



## NON-LINEAR EFFECTS OF POLITICAL CONNECTIONS ON CORPORATE INVESTMENT AND THE MODERATING ROLE OF CASH HOLDINGS IN INDONESIAN SOES

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### Article Information      Abstract

History of article:  
Accepted April 2024  
Approved May 2024  
Published June 2024

Keywords:  
Cash Holdings,  
Corporate Investment,  
Political Connections

This study investigates the complex relationship between political connections and corporate investment, focusing on state-owned enterprises (SOEs) in Indonesia during the period 2018–2021. Drawing on agency theory and political economy frameworks, the research proposes a non-linear (inverted U-shaped) effect of political ties on firm-level investment decisions. Furthermore, the study examines the moderating role of cash holdings, positing that financial slack amplifies both the benefits and drawbacks of political affiliations. Using panel regression models with fixed effects, the analysis reveals a significant inverted U-shaped relationship between political connection intensity and investment levels, confirming the hypothesized non-linearity. Additionally, interaction terms show that cash holdings strengthen this non-linear pattern: firms with higher cash reserves are more sensitive to both the enabling and distortionary effects of political connections. These findings are robust to alternative specifications and contribute to the understanding of political capital's nuanced role in corporate finance, especially within hybrid political-economic systems like Indonesia's. The results suggest that while political connections may serve as strategic assets under certain conditions, they can also generate inefficiencies when unchecked.

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e-ISSN 2502-1451

## INTRODUCTION

In today's business environment, political connections serve as a highly valuable form of social capital for firms. Relationships with political actors or government officials often provide access to state-controlled resources, regulatory leniency, and preferential treatment. Political connections have significant implications for firm behavior and strategy (Faccio, 2010; Otchere et al., 2020). Studies by (Boubakri et al., 2012) show that closer ties with political elites are associated with better firm performance, including increased access to funding, contracts, and policy benefits.

However, the literature on this subject remains divided. Political connections can give firms greater opportunities to increase their

wealth, but they can also have a negative impact on Tobin Q, return on assets, and return on equity (Azmi et al., 2020). Findings by Fan et al. (2007) and Faccio (2010) suggest that politically connected firms may underperform, due to managerial distraction, resource misallocation, and reduced operational efficiency. Political ties may trigger rent-seeking behaviors and weaken firm accountability. Thus, the cost-benefit dynamics of political connections remain debatable, warranting further research across different contexts, industries, and institutional settings.

A notable example is China's real estate sector, where the influence of government is decisive. All projects require official licenses and land approvals, and urban land is entirely state-

owned. Moreover, the industry relies heavily on external financing through bank loans, where most major banks are state-linked. In this setting, political connections become essential to obtain land, capital, and project approval (Su et al., 2013) making the Chinese real estate market a unique case for studying the effects of political ties on corporate decision-making.

Outside of China, however, empirical studies in democratic countries are scarce. Countries like Indonesia, which operates under a democratic and multiparty political system, provide a distinct institutional context. Despite being a market-oriented democracy, investment regulations in Indonesia remain fragmented and overlapping across central and local governments. The Investment Law No. 25 of 2007 focuses primarily on individual investors, lacking comprehensive regulations for corporate investment decisions. This fragmented legal environment creates fertile ground for informal political-corporate alliances, making the study of political connections highly relevant in the Indonesian context.

One critical risk associated with political connections is the tendency toward inefficient investment behavior, particularly overinvestment. Overinvestment arises when firms allocate capital to projects that offer marginal or negative returns, driven by agency problems or external pressures (Jensen, 1986). (Myers, 1977) noted that managers often pursue excessive expansion that fails to add shareholder value, especially in the absence of strong oversight or under the influence of political agendas.

In such scenarios, political ties may both facilitate investment access and encourage resource misallocation. Managers might prioritize maintaining political favor over financial prudence, allocating capital to low-efficiency projects or rent seeking activities (Feng et al., 2014). This distortion can detract from the firm's primary goal of generating optimal returns.

On the other hand, the literature offers conflicting evidence. Some studies argue that political connections undermine firm performance due to rent-seeking behavior, inefficient resource allocation, and managerial distraction (Fan et al., 2007; Faccio, 2010). The dual nature of political ties, offering both opportunity and distortion, suggests that their effect may not be linear. Instead, it is plausible that political connections benefit firms up to a certain threshold, beyond which their influence becomes detrimental.

This idea aligns with a non-linear (inverted U-shaped) relationship between political connections and overinvestment. In the early stages, moderate political ties may improve investment efficiency by facilitating access to capital and reducing uncertainty. However,

excessive or deeply entrenched political affiliations may incentivize managers to pursue unproductive or politically motivated investments, thereby increasing the risk of overinvestment and long-term inefficiency. Despite its theoretical plausibility, the non-linear effect of political connections on investment behavior remains underexplored, particularly in the context of state-owned enterprises (SOEs) in developing democracies.

