

## Political Connection Effect towards Firm Value

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#### ABSTRACT

Political Connection, or the connection that a firm have to the government, can be an interesting subject for accounting research. Political connection can give advantage to the firm. This study wants to determine the effect of existing political connection in a firm to the firm value. Political connection as the independent variable is measured by using dummy variable. While firm value as the dependent variable will be measured by Tobin's Q. The data that are used in this study are secondary data of mining firms listed on the Indonesian Stock Exchange in 2017-2022 and also stock price information from Indonesian stock exchange website. In this study, purposive sampling is used where 37 mining firms are selected. The result of the study indicate that political connection does not have a significant impact on mining firms value. Thus, this study emphasize that investors have less interest on making political connection that mining firms have as a value.

**Keywords:** Firms Value, Indonesia, Mining Firms, Political Connection, Tobin-Q

## **INTRODUCTION**

Political Connection can be an interesting subject for accounting research. Political connection can give advantage to the firm such as stronger power in the market, privileged access to loans, subsidies, lighter tax, and protection from regulation (Sapienza, 2004). These advantages stem from political process and political culture can affect the economy. After a political process successfully appoint certain political actor that firm have connection with, the firms will gain the benefit during that political actor period of rule. Political culture depends upon the historical context of the state and its society. Other than that, political events such as elections, international conflict, and the establishment of certain policy, that occurs in a country can affect the economy. Political connection, however, might come at a price, including heightened scrutiny, reputational harm, expropriation danger, or loss of legitimacy. As a result, the trade-off between advantages and costs in various circumstances will determine the overall impact of political connections on firm value. This trade-off is explained by Shleifer and Vishny (1994) in their work, political connection will become something worth acquiring if firm manage to make the benefits greater than the cost. The management of this trade off is important to maximize the positive advantage of political connection. Firms also need to look at the current political condition in the country to make sure that the political connection that a firm has can be beneficial.

The market value of a company is measured by its firm value, which reflects the firm economic performance and room for growth. Economic performance refers to the evaluation and measurement of a company's financial and operational results. Meanwhile, room for growth refers to how companies can develop their companies. Firm value is an important factor for investors, managers, governments and other stakeholders who care about the financial stability and sustainability of a company. Investor see firm value as an important value of firm's financial health and potential returns on investment. Managers use firm value to measure the effectiveness of their strategic decisions and operational performance. Firm value thus necessary for managers to make the necessary evaluation for the current policy in a firm. While governments monitor firm value to gauge the economic contribution of businesses and ensure regulatory compliance. This is important to make sure that each firm give contribution to the society according to its performance.

Mining firms are often associated with high environmental and social impacts, large capital investments, and long project cycles. Because mining operations sometimes involve the extraction of rich minerals or resources from the earth, acquiring the necessary equipment and technology can be expensive. Furthermore, the extraction methods used may have a significant negative impact on ecosystems, water quality, and landscapes. The social effects of mining are also significant, encompassing anything from potential conflicts over land usage to changes in local demographics. The long project cycles typical of mining endeavors also necessitate consistent time and resource commitments, which adds to the intricacy and tenacity of the difficulties faced by this sector. This is something that is interesting to explore. To protect their business and gain favorable regulations, mining firms may seek political connections. Indonesia is an interesting place to study the influence of political connections on firm value in mining firms because Indonesia is one of the largest producers and exporters of coal, copper, gold, tin, bauxite and nickel in the world.

Political connections have been used as a factor that can affect firm value by many research. Researchers also look into the political aspect with different ways such as using event study, looking into the politically connected members of the firm, dividing the firm into state owned and non-state-owned firms and looking in to the current regime on

a country. An example of event study is conducted by Berkman and Galpoththage (2016) that finds political connections didn't have any effect towards the firm value in Sri Lanka. Chen, Li, Luo, and Zhang (2017) look into the political connections on state owned firms and non-state-owned firms in China and finds that political connections affect positively towards state owned firms value but affect negatively towards non-state-owned firms value. Chung, Jung, and Young (2018) study the political connection effect in South Korea by looking into the current regime, and find that firms that have political connections to the rival party have negative effect towards the firm value and firms that have political connections to the supporting party to current regime have a positive effect to the firm value. While Ika, Rachmanti, Nugroho, and Putri (2021), in their research look into the members of the firm specifically president commissioners and independent commissioners and find a positive relation between political connection and firm value.

