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Political connections and firm performance in non-financial firms listed on Johannesburg stock exchange

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Abstract

This study concerns with how political connections affect firm performance. Extant literature in the subject presented mixed and inconclusive findings. The aim of the study was two fold: to examine the effect of political connections on firm performance and to find out whether or not different types of political connections affect firm performance differently. Fifty (50) firms listed on Johannesburg Stock Exchange (JSE) were used as the sample size of the study based on a study period from 2012 to 2018. A dynamic regression using the GMM estimation technique was used to test the relationship. The results indicate that in general, political connections positively affect firm performance, but not all types of such connections affect firm performance. It was recommended that political connections should be discouraged in non government linked companies because of the instability of such types of connections. Government linked companies on the other hand, should explore other types of political connections in order to enhance performance.

Keywords: political connections, GMM, firm performance, JSE

1. Introduction

There has been an increasing body of literature on the relationship between firms' political connections and their performance. The traditional wisdom is that political connections provides a solid ground for firm performance. A central part supporting this argument is that such connections provide the a firm with many forms of institutional support to access information and resources (Saeed, Belghitar, & Clark, 2014) ^[27]. This includes: accessing government support and contract (Sojli & Tham, 2017; Faccio, Masulis, & McConnell, 2006) ^[30, 12], accessing bank financing and reduced cost of capital (Claessens Feijen, & Laeven, 2008) ^[9], slack tax enforcement and lower tax burden (see, Adhikari, Derashid, & Zhang, 2006) ^[1] and other slack enforcement of regulations (Firth, Rui, & Wu, 2011) ^[13]. If these privileges are effectively used, they could be translate into better firm performance see (Wu, Li, Ying & Chen, 2018) ^[32]. Therefore politically connected firms are strategically positioned for better firm performance as compared to non politically connected firms.

However, the traditional wisdom has been refuted by some researchers who argued that political connections could negatively impact on firm performance. Some of the arguments advanced include; (1) political connections potentially leads oversupply of loan thereby increasing financial burden (Ling, Zhou, Liang Song & Zeng; 2016) ^[19]. (2) Rent seeking and extraction could be the major interest of connected politicians rather than firm value maximization (Shleifer & Vishny 1998) ^[29]. (3) Political interference through appointment of incompetent politicians to run connected firms ultimately affects the performance of such firms, see (Boubakri, Cosset, & Saffar, 2012) ^[3]. Additionally, politically connected firms have the propensity of undertaking risky investments and have poor financial management practices (Hung, Kim, & Li, 2018) ^[16]. They are therefore prone to corporate failures. Such corporate failures could lead to financial losses and loss of jobs thereby having a negative effect on firm performance.

South Africa is one of the leading economies in Africa and has experienced different political crisis in recent years. It has also experienced many corporate scandals in the past decade as reported by (Business insider, South Africa, 2020). It is therefore imperative to understand how political connections affect firm performance in the South African context.

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This is so because there are limited studies in this area that are specific to the South African setting. Past studies on the relationship between political connections and firm performance are mixed and inconclusive. While some found positive relationship, see for instance: (Niessen and Ruenzi, 2009 & Wu, Li, Yin & Chen, 2018) ^[22, 32] others conversely found a negative relationship. See for instance (Chen, Liao, Lin & Yen; 2018 & Ling, *et al.* 2016) ^[32, 19]. There are also studies that found insignificant relationship, see for instance (Sami, Rahnavard & Tabar (2019) ^[28]. It is noteworthy to say that, there are different studies having different definitions for both political connections and firm performance, there are also differences in political systems and types of political connections across the globe. Moreover, market developments differ from one country to another. Hence, findings on political connections-firm performance nexus from a particular country may not be applicable to another. Even though there are many studies on political connections and firm performance nexus, this study however, differs from previous studies in particular ways: (1) while most past studies consider political connections through both past and incumbent politicians, this study only defines one as a politician if and only if he or she holds a high political office in south Africa during the period of the study. (2) The study employed dynamic approach using the GMM estimation technique which was seldomly used by past studies. (3) It also outlined three different types of political connections namely: connections through directors, connections through large shareholders and connections through government linked companies (GLCs). This classification differs from most past studies that have more or less types of connections or in some cases no specific types.

