



# The Impact of Political Involvement on Firms' Financial Performance

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## ABSTRACT

Political involvement helps businesses to obtain key government resources and support. Political involvement assists businesses to take actions that reduce uncertainty, provide shield and environmental dependence from the environmental threats that can directly impact their performance. This study aims to investigate the impact of political involvement on banks' sustainable performance in selected South Asian economies (Pakistan, Bangladesh, India, and Sri Lanka). The data is collected from DataStream for the period of 2013-2022. The generalized method of moments is employed to analyze the results. The study finds that political involvement negatively affects the firm's sustainable performance. This study is helpful for management of the organizations and shareholders to increase firm performance by reducing political involvement.

**Keywords:** Political Involvement, Firm Performance, Financial Leverage, Banking Sector, South Asian Economies

**JEL Classifications:** G30, G32, G34

## 1. INTRODUCTION

No business can exist without interaction from its environment. The interaction with the environment is an essential survival strategy and therefore allows it to be self-sufficient, dependent and above all, sustainable (Aifuwa, 2020). The term sustainable development or sustainability becomes more focused by following the United Nation's transformation agenda which should be achieved before 2030 (Schumacher et al., 2020). The primary focus of the sustainable development is to strengthen the social, environmental, and economic performance of governments and companies around the world (United Nations, 2016). Businesses operate in an environment consisting of internal and external stakeholders. In order to survive and to perform better, businesses need to appease them. Stakeholders can influence the firm's objectives, policies and actions or they can be influenced by the firm's policies. Amongst many, members of the political parties also play an important role as a stakeholder in the operations of a business and their relationship is called the political involvement

between the business elites and politicians. This relationship helps both to take advantage that includes easy recourse to bank debts, tax freedoms and large market share (Bencheikh and Taktak, 2017).

Political involvement is an action that affects concerned political sphere or shapes. Political involvement ranges from right of voting to attending a rally of committing and act of violence to sending a letter to a representative (Salisbury, 1975). Political involvement relates to firm performance (Mayer, 1998). It can be said that, political involvement is the key factor in any organization which is involved in major corporate decision, rules, and regulations (Bencheikh and Taktak, 2017). If firms have better framework and decision policies, they perform better as compared to their competitors.

The relationship between political involvement and firm performance is explained by "grabbing hand" and "helping hand" theories. The grabbing hand theory proposes that the local party committees use firms for their own political and social

objectives, which has a negative impact on the performance of a firm. On the other hand, helping hand theory argues that local party committees positively influence firm's performance because they help firms to secure scarce resources in the economic market and diminishes agency problem in firms having deprived corporate governance (Chang and Wong, 2004). Political involvement effect the performance of every firm, but this effect can be less on private firms. Similarly, the situation and impact is not the same for developed and developing nations. This impact is more in emerging countries because they are facing more political crises as compared to the developed nations. It is also evident that investor's protection is high in developed capital markets, where market is more efficient and disclosure requirements are wider which show less political involvement. While in developing nations, the firms are politically more involved (Guo et al., 2019).

While investigating the impact of political involvement on firm's performance various researchers conclude that political involvement improves the firm performance (Bencheikh and Taktak, 2017; Boubakri et al., 2012) which support the helping hand theory. A key point underlying this premise is that political involvement provides businesses with different types of institutional support by providing them with access to useful resources and information. However, there are studies that show the "dark side" of political involvement and contend that there are no management incentives for a politically involved board to increase shareholders wealth and enhance corporate performance (Boubakri et al., 2008; Chen et al., 2011). Lin (2024) states that different types of political involvement reduce the firm performance. Such firms forgo their profit maximization objective in order to pursue political and social objectives.

Furthermore, too much political involvement decreases the firm's performance of local state-owned enterprises (SOEs) as the managers in these firms focus more on political and social performance rather than economic performance (Chen et al., 2017; Ling et al., 2016). Likewise, politically involved firms negatively influences firm performance and underperform than non-politically involved firms in a developing country setting (Saeed et al., 2016). Guo et al. (2019) find the negative impact of political involvement on local SOEs and relatively positive impact on NSOEs as in NSOEs the ratio of political party members in the board of directors is greater than that in local SOEs. Arniati et al. (2024) indicate the different impacts of political connections on firm performance. Chin et al. (2024) claim that politically connected firms normally underperform than their counterparts.

