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Political Connection and Cost of Capital: Indonesian Case Study

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Abstract

This research aims at examining the impact of political connection on financing facilitation by measuring cost of capital imposed to non-finance companies in Indonesia from 2009-2017. During the period, there is a change in the Indonesian government which is initially led by President Yudhoyono (2009-2014) from the Democratic Party and then by President Joko Widodo (2014-now) from the Indonesian Democratic Party of Struggle. Opposing one another, both parties share different political views. Therefore, it is interesting to find out how governmental change influence cost of capital. The research sample is financial statements of non-finance companies.

INTRODUCTION

We cannot deny that political element cannot be separated from industry. That politics become variable to influence business ecosystem is real (Faccio, 2006). Political connection will be increasingly ordinary in a country with high corruption level (Faccio, 2006). The question is whether the said political element, which in this context is political connection, gives added value to company? Many researches prove that the political factor gives company various impacts (Nys, Tarazi, & Trinugroho, 2014). Some benefits a company gains with political connection are: facilitation of obtaining source of fund (Claessens, Feijen, & Laeven, 2008; Fraser, Zhang, & Derashid, 2006; Khwaja & Mian, 2005; Li, Meng, Wang, & Zhou, 2008); improve trust in legislation system (Li et al., 2008); improve company's performance (Johnson & Mitton, 2003); possible chance to have higher bail-out assistance (Faccio, 2006); improve company's value, as seen with increasing stock price (Goldman, Rocholl, & So, 2009) and lower cost of capital (Boubakri, Guedhami, Mishra, & Saffar, 2012). On the other hand, many research find negative impacts political connection imposes to company. Chaney, Faccio, & Parsley (2011) find that the quality of a company's financial statement with political connection is not better than a company with no political connection.

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The other aspects are: unqualified directors (Boubakri et al., 2012; Leuz & Oberholzer-Gee, 2006); company's long-term decreasing performance (Claessens et al., 2008; Fan, Wong, & Zhang, 2007); and, higher cost of debt (Bliss & Gul, 2012).

Many points of view attempt to explain about political connection and company. First, Wu, Wu and Rui (2012) state that political connection is an expensive resource which cannot be obtained by random company, thus political connection may give competitive advantage to any company with it. Second, Shleifer and Vishny (1994) propose the grabbing hand theory. This theory states that public company will always become an interesting place for politicians to stick their power to. Third, the rent seeking theory proposed by Krueger (1974) states that bureaucrats or politicians "lease" all of their privilege and power as politicians to companies which need them for, naturally, certain return.

Politically connected firms are facilitated to obtain funding aid from banking sector, particularly government-owned banks (Li et al., 2008). An interesting question arises, how much capital is imposed to a company for political connection compared to a company without political connection? Is it only facilitation which is received by politically connected firms? Is there no other impact as the consequence of having political affiliation? The research conducted by Gul (2006) states that politically connected firms have higher leverage level and are deemed at risk by financial market and audit company. This is interesting, since politically connected firms are deemed as having life as a contract which may expire. When political direction changes, politically connected firms will be deemed having lost its supporter, which may interrupt its financial stability, thus creditors will tend to impose higher cost of debt before political life expires. When government shifts, to obtain new funding, politically connected firms must build a connection with the new established government and most of them choose more to perform global financing. Besides the reason above, politically connected firms will have higher cost of capital since financial market and banks believe that the companies will not be able to settle its capital obligation, and the companies will obtain financial aid from the political figure to which it is connected.

The purpose of this research is to test the impact of political connection on financing facilitation as viewed from the amount of cost of capital to be imposed to a company. In this case, company is divided into small company and big company. Financing facilitation should be enjoyed by small company, which is financially not as good as big company. This is in line with the finding of Fu, Shimamoto and Todo (2017), that small company will feel the benefit of political connection more than big company. This research will test the level of cost of capital of company politically connected to current regime. Indonesia is led by two presidents within about the last 10 years. From 2004-2009 and 2009-2014, Indonesia is led by President Susilo Bambang Yudhoyono from the Democratic Party, and from 2014-now is led by President Joko Widodo from the Indonesian Democratic Party of Struggle. Both parties oppose one another and naturally have different political views. The interesting thing is about the financing condition of a company which is initially close to the Democratic Party during the leadership of President Susilo Bambang Yudhoyono, while the leadership shifts in 2014 to a President from an opposing party. Based on this background, this research will use the 2009-2017 data in which there is a shift of leadership, while the data to be used are those of non-finance companies registered with the Indonesian Stock Exchange.

