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Aamir Amanat
Arid Agriculture University Rawalpindi, Pakistan

Ahmed Imran Hunjra
Arid Agriculture University Rawalpindi, Pakistan

Farhan Ahmed
Arid Agriculture University Rawalpindi, Pakistan, farhan.mba2013@gmail.com

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How Corporate Political Strategies Are Related to Cost of Debt?

Aamir Amanat[1] Ahmed Imran Hunjra[2] Farhan Ahmed[3]*
[1,2]University Institute of Management Sciences – PMAS – Arid Agriculture University Rawalpindi, Pakistan
[3]Department of Economics & Management Sciences, NEDUET, Pakistan

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There are many factors, which play a vital role in the financing decisions of firms, and one of the important factors is corporate political strategies. This study examines the impact of corporate political strategies on the cost of debt of non-financial firms listed in the Pakistan Stock Exchange (PSX). Corporate political strategies are measured through political connections. We use panel data of 250 firms from 2001 to 2018. Panel regression is applied to analyze the results. This study finds corporate political strategies negatively affect the cost of debt. This study provides useful policy implications for corporate stakeholders to know the importance of political connections while making the financing decision.

Keywords: *Political connections; cost of debt; corporate political strategies; panel data*

JEL Classification: G30, G38

Introduction

The firms' decision-making process may be affected by the government policies and firms try to develop connections with government officials for taking the benefits. Firms having connections with politicians retain updated knowledge about changes in government policies, reforms, tax rebates, and other shared resources which lead to providing opportunities for easy access to finance at low cost. In this perspective firms used corporate political strategies for their benefits. These strategies may be lobbying, contributing to the campaign, and engage the politicians in their board of directors for serve (Colak, Durnev, & Qian, 2017). Politically connected firms gain the favor, which enhances the company's economic growth. Political connections provide firms with different types of institutional support in the form of access to internal information and other valuable resources. These resources play an important role to get a competitive advantage in the market (Hassan & van Lent, 2016). Antia et al. (2013) explained that politically connected firms get more information about government policies to obtain the maximum benefit from internal information. Al-Hadi, Habib, Al-Yahyaee, & Eulaiwi, (2017) conducted a study on Brazil and found that the politically connected firms have a positive impact on its performance and can easily obtain external finance.

This study has contributed to the previous body of knowledge by providing evidence on

* Corresponding author's email: farhan.mba2013@gmail.com

the relationship of corporate political strategies and the cost of debt from an emerging market such as Pakistan. Only a small number of studies have investigated the cost of debt and corporate political strategies up to the knowledge of the researcher. In those studies, controversial findings were explored so those inconclusive results instigate the researcher, to conduct research and found the relationship of corporate political strategies and the cost of debt in Pakistan.

Jiang & Kim (2015) explained that political agents act on behalf of other officials. Firms try to create connections with political hubs or government officials by using different tactics (Manos, Murinde & Green, 2007). Getz et al. (2002) found that the firms reduce the agency problems that the manager (agent) creates a relationship with government officials which reduces the cost of external financing (Li & Zhou, 2015). There is immense literature that provides evidence about the benefits of corporate political strategies (Faccio, Masulis & McConnell, 2006). Prior studies provide evidence on the relationship between corporate political strategies and the cost of debt. Cooper Gulen & Ovtchinnikov (2010) argued that there is a potential link between the political ties of firms and the cost of debt.

The objective of this study is to find the impact of corporate political strategies on the cost of debt. This study provides insights into the Pakistani setting. Pakistan is a low growth economy, limited state-owned firms, and weak democratic which seems vulnerable to the influence of corporate political strategies. A large number of agriculture allied firms and few other non-financial firms are politically connected but there are no legal restrictions (Rehman, 2006). The findings of the current study provide useful policy implications for corporate stakeholders to know the importance of political connections while making the financing decision.

The remaining part of our study is structured as follows. We provide brief literate in Section 2. Section 3 describes methodology and data, followed by empirical findings in Section 4. However, Section 5 concludes the study with some insights for future research.