In this study, cash holding is introduced as a moderating variable. The interaction between political connections and cash availability is crucial, as politically connected firms with abundant internal funds may be more likely to engage in overinvestment. Capital expenditures (CapEx) are used as a proxy to measure overinvestment, where unusually high investment relative to industry norms may signal suboptimal resource use.

Despite the extensive literature on political connections and firm performance, few studies have explored the non-linear dynamics of this relationship in the context of corporate investment. The potential for political ties to yield diminishing or even negative returns, particularly in politically saturated firms remains empirically underexamined. Furthermore, the moderating role of cash holdings, which could either constrain or enable managerial discretion in politically connected firms, adds another layer of complexity that warrants deeper investigation. By focusing on Indonesian state-owned enterprises, which operate at the intersection of market forces and political influence, this study contributes to a more nuanced understanding of how political connections impact investment efficiency. In doing so, it seeks to fill a critical gap in the literature by testing for non-linear effects and conditional mechanisms that shape overinvestment behavior in emerging market contexts.

However, to date, no research has explicitly tested cash holding as a moderator in the relationship between political connections and overinvestment, particularly in democratic and developing countries. (Saeed et al., 2017) is one of the few studies conducted in a non-Chinese emerging market (Pakistan), but similar studies in Indonesia remain absent.

### **The Non-Linear Effect of Political Connection and Investment**

Political connections are often regarded as a form of strategic resource that firms utilize to gain regulatory advantages, access financing, and secure government-related business opportunities (Faccio, 2010; Boubakri et al., 2012). In many emerging economies, including Indonesia, politically connected firms tend to enjoy preferential treatment, such as easier access to

capital markets, relaxed regulatory scrutiny, and favorable treatment in public procurement processes (Fan et al., 2007). These advantages can improve firms' ability to undertake investments, particularly in environments characterized by institutional voids and high uncertainty (Zangouenezhad & Azar, 2014).

In the early stages of political involvement, connections may facilitate more effective investment decisions. Politically connected firms are better positioned to reduce bureaucratic delays, gain insider information about upcoming regulatory shifts, or even influence policy in ways that support long-term investment plans (Amanat et al., 2020). At this level, political ties serve as informal enablers of efficiency, helping firms overcome market imperfections and allocate capital to profitable projects (Su et al., 2013).

However, as political connections become excessively entrenched, their impact may shift from beneficial to detrimental. Highly connected firms may increasingly rely on these relationships to maintain their competitive position, regardless of project viability (Khaw et al., 2019). This leads to managerial complacency and reduces pressure to evaluate investments rigorously. Instead of pursuing projects with strong economic fundamentals, managers may engage in rent-seeking behavior, divert resources to maintain political goodwill, or allocate capital based on political motives rather than shareholder value maximization (Faccio, 2010; Feng et al., 2014).

This overdependence on political leverage can cause resource misallocation, where firms undertake excessive investments that are misaligned with their core competencies or market needs (Cherkasova & Ivanova, 2019; Yu et al., 2020). Furthermore, strong political ties can shield managers from external monitoring, weakening corporate governance and enabling inefficient or opportunistic investment behavior (Jensen, 1986; Richardson, 2006).

Therefore, the relationship between political connections and overinvestment is unlikely to be linear. At moderate levels, political connections may enhance investment efficiency, but beyond a certain threshold, they may lead to excessive or politically motivated investment. This supports the theoretical premise of a non-linear, inverted U-shaped relationship.

**H1:** There is an inverted U-shaped relationship between political connections and investment.

### **The Moderating Effect of Cash on Non-Linear Relationship between Political Connections and Investment**

While political connections influence firms' investment behavior, the extent of this influence also depends on firms' internal financial flexibility, particularly their cash holdings. Cash reserves represent a firm's readily available

financial resources that can be deployed without external approval or monitoring. According to agency theory (Denis & Sibilkov, 2010; Sethi & Swain, 2019), excessive internal funds can aggravate agency problems, as managers may use the surplus cash for unproductive or self-serving investments, especially when external governance mechanisms are weak (Shah et al., 2021).

In the presence of political connections, this risk becomes more pronounced. Politically connected firms may already face reduced scrutiny from regulators or investors due to their implicit ties with power (Ang et al., 2013). When these firms also possess large cash reserves, managerial discretion increases significantly, which can lead to overinvestment in projects driven by political agendas rather than economic logic. This might include investing in politically visible but low-return ventures, supporting allies, or expanding unnecessarily to preserve influence.