Therefore, the mixed empirical evidences and the possible explanations highlighted above provide a conundrum, which requires further investigation. With this situation one may ask the following questions. Firstly, what will be the effect of political connections on firm performance of firms listed on Johannesburg Stock Exchange (JSE)? Secondly, do different types of political connections have same effect on performance of firms listed on JSE? To answer these questions, two objectives were proposed (1) To examine the effect of political connections on firm performance of firms listed on JSE and (2) to ascertain whether or not different types of political connections affect firm performance differently.

In order to achieve these objectives, I structured the paper as follows. The first section is the introductory part of the paper, the second section deals with literature review covering the underpinning theory and review of empirical studies. The third sections deals with the methodology. The fourth section covers the GMM estimation results and discussion. Finally, the fifth section deals with conclusion

2. Theoretical background and empirical review

2.1 Theoretical background

Based on Resource Dependency Theory (RDT) propounded by Pfeffer and Salancik (1978) ^[24]. RDT is concerned with organizational behaviour, which is affected by need for external resources they utilize. It follows that, in the bid to get competitive advantage over others, firms have to apply different strategies to get access to scarce resource it utilizes. Government is the main source of external resources (Wu, Li, Ying & Chen, 2018) ^[32] especially in

emerging like economies where weak market laws exist (Kuo & Yu, 2017) ^[17].

Consequently, firms go into political connections in order to have access to these vital and scarce resources. These connections help the firms to manage uncertainties and interdependence.

2.2 Review of empirical studies

Studies abound that found a positive relationship between political connections and firm performance. Niessen and Ruenzi (2009) ^[22] investigated the politically connected firms in Germany for the period 2006-2007. They tested among other things the effect of firms' political connections to members German parliament and their performance as compared to their non connected counterparts. Their findings revealed that politically connected firms have slightly better accounting performance and significantly higher market performance than non connected firms. The study however, majors on political connections through members of parliament without taking into consideration other types of political connections.

Prior to this, a study was carried out by Li, Meng, Wang and Zhou (2008) ^[18], their study examined how affiliation to Chinese Communist Party (CCP) influences the business operations of private enterprises in China. Using a survey research design, they found after controlling for human capital and other appropriate variables that CCP membership has a positive effect on firm performance of private enterprises in China. This study also only considered one type of political connections that is, CCP membership.

Recently, a study was conducted by Wong and Hooy (2018) ^[31] in Malaysia, their aim was to find out whether or not different types of political connections affect firm performance differently. After considering four types of political connections, they found that overall, political connections affect firm performance positively, however, there are differences in the way and manner the different types of connections affect performance. They document that a positive relationship exist between political connection through government linked companies (GLCs) and through directors with firm performance, but no such relationship exist if such connections are through businessmen and family members. They argue that connections through GLCs and politicians and board members are more stable than connections through businessmen and family members. One of the issues in this study is that the researchers did not consider a possible dynamic relationship.

Another interesting study was conducted by Ling, Zhou, Liang, Song, & Zeng (2016) ^[19]. They used a sample of 103 listed real estate firms in China, for the period 1998- 2012. They categorized the political connections based on Chinese hierarchical rank system (seven political ranks). This categorization was for firms' board members and Chief Executive officers CEOs. Their results indicated a negative relationship between political connections and Return on Assets (ROA). They argue that undertaking political connections could be a risky investment. They further pointed out that stronger political connections are financed with more long term bank loan and more likely to over invest.