Literature Review

Political connections help firms to easily access bank loans, and the cost of debt and avoid market failures (Khwaja & Mian, 2005). Faccio et al. (2006) explained that the firm is politically connected when its director, a large shareholder or another member of top management is a minister, part of the government as a parliament member or close relative to the head of state. Faccio et al. (2006) stat that the connected firms take benefits in the form of easy access to finance, government provide tax shield, contracts from the government on a preferential basis, and easy access to credit of state-owned banks. It also stated that firms having connections with government officials also obtain an advantage in the form of exemption in tax through regulations or create hurdles through tax regulations for their rivals.

Tullock (1967) views rent-seeking theory helps firms to obtain rare resources such as lower tax rates and other subsidies from the government. Rent-seeking appears to gain substantial profits due to the change in the economic structure in the transition period, (Chaney, Faccio & Parsley, 2011). According to Bertrand et al. (2004), the political connection is a rent-seeking behavior for firms. Besides, by following the resource-based view Wernerfelt (1984), that independent directors are instruments providing facilities to firms to access critical resources. Based on these theories and perspectives, the political connection is a competitive advantage for the firms.

Khwaja & Mian (2005) suggested that politically connected firms get easy access to finance and loan with low-interest rates. They also found that politically connected firms obtain external finance on a preferential basis and it reduces the firms' cost of financing. Chivatxaranukul & Griffin (2001) found that the firms connected politically obtain the long term loan easily from the banks and other financial institutions. As political connections are similar to the collateral for banks and politically connected firms obtain the benefit in the form of a preferential loan. Claessens et al. (2008) explored that the firms obtain external finance easily

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when they contribute in the election to the winning party. Therefore, the winning party supports the firm in obtaining a loan which shows that connections play a vital role in easy access to finance. Firms try to build relationships with the government to obtain loans and easy access to finance. Most of the time connected firms get a preferential loan from state-owned banks due to a strong tie with the government (Shi, Xu & Zhang, 2018). Claessens et al. (2008) explored that corporate political strategies are an important source to obtain easy access to finance. Boubakri, Guedhami, Mishra & Saffar (2012) found that firms having connections can easily access finance, reduction in tax liability, and other bailout packages from the government.

Leuz & Oberholzer-Gee (2006) conducted a study in Indonesia and found that politically connected firms obtain finance at a low cost. Several other studies also supported the same results in Taiwan, Brazil, and the USA (Chaney et al., 2011; Claessens et al., 2008; Houston, Jiang & Lin, 2011). Bliss & Gul (2012) conducted a study in Malaysia and found that politically connected firms pay the high cost on loans and other external financings. Johnson & Mitton (2003) show that political ties impact the loan amounts that means the political connections are useful for firms to access the debt. Literature reports that politically connected firms enjoy special leverage to obtain the government loans and are likely to use more external finance (Ebrahim, Girma, Shah & Williams, 2014; Saeed, Belghitar & Clark, 2016). Literature provides evidence that loan providers accept low interest on their investment as they think that politically connected directors provide resourcing roles while sharing knowledge in finance, law, policy-making and serving in boards of other firms. Based on the above discussion, we develop the following hypothesis:

H1: Corporate political strategies negatively affect the cost of debt of the firm.

We use a set of control variables, i.e., size, profitability, growth and capital intensity in our study to strengthen the analysis. Previous studies provide insights on the importance of mentioned control variables on the cost of debt. Bhojraj and Sengupta (2003) conclude that large-sized firms bear a low cost of debt and cost of equity. Chkir et al. (2019) document a negative relationship between firm size and the cost of debt. Chaney et al. (2011) provide an inverse impact of growth on the cost of debt. An increase in profitability leads to decrease in indebtedness (Vintila et al., 2019). This decrease in debt financing shows that firms have to bear less cost of debt due to an increase in profitability. Chivatxaranukul & Griffin (2001) and Cortez and Susanto (2012) and obtain a negative impact of profitability on debts. Capital intensity shows the inverse impact on the cost of debt. As a result of the high capital intensity ratio, the firm's cost of capital is reduced Chkir et al. (2019). Kullu and Raymar (2018) also provide a negative relationship between capital intensity ratio and the cost of capital.