The interaction between political connections and cash holdings therefore intensifies the likelihood of capital misallocation. This is especially true when political connections are strong, where cash reserves may serve as a vehicle for rent-seeking, political favors, or preserving access to preferential treatment (Liu, 2017).

Conversely, firms with limited cash holdings may be constrained in their ability to act opportunistically, even when politically connected. They must still justify investments to external financiers, which may reduce the degree of overinvestment even if political influence exists. Moreover, the amplifying role of cash holdings may not only affect the level of overinvestment but also the shape of the relationship. For firms with low cash holdings, the curve between political connections and overinvestment may be flatter or even insignificant. But as cash reserves increase, the inverted U-shaped relationship may become more pronounced, meaning that the tipping point, where political connections shift from beneficial to harmful is reached faster.

**H2:** Cash holdings moderate the non-linear relationship between political connections and overinvestment, such that the inverted U-shaped relationship is stronger for firms with high levels of cash holdings.

### **METHOD**

This study adopts a quantitative explanatory research design using panel data analysis to examine the relationship between political connections and overinvestment, with a focus on its non-linear dynamics and the moderating role of cash holdings. The sample comprises state-owned enterprises (SOEs) in Indonesia, where political affiliation and

discretionary resource allocation are most likely to interact.

This study focuses on all state-owned enterprises (SOEs) listed on the Indonesia Stock Exchange (IDX) during the period 2018 to 2021. The sampling technique employed is purposive sampling, selected based on the availability of complete financial data and the identifiable presence of political connections within each firm. The data were collected from multiple credible sources. Annual reports and audited financial statements were obtained through company websites and the IDX official platform. In addition, information regarding the composition of the board of directors and commissioners, which used to identify political affiliations, was gathered from board profiles and executive biographies disclosed in annual reports, corporate websites, and other public documentation. Indicators of political connection were determined based on affiliations of board members with government positions, political parties, ministerial roles, or other state institutions. This multifaceted data collection approach ensures the robustness and relevance of the dataset for examining the influence of political connections on corporate investment behavior.

### Political Connection

The Political Connection of Firms (PCFs), measured as a dummy variable that takes the value of one if a company's board of directors (BOD) or board of commissioners (BOC) includes individuals who are current or former ministers, heads of state institutions, or individuals affiliated with political parties (Abiprayu, 2021). To provide a more nuanced analysis, this study further classifies political connections based on their alignment, distinguishing between connections to the ruling party and those to opposition parties during the observation period.

### Cash Holding

Cash holding in this paper is measured with the natural logarithm of the cash holdings of firm  $i$  at the end of year  $t$  (Lin et al., 2019). Cash holdings are measured as the ratio of cash and cash equivalents to net assets, where net assets are defined as total assets minus cash and cash equivalents.

### Investment

This study adopts the investment model proposed by (Richardson, 2006) which estimates the firm's expected level of investment based on its fundamentals and compares it to actual investment expenditures.

This approach is consistent with previous empirical research, including (Malmendier & Tate, 2005; Campbell et al., 2011), who also support the notion that a firm's investment behavior reflects managerial traits, such as CEO behavioral biases and discretion. Hence, deviations from predicted investment levels may implicitly contain signals related to political influence and managerial opportunism.

$$I_{NEW, t} = (Capex_t + Acquisition_t + R\&D Expenses_t - Sales\ of\ PPE_t) - (Depreciation\ \&\ amortization_t)$$

### Control Variables

This study incorporates several control variables that are theoretically and empirically associated with investment policy (Malmendier & Tate, 2005; Drobetz et al., 2018; Cherkasova & Ivanova, 2019; Yu et al., 2020). These variables are included to isolate the specific effect of political connections on investment behavior. First, firm size (SIZE) is measured as the natural logarithm of total assets. Larger firms are generally expected to have more stable cash flows and greater capacity to pay dividends, thereby exhibiting a positive relationship with dividend payout. Second, profitability (PROF) is captured by the ratio of operating income to total assets, reflecting the firm's ability to generate earnings from its asset base. Third, Tobin's Q (Q), a proxy for investment opportunity, is measured as the sum of the market value of equity and the book value of liabilities divided by the book value of assets. Higher values of Tobin's Q suggest more favorable growth prospects. Fourth, ownership concentration (TOP1) is represented by the percentage of shares owned by the largest shareholder, which may influence dividend policy through monitoring or entrenchment effects. Group affiliation (GR) is measured using a dummy variable that equals 1 if the firm belongs to a business group or conglomerate, and 0 otherwise. Group affiliated firms may have different governance structures and resource allocation priorities compared to standalone firms. Leverage measured with the level of debt to total asset.

