

POLITICKING BEHAVIOUR OF INDIAN FIRMS

Wasim Ahmad and Rishman Jot Kaur Chahal

Department of Economic Sciences
Indian Institute of Technology Kanpur

8TH EMERGING MARKETS FINANCE CONFERENCE, 2017

TABLE OF CONTENTS

- 1 Introduction
 - Why India?
- 2 Identification of Political Connections
- 3 Literature and Hypotheses Construction
- 4 Data and Variable Construction
 - Connection Attributes
- 5 Methodology
- 6 Regression Analysis
- 7 Results and Discussion
 - Large-cap Firms
 - Mid-cap Firms
 - Small-cap Firm
- 8 Summary
- 9 References

- The connection between business and politics has always been a fertile research terrain in Economics.
- Since 1980s researchers have examined this topic in the light of favoritism, corruption, access to credit etc. for a large number of economies including emerging ones.
- To India, the examination of business-politics nexus is important as it is one of the most diversified economies under the emerging market setting.

INTRODUCTION

WHY INDIA?

- The 2017 Index of Economic Freedom ranks India at 143rd position, implying lack of economic and business freedom in the world's largest democracy as compared to various other emerging economies.

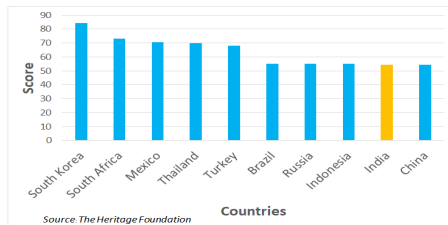


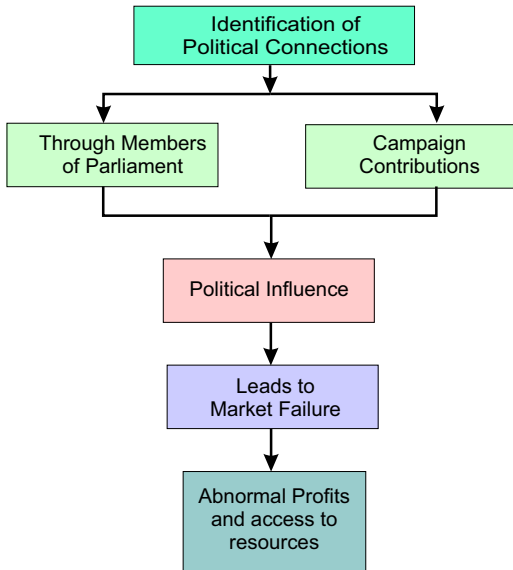
Figure: Business Freedom Score (Median)

- Additionally, India is currently passing through the phase of **Twin-Balance Sheet** syndrome.
- The exorbitant lending to public and private sectors in mid-2000s has opened a flood gate for possible cases of favorable lending or access to credit for politically connected firms (PCFs)¹.
- Thus, understanding the relative significance of political connections in Indian markets is important for deriving possible policy responses and reforms.

¹Source: Economic Survey 2016-17: Chapter-04 *The Festering Twin Balance Sheet Problem*, GOI.

- In the literature, PCFs have been defined by researchers in numerous ways.
- **Faccio** (2006), **Faccio** (2010), **Boubakri et al.**(2012), defined a firm to be politically connected if at least one of its large shareholders (anyone controlling at least 10 percent of voting shares) or one of its top officers (CEO, president, vice-president, chairman, or secretary) is a member of parliament, a minister, or is closely related to a top politician or party.
- **Johnson and Mitton** (2003), **Khwaja and Mian** (2005), **Cingano and Pinotti** (2013), too followed a similar line of definition to look at the impact of political connections on firms' performance in Malaysia, Pakistan and Italy respectively.

- **Cooper et al. (2010), Aggarwal et al. (2012)** define a firm to be politically connected when it is involved in political funding.
- For this study, we consider both the attributes to identify whether a firm is politically connected or not.
- Specifically, a firm is said to be politically connected if **at least once one of its top officer (CEO, Director, Chairperson, Secretary) or large shareholder is or was a Member of Parliament (MPs) or the firm (or Corporate Group's subsidiary) contributes at least once to any of the national political party.**



- **Khwaja and Mian**(2005), investigate higher borrowing and default rate by PCFs, especially in case of public banks.
- **Leuz and Oberholzer-Gee**(2006), find that firms connected to Suharto (President of Indonesia) have easy credit access.
- **Blau et al.** (2013), in their study examines the political connections of banks during 2008 Troubled Asset Relief Program (TARP) for US economy. PCFs were not only more likely to receive TARP but also received a higher amount.