Methodology

Data

The sample of this study consists of non-financial firms listed at Pakistan Stock Exchange (PSX), Pakistan. Eighteen years of panel data of 250 non-financial firms ranging from 2001 -2018. The data is collected from DataStream, Financial statements, and the election commission of Pakistan. We obtain the data of corporate political strategies of firms from the election commission of Pakistan which provides all information about candidates' contests. In this study four general elections' data included for analysis held in 2002, 2008, 2013, and 2018. After the deletion of missing data of different firms, our final sample comprises 250 non-financial firms listed in the Pakistan Stock Exchange with 4500 firm-year observations. We divided our sample into two groups; politically connected firms and non-connected firms so we use a sample of politically connected firms with 1602 observations to check the impact of corporate political strategies on the cost of debt. Politically connected firms are also divided into two subgroups; Agriculture allied connected firms and other non-financial firms. The ob-

Table 1. The Description of Variables

Variables	ABBV	Description	References
Cost of Debt	K_d	Interest expenses of a company divided by the total debt (Long term and short term debt)	Bliss & Gul (2012), Liedong & Rajwani (2018), Qiu & Yu (2009)
Corporate political strategies	CPS	When the firms connected it assigned 1 and otherwise 0	Shi et al. (2018), Wang (2015)
Size	SZ	Calculate by using the natural log of total assets	Bliss & Gul (2012)
Profitability	PRF	Earnings before interest and tax to total assets	Boubakri et al. (2012), Fan, MengRui & MengxinZhao (2008), (Chaney et al., 2011)
Growth	GRW	Calculated by using sales in time t minus t-1 and divided by sales of t-1	Petersen & Rajan (1994), Pittman and Fortin (2004), Chaney et al. (2011)
Capital intensity	CINT	Measured through the gross property, plant, and equipment scale by total assets	Saeed et al. (2016), Boubakri et al. (2012)

Table 2. Descriptive Statistics

	Full Sample				Agriculture Allied				Other Non-Financial			
	Mean	SD	Min	Max	Mean	SD	Min	Max	Mean	SD	Min	Max
Kd	0.069	0.046	0.001	0.454	0.070	0.042	0.001	0.454	0.068	0.049	0.001	0.454
CPS	1.000	0.000	0.000	1.000	1.000	0.000	0.000	1.000	1.000	0.000	0.000	1.000
GRW	0.138	0.920	-1.576	1.891	0.199	0.806	-1.576	1.891	0.073	0.947	-1.576	1.891
SZ	7.004	0.775	5.729	8.680	7.038	0.681	5.729	8.680	6.953	0.801	5.729	8.680
PRF	0.029	0.041	-0.066	0.114	0.031	0.035	-0.066	0.114	0.026	0.042	-0.066	0.114
CINT	0.527	0.130	0.275	0.756	0.537	0.114	0.275	0.756	0.517	0.133	0.275	0.755
Obs.	1602				1026				576			

Note: Kd is the cost of debt, CPS is corporate political strategies, GRW is the growth, SZ is firm size, PRF is profitability, CINT is capital intensity, Med is median, Min is minimum, Max is maximum and Obv is observations

servations used for the analysis of agriculture allied firms are 1026 and other non-financial firms are 576. We exclude the firms having missing values or dissolved during the analysis period. Furthermore, we divide the sample into two groups of business group affiliated and non-business group affiliation to check their impact on the cost of debt.

Statistics

A firm is politically connected if its director or CEO participated in an election of the national assembly or Provincial assembly. We use a dummy variable for a politically connected firm by taking the value of one if at least one director or CEO is politically connected and otherwise zero (Khwaja & Mian, 2005; Faccio, 2006). The cost of debt (K_d) is measured through the interest expenses of the firms divided by total debt during the year (Bliss & Gul, 2012). We use firm size, growth, profitability, capital intensity as control variables in our study. The size of the firm measured by the natural log of total assets, earnings before interest and tax to total assets used as a proxy of profitability, Capital Intensity is measured through gross property, plant, and equipment scale by total assets, and growth are the control variables. We use the following model for hypothesis testing.

