management issues remained underexplored (George et al., 2016). In emerging and developing countries, especially in Africa, access to finance and cost of debt are major impediments to firms (Aryeetey, 1998; Beck et al., 2006). Similarly, corporate governance is very poor in these countries (Young et al., 2008). Could poor governance be a mechanism affecting debt financing in emerging countries? This question is important but has not been adequately addressed, especially in the African context. Moreover, the existing political ties studies in emerging countries draw more on resource based view or dependency theory (Li and Zhang, 2007; Shirodkar and Mohr, 2015), institutional theory (Nell et al., 2015; White et al., 2015) and social network theory (Acquaah, 2007; Peng and Luo, 2000). Though these theories help to explain political activity in emerging countries, they neglect or are perhaps inappropriate to investigate principal-agent relationships and governance dynamics in politically connected firms. Political activity has governance implications which underpin firms’ performance (Hadani and Schuler, 2013). In emerging countries where institutional development is fragile (Acquaah, 2007; Xin and Pearce, 1996), these implications might even be more serious and deserve adequate research attention. Therefore, agency theory is useful for explaining governance practices and organizational behaviours (Eisenhardt, 1989) that mediate the link between political activity and firm-level contractual outcomes.

In this study, we attempt to address the above research gaps using the agency perspective to examine the relationship and mediating mechanisms between political ties and the cost of debt. We propose that the quality of corporate governance in politically connected firms mediates the interest rates these firms are charged when they borrow from banks. Precisely, we argue that politically connected firms have stronger motivations to misreport their financial performance in order to conceal any inappropriate economic appropriation (Guedhami et al., 2014). Thus, the quality of financial reports produced by connected firms is low (Chaney et al., 2011). Also, fraudulent practices in these firms are detected late and the penalties for misbehaviour are usually lenient (Correia, 2014; Yu and Yu, 2011). We contend that leniency in dealing with connected firms will particularly be common in emerging countries where the formal institutions for ensuring compliance are weak or fraught with political interference. Therefore, banks will penalize connected firms with high interest rates to compensate for information asymmetry and risk.

Additionally, we argue that connected firms in emerging countries would want to reduce their visibility to institutional stakeholders in order to avoid scrutiny, especially when their political ties become volatile (Decker, 2011). This implies that the disclosure of non-financial information in these firms will be low, a situation that has negative consequences for loan financing. Further, the strong motivation to avoid scrutiny will cause politically connected firms to have fewer independent or external directors. The resultant weak monitoring and lack of external oversight will reduce creditworthiness and lead to high interest rates (e.g. Anderson et al., 2004; Bhojraj and Sengupta, 2003).

Our study contributes to CPA literature in several ways. First, it adds to the growing strategy research on the performance outcomes of political strategies and sheds more light on the implications of political ties in credit markets. It is worth noting that the effect of political ties on cost of debt has not received adequate attention, despite the importance of loan finance for firms in emerging markets (Beck and Demirgüç-Kunt, 2006). Findings from the few studies that have examined this topic are mixed and inconclusive. For example, on one hand, political ties influence profitability, enhance the creditworthiness of firms and culminates in low loan rates (Houston et al., 2014). On the other hand, political ties may cause poor corporate governance, reduce firm performance, increase information asymmetry and result in high loan rates (Bliss and Gul, 2012). Our study joins this debate and attempts to clarify the impact of political ties in credit markets. Additionally, our study demonstrates how bank ownership moderates the relationship between political ties and interest rates. The findings suggest that due to the principal–agency relationship existing between politicians (principals) and government-owned banks (agents), these banks tend to overlook the agency problems inherent in connected firms. Essentially, government-owned banks are policy tools used by politicians to redistribute or allocate resources (Sapienza, 2004).

Second, this study offers a cautionary insight into the negative effect of political activity on corporate governance. In other words, it addresses the influence of political connections on corporate governance and financial behaviour (Chaney et al., 2011), and shows that there is a dark side to corporate political embeddedness (Okhmatovskiy, 2010). This contribution is very important because even though the dark side of political activity has been documented (Doh et al., 2012; Sun et al., 2016), there is still a paucity of empirical research on what the specific dark elements are, particularly with respect to corporate transparency and monitoring (Okhmatovskiy, 2010).

Finally, this study attempts to enhance our understanding of how political ties affect cost of debt. As noted previously, one of the notable shortcomings in CPA literature is the limited treatise of mediating mechanisms (Guo et al., 2014). By empirically examining the mediating role of agency in the political ties-cost of debt relationship, this study transcends a conjecture of mediation as is commonly done in existing finance and management research. Our findings show that even though political ties lead to poor governance, poor governance does not seem to mediate the impact of political ties on the cost of debt. This suggests that the size of protection or the value of insurance connected firms gain from politicians (e.g. Li and Zhang, 2007; Luo and Zhao, 2013; Xin and Pearce, 1996) causes banks to overlook the inherent information opaqueness in these firms. In sum, this study suggests that in emerging countries, connected firms’ poor governance is reinforced by the unwillingness of politicians and government agencies to enforce compliance and also by the failure of business entities such as banks to penalize them (through loan rates) for their illegal and unethical behaviour.

The rest of the paper proceeds as follows. In the next sections, we review related literature and theory before developing the hypotheses. We then describe the methodology, present the results and discuss the contributions of the study. We conclude with a note on limitations and suggestions for future research.
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