Prior studies indicate that in developed countries, political involvement positively influence the firm's performance but for emerging nations political involvement can be negatively related to firm performance which ultimately reduces the firm performance. In particular for the banking sector, Cornett et al. (2010) investigate the impact of government ownership on state-owned banks and privately-owned banks in an international setting and report inferior performance of state-owned banks. Till date, no study has been conducted on financial sector of emerging South Asian countries concerning the impact of political involvement on firm performance. Pakistan, Bangladesh, India, and Sri Lanka

are the largest and fast-growing economies of South Asia and the banking sector is the key element of these South Asian countries. A stable and profitable functioning of this sector is the prerequisite for a strong economy (Hunjra et al., 2020). This motivates us to investigate whether political involvement negatively impacts the firm's performance in emerging South Asian countries or not? This research contributes to the existing literature by examine the impact of political involvement on banks performance in context of emerging South Asian countries including Pakistan, Bangladesh, India, and Sri Lanka. This study also examines country wise impact of political involvement on firm performance to check the robustness of results.

Overall findings suggest that impact of political involvement on firm performance in selected South Asian countries is significant and negative which supports the grabbing hand theory. Finding implies that the banks performance is worse when secretary served as chairman of the board or as CEO. In addition, government owned banks are more likely to focus on political goals rather than economic gains under the political involvement and ultimately leads to poor firm performance. Present study also includes, company size, total asset growth rate, debt to equity ratio and government directly holding or not as control variables. All of these variables play significant role in influencing firm performance. This study is helpful for management of the organizations and shareholders to increase firm performance by reducing the political involvement.

The reminder of the study is as follows: Section 2 describes the literature followed by methodology in Section 3. Results are presented in Section 4 and conclusion is made in Section 5.

## 2. LITERATURE REVIEW

Firm performance is a multifaceted term that might take meaning of firm's operations or the effect from operations whereas a firm is well thought-out politically involved if one of the manager or shareholder is a member of legislative body, a minister or has close relation with a political party (Faccio, 2006). In fact, several firms that have, a minister, a person that belongs to a political party, a delegate of parliament or any individual having political association at any stage of its ownership structure or board of director is well thought-out to be politically involved.

The impact of political involvement on firm performance has been investigated by number of researchers. It is revealed that in emerging economies, the impact of political involvement on firm performance is higher as compared to developed countries, due to political flux. The regulatory changes have the prospective to endorse or restrain firm performance. Though, the impact of political involvement on firm performance is not definite as it is difficult to decide between the cost and the advantage of political associations.

It is also said that politically involved firms can get benefit of their association either to preserve or to improve the firm performance (Bencheikh and Taktak, 2017). Empirical evidence suggests that political involvement matter most through easy access to capital.

For instance, Faccio (2006); Khwaja and Mian (2005); Luo and Ying (2014) report that politically involved firms have greater and easier access to bank loans. Efficient allocation of such valuable resources gives a firm a competitive edge that can be transformed into improved performance (Su et al., 2015). Politically involved firms avail the considerable advantages in provision of elevated leverage, low excise, and well-built market power (Faccio, 2006). Ahmad and Brahmana (2022) highlight that political involvement is particularly harmful for the firm due to control and ownership difficulties.

Saeed et al. (2015) report that large firms are more involved in political relationships and ultimately it has positive impact on their performance whereas small firms are not involved in political connections. Moreover, large firms enjoy easy access to cash, they can have more debts and can enjoy other benefits like tax shield. This fact has also been proved by Fu et al. (2017); Faisal et al. (2023) show that political connections have a significant influence on firm performance. The degree of high leverage and little taxation reflect an advantage; this advantage might accrue frequently to non-listed firms associated with politicians (Faccio, 2007). Well-Known politicians use their power to advantage their family, friends and those who take benefit from the government (Faccio, 2006). Sharma et al. (2020) incorporate sample of exporter and non-exporter firms to examine how political involvement influences performance of these firms in China and reveal positive impact of political involvement on performance of exporter firms.

