Political Connections and Cost of Debt Financing: Empirical Evidence from China

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ABSTRACT

The purpose of this study is to investigate whether politically connected firms (PCF) play a significant role in cost of debt (CoD) financing. To emphasize this evidence, we empirically analyzed the panel data of the period 2011–2013. We found that PCF have a negative and significant impact on the CoD financing compared to non-PCF. The reducing of CoD in PCF is a consequence based on shared resource knowledge of political connection directors in law, finance and government procurement contracts for favorable government policies and tax rebates. The results of this study significantly contribute to the literature through providing evidence from China.

Keywords: Politically Connected Firms, Politically Connected Directors, Cost of Debt
JEL Classifications: D72, H63, G32

1. INTRODUCTION

In emerging markets, providing sources is a challenge for firms because of the weakened legal institutions and strong control holder (government) for resources allocation (Adhikari et al., 2006; Faccio, 2006). Firms thus started involving with political connections to be viable for gaining an advantage (Allen et al., 2005). Therefore, firms appointed directors whom involved with political connections. However, several studied argued that politically connected firms (PCF) have higher risk than non- PCF, behind this, there are some reasons: Firms with high political connections became more inefficient; and associated with higher leverage (Bliss and Gul, 2012). To the end, this study explore a crucial relationship of effect of politically connected directors (PCD) on the cost of debt (CoD) financing especially in China.

The objective of this study is to answer the questions: (i) What is the impact of political connections on CoD? (ii) Do PCF have different effects on CoD compered to Non- PCF? To answer these questions, we examine Chinese listed firms in the Shanghai and Shenzhen stock exchanges the period from 2011 to 2013.

The results of this paper are including the interest rates charged by lenders to PCFs is significantly lower than those charged to non-PCFs. The lenders' thoughts PCD are playing the resourcing role in firms by sharing their knowledge in law; finance and serving on other boards. PCD also help firms to have high level of access to financial resources, including bank loans; equity finance; and government procurement contracts. In addition, PCD enable firms benefit from favorable government policies, such as favorable tax rates (Boubakri et al., 2012; Claessen et al., 2008; Faccio et al., 2006; Shi et al., 2018). These thoughts give PCFs opportunities to get lower interest rates that is matched with our expectation.

This study has contribution to the literature through providing another evidence on the association between political connections and CoD evidence from China, emerging markets. In the

literature, the controversial findings about the effect of political connections in debt financing over the world. In Indonesia, Leuz and Oberholzer-Gee (2006) found that connected firms enable to access financing at lower costs that supported by several studies in deferent countries such as Brazil; Taiwan; Pakistan and The US (Chen et al., 2014; Claessens et al., 2008; Houston et al., 2014; Khwaja and Mian, 2005). However, In Malaysia, Bliss and Gul (2012) found that the political connected firms have to pay high interest rates. In China, to our knowledge, there is limited research on investigating the relationship between PCF and CoD, this study focuses on typical type of political connections such PCD and its impact on CoD. This study finds negative and significant association between politically connected, independent directors (PCInds), firms (PCF) and CoD.

The rest of this paper is organized as follows. Section 2 discusses the relevant literature and develops the hypothesis. Section 3 presents the study sample, variables and methodology. Section 4 discusses the empirical results. Section 5 concludes this paper.

2. LITERATURE REVIEW AND HYPOTHESES DEVELOPMENT

2.1. Political Connections and CoD
There are two types of agency problems: The conflict of interest between agent and shareholders (agent-principal conflict); and the conflict between controlling and non-controlling shareholders (principal- principal conflict). According to Shi et al. (2018) these two problems are dominated in China. The reasons behind this domination are: The presence of shareholders among Chinese firms (Huyghebaert and Wang, 2012); and there is at least one of fourth of Chinese firms do not have absolute or relative controlling shareholders (Jiang and Kim, 2015).

