

Government Connections and Investment

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The government plays a major role in state-owned enterprises (SOEs) accessing external funds, as the government is the majority shareholder in these firms. This study aims to examine the relationship between government connections and investment. The sample of this study consisted of 603 observations from non-financial firms listed in the Indonesia Stock Exchange during the 2014-2016 period. The analytical method to test the hypothesis is carried out by using OLS regression analysis with SPSS 22 software. The results of this study indicate that government connections are negatively and significantly related to investments made by firms. This negative relationship is because the connected firm investment funds come from government injections, so firms become less flexible in investing. This research can be used as material for the consideration of firm shareholders who have a connection with the government in determining investment choices.

Keywords: *Government connection, Investment, Cash flow, Financial constraints*

Introduction

The risk of fluctuations in share prices is always inherent in investment. Risk is considered the level of uncertainty in investment. Investment has risks an investor can only reduce and mitigate; it is impossible to eliminate risk. Investment in SOEs shares has a higher level of certainty than ordinary firms. In this case, government ownership gives more value to SOE firms, thus creating a stigma that SOE firms will not go bankrupt because they have strong backing (Purwoto, 2011). This stigma is evidenced by the 2015 government buyback of SOE shares by pouring funds of 10 trillion. In investment activities, a comparison can be made between large firms and small firms regarding need of funds for investment (Chen & Chen, 2012; Lubis et al., 2019). For small firms, the need for investment funds tends to be low, making it easier to use funds from trading partners to meet those needs (Soejono, 2010).

Conversely, large firms have a large enough investment scale so that informal finance will not be enough. This condition raises barriers to external financial access, which is a factor in the occurrence of financial constraints (Whited & Wu, 2006; Chan et al., 2012). Firms connected with the government have easy access to obtain external funds to finance their investment activities (Claessens et al., 2008; Beuselinck et al., 2017). Firms with government connections experience low levels of financial constraints because they have protection from the government in terms of financing (Boubakri et al., 2008). Cull et al. (2014) say that firms that have connections with the government have better access to the capital market, enjoying more subsidies and tax benefits.

SOEs are defined in Government Regulation Number 44 of 2005 concerning Procedures for Participation and Administration of State Capital in State-Owned Enterprises and Limited Liability Firms. It states in SOEs, capital is at least 51% owned by the Republic of Indonesia and the enterprise's intention is mainly for profit. Based on these regulations, the government, as the majority shareholder, has the power to exercise its voting rights in influencing business decisions (Fitrianti et al., 2015). Conversely, government ownership can be detrimental to corporate value because the government can use SOEs to maximise social welfare rather than increase corporate value (Vickers & Yarrow, 1991). SOEs in Indonesia have shown better performance from year to year. The establishment of state-owned holding enterprises in the plantation sector and the merger of several SOEs have made the number of SOEs decrease. This strategy is an effort to form SOEs to become stronger, more agile and able to compete internationally (Deng, 2017; Malik & Handono, 2012). Zulaikah et al. (2019) explain that firms with government ownership tend to have exceptional firm performance because they receive full assistance and support from the government.

SOE shares have lower risks than shares of private firms. Low risks are proven when SOEs want to participate in corporate actions such as investment. In these scenarios, the supervision conducted by the government will be more substantial. The government always tries to encourage the performance of SOEs. This is because SOE performance is closely related to the government's image and also affects the ability of firms to get employment contracts from the government. SOEs have several advantages and disadvantages (Cull et al., 2014; Wang et al., 2019). SOEs are very bound by government regulations, which results in less working capital in these firms compared to others. Also, there are several government policies to accommodate the growth of purchasing power. However, this can be detrimental to SOE listed firms.

Deng (2017) explains that firms connected with the government can influence investments made. This influence exists because the government has substantial control over the allocation of resources. It provides bank loans to reduce firms' financial constraints so that they are more dependent on banks than their own internal funds. This study specifically aims

to analyse how firms connected with the government relate to the source of funds firms use to finance their investments. If a firm can easily get external funding sources, it can be categorised as not having financial constraints. This research was conducted using a sample of all non-financial firms listed on the Indonesia Stock Exchange during the 2014-2016 period, totalling 603 observations. The analysis technique used to test the hypotheses is the OLS regression analysis using SPSS 22 software.