- Thus, soft budget and easy access to credit lead to the following hypothesis:
- **Hypothesis 1:** Politically connected firms are highly leveraged owing to their preferential treatment over non-connected peers.

- **Faccio**(2010) emphasized over the tax benefits enjoyed by PCFs.
- A lower or insignificant change in tax payments with high profitability might indicate some sought of political influence.
- However, the results are sensitive to certain limitations.
- **Hypothesis 2:** Politically connected firms pay lower taxes compared to their non-connected peers, though their profits remains high which indicates the tax benefits.

- **Johnson and Mitton** (2003), find Malaysian capital controls as adopted by their government, provided a screen behind which favored firms were supported.
- **Mobarak and Purbasari** (2006) for Indonesia; **Li et al.** (2008) and **Su and Fung** (2013) for China find positive affect of political connections on firm's profitability.
- **Hypothesis 3:** The performance or profitability of politically connected firms is different from their non-connected counterparts which could also differ with the strength of connection.
- However, some studies contrast to these results.

- **Li et al.** (2008) for China; **Yeh et al.** (2013) for Taiwan examine preferential long term bank loans to PCFs.
- **Faccio et al.** (2006) and **Cheng and Leung** (2016) find that PCFs are rebound from financial distress more quickly as compared to NPCFs. With this implicit assumption these firms prefer long term loans.
- **Hypothesis 4:** Politically connected firms have greater access to credit with a higher emphasis on long-term debt as compared to their non-connected peers.

- For Financial indicators, the study used Centre for Monitoring Indian Economy (CMIE) Prowess IQ and DataStream Database.
- For indicators regarding Political Connections:
 - Campaign Contributions: Election Commission of India and Association for Democratic Reforms (ADR).
 - Members of Parliament: Parliament of India website².
- Sample set for Firms: BSE500 companies
- Sample set for National Political Parties: Indian National Congress (INC) and Bhartiya Janta Party (BJP).
- Time Period: 2002-03 to 2015-16.

²<http://parliamentofindia.nic.in/>

- Variable Construction:

- To measure the extent of amelioration in the performance of PCFs, the study includes following variables:
 - **Leverage**: Total debt as a percentage of total capital.
 - **Taxation(Tax)**: Total tax per unit of total income.
 - **Profitability**: Measured by return on assets (ROA) and profit after tax (PAT).
 - **Access to credit**: Measured by short-term debt and long term debt.

- For Political Connections:

- **CONN** measures a firm to be politically connected if at least once one of its top officer (CEO, Director, Chairperson, Secretary) or large shareholder is or was a Member of Parliament (MP) or the firm contributes at least once to any of the national political party.

- **CONMP** measures a firm to be politically connected if at least one of its senior officers is or was a MP.
- **CONCONTRI** measures a firm to be politically connected if at least once the firm, or any of the group's subsidiary contributed to a national political party.
 - Funding to a single national party is weakly connected (**CONTRI1**).
 - Funding to more than one national party is strongly connected (**CONTRI2**).

DATA AND VARIABLE CONSTRUCTION

CONNECTION ATTRIBUTES

Table 1: Connected firms according to different connection attributes

	Total Obs.	Members of Parliament				Contributions to the National Political Parties					
		CONN		CONMP		CONCONTRI		CONTRI1		CONTRI2	
		Obs.	%	Obs.	%	Obs.	%	Obs.	%	Obs.	%
All Firms	419	124	29.59	20	4.77	110	26.25	51	12.17	59	14.08
Large-Cap	58	26	10.32	2	0.79	25	9.92	6	2.38	19	7.54
Mid-Cap	68	24	9.52	7	2.78	19	7.54	4	1.59	15	5.95
Small-Cap	126	30	11.9	7	2.78	24	10.32	19	7.54	7	2.78

Notes: Total Obs. are the firms registered in the Bombay Stock Exchange (BSE500), excluding financial and banking firms. Data for Large-Cap, Mid-Cap and Small-Cap firms is taken from CMIE database and only those firms are included which are listed in BSE. Thus, their sum is not equal to total observations of the sample. CONN stands for political connections based on the definition provided in the study. For different types of connections, CONMP stands for political connections build through MPs and CONCONTRI stands for firms contributing to any one of the national party at least once. To showcase the effect of the strength of connections we use CONTRI1 and CONTRI2 where CONTRI1 refers to firms contributing to a single party and CONTRI2 stands for firms contributing to both the political parties.