$$Kd_{it} = \alpha 0+\beta_1 CPS_{it}+\beta_2 GRW_{it}+\beta_3 SZ_{it}+\beta_4 PRF_{it}+\beta_5 CINT_{it}+\mu_{it} \quad (1)$$

Whereas Kd is the cost of debt, CPS is corporate political strategies, GRW is the growth, SZ is firm size, PRF is profitability, CINT is capital intensity, α_0 is constant, μ is an error term, i is firm and t is the period

We use Gretl software to analyze the data. We apply descriptive statistics to check the characteristics of data, correlation is used to measure the association between variables and to check the multicollinearity issue. We selected the fixed effect model based on the Hausman test results.

Results and Discussion

The results of the descriptive statistics in Table 2 show the characteristics of the variables used in this study. The mean of the cost of debt of overall sample, agriculture allied and other non-financial connected firms show that firms

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Table 3. Correlation Matrix

	Kd	CPS	GRW	SZ	PRF	CINT
Kd	1					
CPS	-0.022	1				
GRW	0.261	0.026**	1			
SZ	0.064**	0.096*	0.644*	1		
PRF	0.308**	0.014**	0.263	0.295**	1	
CINT	0.141*	0.058**	0.105**	0.097*	0.123**	1

Note: Kd is the cost of debt, CPS is corporate political strategies, GRW is the growth, SZ is firm size, PRF is profitability and CINT is capital intensity, ***, **, * are the significance level at 1%, 5%, and 10% respectively

Table 4. Regression Analysis (DV: Kd)

Variables	Overall Sample	Agriculture Allied	Other Non-Financial
CPS	-0.169***	-0.071***	0.120***
	(0.043)	(0.031)	(0.026)
GRW	-0.359	-0.047	-0.101***
	(0.072)	(0.029)	(0.034)
SZ	-0.095**	-0.053**	-0.096**
	(0.045)	(0.040)	(0.028)
PRF	-0.140***	-0.094***	-0.053*
	(0.019)	(0.019)	(0.029)
CINT	-0.168***	-0.108***	-0.610
	(0.021)	(0.023)	(0.082)
Adj. R^2	0.351	0.385	0.331
F- Statistic	10.725***	11.635***	20.790***
H- Statistic	7.483***	9.583***	9.741***

Note: ***, **, * are the significance level at 1%, 5%, and 10% respectively, CPS is Corporate Political Strategies, GRW is growth, SZ is firm size, CINT is capital intensity, PRF is the profitability of the firm and standard error is in parenthesis

pay a consistent return to their loan providers with small deviation in the values. The mean value of the growth explains that firms enjoy growth opportunities in Pakistan. This is because the non-financial sector and Agriculture Allied sectors play an important role in the development of Pakistan's economy, therefore, these sectors find more opportunities to grow and contribute more to the economy. There is less variation in size and more consistency towards spending in total assets. This justifies that firms in Pakistan are keen to survive and spend more money on increasing total assets that result in generating a more favorable outcome. Overall positive average profitability indicates firms in Agriculture allied and non-financial sector of Pakistan is efficiently utilizing its assets to generate profit. The average value of capital intensity provides evidence that firms invest more than half of financing to acquire tangible fixed assets to generate revenues. The small variation in the values of capital intensity shows more consistency of firms to acquire tangible fixed assets.

We present a coefficient correlation in Table 3 which explains the relationship among independent variables. Results show that there is no high correlation which confirms no multicollinearity issue.

We use fixed effect model based on Hausman test to analyze the results in Table 4. The results show that corporate political strategies negatively affect the cost of debt which confirms our hypothesis. It indicates that politically connected firms access external finance easily. The connection makes easy for the firm to obtain the loan at a low cost. Findings justify that politically connected firms have more valuable resources enabling them to get external finances that also include a loan from banks (Claessens et al., 2008; Khwaja & Mian, 2005). Politically connected firms get benefits from favorable policies of the government that also helps firms to manage lower interest rate on debts. The result shows that agriculture allied firms have more connections as compared to other non-financial firms. Furthermore, we find that firm size significantly affects the cost of debt which means larger firms have easy to access external finance because those have more