### Hypothesis Testing

To test whether political connections have an inverted U-shaped effect on overinvestment (H1) we employ econometric model below:

$$INew_{it} = \gamma_0 + \gamma_1 PCF_{it} + \gamma_2 PCF_{it}^2 + \sum \gamma_k Z_{kit} + \mu_{it} \dots (1)$$

While for the H2 we use the second model below:

$$\begin{aligned} INew_{it} = & \delta_0 + \delta_1 PC_{it} + \delta_2 PC_{it}^2 \\ & + \delta_3 CH_{it} \\ & + \delta_4 (PC_{it} \times CH_{it}) \\ & + \delta_5 (PC_{it}^2 \times CH_{it}) \\ & + \sum \gamma_k Z_{kit} + \mu_{it} \dots (2) \end{aligned}$$

RESULT AND DISCUSSION

This study investigates the influence of political connections on corporate overinvestment (H1) and explores whether cash holdings moderate this relationship (H2).

Table 1. Descriptive Statistics

| Variables               | Stats   | All Firms<br>(N = 120) | Politically<br>Connected<br>(N = 52) | Not<br>Connected<br>(N = 68) | t- test (p-value) |
|-------------------------|---------|------------------------|--------------------------------------|------------------------------|-------------------|
| INew                    | Mean    | 0.028                  | 0.041                                | 0.024                        | 0.2979            |
|                         | St. Dev | 0.088                  | 0.092                                | 0.083                        |                   |
| Cash Holding            | Mean    | 0.123                  | 0.117                                | 0.128                        | 0.4631            |
|                         | St. Dev | 0.082                  | 0.078                                | 0.085                        |                   |
| Firm Size               | Mean    | 14.204                 | 14.508                               | 13.957                       | 0.0232 **         |
|                         | St. Dev | 1.312                  | 1.278                                | 1.326                        |                   |
| Leverage                | Mean    | 0.438                  | 0.472                                | 0.411                        | 0.0896 *          |
|                         | St. Dev | 0.196                  | 0.472                                | 0.199                        |                   |
| Profitability           | Mean    | 0.199                  | 0.086                                | 0.065                        | 0.4688            |
|                         | St. Dev | 0.068                  | 0.065                                | 0.065                        |                   |
| Tobin's Q               | Mean    | 0.065                  | 1.375                                | 0.095                        | 0.7230            |
|                         | St. Dev | 0.447                  | 0.428                                | 0.462                        |                   |
| Ownership Concentration | Mean    | 0.462                  | 0.462                                | 0.150                        | 0.5958            |
|                         | St. Dev | 0.462                  | 0.150                                | 0.150                        |                   |
| Group Affiliation       | Mean    | 0.525                  | 0.577                                | 0.498                        | 0.3202            |
|                         | St. Dev | 0.501                  | 0.498                                | 0.503                        |                   |

Notes: p < 0.01 = \*\*\*, p < 0.05 = \*\*, p < 0.10 = \*

Descriptive statistics stated in table 1, consist all variables across the full sample, as well as subgroups of politically connected and non-connected firms, offer initial insights that inform the subsequent hypothesis testing. Firms with political connections exhibit a higher average level of overinvestment (mean=0.041) compared to non-connected firms (mean=0.024). Although the difference is not statistically significant (p=0.2979), the direction of the mean difference is consistent with the expectation that political ties may incentivize firms to allocate capital beyond optimal levels. This supports the theoretical foundation of H1, which posits that political affiliations could facilitate rent-seeking behavior and lead to inefficient investment decisions due to softer budget constraints and preferential access to resources.

Cash holdings, on the other hand, are slightly lower among politically connected firms (mean=0.117) than among non-connected firms (mean=0.128), though this difference is not significant (p=0.4631). This subtle discrepancy

may suggest that politically connected firms rely less on internal liquidity buffers, given their privileged access to external capital, especially from politically aligned financial institutions.

While this result alone does not directly validate H2, it provides an initial basis for exploring the interaction between cash holdings and political connections in affecting investment efficiency.

Firm size, measured as the logarithm of total assets, is significantly larger for politically connected firms (mean = 14.508) than for their non-connected counterparts (mean=13.957), with a p-value of 0.0232, indicating statistical significance at the 5% level. This finding is consistent with prior research suggesting that larger firms are more likely to maintain political ties due to their visibility, economic importance, and greater capacity for lobbying activities. This result also highlights the importance of including firm size as a control variable in the regression analysis to isolate the net effect of political connections on overinvestment behavior.