On the contrary, if financial resources that are readily accessible to politically involved firms are not used effectively, they may have a negative impact on the performance of the business. Political involvement in the management of the firm along with politicians' poor managerial skills could be detrimental to the firm performance (Boubakri et al., 2012). Shleifer and Vishny (1994) argue that, rather than maximizing firm value, connected politicians tend to be more interested in rent-seeking, extraction, and political objectives. Bertrand et al. (2007) report a negative impact of political involvement on firm performance and linked this finding to the fact that politically involved firms formulate their policies in pursuit of political agendas at the expense of their own profit maximization objective. The rising effect of government policies on firm's setting has contributed to political involvement in firm's activity. In some industries government policies affect the firms cost of doing business (Ozer and Alakent, 2013). Politically involved firm shows a lower profit as it increases the fraction of their employment located in politically contested areas, due to higher wage bills (Bertrand et al., 2007). EL Ammari (2023) explained that external investors pay particular attention to politically connected firms as PCs tend to weaken corporate performance.

Chen et al. (2011) discover that directors that are politically involved distort investment efficiency and therefore firm performance. Moreover, considering the impact of political involvement in newly privatized firms, Boubakri et al. (2008) reveal poor performance of politically involved firms than their non-politically involved counterparts. In addition, Fan et al. (2007) indicate that in terms of post-IPO stock returns, newly

privatized Chinese companies with politically involved CEOs are related to poor performance. While analyzing the impact of political involvement on firm performance in developing countries perspective, Saeed et al. (2016) reveal negative influence of political involvement on firm performance in Pakistan. Likewise, Ling et al. (2016) explore the relationship between political involved firms, corporate investments, and performance of firms in Chinese context. The findings suggest that political involvement is negatively linked to firm performance in China. In addition, more political involved firms are funded with longer-term bank loans and are more inclined to overinvest. This negative relationship among political involvement and firm performance is also revealed by Guo et al. (2019). Based on the above arguments, this study develops the following hypothesis.

H<sub>1</sub>: Political involvement negatively affects the firm performance.

### 3. METHODOLOGY

This research evaluates the impact of political involvement on sustainable performance of government owned banks in four South Asian economies i.e. Pakistan, Bangladesh, India, and Sri Lanka. The sample consists of fifty-three government owned banks out of total registered banks in selected South Asian countries for the period of 2013-2022. Out of which 15 banks are from Pakistan, 14 from Bangladesh, 15 from India and 09 are from Sri Lanka. Present research obtains the data of political involvement manually from banks' websites and annual reports and data of other variables is collected from DataStream. Organizations with improved (poorer) firm performance are more (less) probable to desire members of the Par or political parties to partake in board of governance (Guo et al., 2019). This study uses the following mathematical model to evaluate the results.

$$FP_{i,t} = \beta_0 + \beta_1 Par_{i,t} + \beta_2 AgeGov_{i,t} + \beta_3 Size_{i,t} + \beta_4 Lev_{i,t} + \beta_5 GRW_{i,t} + \beta_6 Gov_{i,t} + e_{i,t} \quad (1)$$

In equation 1., *i* and *t* indicate the number of banks and number of years, respectively. Whereas, FP is firm performance which is measured by return on assets (ROA) and return on equity (ROE). Political connection is measured by a dummy variable in majority of the studies dealing with politically involved firms (Faccio, 2006; Saeed et al., 2015). This study uses the representatives of the Par as directors (including the chairman) or executives (including the CEO) as political involvement measures. Par is equal to 1 if the secretary or the deputy Secretary acts as directors or managers of a corporation (including the chairman or CEO), otherwise 0 (Guo et al., 2019). This research uses a set of control variables i.e. bank Age, Size, Leverage (Lev), Growth (GRW) and Government directly holding or not (Gov). Saeed et al. (2015) report that large and old politically involved firms have easy access to credit. Moreover, they can enjoy high debt to equity ratio because of high political involvement. Further, Guo et al. (2019) suggest positive impact of assets growth on politically involved firms performance. It is revealed that leverage, age, and equity holding enhance the market performance of politically involved firms (Ferguson and Voth, 2008; Li et al., 2008). The error term is denoted by *e*. The summary of variables description is presented in Table 1.