- To estimate the difference in performance of PCFs and NPCFs, the following panel data model is used in the study:

$$\begin{aligned}
 Y_{it} = & \alpha + \beta_1 CONN_i + \beta_2 Firm\ Attributes_{it} + \beta_3 Country\ Control_t \\
 & + \sum_{i=2}^N \gamma_i E_i + \sum_{t=2}^T \delta_t Time_t + \epsilon_{it}
 \end{aligned}
 \tag{1}$$

where

i = firms, t = years,

Y = Various Performance Indicators,

$CONN$ = Binary variable for various Political Connections,

$Firm\ Attributes$ = Total Production, Operating Expenses,
State-Owned dummy variable,

$Country\ Control$ = Gross Fixed Capital Formation (constant LCU)

E = Binary variable for entity fixed effects,

Table: General definition of Political Connection

	Model 1	Model 2	Model 3		Model 4	
Dependent Variable	Leverage	Tax	ROA	Profit	Short term debt	Long term debt
CONN	3.012*** (1.027)	0.975** (0.406)	0.706 (0.624)	0.868 (0.788)	2.485* (1.462)	-0.720 (1.327)
State	-3.169*** (0.651)	-0.122 (0.246)	-0.347 (0.396)	1.494*** (0.502)	2.830*** (0.941)	4.638*** (0.987)
<i>Firm Attributes</i>						
Total Cap	-0.0172 (0.0343)	0.00863 (0.0130)	0.0447** (0.0217)	0.305*** (0.0347)	-0.0454 (0.0498)	-0.116*** (0.0434)
Labour	0.145** (0.0654)	-0.0174 (0.0232)	0.0466 (0.0403)	-0.205*** (0.0467)	0.320*** (0.0952)	0.305*** (0.0829)
Operating Exp	-0.00247 (0.0386)	-0.0181 (0.0142)	0.0563** (0.0242)	-0.0788*** (0.0281)	-0.000618 (0.0553)	-0.00987 (0.0490)
<i>Country Control</i>						
GFCF	-0.496*** (0.124)	-0.118*** (0.0428)	-0.152** (0.0735)	-1.311*** (0.0778)	1.296*** (0.179)	0.831*** (0.159)
Constant	15.30*** (3.703)	5.957*** (1.275)	5.908*** (2.188)	46.57*** (2.339)	-30.46*** (5.341)	-16.07*** (4.757)
Firm dummies	Yes	Yes	Yes	Yes	Yes	Yes
Year dummies	Yes	Yes	Yes	Yes	Yes	Yes
Observations	2,215	2,589	2,293	2,432	2,130	2,062
R-squared	0.706	0.818	0.542	0.875	0.779	0.838

Standard errors in parentheses

*** p<0.01, ** p<0.05, * p<0.1

Table: Connection through MPs

	Model 1	Model 2	Model 3		Model 4	
Dependent Variables	Leverage	Tax	ROA	PAT	Short term debt	Long term debt
CONMP	3.012*** (1.027)	-1.344*** (0.399)	0.466 (0.617)	2.145*** (0.777)	2.485* (1.462)	3.434** (1.419)
State	3.306*** (0.758)	-0.176 (0.296)	-0.347 (0.396)	1.494*** (0.502)	2.830*** (0.941)	1.742 (1.301)
<i>Firm attributes</i>						
Total Cap	-0.0172 (0.0343)	0.00863 (0.0130)	0.0447** (0.0217)	0.305*** (0.0347)	-0.0454 (0.0498)	-0.116*** (0.0434)
Labour	0.145** (0.0654)	-0.0174 (0.0232)	0.0466 (0.0403)	-0.205*** (0.0467)	0.320*** (0.0952)	0.305*** (0.0829)
Operating Exp	-0.00247	-0.0181	0.0563**	-0.0788***	-0.000618	-0.00987
<i>Country Control</i>						
GFCF	-0.496*** (0.124)	-0.118*** (0.0428)	-0.152** (0.0735)	-1.311*** (0.0778)	1.296*** (0.179)	0.831*** (0.159)
Constant	15.30*** (3.703)	5.957*** (1.275)	5.908*** (2.188)	46.57*** (2.339)	-30.46*** (5.341)	-16.07*** (4.757)
Firm dummies	Yes	Yes	Yes	Yes	Yes	Yes
Year dummies	Yes	Yes	Yes	Yes	Yes	Yes
Observations	2,215	2,589	2,293	2,432	2,130	2,062
R-squared	0.706	0.818	0.542	0.875	0.779	0.838