## **LITERATURE REVIEW**

### **Political Condition in Indonesia**

Ever since the end New Order government in 1998, Indonesia enter into a more open and democratic political and social environment. Many political parties appear that represent different ideologies, interests, and constituencies. Political system in Indonesia faces several challenges in the 21st century, such as ensuring free and fair elections, defending civil liberties, battling corruption, and encouraging tolerance and diversity, seeking equitable growth, reducing poverty and inequality, investing in infrastructure and education, protect natural resources. and biodiversity, and balancing economic development with environmental sustainability.

Other than current political system in Indonesia the other thing that needed to be considered is political culture in Indonesia. Political culture is a set of attitudes, convictions, standards, and values that influence a society's political participation and behavior. Political culture in Indonesia has been influenced by several factors, such as history, ethnicity, religion, and modernization. Indonesia has a diverse and complex political culture that reflects its pluralistic and multicultural society (Herdiansah & Sumadinata, 2019). It is not easy to compare it to other countries, as each country has its own unique political culture. However, a possible comparison can be made based on the degree of political awareness and participation, Indonesia has a mixed political culture that combines elements of parochial, subject, and participant types (Marijan, 1999). This means that some segments of society are more aware and involved in politics than others, depending on their education, location, and access to information. In contrast, some countries have a more homogeneous political culture, such as Japan, which has a predominantly subject political culture (Herdiansah & Sumadinata, 2019). Therefore, it is important for mining firm to make sure that information such as annual or financial report can easily accessible. Because information can be used by mining firm to attract acting or former government officials to invest or be a part of the firm. This is done by the mining firm to have an advantage on having a political connection.

### **Firm Value in Mining Firm and Their Correlation with Political Connection**

One of the essential measures of a mining firms' effectiveness and success is its firm value. It reveals how highly the market values the business' resources, operations, and prospects for the future. Resources is one of the things that can add value to a firm. The way firm acquire and use the resources is an interesting factor for investors or other stakeholders. Resources itself not only reflects raw materials of production or technology that firm has but things like human resources or intellectual property is also important thing to look into. As for operations and prospect for the future, investor tend to measure it from the firm share condition. The share price is a key indicator of how the market perceives the firm's current and future performance. Positive developments and

operations can lead to an increase in share prices which later add the firm value. While negative development can lead firm to a decrease in value. Firm value can also be measured in several ways and there are some factors that can affect it. The measurement can sometime depend on the individual that measure it. Some like to measure it from the firm revenue or the firm budget on the R&D or how well the firm executing its Corporate Social Responsibility (CSR) to the society. One thing for certain though is that with a high firm value, a firm can increase profits for its shareholders and gain a competitive edge in the market and also attract investor to invest in the firm.

Leuz and Oberholzer-Gee (2006) views that political connection is an important factor to gain firm value in Indonesia. One of the examples of this is that the majority of the successful bidders for toll road projects are state-owned firms that have connection to the ruling party (Pratama & Setiawan, 2019). Responsibility to build the toll road can increase firms' reputation which later can increase their value. A more direct example come from the research conducted by Mobarak and Purbasari (2006), they stated that a firm with connections to the current government has an edge when applying for import licenses. This enables user to gain resources and even technology from other countries. These can be useful for increasing daily production and increasing the progress for Research and Development (R&D). Having advanced technology and a lot of resources from labor and essential materials can also help firm on fulfilling Indonesia current agenda that wish to produce downstream product by using raw materials in Indonesia. All of this later emphasize that political connection can be one of the factors that investor or other stakeholder see when measuring the value of a firm.