The results of this study indicate that government connections are negatively related to investments made by firms. These results shows that firms connected with the government will have lower investment value. This relationship exists because the connected firm investment funds come from government injections, so firms becomes less flexible in investing. Also, SOE firms' investment opportunities tend to be limited due to the complexity of the bureaucracy that must be done when investing. SOEs must also comply with government regulations.

This study also found that a firm's cash flow, firm age, and foreign ownership were positively related to the investments made. Financial constraints were negatively related to corporate investment. This research contributes to the literature on government ownership and political connections by providing evidence that the political connections of SOE firms can worsen the value of their investment. This research can also be used as material for consideration for firm shareholders who have connections with the government in determining investment choices.

The research will be explained in the following structure: Section 2 contains research on developing research hypotheses; Section 3 includes explanations for variables and samples as well as research models; Section 4 contains empirical analysis and the results of hypothesis testing; and Section 5 provides conclusions of the study and suggestions for further research.

Literature Review

The Relationship Between Government Connections and Investment

Cull et al. (2014) explain that government connections are related to political connections where the ownership of government shares in a firm is above 50%. In these scenarios, the government becomes the dominant or majority owner, and ultimately the government has power over the firm. Connection with the government is closely related to financial constraints. Kaplan and Zingales (1997) explain that financial constraints occur when firms face the difference between capital costs from internal funding sources and capital costs from external funding sources. Financial constraints are defined when a firm has access to profitable investment opportunities, but in funding these investment opportunities with external financing, the firm experiences several limitations (Hannessy & Whited, 2006).

Firms whose shares are owned by the government will get assistance in funding so they do not bear too much risk. They can enjoy more subsidies and tax benefits and are more likely to be saved when facing financial pressures when compared to firms that are not connected with the government through their shares (Boubakri et al., 2012; Li et al., 2008). Fazzari (1987) explains that the higher the level of corporate financial constraints, the greater investment firms' sensitivity to corporate liquidity. Firms with high external funding need to reflect on financial constraints from internal funding when financing investments externally (He & Kyaw, 2018; Hidayat, 2010; Sadalia, 2016). Conversely, if a firm can manage and finance its investments with internal funding, the firm is said to not be experiencing financial constraints. Hence, the firm does not depend on external financing and shows a decent level of liquidity in its investment activities.

Purwoto (2011) states that Indonesia and President Soeharto are involved in the initial development of the political connection literature. Harymawan et al. (2019) also explain the resignation of former Indonesian President Suharto could affect stock prices. The results suggest that politically connected firms use certain methods to have political ties or seek closeness with politicians or the government. Faccio (2006) saw a connection with the government that could be owned by the presence or absence of the government directly connected with the company. Several previous studies describe companies that have political links with governments that make fewer investments (Chen et al., 2011; Boubakri, 2008). Therefore, the political connection phenomena and SOEs have been common in Indonesia (Harymawan et al., 2020b)

Firms tend to invest their money in utilities, infrastructure, and public housing (Munizu & Hamid, 2018). Firms with fixed asset investments receive benefits in the long run. This happens gradually through depreciation of funds that have been embedded. Nuradi and Fatimah (2015) explain that firms that can realise investments are able to achieve decent performance. Deng (2017) measured government intervention through government ownership. The results show that firms connected with the government can prioritise aligning corporate goals with government goals rather than maximising shareholder wealth. Thus, firms are more likely to implement government stimulus plans even if investment projects are not as profitable because firms are under government control. As a result, firms will be subject to government regulations, which can lead to lower investment. Harymawan et al. (2020a) found that politically connected firms were more likely to be involved in short-term investment.

Wu et al. (2012) conducted a study that examined the effects of political connections on the performance of SOEs and private firms. The results show that private firms with politically connected managers outperform firms whose managers are not politically connected. This is

because firms can enjoy tax benefits. SOEs with politically connected managers have worse performance than firms that are not connected because they are vulnerable to problems with investment.

Stages of investment activities exist in a long series. Firms that are connected with the government will experience difficulties in bureaucracy because firms are constrained by government regulations and the benefits of economic rent in funding. Shleifer and Vishny (1997) explain that the government has a primary focus to achieve political goals, which is often different from the goal of maximising profits. Firms that are connected with the government have unfavourable growth opportunities (Cull et al., 2014). This unfavourable growth is because the funds raised are diverted to cover firm arrears rather than used for productive investments. Also, the investment patterns of firms only exist in available external funds, so it can be concluded that the government plays a role and controls the firms that are connected with it. Thus, the hypothesis proposed in this study is as follows:

Hypothesis: Government connections have a negative relationship to investment.