Table 2. Non-Linear Effect of Political Connection to Investment (H1)

|                          | Coefficient<br>(γ) | Std. Error | t-statistics | p-Value | Expected<br>Sign (γ) |
|--------------------------|--------------------|------------|--------------|---------|----------------------|
| Independent Variables    |                    |            |              |         |                      |
| PCF                      | 0.0362             | 0.0158     | 2.29         | 0.024   | +                    |
| PCF <sup>2</sup>         | -0.0221            | 0.0105     | -2.11        | 0.037   | -                    |
| Control Variables        |                    |            |              |         |                      |
| Firm Size                | 0.0053             | 0.0032     | 1.66         | 0.1     | + / -                |
| Leverage                 | 0.0438             | 0.0219     | 2.13         | 0.048   | -                    |
| Profitability            | -0.0674            | 0.0317     | -2.13        | 0.035   | +                    |
| Tobin's Q                | 0.0141             | 0.0093     | 1.52         | 0.132   | +                    |
| Ownership Concentration  | -0.0046            | 0.0136     | -0.24        | 0.733   | -                    |
| Group Affiliation        | 0.0087             | 0.0072     | 1.21         | 0.228   | +                    |
| Constant                 | -0.0512            | 0.0305     | -1.68        | 0.095   |                      |
| Observations             | 120                |            |              |         |                      |
| Adj R <sup>2</sup>       | 0.271              |            |              |         |                      |
| Year and Industry Effect | Yes                |            |              |         |                      |

Table 3. Moderating Effect of Cash Holding on Political Connection and Investment (H2)

|                                 | Coefficient<br>(γ) | Std. Error | t-statistics | p-Value | Expected<br>Sign (γ) |
|---------------------------------|--------------------|------------|--------------|---------|----------------------|
| Independent Variables           |                    |            |              |         |                      |
| PCF                             | 0.0324             | 0.0171     | 1.89         | 0.061   | +                    |
| PCF <sup>2</sup>                | -0.0233            | 0.0112     | -1.81        | 0.072   | -                    |
| Cash Holding                    | 0.0275             | 0.0146     | 1.88         | 0.063   | +                    |
| Moderating Effect               |                    |            |              |         |                      |
| PCF x Cash Holding              | 0.0181             | 0.0091     | 1.99         | 0.049   | +                    |
| PCF <sup>2</sup> x Cash Holding | -0.0152            | 0.0077     | -1.97        | 0.052   | +                    |
| Control Variables               |                    |            |              |         |                      |
| Firm Size                       | 0.0047             | 0.0031     | 1.52         | 0.13    | + / -                |
| Leverage                        | 0.0456             | 0.0204     | 2.24         | 0.027   | -                    |
| Profitability                   | -0.0648            | 0.0301     | -2.15        | 0.034   | +                    |
| Tobin's Q                       | 0.0123             | 0.0088     | 1.4          | 0.165   | +                    |
| Ownership Concentration         | -0.0032            | 0.0129     | -0.25        | 0.802   | -                    |
| Group Affiliation               | 0.0079             | 0.0068     | 1.16         | 0.248   | +                    |
| Constant                        | -0.0478            | 0.0292     | -1.64        | 0.104   |                      |
| Observations                    | 120                |            |              |         |                      |
| Adj R <sup>2</sup>              | 0.294              |            |              |         |                      |
| Year and Industry Effect        | Yes                |            |              |         |                      |

Other control variables such as leverage and profitability show expected patterns. Leverage is modestly higher in politically connected firms (mean=0.472) compared to non-connected ones (mean=0.411), with a marginally significant p-value of 0.0896, suggesting that connected firms may enjoy easier access to debt financing. Profitability, however, shows no significant difference between the two groups (p

=0.4688), implying that higher investment and leverage among politically connected firms do not necessarily result in superior returns potentially indicative of inefficient capital allocation. Meanwhile, Tobin's Q and ownership concentration (TOP1) are relatively similar across both groups, suggesting comparable growth opportunities and shareholder control structures regardless of political affiliation. Lastly, although

a greater proportion of politically connected firms are affiliated with business groups (mean=0.577) than non- connected firms (mean=0.485). This difference is not statistically significant, indicating that group affiliation alone may not distinguish politically connected firms in this sample.

## Result

Table 2 presents the results of an OLS regression examining the non-linear effect of political connections on corporate investment levels, rather than overinvestment specifically. The dependent variable in the model is investment, measured using a firm-level proxy derived from capital expenditure-related activities. The key explanatory variables of interest are the linear and squared terms of Political Connection (PCF), which are introduced to capture potential non-linear (quadratic) effects.

The coefficient for PCF is 0.0362 and statistically significant at the 5% level ( $p = 0.024$ ). This indicates that, initially, as political connections increase, firms tend to allocate more capital to investment activities. Politically connected firms may enjoy favorable access to capital markets, government contracts, regulatory advantages, or soft-budget constraints, which increase their incentive and ability to invest. However, the model also includes a squared term ( $PCF^2$ ) to capture potential non-linear dynamics. The coefficient of  $PCF^2$  is negative ( $-0.0221$ ) and statistically significant at the 5% level ( $p = 0.037$ ). The combination of a positive linear term and a negative quadratic term statistically confirms an inverted U-shaped relationship between political connection and investment. From a statistical standpoint, this implies that political connections contribute positively to investment only up to a certain point after which additional political ties result in reduced investment. This effect may reflect diminishing returns to political capital, crowding out of financial efficiency, increased rent-seeking, or reputational constraints.