### **Resource Dependency Theory**

Resource Dependency Theory (RDT) aims to explain that firms need to establish connection to other organizations to secure resource for the firm's growth (Salancik & Pfeffer, 1978). RDT further explains that firms are not independent entities and instead rely on their surroundings for vital resources like funding, raw materials, and labor. As a result, businesses engage in mergers, acquisitions, joint ventures, alliances, contracts, lobbying, and political connections, and other techniques. These are necessary as some or particular resources may be occupied by a certain organization. Thus, Organizations with access to critical resources wield influence over those dependent on them. As a result, in an effort to increase their independence and decrease their susceptibility, organizations work to diversify their sources of resources, establish tactical partnerships, and negotiate.

How organizations handle uncertainty and their dependence on other organizations is one of RDT's key issues. Uncertainty refers to the unpredictability of the availability, quality, and price of the resources that an organization needs. Uncertainty of resources can be a threat for an organization or a firm. As an organization or a firm doesn't want to run out of resources because it will stop the production. Organization or firm need to know the quality of the resources and how much it cost to require it. This resources mainly refers to the most main resources like, raw materials, main ingredient, or capable human resources. All of these need to be secured to maintain good performance in a firm and the advancement of the firm itself. While at the same time, firm need to handle their dependence to other organization in order to avoid being overly dependent.

Political connections in a firm's existence can be understood using an RDT perspective. Political connections can be a solution for firms to face the uncertainty of the external environment because with existing connections with the government, companies can obtain a lot of resources and advice (Hillman & Dalziel, 2003; Salancik & Pfeffer, 1978). The advantages that firms will receive by having political connections is essential for the firm's growth. RDT have been used by several researchers to explain the effect of

political connections for firms' growth. An example of this, is the research conducted by Ismail, El-Deeb, and Halim (2022) which show that political connections have positive effect towards firm value in Egypt. Nguyen, Vo, and Vo (2020) also use RDT to explain political connections in Vietnam firms and found that political connections increase firm performance which later resulted more profit margin for the firms. RDT is also used by Fanani and Alfianti (2020) which found that political connections have a positive effect on company reputation in Indonesia, where company reputation is measured using the natural logarithm of the brand value of the 100 most valuable brands for 2014, 2015 and 2016 as reported by SWA Magazine.

### **Hypothesis Development**

Political connection can bring value to the firm as it can bring reputation, stronger market power and other advantages. When a firm forms connection with powerful political individuals, stakeholders frequently see it as having more legitimacy and trust. The firm's reputation can be improved by its affiliation with reputable political individual or organizations, which shows clients, investors, and the general public that it functions inside a framework of support and trust. Political connection act as recommendations that verify a firm's operations and ethical standards, which can be especially helpful in areas where public perception and trust are crucial. Besides reputation, political connection may bring stronger market power for the firm. Having access to government officials and policymakers can help the firm with valuable insights regarding regulatory developments and prospective modifications, thus enabling it to adjust and plan ahead of time. Political connection can also be useful as a deterrent to potential competitors, as the firm is perceived to have influential advocates, strong reputation and legitimacy.

The importance of political connection is also raised by RDT as firms may need the connections to increase firm growth. Political connections can be one of the factors to increase firm growth such as increasing revenue, obtaining legality in the use of production sites and increasing the customer base. This will later improve the firm value in the market. One of the advantages of having political connection is explained by Tao, Sun, Zhu, and Yang (2017) on their research that finds having political connections can give firms in China the benefits of subsidies from the government. Dang, So, and Yan (2018) also finds that having connections to president Mubarak and his family members will bring positive value to the firms in Egypt. However, there is research from Haryati, Rustiarini, and Dewi (2021) which proves that political connections as measured by the status of firm officials in government and firm status have no effect on firm value. It can add more possibilities to this study as stakeholders may not see political connection in a firm can bring more value.

Ha: Political connections have a positive effect on company value.