Standard errors in parentheses
 *** p<0.01, ** p<0.05, * p<0.1

Table: Connection through Contributions

	Model 1	Model 2	Model 3		Model 4	
Dependent Variables	Leverage	Tax	ROA	PAT	Short term debt	Long term debt
CONCONTRI	0.553 (1.038)	0.975** (0.406)	0.466 (0.617)	0.868 (0.788)	2.485* (1.462)	3.903*** (1.316)
State	-3.169*** (0.651)	-0.122 (0.246)	-0.347 (0.396)	1.494*** (0.502)	2.830*** (0.941)	4.638*** (0.987)
<i>Firm Attributes</i>						
Total Cap	-0.0172 (0.0343)	0.00863 (0.0130)	0.0447** (0.0217)	0.305*** (0.0347)	-0.0454 (0.0498)	-0.116*** (0.0434)
Labour	0.145** (0.0654)	-0.0174 (0.0232)	0.0466 (0.0403)	-0.205*** (0.0467)	0.320*** (0.0952)	0.305*** (0.0829)
Operating Exp	-0.00247 (0.0386)	-0.0181 (0.0142)	0.0563** (0.0242)	-0.0788*** (0.0281)	-0.000618 (0.0553)	-0.00987 (0.0490)
<i>Country Control</i>						
GFCF	-0.496*** (0.124)	-0.118*** (0.0428)	-0.152** (0.0735)	-1.311*** (0.0778)	1.296*** (0.179)	0.831*** (0.159)
Constant	15.30*** (3.703)	5.957*** (1.275)	5.908*** (2.188)	46.57*** (2.339)	-30.46*** (5.341)	-16.07*** (4.757)
Firm dummies	Yes	Yes	Yes	Yes	Yes	Yes
Year dummies	Yes	Yes	Yes	Yes	Yes	Yes
Obs.	2,215	2,589	2,293	2,432	2,130	2,062
R-Squared	0.706	0.818	0.542	0.875	0.779	0.838
Standard errors in parentheses						
*** p<0.01, ** p<0.05, * p<0.1						

Table: Contributions to Single vs Both the Parties

	Model 1	Model 2	Model 3		Model 4	
Dependent Variables	Leverage	Tax	ROA	PAT	Short term debt	Long term debt
CONTRI1	3.012*** (1.027)	0.336 (0.402)	0.466 (0.617)	2.145*** (0.777)	-3.986*** (1.477)	5.613*** (1.314)
CONTRI2	2.846*** (1.018)	0.296 (0.399)	-0.170 (0.619)	1.855** (0.780)	3.172** (1.466)	3.903*** (1.316)
State	-3.169*** (0.651)	-0.122 (0.246)	-0.347 (0.396)	1.494*** (0.502)	2.830*** (0.941)	4.638*** (0.987)
<i>Firm Attributes</i>						
Total Cap	-0.0172 (0.0343)	0.00863 (0.0130)	0.0447** (0.0217)	0.305*** (0.0347)	-0.0454 (0.0498)	-0.116*** (0.0434)
Labour	0.145** (0.0654)	-0.0174 (0.0232)	0.0466 (0.0403)	-0.205*** (0.0467)	0.320*** (0.0952)	0.305*** (0.0829)
Operating Exp	-0.00247 (0.0386)	-0.0181 (0.0142)	0.0563** (0.0242)	-0.0788*** (0.0281)	-0.000618 (0.0553)	-0.00987 (0.0490)
<i>Country Control</i>						
GFCF	-0.496*** (0.124)	-0.118*** (0.0428)	-0.152** (0.0735)	-1.311*** (0.0778)	1.296*** (0.179)	0.831*** (0.159)
Constant	15.30*** (3.703)	5.957*** (1.275)	5.908*** (2.188)	46.57*** (2.339)	-30.46*** (5.341)	-16.07*** (4.757)
Firm dummies	Yes	Yes	Yes	Yes	Yes	Yes
Year dummies	Yes	Yes	Yes	Yes	Yes	Yes
Obs.	2,215	2,589	2,293	2,432	2,130	2,062
R-Squared	0.706	0.818	0.542	0.875	0.779	0.838

Standard errors in parentheses

*** p<0.01, ** p<0.05, * p<0.1

- Regression analysis suggest that political connections are opportune to business activities in a developing economy like India.
- A broader definition for political connections indicate weaker results as compared to a precise definition.
- Overall, PCFs confirm higher leverage and greater credit access.
- However, profitability and taxation results remain mixed and differs with the channel of forming connection.
- Political Connections through different channels provide benefits to the firms which differ with the firm size and strength of connection.