This research is arranged as follows. Chapter 2 explains the political connection in Indonesia, including an explanation of the structure of corporate board in Indonesia and some advantages and disadvantages experienced by politically connected firms (PCFs). Chapter 3 explains about the sample, data and variables to be used in the research.

Hypotheses Development

Political Connection in Indonesia

The political life in Indonesia experiences various movements, starting from an unstable political condition during Suharto's regime (1966-1998), followed by Habibie, Abdurrahman Wahid and Megawati. After 2004, particularly that Indonesia is led by Susilo Bambang Yudhoyono and followed by Joko Widodo, the politics in Indonesia starts to be stable. This political stability in Indonesia begins with President Yudhoyono's act to engage other parties into his cabinet. Following the end of Suharto's regime in 1998, Indonesia enters a reformation era, in which entrepreneurs enter political life (Fukuoka, 2013; Mietzner, 2006). This is increasingly prevalent since President Yudhoyono regime (2004-2009), that since many entrepreneurs enter the parliament, they facilitate other entrepreneurs' path to enter into contract with the Government (Fukuoka, 2013). Since then, politicians increasingly depend on the companies (Habib, Muhammadi, & Jiang, 2017), thus the number of politically connected firms (PCFs) increases.

Some examples of political intervention in the companies, particularly State-Owned Enterprises, are given below. Since his office as the President in 2014, President Jokowi appoints as commissioners of State-Owned Enterprises those with background affiliated to government supporting parties. Jeffry Wurangin, for example, a legislative candidate from Nasdem party, is assigned as the commissioner of BRI, which is a government-owned company. Hilmar Raid, an ex-winning team of Jokowi since his participation in the election of Guvernor of DKI Jakarta in 2012 until Jokowi participates in Presidential election in 2014, is assigned as the commissioner of PT Krakatau Steel. Besides Hilmar Raid, Roy E Maningkas is a cadre of PDI-P who is also assigned as the commissioner of PT Krakatau Steel. Pataniari Siahaan, who is taking office as the independent commissioner of BRI, is one of expert staffs of the winning team of Jokowi-JK in 2014. There are many other names, and this is likely to be common phenomena.

The structure of corporate board in Indonesia uses the two-tier systems, which are Board of Directors (BOD) and Board of Commissioners (BOC), in which the highest position of BOD is at the hand of President Director and the highest position of BOC is at the hand of President Commissioner (Habib, Muhammadi, & Jiang, 2017). BOD consists of the board of executives assigned to perform company's daily operational activities, while BOC is assigned to supervise the executives' performance and to provide suggestions to BOD. Since the leadership of President Joko Widodo, about 125 people are appointed as members of board of commissioners of State-Owned Enterprises, such as Paiman Rahardjo, Pataniari Siahaan, Fadjroel Rahman, etc. Following the research conducted by Prabowo (2013), a company is classified as politically connected firm (PCF) if one of its BODs or BOCs is a minister or the head of a state or a person connected to political party.

The research conducted by Fu et.al (2017) explains that PCFs in Indonesia are treated specifically by banks, in which they are facilitated to borrow fund from Government-banks (State-Owned Enterprises) and to obtain approval for their proposed borrowing nominal. However, both apply only to SMEs, and do not apply to big companies (Fu et. al, 2017). Politically connected firms basically receive high facilitation in its management, particularly financing facilitation (Fu et al, 2017). Politically connected firms (PCFs) have some benefits in relation to regulations and competitors, in which they may negotiate with the Government with regard to regulation and the application of rate to competitors (Goldman et al., 2009). The cost of operation of politically connected firms is also lower because of its lower tax than that of non-politically connected firms (Faccio, 2010). Low quality of income statement is only associated with higher cost of debt of non-politically connected firms (non PCFs), while politically connected firms (PCFs) have lower cost of debt (Chaney et. al, 2011).