Similarly, Omonona & Oni (2019) ^[23] examined the relationship between political affiliations and performance of firms in South African mobile telecommunication industry. They conducted a survey on population drawn

from selected mobile telecommunication organization and their result indicated that political connections affects both performance and non performance of mobile telecommunication firms. They therefore suggested a reduction in frequent cabinet reshuffle while ensuring political integration and government stability.

Table 1 below gives a summary of empirical studies on political connections and firm performance. The table indicates the authors, country of research, period of research, measurements of main variables of interest, method and results.

Table 1: Selected empirical studies on political connections and firm performance relationship

S/N	Author(s)	Country	Period	Variables		Method	Results
				Political Connections	Firm Performance.		
1	Saeed, Belghitar and Clark (2016)	Pakistan	2002-2010	Connections through Directors	ROA and ROE, Tobins'q	FE, Heckman 2stage regression, GMM	+
2	Wu, Wu Zhou & Wu (2012)	China	1999-2007	Connections through Managers	Tobins'q	OLS and Heckman regression	Private PC out perform SOEs
3	Li, Meng, Wang & Zhou (2008) ^[18]	China	2002	Party membership of entrepreneurs	ROA & ROE	OLS	+
4	Zhang, Li, Zhou & Zhou (2013)	China	2007-2010	Government background of firms' executives	ROA	Regression analysis	+
5	Chen, Liao, Lin & Yen (2018) ^[32]	Multi country	2004- 2006, 2007-2009	Politically connected CEO'S	ROA, ROE	Panel data model	-
6	Hung, Jiang, Liu, Tu, & Wang (2017) ^[15]	China	2007-2014	CEO'S with former government experience	ROA	Panel data model	+
7	Chung, Byun, & Young (2019) ^[8]	South Korea	1998-2013	Previous or serving politician or public servant as a director or top officer	ROA & Tobins'q	Fixed effect	+
8	Muttakin, Monem, Khana, & Subramaniam (2015) ^[21]	Bangladesh	2005-2009	Connected family firms	ROA & Tobins'q	OLS	+
9	Niessen & Ruenzi (2009) ^[22]	Germany	2006-2007	Connections through delegates	ROA, ROI, P/E ratio & Tobins'q	Panel data model	+
10	Wong & Hooy (2018) ^[31]	Malaysia	2002-2016	Four types of political connections	ROA & Tobins'q	Panel data model	+, 0
11	Wu, Li, Ying & Chen (2018) ^[32]	China	2005-2012	Connected firm executives (CEOs)	ROA	Pooled cross sectional regression	+
12	Cao, Lemmon, Pan, Qian, & Tian (2018) ^[6]	China	2005-2011	CEOs of SOEs	ROA & ROE, Tobins'q	Logistic regression and 2SLS regression	+
13	Ling, Zhou, Liang, Song, & Zeng	China	1998-2012	Seven political ranks	Tobins'q & ROA	FE	-
14	Sami, Rahnavard & Tabar (2019) ^[28]	Iran	2015	Political ties	Balance scorecard	Applied research and descriptive survey	0
15	Maaloul, Chakroun, & Yahyoui (2018) ^[20]	Tunisia	2012-2014	Connections through firms' officers and directors	Tobins'q & ROA	2SLS regression and OLS	+
16	Amonoma & Oni (2019)	South Africa		Senior and management staff response		Survey research design	+

Source: Author's compilation, 2020

NB: ROA = return on assets, ROE = return on equity, ROI = return on investment, P/E ratio = price/earning ratio, FE = fixed effect, SOEs = state owned enterprises, GMM = generalized method of moments, OLS = ordinary least square, PC = political connections, 2SLS regression = two stage least square regression

3. Methodology

3.1 Data and variable

As earlier stated, the objectives of this study were twofold, firstly is to examine the relationship between political connections and firm performance and secondly, to find out if the relationship differ with differences in types of political connections. All variables in this paper were selected based on previous studies on political connections and firm performance, see for instance: tobins'q: (Chung *et al.*, 2019; Saeed, *et al.*, 2018; and Muttakin *et al.*, 2015)^[8, 21]. Firm size, see (Wu, *et al.*, 2018; Guo, Li, & Zhong, 2019)^[32, 14] and board independence: (Gou, Li and Zhong 2019; and Maaloul *et al.*, 2018)^[14, 20]. The study used a sample of 50 non financial services companies listed on (JSE). The sample of 50 firms was select based on availability of complete data. The study period was from 2012 to 2018.