RESULTS AND DISCUSSION

LARGE-CAP FIRMS

- For Large-cap firms, the results remain robust and complement CONMP, CONCONTRI, CONTRI1 and CONTRI2 at overall level.
- However, there is no evidence of connection-strength effect in case of PCLFs.

- With the ill-functioning and weak market institutions of developing economies, Mid-cap firms have an incentive to build connections to extract larger benefits.
- PCMFs indicate high profitability with low credit dependence which shows their substantial efficiency over PCLFs.
- CONMP does not show any significant affect for PCMFs but results remain robust for CONCONTRI.
- Presence of connection-strength effect in case of PCMFs.

- Results for CONMP remain weak in case of PCSFs with no significant affect on their profitability but favourable credit access.
- However, there is a presence of connection-strength effect in case of PCSFs.
- Results at aggregate level are not influenced by the composition of the sample.

Summary

- This study analyses the effect of different channels of forming political connections for the decentralized structure of Indian economy.
- Political connections have a positive effect on firms profitability and credit access which varies with the strength of connection.
- The connection-strength effect differs with the firm's size.
- Outlook:
 - Main limitation of the study is Data. The study tried to reduce the Type I error due to data constraint for political contributions.
 - Type I: There might be firms who contribute to both the parties, but from known sources they seem to be contributing a single party or firms who always contribute from unknown sources.

References I

-  Aggarwal, R. K., Meschke, F., & Wang, T. Y. (2012). Corporate political donations: Investment or agency. *Business and Politics*, 14(1), 3.
-  Boubakri, N., Cosset, J. C., & Saffar, W. (2012). The Impact Of Political Connections On Firms' Operating Performance And Financing Decisions. *Journal of Financial Research*, 35(3), 397-423.
-  Blau, B. M. and Brough, T. J. and Thomas, D. W. (2013). Corporate lobbying, political connections, and the bailout of banks. *Journal of Banking & Finance*, 37(8), 3007–3017.
-  Cooper, M. J., Gulen, H., & Ovtchinnikov, A. V. (2010). Corporate political contributions and stock returns. *The Journal of Finance*, 65(2), 687-724.

References II

-  Cingano, F. & Pinotti, P. (2013). Politicians at work: The private returns and social costs of political connections. *Journal of the European Economic Association*, 11(2), 433–465.
-  Cheng, L. T., & Leung, T. Y. (2016). Government protection, political connection and management turnover in China. *International Review of Economics & Finance*, 45, 160-176.
-  Fisman, R. (2001). Estimating the value of political connections, *The American Economic Review*, 91(4), 1095–1102.
-  Faccio, M. (2006). Politically connected firms. *The American Economic Review*, 96(1), 369–386.
-  Faccio, M. (2010). Differences between politically connected and non-connected firms: A cross-country analysis. *Financial Management*, 39(3), 905–928.

References III

-  Johnson, S. & Mitton, T. (2003). Cronyism and capital controls: evidence from Malaysia. *Journal of Financial Economics*, 67(2), 351–382.
-  Khwaja, A. I. & Mian, A. (2005). Do lenders favor politically connected firms? Rent provision in an emerging financial market. *The Quarterly Journal of Economics*, 120(4), 1371–1411.
-  Leuz, C. & Oberholzer-Gee, F. (2006). Political relationships, global financing, and corporate transparency: Evidence from Indonesia. *Journal of Financial Economics*, 81(2), 411–439.
-  Li, H., Meng, L., Wang, Q. & Zhou, L. (2008). Political connections, financing and firm performance: Evidence from Chinese private firms. *Journal of Development Economics*, 87(2), 283–299.

References IV

-  Mobarak, A. M., & D. P. Purbasari (2006). Corrupt protection for sale to firms: Evidence from Indonesia. *Working Paper, University of Colorado at Boulder*.
-  Su, Z. & Fung, H. (2013). Political connections and firm performance in Chinese companies. *Pacific Economic Review*, 18(3), 283–317.
-  Yeh, Y., Shu, P. & Chiu, S. (2013). Political connections, corporate governance and preferential bank loans. *Pacific-Basin Finance Journal*, 21(1), 1079–1101.

Thanking you for your attention!!