There are controversial findings about the effect of political connections in debt financing. In Indonesia, Leuz and Oberholzer-Gee (2006) found that connected firms enable to access financing at lower costs that supported by several studies in deferent countries such as; Taiwan; Brazil; The US and Pakistan (Chen et al., 2014; Claessens et al., 2008; Houston et al., 2014; Khwaja and Mian, 2005). However, In Malaysia, Bliss and Gul (2012) found that the political connected firms have to pay high interest rates. In China, there is no study investigating the relationship between PCF and CoD. We thus hypothesize that:

H$_1$: Ceteris Paribus, there is a negative relationship between PCF and CoD.

2.2. PCD and CoD
There are few studies investigated the cost debt and the determinants of debt financing practically, in China. As Pittman and Fortin (2004) studies IPOs with considering the effect of auditor types on the cost debt. They also found the borrowing costs can reduces by enhancing the credibility of financial statements in the big audit firms. However, a decision of interest rates charged on debt over time leading to reduce the importance of the auditor

choice (Pittman and Fortin, 2004). In addition, Francis et al. (2009) investigated the level of voluntary disclosures and its effect on CoD and equity capital made in financial statement reporting. These researchers found that the firms with high level of voluntary disclosure have lower costs of debt and equity.

Political connections are valuable resource for firm leading enable firms to access financial resources, including bank loans (Claessens et al., 2008; Khwaja and Mian, 2005). Equity finance, government bailouts, government procurement contracts, government procurement contracts and favorable tax rates are other financial resources delivered by political connections (Boubakri et al., 2012; Faccio et al., 2006; Francis et al., 2009; Goldman et al., 2013; Johnson and Mitton, 2003). The body of literature focuses on the effect of political connection on debt financing in general with some researchers studied political directors with value of firms so, in this study focuses on the total of political connection that the role of PCD in debt financing. So we hypothesize that:

H$_2$: Ceteris Paribus, there is a negative relationship between PCD and CoD.

3. RESEARCH METHODOLOGY

3.1. Sample
Initially, the sample consists of all Chinese listed firms in both the Shanghai and Shenzhen Stock Exchanges at period from 2011 to 2013[1]. Using China Stock Market and Accounting Research (CSMAR) to collect other variables data about listed firms. Firstly, we count the listed firms on both the Shanghai stock exchange and Shenzhen stock exchange on 2011–2013 are 5163 observations firms then, we excluded the firms those have unavailable data and financial firms. So, the observations left with 4956 firms. Then, we divided our sample into two groups: Politically connected (PCF) and non- PCF (non-PCF) so, we use observation of PCF are (1615).

3.2. Measurement of the Variables
3.2.1. Dependent variable
Following the prior studies (Bliss and Gul, 2012; Liedong and Rajwani, 2018), we use interest expenses (IR) to measure the CoD by the interest expense of the firm divided by its average short term and long term debt during the year. The interest expenses have been collected from disclosed income statement of Chinese firms in CSMAR Database and from disclosed balance sheet, we collect the short and long terms of debt.

3.2.2. Experimental variables
We use CSMAR to obtain the information about firm and directors' characteristics. In this study, we identify the politically connected firm whether this firms has at least one director who is politically connected and directors whether a director is politically connected by following prior studies as (Shi et al., 2018; Wang, 2015). Especially, a director is a current or former in: Government or Party official; or member of the National People's Congress; or member of the Chinese People's Political Consultative Conference.

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1   Using only this period because of availability of data.

We use dummy variable of PCFs taking the value one if at least one a director is politically connected in a firm otherwise zero and the total PCD.

3.2.3. Control variable

Fallowing the literature on CoD see (Bliss and Gul, 2012; Francis et al., 2005; Petersen and Rajan, 1994; Pittman and Fortin, 2004; Qiu and Yu, 2009). There are several variables considering as control variables in our regression model: The total assets (Size); Leverage (Leverage); cash-flow (CASHFLOW), sales growths (SALESGROWTH); current ratio (Current Rat.) and executive directors' duality (CEO-Duality).