Research Methodology

Sample and Data Sources

The sample of this study consisted of non-financial firms owned by the government (SOEs) and non-financial firms owned by private firms listed on the Indonesia Stock Exchange (IDX) during the 2014-2016 period. The sources of data in this study were obtained through annual reports and financial reports of each non-financial firm downloaded from the Indonesia Stock Exchange (IDX) website. In this study, sampling was conducted using a purposive sampling approach with the following criteria: (1) Exclude firms engaged in finance, such as insurance firms, the finance industry, or banking firms and other financial institutions. (2) Exclude firms that have incomplete data of annual and financial reports related to the variables that will be used in research. Based on the results of sample selection, the total final observations of this study amounted to 603 firm-year observations consisting of 231 firms.

Variable Operationalisation

Dependent Variable

The dependent variable in this study is the investment made by the firm (INV). The investment in this research focuses on investment in the firm's fixed assets, which long-term investment. Firms with fixed asset investments gradually receive benefits in the long run through depreciation of funds that have been embedded. In this study, investments with fixed assets are calculated using the following formula:

$$INV_{i,t} = \frac{Fixed\ Asset_{i,t} - Fixed\ Asset_{i,t-1} + Depreciation_{i,t}}{Fixed\ Asset_{i,t}}$$

Independent Variable

The independent variable in this study is government connections (GOV). Government connections describe firms that are directly connected to the government. Deng (2017) indicates firms connected with the government can prioritise aligning corporate goals with government goals rather than maximising shareholder wealth. Thus, firms are more likely to implement government stimulus plans, even if investment projects are not profitable because firms are under government control and are subject to government regulations. In this study, government connections are measured using a dummy variable. This is given a value of 1 if the firm is politically connected, as illustrated by >50% government share ownership. It is given a value of 0 if the firm is not politically connected, as described by <50% share ownership.

Control Variables

This study uses several control variables, such as cash flow, firm age, foreign ownership, and financial constraints to overcome the problem of endogeneity. The cash flow variable (CASHFLOW) in this study can be calculated by dividing the results of the sum of net income and depreciation by the firm's fixed assets. Firm age (FAGE) is the age since the founding of a firm that has been able to carry out operational activities to be able to maintain its existence in the business world. Firm age is measured using the natural logarithm of the difference between the observation year and the year the firm was founded. Furthermore, foreign ownership variables (FOREIGN) are measured using total foreign ownership in the firm. Financial constraints (FINCONS) regard situations where firms experience difficulties due to higher debt levels than assets. The calculation of financial constraints is also used to prove the strength of the government's influence in helping SOE firms in their investments. In this study, financial constraints are measured by deflating total debt with total assets owned by the firm.

Methodology

This study uses an OLS regression analysis technique to test the relationship between government connections and investment using SPSS 22 software. The GOV variable is expected to show a negative value. Also, before conducting a regression analysis, the research model must meet the BLUE (Best Linear Unbiased Estimator) criteria. Therefore, some classic assumption tests were previously carried out. The regression equation is formulated as follows:

$$INV_{it} = \beta_0 + \beta_1 GOV_{it} + \beta_2 CASHFLOW_{it} + \beta_3 FAGE_{it} + \beta_4 FOREIGN_{it} + \beta_5 FINCONS_{it} + \epsilon_{it}$$

Where

Inv: Investment of the firm.

Gov: Government connections of the firm.

Cashflow: Firm cash flow.

Fage: Firm age.

Foreign: Firm foreign ownership.

Fincons: Financial constraint experienced by the firm.

Results and Discussion

Descriptive Statistics

Table 1: Descriptive Statistics

	N	Minimum	Maximum	Mean	Std. Deviation
Inv	603	0.014	1.993	0.687	0.476
Gov	603	0	1	0.060	0.231
Cashflow	603	-4.370	8.845	0.821	1.073
Fage	603	1	95	31.710	17.449
Foreign	603	0.000	0.980	0.217	0.287
Fincons	603	0.000	1.250	0.435	0.245