**Table 1: Measurement of variables**

Variables	Abbreviation	Description and formula	Sources
Return on asset	ROA	ROA is return on assets and it is used to measure firm's performance	Sultana et al. 2019
Return on equity	ROE	ROE is return on equity and is used to measure firm's performance for firm I in year t	Guo et al. (2019)
Party committee	Par	Equal to 1 if the secretary or the deputy Secretary acts as directors or managers of a corporation (including the Chairman or CEO), otherwise 0	Guo et al. (2019)
Government directly holding or not	Gov	Equals to 1 if government directly hold shares of the firms and else 0	Wu et al. (2012)
Company size	Size	The natural logarithm of total assets at the end of current year	Xu et al. (2015)
Leverage	Lev	The ratio of total liabilities and total assets at the end of the recent year	Faccio (2007)
Growth	GRW	The change of total asset in year t scaled by the total assets at the beginning of the year	Sokolov and Solanko (2017)
Listed years	Age	The number of listed years of a firm	Guo et al. (2019)

ROA: Return on assets, ROE: Return on equity, PAR: Party committee, GRW: Growth, SIZE: Company size, LEV: Leverage, AGE: Listed years, GOV: Government directly holding or not

**Table 2: Descriptive statistics and correlation analysis**

Variables	Mean	SD	ROA	ROE	PAR	GRW	SIZE	LEV	AGE	GOV
ROA	0.046	0.656	1.000							
ROE	0.377	3.739	0.966	1.000						
PAR	0.425	0.495	0.050	0.035	1.000					
GRW	0.528	3.101	0.306	0.285	0.117	1.000				
SIZE	11.556	0.582	0.040	0.052	-0.147	-0.094	1.000			
LEV	0.689	0.350	-0.007	-0.008	-0.015	-0.024	-0.132	1.000		
AGE	10.864	9.028	0.061	0.079	-0.097	-0.005	0.425	-0.007	1.000	
GOV	0.306	0.461	-0.023	0.004	-0.033	-0.067	0.522	0.042	0.437	1.000

ROA: Return on assets, ROE: Return on equity, PAR: Party committee, GRW: Growth, SIZE: Company size, LEV: Leverage, AGE: Listed years, GOV: Government directly holding or not, SD: Standard deviation

**Table 3: Test of multicollinearity**

Variable	VIF	1/VIF
ROE	1.100	0.908
PAR	1.040	0.960
Gov	1.520	0.657
Size	1.560	0.639
Age	1.340	0.748
GRW	1.120	0.896
Lev	1.040	0.963

VIF: Variance inflation factor, ROE: Return on equity, PAR: Party committee, GOV: Government directly holding or not, SIZE: Company size, AGE: Listed years, GRW: Total asset growth rate, LEV: Leverage

**Table 4: Two step dynamic panel estimation**

Variables	ROA		ROE	
	Coefficient	t-statistic	Coefficient	t-statistic
L1.	0.090***	24.210	0.095***	33.050
L2.	-0.477***	-22.880	-0.314***	-78.300
PAR	-0.168***	-35.850	-0.836***	-76.370
Gov	0.031***	83.860	0.828***	88.470
GRW	0.317***	20.750	0.393***	78.100
Size	0.364***	19.830	0.485***	45.530
Lev	0.051***	12.460	0.155***	84.800
Age	0.000	-0.780	0.044***	30.360
Sargan value	4.131	-	3.961	-
AR (1)	0.039	-	0.009	-
AR (2)	0.373	-	0.183	-