Large firms have more assets leading to CoD negatively associated with firm' size (Size) this evidence provided by Bliss and Gul (2012). According to Chaney et al. (2011), cash flow (CASHFLOW) is one method that lenders can assess the firms to identify the level of firms' risk to servicing their loan leading to lower CoD. Chaney et al. (2011) provide evidence that leverage (Leverage) is positively associated with higher CoD. Higher sales growth (SALESGROWTH) of firms leads to facility of payments of loans that gives lenders to give lower interest rates to firms whom have higher sales growth (SALESGROWTH) Chaney et al. (2011). In additions, current ratio (Current Rat.) is another indicator for lenders to indicate that the firms have high level of current ratio enable to service their loan leading to lower CoD (Pittman and Fortin, 2004).

To avoid the endogeneity concerns and economic shocks, we use also dummy variable of years taking the value one for specific year, others zero. We use 3 years dummy variables for the period (2011–2013).

3.3. Regression Model

To test the hypotheses, we used the regression models bellow:

$$CoD = \alpha_0 + \alpha_1 \ PCF + \alpha_2 \ SIZE + \alpha_3 \ LEVERAGE + \alpha_4 \ CASHFLOW + \alpha_5 \ SALESGROWTH + \alpha_6 \ CURRENTRATIO + \alpha_7 \ CEODUALITY + year \ dummies + \varepsilon \quad (1)$$

$$CoD = \alpha_0 + \alpha_1 \ PCD + \alpha_2 \ SIZE + \alpha_3 \ LEVERAGE + \alpha_4 \ CASHFLOW + \alpha_5 \ SALESGROWTH + \alpha_6 \ CURRENTRATIO + \alpha_7 \ CEODUALITY + year \ dummies + \varepsilon \quad (2)$$

All study variables are defined in Table 1.

4. RESULTS AND DISCUSSION

4.1. Descriptive Statistics

In Table 2, Column A presents the summary statistics of all the study's variables in both Chinese listed firms while, Column B related to Chinese PCF. The mean of PCF and PCInds are 0.3204 and 0.15193 respectively, which means that the PCF is around 32% of all observations of Chinese listed firms. In Column A, the mean of CoD is 7.0576 and it is 7.0199 in Column B. The ownership occurs in 19.6% and 22.12% in all listed firms and PCF respectively. In PCF, the mean of leverage is 21.76% while, 20.61% in all listed firms. The mean of size is almost same in both of Column A and B (22.244 and 22.4194). PCF has lower cash flow than non-PCF. In addition, the mean of sales growth is 8.1222 and the mean of CEO duality is 1.7816 in PFC.

4.2. Correlation

In general, Table 3 reports on the statistic correlations on all of our sample. It is found that CoD is significantly and positively correlated with leverage; size; cash flow; ownership; and year dummies; and duality. It is found that significantly and negatively with PCF; PCD; current ratio; and sales growth. Thus, from this correlations matrix, it is clear that our study is on the wright root due to the significance of the correlations between the independent and dependent variables.

4.3. Regression Results

In Table 4, column A reports the multiple regression results evidence from Chinese firms that there is negative relationship political connection and CoD. It reports the results of this study from testing the relationship between CoD and experimental variables and control variables. In Column B, the multiple regression results test the relationship between CoD and firms with political connections (PCF) to enable the test of first hypothesis. The coefficient of PCF is negative and high significant (−2.2642, t = −10.68, P < 0.001) supporting the first hypothesis. This evidence consistent with Houston et al. (2014) argument that PCF have lower systematic risk because they obtain financial guarantees from government. To test the second hypothesis, the results in Column B of Table 4 provides testing the relationship between the CoD and PCD. The coefficients of PCD is negative and high significant (−1.6318, t = −3.54, P < 0.01) supporting the second hypothesis. In China, PCD enable firms benefit from favorable government policies, such as favorable tax rates. Time's coefficient is negative and significant

