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EFFECT OF POLITICAL CONNECTIONS ON PROFIT PERSISTENCE: EVIDENCE FROM INDIA

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INTRODUCTION

Firms undertake non-market strategies to manage their relationships with the government and minimize the risk associated with external dependencies. These non-market strategies often involve corporate political activities (CPAs) such as funding elections, constituting political action committees (PACs), lobbying, and forming formal and informal connections with government officials. Corporate political activities provide firms with several advantages such as access to government and public policy-related information (Hadani and Schuler, 2013; Hillman, Keim, and Schuler, 2004), preferential access to finance (Khwaja and Mian, 2005), an increase in rivals' costs (McWilliams, Van Fleet, and Cory, 2002), and corporate bailouts (Faccio, Masulis, and McConnell, 2006). While the extant literature reports that CPAs help in *creating* rents, whether these rents are *sustained* remains largely unanswered, despite the sustainability of rents being a fundamental issue in the field of strategy (Barney, 1991; Peteraf, 1993). In this study, we focus on political connections—a widely used form of CPA—and examine how they help not only in creating rents but also in sustaining them.

The literature on performance persistence (e.g., Mueller, 1986; McGahan and Porter, 1999) examines how factors such as market imperfections (Chacar and Vissa, 2005), pro-market reforms (Chari and David, 2012), and firm-specific resources such as corporate reputation (Roberts and Dowling, 2002) affect sustainability of rents. To the best of our knowledge, no prior work has examined the role of political connections in sustaining superior financial performance over time. Since the benefits of political connections are dynamic in nature and endure for a long time, it is important to examine the effect of political connections on the persistence in profit performance. In this study, we address this gap in the literature. Our results broadly show that political connections help in sustaining superior performance over time, providing strong support for our principal hypothesis.

We chose India as the context of our study. Like in other emerging economies, political connections are particularly important in India since pro-market institutions in India are still evolving. Our research setting also allowed us to explore interesting nuances associated with *when* and *where* political connections matter more. Prior studies have mainly emphasized the policy-related benefits that political connections provide to firms while overlooking the *micro and episodic benefits* that can improve the ease of doing business. These benefits that political

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connections can provide include help with acquiring industry licenses, obtaining approvals for construction activity, obtaining clearances related to the health, safety, and welfare of workers and the environment, and securing basic infrastructure such as roads, electricity, and water for their establishments. Firms also need many such clearances and approvals on an ongoing basis for their current operations as well, which political connections can facilitate in a timely and recurrent manner. We argue and find that state-level politicians are more likely to provide such benefits compared to national-level politicians. Thus, our findings emphasize the importance of micro and episodic benefits that political connections provide in emerging economies, thereby uncovering an important mechanism of rent creation and sustenance in political markets. Our results also show that in industries that are classified as highly regulated, political connections increase the persistence in profit performance.

THEORY AND HYPOTHESES

Given the large role that government representatives play in their authority as policy makers and regulators, many firms often engage in CPA to improve or sustain their performance. Of the various forms of CPA, political connections have been examined the most in the extant literature (Rajwani and Liedong, 2015). While the extant literature recognizes the importance of political connections in creating rents, there has been no explicit theoretical formulation as to how political connections help firms in sustaining the rents that have been created. Further, prior research has not adequately distinguished between the advantages that political connections create in product markets and the advantages they create in political markets. We make this distinction to conceptualize how rents are *created* and *sustained* in political markets and how rents are *sustained* in product markets. Since the creation of rents in product markets has been widely investigated in the economics and strategy literatures, we do not focus on this aspect in the present study.

Persistence of rents in product markets through political connections

Rents in product markets can be broadly classified as monopoly rents or Ricardian rents. Political connections can enable persistence of monopoly rents in product markets by creating barriers to entry (Dean *et al*., 1998). Political connections can also help maintain a favorable competitive landscape by changing the rules in the buyer and supplier industries related to restrictions on price and quantity produced, taxes and consumption and production standards (Rehbein and Lenway, 1994). Political connections can enable persistence of Ricardian rents by protecting superior factors of production, blocking the use of substitute resources to raise rivals' costs (McWilliams *et al*., 2002) and ensuring that the resource stays durable and competitively superior (Boddewyn and Brewer, 1994; Park and Luo, 2001; Peteraf, 1993).

Creation of rents in political markets

The extant literature has discussed the many ways in which political connections help create rents in political markets, termed as influence rents (Ahuja and Yayavaram, 2011). First, a firm can use its political connections to influence the government such that rules, regulations, and policies are modified to favor the firm. Second, firms with political connections can obtain and use their superior access to information about proposed policy changes to anticipate and

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adapt to new policies and regulations and exploit opportunities arising from such changes (Oliver and Holzinger, 2008). Third, firms can access many critical resources through their political connections such as preferential access to finance (Khwaja and Mian, 2005), corporate bailouts (Faccio *et al.*, 2006), natural resources (Fan *et al.*, 2007; Frynas *et al.*, 2006; Garcia-Canal and Guillen, 2008), and government contracts (Agrawal and Knoeber, 2001). Finally, political connections also provide several micro and episodic benefits to firms such as the granting and renewal of industrial licenses, allotment of land, and approval of construction activity. We will discuss these micro and episodic benefits in greater length later in the paper.