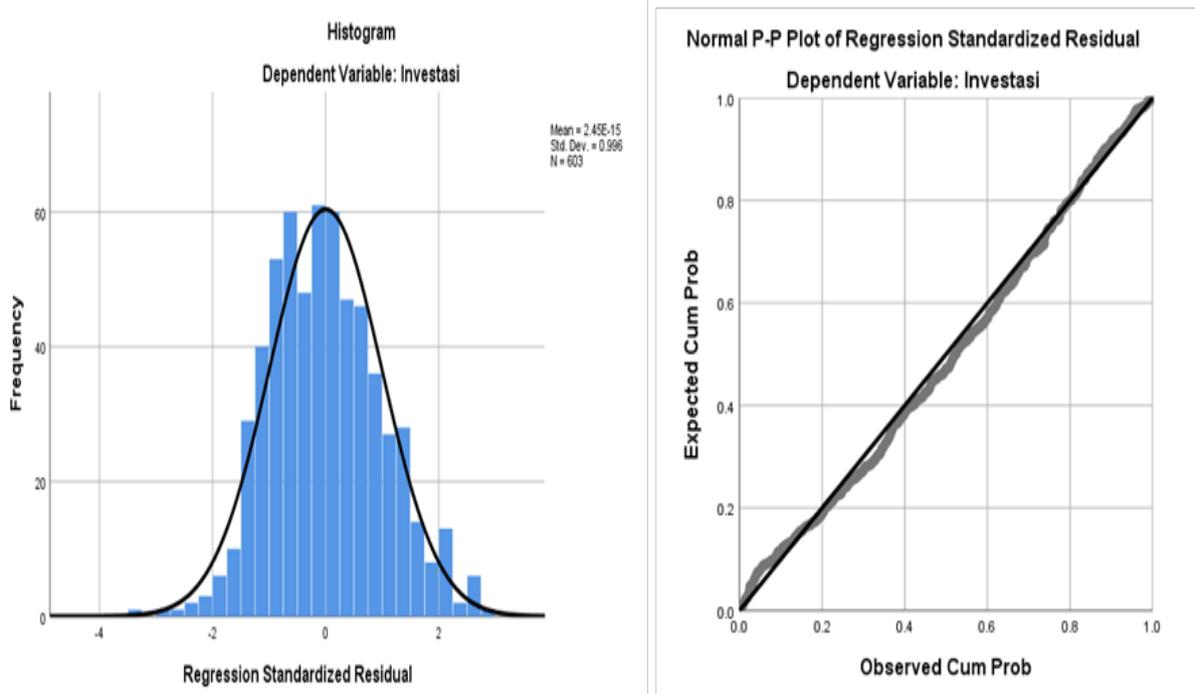
Table 1 shows the results of the descriptive statistics of the variables in this study. The average value of the investment variable (INV) is 0.687, and the standard deviation is 0.476. This value explains that the average investment made by the firm is 68.7%. The government connection variable (GOV) has an average value of 0.06 and a standard deviation of 0.231. The average value explains that the average firm has a relationship with the government at 6%. The firms studied have an average cash flow of 0.821, have foreign ownership of 21.7%, and have an average value of financial constraints of 0.435. The average firm age is 31.710, and the standard deviation is 17.449.

Classic Assumption Test

Normality Test

The normality test aims to examine whether the regression model has a normal distribution. In this study, a normal distribution is detected by histogram chart analysis and normal probability plot. Based on the results of the normality test shown in Figure 1, it can be seen that the points spread around the diagonal line, and the distribution follows the direction of the diagonal line. Thus, it can be concluded that the distribution of data is near normal or meets the assumption of normality. This conclusion is supported by the appearance of a histogram graph that is not too far to the right or left of a similar normal distribution pattern.

Figure 1. Normality Test Results



Multicollinearity Test

The multicollinearity test aims to examine whether the regression model correlates with independent variables. The value of tolerance and a variance inflation factor (VIF) is used to detect the presence or absence of multicollinearity. Multicollinearity occurs when the tolerance value is less than 0.10 and VIF values are more than 10. Based on the results of the multicollinearity test in Table 2, it can be seen that the tolerance value for each variable is greater than 0.10, while the VIF value for each variable is smaller than 10. Thus, it can be concluded that there are no multicollinearity symptoms among the variables in the regression model equation used in this study. Consequently, it can be reliable and objective.