The data on the dependent variable tobins'q was retrieved from data stream and was calculated as follows market value by company divided by common shareholders' equity. I extracted the data on political connections from the firms' annual reports and list of members of parliaments downloaded from the website of the parliament of the republic of south Africa. A company is said to be politically

connected if any of its directors or large share holders (having at least 10% voting right) is a member of parliament, minister or prime minister of the republic of South Africa or a close relative (parent, child, sibling and spouse) of a member of parliament, minister, or prime minister or the company has a link to the government which has at least a 10% voting right through any of its agencies.

The data on political connections were painstakingly extracted from the two sources and, where it was difficult to establish the certainty of political connections, a general search on the internet was conducted to avoid errors. A combination of all these political connections was used to estimate the model for the first objective. From this also can be seen, three different types of political connections namely: connection through board of directors, connection through large share holders (owners) and connection through GLCs. The three types of connections were used to examine their individual effect on firm performance. Firm size and board independence were used as control variables calculated as natural log of total assets and percentage of independent directors based on the total number of directors respectively.

Table 2: Descriptive statistics

S/N	Variable	Measurement	Mean	Std. Dev.	Min	Max	Obs
1	Tobins'Q	Market value by company/common share holders' equity	0.003	0.003	0.000	.020	350
2	LTobins'Q	Lag of tobins'q	0.003	0.003	0.000	.020	300
3	PCDirectors	Connections through directors	0.123	0.329	0	1	350
4	PCowners	Connection through large shareholders	0.066	0.248	0	1	350
5	NonPCglcs	3 and 4	0.180	0.399	0	1	350
6	PCglcs	Government linked companies	0.446	0.498	0	1	350
7	PConnections	5 and 6	0.554	0.499	0	1	350
8	Bindependence	Percentage of independent directors	0.543	0.205	0	1	350
9	Lnfsiz	Ln of Total assets	16.548	1.286	12.297	219.851	350

Table 2 shows the descriptive statistics of all main variables and how they were measured. The average, standard deviation, minimum, maximum and number of observations are also displayed. The table revealed that there was an average increase in firm performance proxy of Tobins'Q by 0.3 percent during the period of the study. This shows an overall law performance with least performing firms gaining almost nothing and performing firms increasing performance by 2 percent. Average political connections through directors and large shareholders increased over the period by 12 percent and 6.6 percent respectively, while that of government linked companies increase 44.6 percent. Overall, political connections increased by 55.6 percent. Average board independence increased by 54.3 percent while the natural log of total assets increased by 1654 percent.

3.2 Method of estimation

Based on past studies, two most common proxies used for firm performance are Tobins'Q and ROA. These variables have been selected based on theory and empirical findings of past studies. However, based on the data obtained from data-stream, there were some missing observations for ROA hence Tobins'Q only was use. It is note worthy to state that, this section presents the estimation procedure of the study. In line with previous literature and to control for the problems of possible endogeneity, auto-correlation and heteroskedasticity that may occur in a dynamic panel regression, I adopted the Generalized Method of Moments (GMM) estimation technique proposed by Arellano and Bond (1991) [2] and Roodman (2009) [26]. A problem of possible endogeneity occurs where lagged dependent variable is added in a regression model see for instance (Danjuma and Nadiyasu, 2020) [10]. It is therefore believed that the OLS, Random Effect and Fixed effect models are unable to take care of simultaneity and endogeneity bias, as revealed by (Arellano and Bond, 1991) [2]. Hence the following dynamic model was proposed.