Sustenance of rents in political markets

For understanding how influence rents can be sustained, it is useful to view political connections as a resource that provides influence and then examine how this resource can be made scarce, inimitable, non-substitutable, and durable (Barney, 1991; Peteraf, 1993). The continuous exchange between the firm and the politician embeds the political connection, makes it "relational" in character (Hillman and Hitt, 1999) and immobile. Given the immobility of political connections, the limited supply of politicians, and the fact that a politician is unlikely to be connected to more than one firm from the same industry, a political connection is a resource that is scarce and inimitable. In addition, blocking political reform can increase the non-substitutability of the benefits that political connections provide. Political connections are also a durable resource as the political power of a firm is often more likely to endure than its economic power (Boddewyn and Brewer, 1994). In short, political connections are resources that are scarce, durable, and difficult to imitate and substitute; thus, the rents that are created in political markets can be sustained.

In light of the arguments above, we posit that political connections are resources that enable the creation of rents in political markets and the persistence of rents in both product and political markets. We thus argue that the rents that accrue to firms with political connections are likely to be sustained.

Hypothesis 1: The presence of political connections through the board of directors enhances persistence in profit performance.

Moderating effect of politician heterogeneity

The rents that are created and sustained through political connections will differ with the *type* of political connections. One dimension along which political connections differ is whether the connection is with the national/federal-level politicians or the state/province-level politicians. Emerging economies are typically rated poorly in terms of ease of doing business. For example, India (the empirical setting for this study) is one of the least business-friendly destinations. According to the World Bank's *Doing Business 2016* report, India ranks 130 overall in terms of "ease of doing business," 155 in "starting a business," and 183 in "dealing with construction permits" out of the 189 countries that were surveyed. Firms need to engage with several government agencies to set up new projects and to run their current operations. For new projects, firms need industry licenses, allotment of land, approval of construction activity and building plans, and clearances related to the health, safety, and welfare of workers and the environment. Firms also find it difficult to secure infrastructure such as roads, electricity, and water for their

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new establishments. For running their current operations, firms need to renew licenses, and comply with labor laws and quality control. In addition, they need to comply with various industry-specific regulations on an ongoing basis.

Political connections provide several micro and episodic benefits related to compliance that can help firms meet compliance requirements in a timely manner. Thus, firms can use their political connections to create value through not just influence but also compliance (Oliver and Holzinger, 2008). While influence leads to legislation that is favorable to a firm, compliance provides survival-related benefits by increasing legitimacy, social support, and reputation (Henisz and Zelner, 2003; Mahon, 2002). Further, for a large number of firms, benefits obtained through compliance within the realm of the current set of legislations and institutional arrangement may be more pertinent than the benefits obtained through influence on policy. The magnitude of resources (e.g., financial resources, time) required for influencing macro-level policy may not be justified by the outcome achieved.

As most of the permits/approvals and no objection certificates that are required to achieve compliance are mandated by state governments or local governments/municipalities, a state-level politician is more likely to be helpful in obtaining these compared to a national-level politician. Moreover, state-level politicians can devote more time to a firm since national-level politicians may be occupied with federal issues related to the entire nation and may not be able to devote their time to an individual firm on a regular basis. Thus, we hypothesize:

> *Hypothesis 2: Political connections with state-level politicians (members of state legislative assemblies/councils) through the board of directors will have a greater effect on persistence in profit performance compared to political connections with national-level politicians (members of parliament).*

Moderating effect of industry regulation

Industry regulation is another important determinant of CPA (Hillman et al., 2004). In industries that have a high level of government regulation, political connections become more important because of the higher rent-seeking potential of these industries (Hadani and Schuler, 2013; Hillman, 2005). Government regulations play the role of limiting rivalry and sustaining any performance advantages that have been created for incumbents (Frynas *et al.,* 2006). Regulation also limits access to resources such as minerals, telecom spectrum, electricity distribution, and transportation infrastructure, thus accentuating first mover advantages of early entrants with access to such resources. Thus, CPA in the form of political connections at the board level should have a higher effect on the persistence of profit performance of firms in highly regulated industries compared to firms in other industries.

> *Hypothesis 3: Political connections through the board of directors will have a greater effect on persistence in profit performance in highly regulated industries than in other industries.*

DATA AND METHODOLOGY

We chose India as the empirical context for testing our hypotheses. To identify political connections, i.e., directors who are elected representatives, we combined two different datasets.

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The first dataset, compiled by the Association for Democratic Reforms (ADR)—a non-government, not-for-profit organization—has data on candidates contesting in parliamentary and state legislative elections from 2004 up to June 2013. The second dataset contains year-wise data on the board of directors of all companies in the CMIE Prowess Database. We matched the data on elected representatives and board members using several name-matching procedures. Name matching has to be done carefully because of multiple issues such as variations in writing names in different records (e.g., there are no uniformly used naming conventions in India such as "first name followed by last name" or "family name followed by given name" that are common across the country; middle names are sometimes left out; initials are sometimes used instead of spelled out names), and the high frequency of common names in India. We used several name-matching algorithms to generate the maximum number of *possible* matched pairs.