Table 2: Multicollinearity Test Results

Variable	Collinearity	
	Tolerance	VIF
GOV	0.879	1.137
CASHFLOW	0.900	1.111
FAGE	0.866	1.155
FOREIGN	0.905	1.105
FINCONS	0.889	1.125

Autocorrelation Test

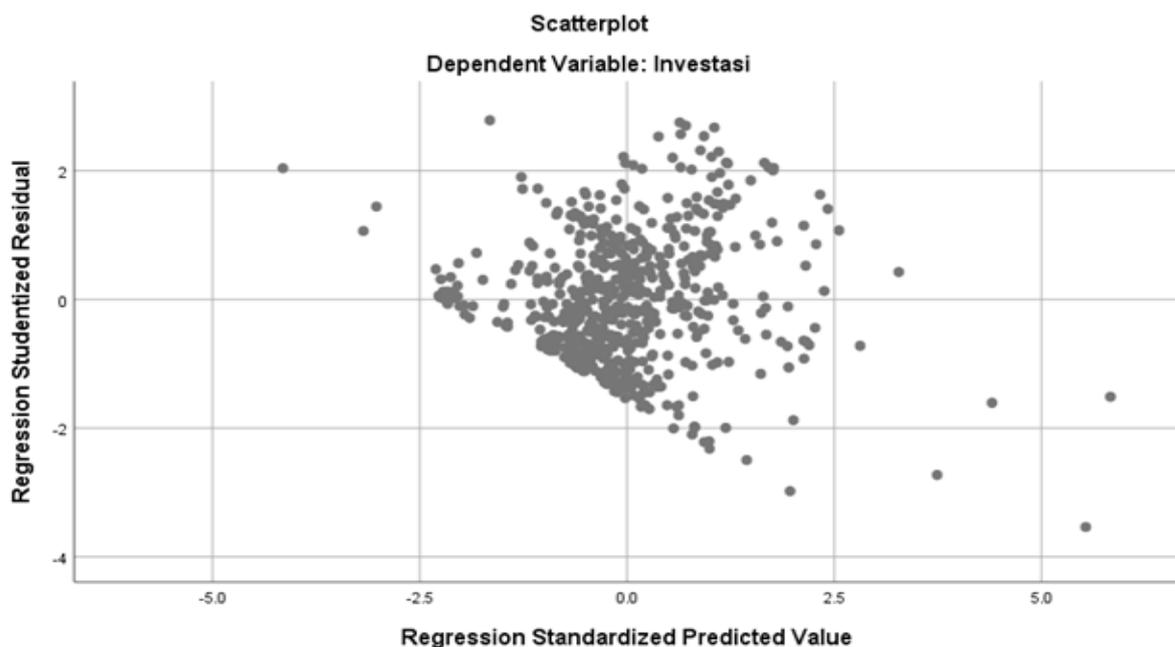
Autocorrelation shows the correlation between residuals in the current period (t) and confounding errors in the previous period (t-1). To find whether an autocorrelation can be

done, the Durbin-Watson value is referred to. If the Durbin-Watson value produced is between d_u and $4 - d_u$, then there is no autocorrelation (Ghozali, 2007). Based on the results of the autocorrelation test, the Durbin-Watson value obtained was 2.112. This value is in the interval $d_u < d < 4 - d_u$. Thus, it can be concluded that the regression model does not exhibit autocorrelation symptoms.

Heteroscedasticity Test

A heteroscedasticity test aims to examine whether the regression model occurs in variance and residual inequality from one observation to another. Symptoms of heteroscedasticity can be known by looking at the plotted graph of the predicted value of the dependent variable, ZPRED, and the residual SRESID. Based on the heteroscedasticity test in Figure 2, it can be seen that the points spread randomly. Thus, it can be concluded that heteroscedasticity does not occur in the regression model, so the regression model is feasible to use.

Figure 2. Heteroscedasticity Test Results



OLS Regression Analysis Results

Table 3: Regression Analysis Results

Variable	Coefficient	t value	Sig $\alpha=0,05$
Gov	-0.136	-4.014	0.000
Cashflow	0.460	13.730	0.000
Fage	0.072	2.112	0.035
Foreign	0.072	2.151	0.032
Fincons	-0.199	-5.904	0.000
Constant	0.616		
Correlation Coefficient (R)	0.629		
Coefficient of Determination (R ²)	0.396		
Adjusted R square	0.391		

Table 3 shows the results of OLS regression used to test the relationship between government connections and investments made by firms. The coefficient value of the government connection variable (GOV) is -0.136 ($t = -4.014$) and significant at a level of 1%. This value shows that each increase in government connections by one unit will reduce the value of the firm's investment by 0.136. Thus, the first research hypothesis (H1) is supported, as it is proven that government connections have a negative relationship with investments made by firms. Furthermore, the value of R square, or the coefficient of determination of the research model, is 0.110. This value indicates that variable government connection, cash flow, age of a firm, foreign ownership, and financial constraints can explain 39.6% of a firm's investment variable, while the remaining 60.4% is explained by other variables excluded from the research model.