$$\pi_{it} = \beta_0 + \beta_1 \text{tobins}Q_{it-1} + \beta_2 \pi_{it-1} + \sum \beta_3 X_{it} + y + d_t + \varepsilon_{it}$$

(1)

Where; π_{it} represents tobins'Q (proxy of firm performance), $\text{tobins}Q_{it-1}$ represents tobins'Q of past year, π_{it-1} represents previously accumulated performance. X_{it} is the vector of the control variables (board independence and firm size (natural log of total assets)). \mathcal{Y} represents the the firms' characteristics that are time invariant and not observable, but controllable with the explanatory variable. d_t represents the year dummy that controls the time effect. ε_{it} represents the error term which changes based on time and firm, while, β_1 and β_2 represent regression coefficient showing the persistence of performance and regression coefficient explaining the past political connections on current political connections.

As stated earlier, when the lag of the dependent variable has been included in the regression as seen in the equation above, the problem of endogeneity occurs. Previous studies used the GMM estimation technique to solve the this problem. This study therefore adopts the GMM techniques to test the hypotheses on (1) the effect of political connections on firm performance. (2) The variation in the relationship in (1) where exists different types of political connections.

4. Estimation result

The correlation matrix in table 3 shows no problem of multicollinearity among the variables of interest. Because the few coefficient above are 0.5 are those that contain some elements of the corresponding variable in them and will not be regressed together except for the lagged dependent variable. While the correlation matrix shows a positive association between overall political connections and political connections through GLCs with firm performance, it also revealed a negative association between others namely: board independence, firm size and other types of political connections. Apart from lagged dependent variable, the strongest correlation with firm performance is the connection through the GLCs (0.2138) while the weakest connection through directors (-0.1739).

Table 3: Correlation matrix

	Tobinsq	Ltobinsq	Pcdir.	Pcown.	Nonpcglcs	Pcglcs	Pconnections	Bindependence	Lnfsiz
Tobinsq	1.0000								
Ltobinsq	0.8598	1.0000							
Pcdir	-0.1739	-0.1823	1.0000						
Pcown	0.0229	0.0365	0.0764	1.0000					
Nonglcs	-0.1319	-0.1308	0.8132	0.6032	1.0000				
Pcglcs	0.2138	0.1377	-0.0204	-0.0522	-0.0732	1.0000			
Pconnections	0.1345	0.0563	0.3356	0.2378	0.4048	0.8041	1.0000		
Bindependence	-0.0554	-0.0559	0.0256	-0.0175	-0.0209	0.1425	0.0495	1.0000	
Lnfsiz	-0.1639	-0.1406	0.1414	-0.0704	0.0694	0.0044	0.0402	0.1301	1.0000

From the estimation result in table 4, the level instrument are valid since the number of instruments are less than the number of groups in each of the models hence, no problem of too many instruments see (Roodman, 2009) [26]. Also the Hansen statistics showed insignificant p-values in all the models which means valid over-identifying restrictions of all instruments. Furthermore, time dummy variables have been introduced in order to control for cross-sectional dependency and avoid time varying shocks in the model.

This was used by previous researchers like: (Danjuma *et al.*, 2020 & Ding, Li and Wu, 2018) [10, 30]. Finally, the second order auto-correlation result of Arellano and Bond are within the acceptance level. This indicates no auto-correlation problem. Therefore, since all instruments and the model specification must be valid to fulfil the requirements of the GMM estimation technique, I argue that the employment of GMM technique in this study was also in place.