Table 1: The definitions of Study's variables

Variables	Definitions
CoD	Finance expense of a corporation divided by its average short-term and long-term debt
PCF	Dummy variable, 1 if the firm has political connections, otherwise 0
PCD	The total of PCD in firms
Year Dummies	Using Dummy variable, 1 for 2011; and otherwise 0; Using Dummy variable, 1 for 2012 and otherwise 0; Using Dummy variable, 1 for 2013 and otherwise 0
Size	Using natural logarithm of total assets
Leverage	Using sum of total short-term and long-term debt divided by total assets
Cash Flow	Using cash flow from operations divided by total assets
Sales growth	Using sales revenues in year t minus sales revenues in year t−1 divided by sales revenue in year t−1
Current Ratio	Using current assets divided by current liabilities
CEO Duality	Using dummy variable, 1 if chief executive officer is also chairman of the board, otherwise 0

CoD: Cost of Debt, PCD: Politically connected directors

(−0.8693, t = −6.16, P < 0.001) that means the CoD decrease with time for all Chinese firms. To emphasize the evidence, we use the sample of PCF to test our second hypothesis; and the results are reported in Column B of Table 4.

In Table 4, Column B reported the multiple regression results from testing the relationship between CoD and experimental[1] and control variables in Chinese Political Firms. The coefficient of PCD is negative and significant (−1.0343, t = −2.32, P < 0.05).

In addition, the control variables of this study has deferred results in our OLS regression tests. In Table 4, Size and CEO duality has positive and significant impact on the CoD, unlike, leverage, cash flow; sales growth and current ratio have negative coefficient. Moreover, in Table 4, the coefficient of sales growth is positive before and after the regulatory change not only sale growth but also coefficient of leverage is changed to positive after the change. Furthermore, the adjusted R square of our regression analysis extend from 13.90% to 19.08%.

5. DISCUSSION

The contributions of this study to the literature is that this study provide another evidence on the association between political connections and CoD especially in China, emerging markets. The controversial findings about the effect of political connections in debt financing over the world. In Indonesia, Leuz and Oberholzer-Gee (2006) found that connected firms enable to access financing at lower costs that supported by several studies in deferent countries such as Brazil; Taiwan; Pakistan and The US (Claessens et al., 2008; Chen et al., 2014; Khwaja and Mian, 2005; Houston et al., 2014). However, In Malaysia, Bliss and Gul (2012) found that the political connected firms have to pay high interest rates. In China, there is no study investigating the relationship between PCF and CoD this study focuses on typical type of political connections

Table 2: Summary statistics of Chinese listed firms and PCF

| Variables | Chinese listed firms (n=4956) | | PCF (n=1615) | |
| | Column A | | Column B | |
	Mean±SD	Median	Mean±SD	Median
PCF	0.3204±0.4666	0.0000	1.0000±0.0000	1.0000
PCD	0.15193±0.3589	0.0000	0.4742±0.4994	0.0000
CoD	7.0576±6.9668	7.0305	7.0199±6.6509	2.3561
Leverage	0.2061±0.1528	0.1848	0.2176±0.14398	0.1978
Size	22.244±1.3265	22.085	22.4194±1.3825	22.2177
Cash flow	0.3307±0.1207	0.3392	0.03016±0.07571	0.03187
Current ratio	1.5946±1.3464	1.3265	1.5376±1.1691	0.1214
Sales growth	10.1805±612.25	0.1104	8.1222±357.2218	0.12141
Year dummies	0.5338±0.4988	1.0000	0.5257±0.4994	1.0000
CEO duality	1.7835±0.41184	2.0000	1.7816±0.4131	2.0000

[A]Please see Table 1 for variables definitions. PCF: Politically connected firms, CoD: Cost of Debt