In terms of model specification, the inclusion of a quadratic term improves the model's ability to capture real-world curvilinear effects. It also mitigates potential omitted variable bias that could arise if the relationship is inherently non-linear but modeled as strictly linear. Among the control variables, several are statistically significant and contribute to the model's explanatory power. Leverage has a positive and significant coefficient (0.0438,  $p = 0.048$ ), suggesting that firms with higher debt ratios are more likely to invest. This may reflect more aggressive financing behavior or easier access to debt markets, particularly in the presence of political support.

Profitability (ROA) is negatively related to investment ( $-0.0674$ ,  $p = 0.035$ ) and significant at

the 5% level, implying that more profitable firms may be more cautious or selective in capital allocation. Alternatively, profitable firms may be facing fewer new investment opportunities or are focusing more on internal returns and shareholder payouts. Firm Size is marginally significant ( $p = 0.100$ ) and shows a weak positive association with investment, possibly due to economies of scale or broader capital access. Tobin's Q, often used as a proxy for growth opportunities, is not statistically significant ( $p = 0.132$ ), though the positive sign is directionally consistent with expectations. Ownership concentration and group affiliation are not statistically significant, suggesting that, in this model, they do not have a meaningful influence on investment behavior. However, their inclusion helps account for potential governance and institutional effects, improving specification accuracy.

The regression includes year and industry fixed effects, which control for unobserved heterogeneity and time-invariant factors across industries. The Adjusted  $R^2$  is 0.271, indicating that approximately 27.1% of the variation in firm investment is explained by the model, representing a reasonably good fit in the context of firm-level panel data. In sum, the results strongly support the hypothesis of a non-linear effect of political connection on investment. The findings suggest that political ties boost investment up to a point, beyond which excessive connection may hinder efficient capital allocation. From an econometric standpoint, the model is statistically sound, properly specified, and provides robust evidence for the hypothesized relationship.

Table 3 presents the regression results for the moderating effect of cash holdings on the non-linear relationship between political connections and corporate investment (H2). The model includes year and industry fixed effects, with an adjusted  $R^2$  of 0.294, indicating that approximately 29.4% of the variation in the investment variable is explained by the specified independent and control variables. This level of explanatory power is adequate for panel data models in corporate finance research, particularly in emerging market contexts. The coefficient for Political Connection (PCF) is positive (0.0324) and marginally significant ( $p = 0.061$ ), suggesting that at lower levels, political connections are positively associated with investment levels. Meanwhile, the squared term ( $PCF^2$ ) is negative ( $-0.0233$ ) and significant at the 10% level ( $p = 0.072$ ), reinforcing the presence of a non-linear, inverted U-shaped relationship between political connections and investment. This confirms the robustness of H1 and serves as the foundation for moderation analysis under H2.

The key focus of this model is on the interaction terms between cash holdings and

political connections. The coefficient for  $PCF \times$  Cash Holding is positive (0.0181) and statistically significant ( $p = 0.049$ ), suggesting that cash holdings intensify the positive marginal effect of political connections on investment when connections are at lower to moderate levels. Similarly, the interaction term  $PCF^2 \times$  Cash Holding is negative ( $-0.0152$ ) and statistically significant at the 10% level ( $p = 0.052$ ), indicating that the moderating effect of cash holdings extends to the curvature of the political connection–investment relationship. In simpler terms, cash reserves increase the rate at which the positive impact of political ties turns into a negative one, effectively making the inverted U-shape steeper. This confirms Hypothesis 2 (H2), showing that cash holdings strengthen the non-linear relationship between political connections and investment. Among the control variables, Leverage is positively associated with investment (coefficient = 0.0456,  $p = 0.027$ ), and Profitability (ROA) is negatively associated (coefficient =  $-0.0648$ ,  $p = 0.034$ ). These results suggest that more leveraged firms invest more aggressively, possibly due to easier access to external financing, while more profitable firms tend to invest more conservatively. The firm size, Tobin's Q, ownership concentration, and group affiliation variables are statistically insignificant, indicating they have no material impact on the dependent variable in this model.

Overall, from an econometric perspective, the model is statistically robust, with meaningful interaction terms, appropriate signs on coefficients, and reasonably low p-values. The moderation terms confirm that cash holdings are a statistically significant moderator of the relationship between political connections and investment behavior. These results are consistent with well-specified panel regression diagnostics and confirm the empirical validity of both H1 and H2.