Table 4: The effect of political connections on firm performance using one step system GMM estimation

Variables	(1)	(2)	(3)	(4)	(5)
	Tobins'q	Tobins'q	Tobins'q	Tobins'q	Tobins'q
L tobins'q	0.822*** (0.0870)	0.842*** (0.0866)	0.830*** (0.0872)	0.837*** (0.0871)	0.815*** (0.0881)
P connections	0.000321** (0.000157)				
P cdir		-6.61e-05 (0.000261)			
Pcown			-9.49e-05 (0.000306)		
Nonglcs				-0.000107 (0.000212)	
Pcglcs					0.000346* (0.000182)
B independence	0.000342 (0.000473)	0.000377 (0.000498)	0.000397 (0.000503)	0.000391 (0.000502)	0.000261 (0.000467)
Lfnsize	-0.000234* (0.000122)	-0.000224* (0.000112)	-0.000231* (0.000119)	-0.000225* (0.000115)	-0.000231* (0.000121)
Constant	0 (0)	0 (0)	0 (0)	0 (0)	0 (0)
No. of instruments	28	29	29	29	29
Observations	300	300	300	300	300
No. groups	50	50	50	50	50
Year dummy	yes	yes	yes	yes	yes
Hansen stat.	0.123	0.123	0.127	0.233	0.119
AR(1)	0.002	0.003	0.003	0.003	0.003
AR(2)	0.119	0.256	0.246	0.128	0.125

Robust standard errors in parentheses*** $p < 0.01$, ** $p < 0.05$, * $p < 0.1$

Table 4 above presents five different models with robust standard errors. The first model is the general model consisting of the three different types of political connections used in this study. From this general model, it revealed that the coefficient of past performance is positive at 1 percent level of significance. This means that higher performance achieved the previous year led to higher performance in the current year. It suggests that a firm's ability to achieve higher performance in the future potentially depends on its ability to positively perform in the current year. The result also shows that a unit increase in current year's firm performance might lead to 0.82 unit increase in future performance. The significance level remains almost the same regardless of the differences in political connections.

Furthermore, the general model indicates that the coefficient of all the three types of political connections combined together is positively significant at 5 percent. Meaning that political connections significantly increases firm performance. This findings agrees with that of Wong and Hooy (2018) [31] who found that political connections (through directors, GLCs, business men, family ownership) jointly have positive effect on firm performance. This however contradicts the findings of Chen, *et al.* (2018) [14]. Who found a negative relationship between politically

connected CEOs and firm performance. While this is clear, it is also clear that not all the types of political connections affect firm performance in the same way. Columns (2), (3) and (4) representing political connections through directors, large shareholders and a combination of both (political connections through director and large shareholders) respectively revealed that these two types of political connections whether individually or combined have negative, but statistically insignificant relationship with firm performance. However, column (5) which presents the result of government linked companies, shows that at 10 percent significant level, GLC type of connection has a positive effect on firm performance. This also concurs with the findings of Wong and Hooy (2018) [31] who found that GLCs significantly increases firm performance. This is true because GLCs have a more stable connections because of the presence of government ownership than other types of political connections. While political connections through shareholders and directors may not be stable because of changes in governments, it is however not always so with GLCs because the government shareholdings belong to the government not individuals. Politicians come and go, but the government remains, hence, it is not a surprise to see that only connections through the GLCs shows a significant positive effect on firm performance.

Another interesting finding of the study shows that combining all the types of political connections gives a more significance level of 5 percent as opposed to that of political connection through GLCs alone which is only significant at 10 percent. It could therefore be argued that while GLCs positively affect firm performance, the effect becomes more significant with other types of political connections in place, but political connections through large shareholders and directors individually or both do not have any significant relationship with firm performance in the South African context. Lastly, the results also revealed a negative effect of firm size on firm performance at 10% significance level.

5. Conclusion

This study examines the relationship between political connections and firm performance using a firm-level panel data of 50 firms listed on JSE, with major attention given to dynamic relationship and types of political connections. The findings revealed that political connections have positive effect on firm performance, but such effect differs with type of political connections. Therefore political connections should be discouraged in private companies except for government linked companies which are encouraged to have more types of political connections for better performance.

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