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Can firms with political connections borrow more than those without? Evidence from firm-level data for Indonesia☆

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ABSTRACT

Using a unique firm-level dataset for the manufacturing sector in Indonesia, we examine how firms' political connections affect their access to finance and performance. We determine individual firm's political connections by identifying whether the government owns shares in the firm, whether politicians are on its board of directors, and whether highly-ranked managers personally know any politician. Although several studies have examined effects of political connections on firms financing and performance, we contribute to the literature by distinguishing between large firms and small and medium enterprises (SMEs), between the loan approval and amount setting processes, and between formal and informal political connections. We find that politically connected firms are more likely to be able to borrow from state-owned banks. Moreover, being connected to the government raises the probability that a firm can receive the full loan amount it applied for. The improvement in access to finance from political connections is more prominent for SMEs than for large firms. Furthermore, such improvement mostly comes from personal connections with politicians rather than more formal connections measured by the government ownership or politicians on the board of directors. Finally, we examine the effect of political connected lending on allocative efficiency of capital and find weak evidence that scarce financial resources are likely channeled by state-owned banks to politically connected but less productive firms.

1. Introduction

How political connections of firms affect their access to finance and performance has been the subject of extensive debate in the literature (see, e.g., Goldman, Rocholl, & So, 2009; Khwaja & Mian, 2005). Firms with political connections tend to receive preferential treatment from state-owned banks and other financial institutions, as shown by studies for China

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(Li, Meng, Wang, & Zhou, 2008), Pakistan (Khwaja & Mian, 2005), and Italy (Sapienza, 2004). Faccio, Masulis, and McConnell (2006), using firm-level data from 35 countries, moreover find that firms involving government officials are more likely to receive financial assistance from the government when they are distressed.

Better access to finance due to political connections may distort financial markets. Bliss and Gul (2012) show that politically connected firms have higher leverage and are perceived by financial markets and audit firms as being of higher risk. However, political connections may help to improve efficiency of financial markets that are distorted by asymmetric information and weak law enforcement. This is particularly the case in less developed countries where these problems are more prominent (Li et al., 2008). Thus, the literature is still unclear about the role of political connections in financial markets.

The aim of the present study is to examine this issue using a firm-level dataset for Indonesia compiled by the authors. Our contribution to the literature is threefold. First, we distinguish between large firms and small and medium enterprises (SMEs) and examine possible differences between the two types of firms. Although some studies found that political connections have a significant impact on the value (Fisman, 2001) and financing patterns of firms (Leuz & Oberholzer-Gee, 2006), these studies focused on a small number of very large listed firms. That is, they ignored SMEs, although SMEs are a key source of employment and economic growth in Indonesia (OECD, 2012). Second, we investigate the impact of political connections on firm financing in both the loan approval and loan amount setting processes. This empirical strategy explicitly resolves the sample selection problem. Finally, a unique feature of our data is that we can identify different types of political connections, distinguishing between formal and informal connections.

We find that politically connected firms in Indonesia receive preferential treatment from banks in two ways: first, such firms are more likely to be able to borrow from state-owned banks, and second, they are more likely to receive the full loan amount they apply for. In addition, while the benefits of political connections in terms of improved access to bank financing are found to be significant for SMEs, this is not the case for larger firms. This finding is consistent with the findings of studies indicating that SMEs benefit more from financial development (Beck, Demirgüç-Kunt, & Maksimovic, 2008; Laeven, 2003; Love, 2003). Finally, we find that informal political connections to the government, which we measure in terms of whether firm managers have personal connections with politicians, play a more important role in improving access to finance than formal connections measured by government ownership and politicians on the board of directors. Finally, our findings indicate lower returns to capital for firms that are politically connected and financed by state-owned banks.

The rest of the paper is organized as follows. Section 2 provides the conceptual framework and hypotheses for estimation, and Section 3 describes data. Section 4 shows results from the estimations. Section 5 discusses the results and then concludes.

2. Conceptual framework

2.1. Political connections and access to credit

There is a considerable body of literature discussing how political connections could affect firm financing in transition and less developed countries.

Because financial constraints are one of the most robust obstacles to firm growth (Ayyagari, Demirguc-Kunt, & Maksimovic, 2008), private firms often rely on political connections for access to finance (Johnson & Mitton, 2003). The role of political connections in financing is more important in less developed countries as asymmetric information is more serious, law enforcement is weak, and state-owned banks are dominant in the financial sector (Li et al., 2008; Shleifer & Vishny, 1993).

Empirical studies mostly support this conjecture. Faccio et al. (2006), for instance, find that politically connected firms are more likely to be bailed out by banks than non-connected firms when facing distress. Similarly, for China, Li et al. (2008) find that being a Communist Party member helps private entrepreneurs to obtain loans from banks and other state institutions. Firth, Lin, Liu, and Wong (2009) also find that political connections play an important role in gaining access to bank finance in China.

In summary, the existing literature shows that political connections distort the availability and costs of bank loans. Based on these considerations, we posit the following benchmark hypothesis to be tested.

Hypothesis 1. Political connections are associated with a higher probability that firms receive credit from banks, and in particular, from state-owned banks.

Although most existing studies focus only on the effect of political connections on whether firms can access bank finance, we go further. Specifically, we examine whether politically connected firms are more likely to be able to borrow as much as they request, conditional on their having already applied and received approval for a loan. For the same reasons given in connection with Hypothesis 1, we would expect a positive effect of political connections on the amount of loan funds provided to firms. Therefore, our next hypothesis is as follows.

Hypothesis 2. Conditional on banks' having approved a loan, political connections are associated with a higher probability that firms receive the amount of credit they seek.