L1 is first lag of dependent variable, L2 is second lag of dependent variable, ROA: Return on asset, ROE: Return on equity, PAR: Party committee, GRW: Total asset growth rate, Size: Company size, LEV: Leverage, AGE: Listed year of company, GOV: Government directly holding or not. \*\*\*,\*\*,\* Significance level at 1%, 5% and 10%

This study applies descriptive statistics to check normality of the data. To check multicollinearity in the data, this study uses correlation analysis and also performs variance inflating factor (VIF) test. This study employs generalized method of moments (GMM) developed by Arellano and Bond (1991); Arellano and Bover (1995) to test the hypothesis. This study uses two-step dynamic panel estimation for this purpose, which is effective for cross-sectional and short data. This approach is useful for recognizing changes and biases concerning endogeneity issues (Gonzalez, 2013).

## 4. RESULTS

This research applies descriptive statistics which summarizes the data followed by correlation analysis to check multicollinearity. Two step system dynamic panel regression is also employed to investigate the impact of political involvement on firm's sustainable performance.

Table 2 shows the descriptive statistics and correlation analysis. Results show that average banks performance of selected South Asian countries does not show much variation as there are no extreme values in data set. Results reveal that on average there are more board of directors who are politically involved than those government members who directly holds firm's shares which is not increasing the firm performance. In addition, corporate business growth rate is increasing on average and this sector is also growing in terms of business size. Further, this study applies correlation analysis to check the issue of multicollinearity between independent variables. The results show that there is not highly correlation between explanatory variables, therefore there is no issue of multicollinearity.

In Table 3, VIF and Tolerance (1/VIF) are used to check the issues of multicollinearity. The results confirm that there is no issue of multicollinearity in the data.

Table 4 reports the results of two step dynamic panel estimation with ROAs and ROE. To verify the validity of the instruments, present research runs Sargan test in this study. Present research finds insignificant values of Sargan test indicating validity of the instruments. Present research also applies Arellano–Bond test to check autocorrelation. Present research finds significant P-values of AR1 but insignificant values of AR2 which suggest that there is no autocorrelation in second lag. Findings indicate the significant negative impact of political involvement PAR on ROAs. Findings implies that the banks performance is worse when Secretary served as chairman of the board or as CEO. In addition, government owned banks are more likely to focus on political goals rather than economic gains under the political involvement and ultimately leads to poor firm performance. Yi and Demirel (2023) contribute to the sustainability-oriented dynamic capabilities literature by showing that different political capabilities have different implications for firm growth depending on the firm's base performance and the time periods under consideration. The findings are supported by grabbing hand theory and suggest that political members involved in board of firms to use firms for their own political and social objectives rather than maximizing firm's performance. This result is empirically supported by Guo et al. (2019), who find a significant negative relation of political involvement and firm performance on local SOEs. Other variables (growth, government directly holdings or not, company size, Leverage) have significantly positive impact on ROAs which are similar to the findings of Bencheikh and Taktak (2017), who reveal that leverage, age, and equity holding positively influence the market performance of politically associated firms. Likewise, findings with respect to ROE also show significant negative impact of political involvement on ROE which is supported by Castells and Trillas (2013), who found a significantly negative impact of political involvement on the financial market during elections. In addition, growth, company size, Leverage, government direct holdings or not and age found to have a significant positive impact on ROE of financial firms of South Asian countries.

This study also applies the country wise (Pakistan, Bangladesh, India, and Sri Lanka) analysis to check the robustness of results. Table 5 reports the mixed outcomes with respect to ROAs and ROE. Value of Sargan test, AR1 and AR2 confirms the validity of the instruments and verify that there is no autocorrelation. This research finds that political involvement has significant negative impact only on the performance of Indian, Pakistani and Sri-Lankan firms (measured with ROA). Findings suggests that politically involved banks in these countries are more likely to focus on political objectives rather than economic gains, thus deteriorate banks performance. The findings support the grabbing hands theory and consistent with findings of Guo et al. (2019), who confirms the same finding in context of Chinese SOEs. However, this research finds that political involvement is insignificantly related to performance of banks in Sri Lanka estimated with performance measure (ROE). Findings implies that political involvement in this country is not related to performance