Table 5. Foreign-Owned v/s Domestic Owned firms and Business Group v/s Non-Business Group

Variables	FO	DO	Variables	BG	NBG
CPS*FO	-0.098 (0.037)		CPS*BG	-0.0520*** (0.0060)	
CPS*DO		-0.200*** (0.034)	CPS*NBG		-0.240 (0.055)
GRW	-0.272 (0.111)	-0.284 (0.266)	GRW	-0.3580*** (0.1270)	-0.089 (0.016)
SZ	-0.378*** (0.054)	-0.237*** (0.048)	SZ	-0.1310*** (0.0400)	-0.233*** (0.050)
PRF	0.212** (0.183)	-0.086*** (0.021)	PRF	-0.0561** (0.0260)	-0.138** (0.063)
CINT	-0.193* (0.063)	-0.179*** (0.022)	CINT	-0.1890*** (0.0200)	-0.058** (0.027)
Adj. R^2	0.227	0.126	Adj. R2	0.4310	0.492
F- Statistic	12.590***	40.198***	F- Statistic	49.9300***	32.270***
H- Statistic	4.724***	10.742***	H- Statistic	3.8450***	6.548***

Note: ***, **, * are the significance level at 1%, 5%, and 10% respectively, CPS is Corporate Political Strategies, GRW is growth, SZ is firm size, CINT is capital intensity, PRF is the profitability of the firm, FO is foreign-owned, DO is domestically owned, BG is a business group and NBG is nonbusiness group

resources and relationships with financial institutions. The negative impact of firm size on the cost of debt is in line with the findings of Bhojraj and Sengupta (2003). The result indicates that profitable firms listed in Pakistan raise less finance through debt. The findings of our study are consistent with Chivatxaranukul & Griffin (2001) explain that the profitable firms used less leverage even tax shelter is associated with profitability. The findings of our study further reveal the negative impact of capital intensity ratio on the cost of capital. Negative influence follows the results of Kullu and Raymar (2018).

The result of Table 5 shows that foreign-owned politically connected firms and the cost of debt have a negatively insignificant relationship. It shows that foreign-owned firms do not need to access the leverage so the cost of debt has an insignificant relationship with foreign-owned connected firms. We find that politically connected domestic firms have easy access to external finance. It shows that connection makes easy for the firm to obtain the loan at a low cost. In Pakistan, politicians have an influence in financial institutions because policies made by the state bank with the consultation of a member of the national assembly dealing with trade and commerce. So banks have a lenient policy for domestic firms having connections with politicians. The result also indicates that the politically connected firms and having business group affiliation obtain the debt easily. The firms affiliated with large business groups can share the repute as a group and thus made easy to access external finance. It also finds that the business group has more ability to establish connections as compared to non-business group firms. The result shows that the non-political connected firms with a business group cannot obtain the debt easily which increases the cost of debt of non-connected firms. Hassan & van Lent (2016) find that the firms having political connections enjoy the easy access to finance from government banks. Large business groups have more affiliation with politicians or other government officials and they are the part of policymakers. Firms attached to those giants get more benefits as compared to other non-connected firms (Tahoun & Vasvari, 2019).

Conclusions

The objective of this study is to investigate the impact of corporate political strategies on the cost of debt financing. We find that corporate political strategies negatively affect the cost of debt. It is also revealed that agriculture allied firms have more connections than other non-financial firms listed at Pakistan stock exchange. It means that the fund providers give the preference to politically connected firms and easy access to external finance which leads to maintaining high leverage. The findings of

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this study have important implications for information users, organizations, and regulators. Our study reveals that the firms having connections received preferential treatment from the government in the form of a tax shield and other contracts. Lenders perceived that firms having connections are more secured and lower default risk. Therefore, lenders provide the loan to politically connected firms with a low-interest rate and easy access. Our study has certain limitations. We took data of non-financial firms, whereas, the same set of studies can be done by incorporating data of financial firms and comparison analysis may also be done in future research. Future research can be conducted by using the corporate governance variables such as CEO duality, ownership structure, board size and other dimensions. Our study is limited to Pakistan only; however, incorporating other developing countries for similar study can be the area of interest for future research.

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