### **RESEARCH METHOD**

The population used in this research is mining firms listed on the Indonesia Stock Exchange (BEI) in 2017-2022. Purposive sampling was used in this research. The criteria in this research are companies whose shares were actively traded during the research period. This can be seen from the share price. If the share price remains at IDR 50 per share for two consecutive years, it means that there is no active trading in the company's shares.

Political connections were measured by dummy variable. Dummy Variable have been used by (Faccio, 2006; Joseline, Frandy & Pangestu, 2021; Haryati, Rustiarini, & Dewi, 2021) in their research to measure political connections. A score of 1 will be given to members of the Board of Commissioners, Directors or Audit Committee of a firm who

are or have been active in Ministries or State Institutions, the Police or the Army. Meanwhile, a score of 0 is given if there are no members of the Board of Commissioners, Directors or Audit Committee of a firm who have ever been active in Ministries or State Institutions, the Police or the Army.

Firm value in this research will be measured by Tobin's Q. Tobin's Q measures the firm's market value compared to its book value. Tobin's Q has been used by (Berkman & Galpoththage, 2016; Yulianti, Widagdo, Setiawan, & Sutopo, 2020; Hendratama & Barokah, 2020) to measure firm value. The formula for Tobin's Q is as follows:

$$\text{Tobin's Q} = (\text{MVE} + \text{DEBT}) / \text{TA}$$

This research uses regression analysis to test the effect of political connections on firm value while profitability, leverage and total assets are control variables.

Profitability is a tool to assess a company's ability to generate profits. Firms with a high profit margin will be more likely to draw interest from investors than those that show a loss. Profits for the firm will have an impact on the firm's value and reputation in addition to investment outcomes (Kepramareni, Pradnyawati, & Muliahati, 2023).

Leverage is an important indicator used by investors to predict a firm's ability to maximize the use of capital originating from debt or loans to generate profits. Apart from that, leverage is also used to assess the firm's ability to meet its debts or loans (Kepramareni, Pradnyawati, & Muliahati, 2023). Total assets are a proxy for firm size because the greater the total assets, the larger the firm size because the greater the capital invested to develop the firm (Nugroho & Budiman, 2022).

The regression model in this research is as follows:

$$\text{FV} = \beta_0 + \beta_1 \text{PC} + \beta_2 \text{PRO} + \beta_3 \text{LEV} + \beta_4 \text{LnTA} + \varepsilon$$

In this equation:

PC represents the value of the firm, which is measured using Tobin's Q.

PC represents the value 1 if there is a political connection or 0 if there is no political connection.

PRO represents the firm's profitability, which is measured using return on assets (ROA).

LEV represents the firm's leverage as measured by the debt-to-equity ratio.

LnTA represents firm size measured using the natural logarithm of total assets.

## **RESULTS**

The results of observations over six years of companies whose shares were actively traded were 37, resulting in 222 observations. From 222 observations, researchers could not obtain the annual reports for 7 firms. Thus, the number of samples in this research is 215 firm years. The following are descriptive statistics for the entire sample:

**Table 1. Descriptive Statistics Example (N = 215)**

Construct	Min.	Max.	M	SD
Firm Value (Tobin Q)	0.07246	38.81755	5.050694	6.126964
Profitability (ROA)	-1.538286	0.616346	0.065234	0.181300
Leverage (DAR)	0.0880	1.32537	0.512350	0.237768
Firm Size (Total Assets)	276.000.00.000	168.000.000.000.000	18.400.000.000.000.00	25.700.000.000.000.00

Note: M = Mean, SD = Standard Deviation.

In accordance with the measurement of political connections using dummy variable, the observation results show that 122 firms' years have members of the Board of Commissioners, Directors or Audit Committee who are still or have been active in other Ministries or State Agencies, the Police or the TNI. However, 93 firms' years have no political connections. This data shows that 56% of the sample has political connections.

The average firm value is quite high, which is above 5. A high firm value indicates that shares in the mining sector are quite attractive to investors. The average profitability 6% and average leverage 51%. Judging from total assets, the highest firm's size is IDR 168,000,000,000,000.00 and the average is IDR 18,400,000,000,000.00.