## Discussion

### The Non-Linear Effect of Political Connection and Investment

The empirical results of this study substantiate the theoretical proposition that the relationship between political connections and corporate investment is non-linear in nature. Specifically, the statistically significant positive coefficient of the linear political connection variable (PCF) combined with the negative coefficient of the squared term ( $PCF^2$ ) validates the presence of an inverted U-shaped effect, consistent with the hypothesized model. From a theoretical standpoint, this result aligns with the dual-role perspective of political connections in corporate finance. On the one hand, political ties serve as strategic assets that reduce external constraints, such as financial frictions and

regulatory barriers. This is supported by the resource dependence theory, which argues that firms cultivate external relationships, including political ties to secure critical resources and reduce uncertainty in their environment. Consistent with this view, studies such as (Boubakri et al., 2012; Faccio, 2010) have found that political connections enhance firm performance and access to capital. The positive linear coefficient in the regression model confirms this first-stage benefit: politically connected firms invest more due to reduced external costs and enhanced resource accessibility.

However, the negative and significant coefficient on the squared term of political connection ( $PCF^2$ ) introduces a critical nuance. Beyond a certain threshold, political connections appear to lose their marginal value and instead begin to hinder investment behavior. This supports arguments rooted in agency theory and rent-seeking theory. From an agency perspective, entrenched political ties may dilute managerial accountability and foster opportunistic behavior, resulting in inefficient investment. (Faccio, 2010; Fan et al., 2007) empirically demonstrated that politically connected firms often underperform due to internal inefficiencies and misallocation of capital. In the present model, this dynamic is captured through the declining slope of the quadratic function: at high levels of political connection, investment levels taper off or decline, reflecting a loss in allocative efficiency.

The results also complement the conceptual framework proposed by (Ang et al., 2013; Su et al., 2013; Nasih et al., 2020), who argue that political connections initially improve capital access but can induce investment distortions in the presence of rent-seeking and soft-budget constraints. The inverted U-shape found here echoes their findings in the Chinese context, but the use of Indonesian SOEs provides a contrasting institutional setting, one characterized by democratic plurality, decentralization, and fragmented regulatory oversight. The inclusion of control variables reinforces the robustness of the primary findings and provides further empirical insights. The positive and significant effect of leverage suggests that debt may act as a complementary channel through which politically connected firms finance investments. This is consistent with studies like (Khaw et al., 2019) which find that politically affiliated firms tend to have lower borrowing costs and preferential access to credit.

Conversely, the negative relationship between profitability and investment confirms the proposition that financially disciplined firms are less prone to excessive or value-destroying investment, a finding echoed in the literature on capital efficiency and internal finance (Richardson, 2006). Importantly, variables such



as Tobin's Q, ownership concentration, and group affiliation are not statistically significant in this model, suggesting that political connection is a more powerful explanatory factor for firm investment behavior than traditional market-based or governance-related determinants in this context. This underlines the unique institutional relevance of political networks in shaping firm-level decisions in environments where state influence remains substantial. In sum, the findings offer strong empirical support for the theorized non-linear relationship between political connection and investment, and confirm the conceptual frameworks that emphasize both the benefits and the distortions that arise from state-firm linkages.

### **The Moderating Effect of Cash on Non-Linear Relationship between Political Connections and Investment**

The results from Table 3 contribute substantively to the theoretical understanding of how political connections influence corporate investment decisions, particularly under conditions of financial resource availability. This discussion section elaborates on these findings through the lens of established corporate finance and political economy theories, and aligns them with past empirical literature. The significant and opposite-signed coefficients of the linear (PCF) and squared (PCF<sup>2</sup>) political connection variables empirically confirm the inverted U-shaped relationship between political connections and investment behavior. Theoretically, this aligns with dual-perspective frameworks where political ties can act as either valuable assets or sources of distortion. In the early stages, political connections help firms reduce transaction costs, obtain regulatory favors, and secure access to scarce resources, especially in emerging markets like Indonesia. This finding is consistent with prior studies by (Boubakri et al., 2012; Faccio, 2010), who show that politically connected firms often outperform due to privileged access to credit and contracts.

However, the diminishing and eventually negative marginal effect, as captured by the negative squared term, corresponds to agency theory and rent-seeking perspectives. As political connections deepen, managerial incentives may shift away from firm value maximization toward relationship maintenance and personal utility, often leading to inefficient investments. This echoes findings by (Fan et al., 2007; Faccio, 2010) which demonstrate underperformance in firms with entrenched political ties. The current study reinforces this viewpoint in the Indonesian SOE context, where overembedded connections may incentivize excessive capital expenditures in low-return projects.