Table 5: Two step dynamic panel estimation country wise

Variables	Pakistan		India		Sri Lanka		Bangladesh	
	ROA	ROE	ROA	ROE	ROA	ROE	ROA	ROE
L1	0.523** (2.230)	0.832 (1.610)	0.015 (1.370)	0.001 (0.120)	3.258 (1.070)	5.918 (1.510)	0.059 (0.640)	0.460** (2.440)
L2	-0.269 (-1.490)	-0.278 (-1.580)	0.512*** (97.600)	0.499*** (105.360)	-2.704 (-1.590)	-5.072* (-1.780)	0.611** (2.150)	-0.202 (-0.830)
PAR	-0.045** (-2.950)	-0.262* (-1.873)	-0.004** (-2.490)	-0.054** (-3.890)	-0.022* (-1.672)	-0.563 (-1.540)	-0.030 (-0.890)	-1.932** (-2.600)
Gov	0.004 (1.360)	0.046 (0.470)	0.003 (0.180)	0.324 (0.540)	-217.550 (-1.090)	-0.587 (-1.490)	-0.009 (-0.450)	-0.079 (-0.170)
GRW	0.001*** (3.280)	0.012*** (2.690)	-0.007 (-1.150)	-0.087 (-0.600)	1.010*** (2.650)	0.869* (1.860)	0.014*** (2.580)	0.253*** (2.720)
Size	-0.003 (-1.540)	0.014 (1.300)	-0.017 (-1.430)	-0.713* (-1.750)	10.073 (1.060)	0.289 (1.540)	0.007 (0.540)	0.290 (0.120)
Lev	0.002** (2.410)	0.034 (1.520)	0.000 (-0.210)	0.007 (0.560)	-0.215 (-1.030)	-4.561 (-1.390)	-0.003** (-2.060)	-0.308 (-1.190)
Age	0.000 (1.500)	-0.002 (-0.670)	0.000 (-1.220)	-0.001 (-0.140)	-0.833 (-1.080)	-4.517 (-1.440)	0.002*** (4.960)	0.046 (0.440)
Sargan value	5.611	6.353	4.092	3.884	7.938	5.714	6.108	9.114
AR (1)	0.001	0.035	0.016	0.051	0.005	0.037	0.000	0.042
AR (2)	0.259	0.512	0.217	0.437	0.691	0.762	0.295	0.431

L1 is first lag of dependent variable, L2 is second lag of dependent variable, ROA: Return on assets, ROE: Return on equity, PAR: Party committee, GRW: Total asset growth rate, Size: Company size, LEV: Leverage, AGE: Listed year of company, GOV: Government directly holding or not. \*\*\*, \*\*, \*Significance level at 1%, 5% and 10%

of firms and found no support for either grabbing hand theory or helping hand theory. Among control variables Growth (GRW) has significant impact on banks performance (with both performance measure) in Pakistan, Bangladesh, and Sri Lanka consistent with the findings of Guo et al. (2019). However, Leverage significantly influences firm performance in Pakistan and Bangladesh measured with ROA similar to the findings of Saeed et al. (2015). Size and Age are significantly related to bank performance only in India and Bangladesh respectively consistent with findings of Li et al. (2008).

## 5. CONCLUSION

Political involvement helps businesses to reduce uncertainty, provide shield and environmental dependence from the environmental threats that can directly impact their performance. This study aims to investigate the impact of political involvement on banks' sustainable performance in selected South Asian countries (Pakistan, India, Bangladesh, and Sri Lanka). This research applies GMM to estimate the results. Political involvement, bank size, leverage, bank age and growth pay significant role in determining firm performance in the selected South Asian countries. Overall analysis indicates significant negative impact of political involvement on firm performance. Findings implies that the firm performance is worse when Secretary served as chairman of the board or as CEO. In addition, government owned banks are more likely to focus on political goals rather than economic gains under the political involvement and ultimately leads to poor firm performance.

This study provides help for management of organization to sustain and increase firm performance by minimizing political involvement. The impact of political involvement on stock market performance can be an interesting future study.

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