**Table 2. Regression Results between Political Connection Firms Value**

Construct	B	SE B	$\beta$
C	-28.38	11.69	-2.42
Political Connection	-2.27	1.52	-1.48
Profitability	-6.90	2.85	-2.42**
Leverage	0.27	0.21	1.27
Firm Size	1.17	0.43	2.72**

Note:  $R^2 = .13$  ( $p < .05$ ) \*\* $p < .05$ .

From Table 2 it can be seen that political connections have no effect on company value because  $\beta$  of -1.48 has a p value of 0.13, thus the p value is more than 0.05. The results of this study support research (Seftiana, Evana, & Amelia, 2022; Berkman & Galpoththage, 2016; Haryati, Rustiarini, & Dewi, 2021; Tangke, 2019). Meanwhile, p for profitability, leverage and firm size are 0.01, 0.20 and 0.007 respectively. This shows that profitability and firm size influence company value, while leverage does not.

## DISCUSSION

This research shows that political connections have no effect on firm value in the context of mining firms in Indonesia. This unexpected result challenges conventional wisdom and emphasizes the complexity of the relationship between political connections and firm value especially in the Indonesian economy. There may be several factors that led to this unexpected result. One of them is that investors do not see political connection as an important value as the relation may not bring clear or stable effect.

Another factor is that growth of Indonesia economy which later can separate itself from the influence of politics which shows that market conditions in Indonesia wish to create a fairer competitive environment. The effect of political connection may also be moderated by the current institution in Indonesia. Indonesia reformation at 1998 have made the institutions in Indonesia stronger which makes it hard for firm to gain certain access.

The results of this research also conflict with RDT which makes mining firm not rely on their political connections to obtain resources but instead rely on other sources. Although political connections are considered influential in some studies (Dang, So, & Yan, 2018; Joseline, Frandy & Pangestu, 2021; Yuliana & Munandar, 2023) these results indicate that other factors play a more important role in determining the firm value of mining firm in Indonesia. In mining firms, factors such as technological innovation and market competition can play a more critical role. It also shows that the correlation between political connections and firm value can be influenced by the industry and the nature of the firm's operations.

This study contributes a valuable insight to academic research and industrial practice. Understanding what factors help shape firm value in the Indonesian mining sector is important for investors, policy makers and industry players. Future research could explore the political connections that exist in mining companies in more depth, thereby providing a more comprehensive view of the quality of the political connections that mining companies have.

## **CONCLUSION**

In summary, the research on mining firms in Indonesia challenges conventional beliefs by revealing that political connections do not influence firm value in this context. The unexpected findings highlight the complexity of the relationship between political connections and firm value in the Indonesian economy, suggesting that factors such as investor perceptions, the evolving economic landscape, and strengthened institutions post-1998 play a role in mitigating the impact of political ties. Contrary to the Resource Dependence Theory, the study indicates that mining firms in Indonesia rely more on factors like technological innovation and market competition, emphasizing the industry-specific and operational nuances of the correlation between political connections and firm value.

This research contributes valuable insights for both academic and industrial stakeholders, emphasizing the importance of understanding diverse factors that shape firm value in the Indonesian mining sector. Investors, policy makers, and industry players stand to benefit from recognizing the limited influence of political connections and focusing on other critical determinants. The study suggests avenues for future research to deepen our understanding of the quality and dynamics of political connections within mining companies, providing a more nuanced perspective on their impact on firm value.

## **LIMITATION**

Political connections in this study are measured using a dummy variable, a value of 1 will be given to members of the Board of Commissioners, Directors or Audit Committee of a company who are or have been active in Ministries or State Agencies, the Police or the Army. If there is no involvement it is assessed as zero. Research results may be different when the political connection variable is measured based on the number of members of the Board of Commissioners, Directors or Audit Committee who have political involvement. For further research, we can test again with these measurements.



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