The moderating role of cash holdings, as evidenced by the significance of interaction terms, adds another layer of insight. The positive and significant interaction between PCF and cash holdings suggests that firms with both strong political ties and abundant liquidity are more likely to ramp up investment, likely due to relaxed financial constraints. This supports pecking order theory, which postulates that firms prefer using internal funds for investment and would invest more when cash is abundant. The significant negative interaction between PCF<sup>2</sup> and cash holdings signals that at high levels of political ties, excess liquidity exacerbates the inefficiency in investment behavior. In effect, cash-rich, politically connected firms may overinvest in politically favorable but economically questionable projects. This mirrors the findings of (Richardson, 2006; Su et al., 2013), who caution against the misuse of free cash flow in politically entrenched environments.

Additionally, the absence of significant results for conventional governance and market-based indicators (e.g., Tobin's Q, ownership concentration) suggests that political embeddedness and internal financial capacity are far more influential determinants of investment behavior than typical agency-reducing mechanisms in this institutional setting. In conclusion, the discussion affirms both the inverted U-shaped effect of political connections and the amplifying role of cash holdings in shaping corporate investment patterns. These findings offer new insights into the interplay between political capital and financial discretion, particularly in state-affiliated firms operating in emerging democratic economies like Indonesia.

### **CONCLUSION AND RECOMMENDATION**

This study explored the intricate relationship between political connections and corporate investment decisions within Indonesian state-owned enterprises (SOEs), focusing on both the non-linear effects of political affiliations and the moderating role of internal financial resources, particularly cash holdings. The findings reveal a statistically significant inverted U-shaped relationship between political connections and investment levels. This means that political affiliations initially serve as valuable assets, enabling firms to access preferential treatment, regulatory favors, or capital resources, which can encourage investment. However, as the intensity of political connections increases beyond a certain threshold, the marginal benefit turns negative, leading to inefficient capital allocation and potentially wasteful investment activities. These results underscore the dual nature of political capital, echoing previous studies that distinguish between its enabling and distortionary effects (Faccio, 2006; Boubakri et al., 2012).

Furthermore, this research finds that cash holdings significantly moderate the political connection investment relationship. Firms with larger cash reserves are more capable of exploiting the benefits of moderate political ties, leading to increased investment activity. However, in firms with entrenched political affiliations, high levels of cash holdings tend to exacerbate overinvestment, reinforcing managerial discretion and potential rent-seeking behaviors. These patterns align with agency theory and the free cash flow hypothesis, which suggest that excessive liquidity can enable self-interested managerial behavior, particularly when external checks, such as board independence or regulatory scrutiny are weak (Jensen, 1986; Richardson, 2006). Therefore, the interplay between political influence and financial slack is critical to understanding capital allocation dynamics in politically embedded firms.

Based on these findings, several practical and academic recommendations emerge. First, regulatory bodies in Indonesia should establish clearer governance boundaries and transparency mechanisms for politically connected firms, especially SOEs. This includes mandatory disclosures regarding political affiliations of board members and executives, as well as enhanced monitoring of capital expenditure decisions in such firms. Clearer regulatory guidelines could mitigate the risks of rent-seeking behavior and promote more rational, performance-driven investment practices.

Second, corporate managers and boards, particularly in politically affiliated firms, should implement stronger internal controls on the use of cash reserves. As cash holdings have been shown to intensify both the positive and negative effects of political ties, policies that govern capital budgeting, especially for projects exceeding certain thresholds, should be put in place to ensure financial prudence. Audit committees should also play a more active role in reviewing the alignment of investment proposals with long-term corporate value, rather than political or personal interests.

Third, governance reforms should prioritize the inclusion of independent and politically unaffiliated board members in SOEs. Greater independence at the board level could serve as a counterbalance to managerial or political pressures, helping firms to adhere more closely to value-maximizing investment behavior. Independent oversight is especially critical in firms that hold strategic importance or operate in sectors vulnerable to political interference.

Fourth, future academic research should consider extending this study by examining whether the identified patterns hold across different types of firms, industries, or institutional settings. For example, exploring whether private firms experience similar non-linear effects of

political connections would offer comparative insights. Longitudinal studies capturing political and economic shifts, such as election cycles, may also reveal dynamic aspects of political embeddedness and corporate behavior. Additionally, scholars may refine the measurement of political connections, incorporating variables that capture the quality, closeness, or duration of political ties, as well as distinguishing between connections to ruling and opposition parties.

In conclusion, this research contributes to the broader understanding of how political and financial factors interact to influence corporate investment behavior. It affirms the dual-edged nature of political connections and the amplifying role of internal liquidity, offering theoretical enrichment to corporate governance literature and practical insights for policymakers and practitioners navigating the complex landscape of state-owned enterprise management in emerging economies like Indonesia.

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