Table 3: Correlations among CoD, PCF, PCD, and control variables

	PCF	PCD	CoD	Leverage	Size	Cash flow	Current ratio	Sales growth	Year dummies	Duality
PCF	1.0000									
PCD	0.16164***	1.0000								
CoD	−0.1090***	−0.0569***	1.0000							
Leverage	0.0515***	0.0681***	0.0361***	1.0000						
Size	0.0905***	−0.0000	0.1864***	0.1307***	1.0000					
Cash flow	−0.0165*	−0.0241**	0.0032	−0.0382***	0.0500***	1.0000				
Current ratio	−0.0291***	−0.0167*	−0.1147***	−0.3169***	−0.2100***	0.0432***	1.0000			
Sales growth	−0.0023	0.0041	−0.0097	0.0018	0.0098	0.0074	−0.0058	1.0000		
Year dummies	−0.0111***	−0.4530***	−0.0347***	−0.1069***	0.1247***	0.0388***	0.0223**	0.0031	1.0000	
Duality	−0.0032	0.0046	0.1702***	0.0400***	0.1638***	0.0206**	−0.0771***	0.0004	−0.0404***	1.0000

[A]Please see Table 1 for variables definitions. *Significance at 0.10. **Significance at 0.05. ***Significance at 0.01, CoD: Cost of Debt

Table 4: OLS regression analysis of all listed Chinese Firms and Chinese PCF

| Variables | This study (2011–2013) | | PCF in this study (2011–2013) | |
| | Column A | | Column B | |
Dependent variable=CoD	Coefficient	T-value	Coefficient	T-value
Experimental variables				
PCF	−2.2642	−10.68***		
PCD	−1.6318	−3.54***	−1.0343	−2.32**
Control variables				
Leverage	−1.2366	−2.48**	0.0445	0.05
Size	0.8456	16.13***	1.2296	14.43***
Cash flow	−0.6096	−1.10	−3.4151	−2.34**
Current ratio	−0.4704	−8.04***	−0.3588	−3.47***
Sales growth	−0.00012	−1.16	0.00005	0.19
CEO duality	2.3362	14.51***	1.61001	6.02***
Year dummies	−0.1670	−0.246		
Firm-year observations	4956		1615	
Adj. R²	0.1824		0.1916	

[A] Please see Table 1 for variables definitions. *Significance at 0.10. **Significance at 0.05. ***Significance at 0.01, CoD: Cost of Debt

such PCInds and its impact on CoD. This study finds negative and significant association between PCF and CoD.

6. CONCLUSION

The main objective of study is to investigate the relationship between political connections and CoD particularly PCD. In emerging markets, the researchers found PCF are more risky than no-PCF such Malaysian Firms regarding to PCF has higher CoD than non-PCF (Bliss and Gul, 2012; Johnson and Mitton, 2003). This study provide evidence that PCF has lower CoD than non-PCF.

The findings of this study is negative and significant relationship between CoD and PCF. It also find that negative relationship between CoD and PCD particularly, in China. This results suggests that PCD are by sharing their knowledge in law; finance and serving on other boards. PCD helps firms to have high level of access to financial resources, including bank loans; equity finance; and government procurement contracts. PCD enable firms benefit from favorable government policies, such as favorable tax rates. These roles give lenders perceive that PCF has lower risk lower than non-PCF. This perceiving leading to lower interest rate charged by lenders for firms with PCD than firms with non- PCD.

In this study, there are two limitations: Firstly, following Fan et al. (2007); Wang (2015) and Shi et al. (2018) to identify the PCF and PCD is an objective criterion. In our data, we may identify some firms and directors as non-PCF and non- PCD but they may be politically collected. The levels of political connections in PCF and PCD perhaps have deferent levels of impact on CoD. Secondly, only one corporate governance characteristic, the impact of CEO duality on CoD in PCF. The quality of corporate governance could be considered may have mediate the relationship between the PCF; and PCD and CoD.

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