As previously explained, PCFs have bad quality of income statement. This shows that the managers of PCFs do not attempt to improve accounting information (Chaney et. al, 2011). In addition to this, some problems arise in PCFs, such as arising agency conflict (Qian et al, 2011) and weak corporate governance since possible existing political figures affiliated to the companies will utilize the companies for their personal gain. This is in line with the research conducted by Leuz and Oberholzer-Gee (2006), that companies in Indonesia prefers not following US market because of its strict supervision, thus they cannot take personal gain, although US market in fact provides higher profit to other shareholders. Pursuant to the concept of rent seeking theory proposed by Krueger (1974), a company will bear an amount of cost as the consequence of political connection. The other risks are also caused by high level of company's asymmetric information because of bad quality of financial statement

(Chaney et al, 2011) and low accuracy level of financial analysis (Chen et al, 2010). The aforementioned risks, such as politicians' activities to obtain personal gain and the information asymmetry issue, cause shareholders to improve the required return for their investment with PCFs, and lead to higher cost of capital to be imposed to the companies than to non-politically connected firms. Based on the analysis above, the first hypothesis is as follows:

H1: politically Connected Firms has higher level of cost of capital

METHOD

The sample companies are non-finance companies registered with the Indonesian Stock Exchange from 2009 to 2017. The period is taken since the Indonesian political condition gets to stable during the period and there is a shift of leadership from President Yudhoyono (Democratic Party) to President Joko Widodo (PDIP), thus it is interesting to examine how the impact of a shift of political power on the cost of capital borne by companies is.

This research is conducted with a regression using the following formula:

$$\mathbf{CC_{,t} = \alpha_{i,t} + {}_1\,Connected_{i,t} + \sum \beta_n Control_{i,t} + e_{i,t}}$$

CC	= Dependent variable of cost of equity capital (CC)
Connected	= A company deemed having political connection is measured using two proxy tools: first, PCFs or Politically Connected Firms, measured uding the dummy variable with score one if the company has political connection; and, second, SOEs, a dummy variable with score one if the company is a State-Owned Enteprrise.
Control	= Size, Lev, IOS

Dependent Variable

To measure the cost of equity, this research employs a model developed by Easton (2004).

Many literatures test cost of equity using weighted average of the models developed by Gebhardt et al (2001), Ohlson and Juettner-Nauroth (2005), Claus and Thomas (2001) and Easton (2004) like what is conducted by Boubakri et al (2012) which aims at reducing estimation error level. However, because of limited data, only one model is used in this research. This is not a problem since the finding of Hu et al (2018) shows that the models have significant positive correlation level with alpha 1%.

$$\mathrm{CC}=\sqrt{(\mathrm{EPS}_2 - \mathrm{EPS1})\ /\ \mathrm{P}_0}$$

EPS is the earning per share value and P is the value of closed price of stock.

Independent Variable

To measure a political connection, this research employs some measuring tools tested by previous researchers to ensure the robustness of the political connection variable. First, the PCFs variable is believed as the dummy variable with score one if a company has BOD or BOC who is a minister, the head of a state or a person representing a connection to certain political party (Prabowo, 2013). For this proxy, this research will attempt to divide political connection into political connection with a ruling party and political connection with an opposition party during the observation period. Second, the SOEs (State-Owned Enterprises) variable is the dummy variable with score one if the company is a State-Owned Enterprise (Nys et al., 2015). A State-Owned Enterprise is directly organized by the President (Leuz & Oberholzer-Gee, 2006).

Control Variables

The control variables in this research are all variables empirically proven as influencing company's cost of capital pursuant to the research conducted by Boubakri (2012). The variables are Company Size (in total assets), Leverage (debt to total assets) and Investment Opportunity Set (book value to market value of equity).