The name-matching process resulted in 34,499 potential matched pairs. To confirm the political connection, we then manually checked all the matched pairs using databases such as Corporate Directory, Bloomberg Business Week, and Capitaline, company websites, annual reports, newspaper articles, details on professional networking websites such as LinkedIn, and politician profiles on Wikipedia and Facebook. Given the paucity and lack of reliability of confirmation indicators, we chose to confirm a match only if we were able to triangulate the information from multiple sources. Given the conservative nature of our inclusion criteria, our final list of confirmed political directors is downward biased, resulting in a possible under-counting of political directors. We were finally able to confirm that 353 firm-year observations had a political connection out of the final sample of 34,688 observations. Data on control variables was obtained from CMIE Prowess.

Method

To test for sustenance in firm profit performance, we included the lagged value of the dependent variable. Since this creates a bias in estimations of fixed effects models (Hsiao, 1986; Nickell, 1981), we used the Arellano-Bond dynamic panel data estimation in our analysis. Specifically, we used the *xtabond2* procedure in Stata (Roodman, 2009).

Variables

In line with most prior studies (Chacar and Vissa, 2005; Chari and David, 2012), we measured performance persistence using the first-order lagged dependent variable in the regression models. Our dependent variable is Return on Sales, which is calculated as Profit before Depreciation, Interest, Tax and Amortization (PBDITA) divided by Total Sales. We measured political connections using a dummy variable (*Political director*) that takes the value 1 if a firm in a particular year has one or more elected representatives as directors on its board, and 0 otherwise. For testing Hypothesis 2 about the relative effects of national-level vs. state-level political connections, we used two additional dummy variables *MP_Director* and *MLA_Director* corresponding to whether a particular board member was elected at the national level or state level, respectively. For testing Hypothesis 3 about the persistence in firm profit performance in highly regulated industries, we created an index of highly regulated industries. Using this index, we created a dummy variable *HRI* that takes the value 1 if a firm operates in highly regulated industries and 0 otherwise. We used several control variables such as firm size (log of total assets), firm age, ownership of major groups (promoter, domestic financial institutions, domestic

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corporates, foreign financial institutions, foreign corporates, and government), board size, affiliation to a business group, and debt-equity ratio (Chizema *et al*., 2015; Hadani and Schuler, 2013).

RESULTS

The results (available from the authors) show that the coefficient of the interaction term between the *Political director* dummy and the lagged performance variable is positive and significant ($\beta = 0.500$; $p < 0.001$), lending support to Hypothesis 1, which predicts that political directors enhance persistence in performance. The presence of a political director increases the effect of lagged performance from 0.288 to 0.788 (0.288 + 0.500).We also find that the coefficient of the interaction variable between *MP_Director* and the lagged performance variable is significant ($\beta = 0.256$; $p < 0.001$). Similarly, *MLA_Director* and the lagged performance is also positive and significant effect ($\beta = 0.599$; $p < 0.001$). Further, a test of the differences shows that the coefficient of *MLA_Director* is significantly higher than that of *MP_Director*. This supports Hypothesis 2, which predicted that a state-level politician (*MLA_Director*) as a director would have a more positive impact on a firm's performance persistence compared to a national-level politician (*MP_Director*) as a director. Finally, we also find that the effect of the interaction of *HRI* (dummy for highly regulated industries), political director dummy and the lagged performance variable is positive and significant ($\beta = 0.535$; $p < 0.001$). This supports Hypothesis 3, which predicted that firms in regulated industries exhibit a higher level of persistence compared to firms from other industries.

DISCUSSION AND CONCLUSION

This study advances the literature on CPA and profit persistence in several ways. First, we contribute to the core debate of strategy scholars and the primary concern of practitioners—how to sustain rents (Barney, Wright, and Ketchen, 2001)—by introducing an important factor for achieving this advantage: political connections, in particular, and CPA, in general. We develop a typology that distinguishes between product markets and political markets, as well as between creation and sustenance of rents. This distinction helps in conceptualizing the underlying mechanisms that lead to the creation of rents in political markets and the sustenance of rents in both product and political markets. Thus, we develop a more fine-grained understanding of the mechanisms underlying the creation and sustenance of rents through political connections. Second, our results suggest that, in the context of an emerging economy, political connections are more important for gaining micro and episodic benefits (e.g., help with obtaining approvals and compliance) compared to the uncertain benefits of influencing policy. This study emphasizes the need for further research on the micro and episodic benefits of political connections, which have so far received scant attention relative to the policy-related benefits of political connections. Third, prior literature has found strong evidence that political connections have a larger effect on performance in highly regulated industries than in other industries (Hadani and Schuler, 2013; Hillman, 2005). We build on this stream of work and show that the effect of political connections on persistence in profit performance is higher in highly regulated industries than in other industries.

REFERENCES AVAILABLE FROM THE AUTHORS