RESULT AND DISCUSSION

Table 1. Descriptive Statistics

Variable	N	Mean	Std. Dev.	Minimum	p25	p50	p75	Maximum
CC	753	0.233	0.423	0.094	0.231	0.441	0.565	0.754
Connected	753	0.047	0.210	0	0	0	0	1
SIZE	753	10.124	1.843	5.506	12.508	13.735	14.933	19.021
IOS	753	2.421	1.478	0.003	0.769	0.981	1.946	19.921
Lev	753	0.211	0.186	0.175	0.415	0.546	0.671	0.894

From the descriptive data above, we may summarize some information, for example, that the sample's cost of capital has an average value of 0.233 with deviation standard of 0.094. The political connection variable (Connected) has an average value of 0.047 with deviation standard of 0.210. The political connection variable is measured using the dummy variable with score 1 if the company has a member of Board of Directors or Board of Commissioners with political background. We may see that the average value of 0.047 shows that the number of companies as the sample of political connection in this research is not higher than a half of the total sample companies.

Table 1 provides descriptive statistics for both our main test variable and control variables. The mean of Cost of Capital as dependent variable is 23.3%. The average percentage of connected firms (excluding banks) in Indonesia between 2009 – 2017 is 4.7%. This number is quite low compared to politically connected banks in Indonesia which is 58.7% during the period 2001 – 2008 (Prabowo, 2013).

The result on Model 3 in table 2 shows that politically connected firms have significant and positive impact on the firm's cost of capital, which confirms hypothesis 1. As firms are politically connected, they may obtain benefit by receiving support from government and reduce requirements for making contract (Goldman et.al, 2009). Mobarak and Purbasari (2006) who conduct research in Indonesia, argue that companies which are connected to Suharto regime gain benefit for import license. In contrast, some researches show that politically connected firms (PCF) may plague their activities. Agency problem may arise as the result of company's affiliation to political figures (Qian et al., 2011). Asymmetric information is resulted from bad financial statement (Chaney et.al, 2011). Shareholders perceive those negative impacts as the risks faced by firms, thus increasing their required return which leads to higher cost of capital. Faccio et al. (2006) find that politically connected firms have higher chance to obtain Government's aid during their financial distress than non-connected firms. Therefore, politically connected firms will be more likely to gain higher cost of capital value since creditors believe that the firms will be able to return the cost of capital.

Table 2. Regression Results

	Model 1	Model 2	Model 3
Connected		0.455**	0.423**
		(8.06)	(4.25)
Size	0.128**		0.067***
	(7.24)		(5.65)
IOS	5.876**		3.655*** (3.56)
	(10.91)		
LEV	2.677*** (4,17)		0.577*** (9.64)
Constant	-7.52***	-7.93***	-7.76***
	(-13.04)	(-12.94)	(-12.62)
Observation	753	753	753
Adj-R^2	0.20	0.22	0.28

Z statistics in parentheses *p<0.1 **p<0.05 ***p<0.01

Robustness testing is completed by excluding control variables (SIZE, IOS and LEV) to check whether the results in Model 3 are caused by endogeneity. After excluding all of the control variables, it is clearly seen that politically connected firms have the same performance, indicating that the results of this variable are not triggered by endogeneity.

CONCLUSSION & RECOMMENDATION

Cost of capital is the key for a company to run its investment activities well and to improve its credibility in stockholders' perspective. Company's ability to pay the cost of capital to stockholders will also influence its financial performance, thus it is not surprising that cost of capital is commonly known as hurdle rate, a minimum standard to be passed by a company with good financial performance. This research aims at testing the impact of politically connected firms (PCFs) on the cost of capital the company must bear. We believe that political connection may present negative impact on company. The research conducted by Chaney, Faccio, & Parsley (2011) finds that the quality of financial statement of politically connected firms is not better than that of non-politically connected firms. This is the result of non-qualified directors (Boubakri et al., 2012; Leuz & Oberholzer-Gee, 2006) and, company's long-term decreasing performance (Claessens et al., 2008; Fan, Wong, & Zhang, 2007). As the consequence of such negative impact, the stockholders will bear a higher risk, thus it is reasonable if they require higher rate of return.
The test results show that PCFs have higher cost of capital than non-political firms, which means that in shareholders' perspective, the company is at higher risk. We also test the endogeneity issue by testing some control variables which eventually shows robust result.

Some matters to study in the future include comparing company's cost of capital in case of a shift to the political regime. We predict that there will be fairly big shift in the companies, that existing politically connected firms will lose their connection at the time of regime shift. Therefore, this is something quite interesting to test.

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