The results of this study indicate that government connections have a statistically significant negative relationship with investment. These results are consistent with the research of Cull et al. (2014), which concludes that government connections are related to investment. The greater the influence of the government in a firm, the greater the extent to which the firm's funding comes from government injections. Hence, the investment pattern is more related to available external finance. Investments by firms with substantial government connections are not good indicators of growth opportunities because it becomes difficult for the firm to spread its wings in investment activities. This phenomenon is related to the existence of bureaucratic constraints that cause firms to be unable to move freely because they have to comply with government regulations. Therefore, firms that are connected with the government experience difficulties in growth.

In addition, the regression results also show that other factors can be related to investment actions taken by a firm, such as the level of cash flow, age of the firm, foreign ownership, and financial constraints faced by the firm. High cash flow shows the liquidity of the firm's

internal funds. The liquidity of the firm will affect the valuation of the firm's investment and will ultimately improve firm performance. It can be seen in Table 3 that the coefficient value of the firm's cash flow variable (CASHFLOW) is 0.460 ($t = 13.730$) and significant at the level of 1%. This value shows that the firm's cash flow is positively and statistically significant related to investment. This result is consistent with Carpenter and Guariglia's (2008) research, which concludes that cash flow is a source of internal funds where cash flow receipts can be used as capital to finance firm activities so that cash flow can determine a firm's investment.

Next, the coefficient value of the firm age variable (FIRMAGE), shown in Table 3, is 0.072 ($t = 2.112$) and significant at the 5% level. This value indicates that the age of the firm is positively and statistically significantly related to investment. A firm's age shows the firm's ability to survive, compete, and take business opportunities in the economy. These results are consistent with research by Coad et al. (2016), which concluded the longer a firm was established, the more experienced it was and the more information was obtained by the public about the firm. This relationship leads to shareholder confidence in the firm, so investment is far more mature in older firms when compared to younger firms that seem riskier.

Based on the results in Table 3, it can be seen that the coefficient of the foreign ownership variable (FOREIGN) is 0.072 ($t = 2.151$) and significant at the 5% level. This value shows that foreign ownership is positively and statistically significantly related to investment. A high percentage of foreign share ownership shows that foreign parties, as majority shareholders, will appoint foreigners to serve on the board of commissioners or board of directors. These results are consistent with research by Chibber and Majumdar (1999), which explains that if more foreign parties invest their shares in a firm, it improves the firm's performance. This improvement is caused by foreign parties with reasonably good technology, management and innovation systems, expertise, and marketing who invest their shares. They can have a positive influence on a firm. Meidiyanti (2017) explains that foreign ownership directly has an effect of abundance. This directly contributes to capital increase, technological development, and access to global markets, as well as managerial skills and transfers.

The level of financial constraints faced by a firm also relates to investments made by the firm. Table 3 shows that the coefficient of the financial constraint variable (FINCONS) is -0.199 ($t = -5.904$) and significant at the level of 1%. This value shows that financial constraints are negatively and statistically significant in relation to investment. The high degree of financial constraints shows that it is difficult for firms to obtain external funds to finance their investment activities. This result is consistent with Lerskullawat's research (2018), which concludes that large firms with large investment needs finance their needs with external funds so, inducing a high level of debt. Such a firm has a high leverage ratio where



the firm's assets are funded more by debt. Thus, the firm will tend to experience financial constraints. Firms with a high degree of leverage will experience high financial constraints with a high level of risk. The higher the leverage ratio, the smaller the internal funds available to finance a firm's investment.

Conclusion

This study aims to examine the relationship between government connections and investments made by all non-financial firms listed on the Indonesia Stock Exchange in the 2014-2016 period. The results show that government connections are negatively related to investment. This indicates firms that have connections with the government tend to have poor growth opportunities. This depends on external funding, such as bank loans, and there tends to be difficulty in bureaucratic matters due to government regulations. Finally, firms will find it challenging to make more flexible and profitable investments. This study also found that a firm's cash flow, firm age, and foreign ownership in the firm were positively related to the investments made. Conversely, financial constraints were negatively related to corporate investment.

This research has important implications for SOE firms, where the government has full control over the firms. Firms are expected to pay attention to external funds provided by the government for productive investment considerations. Firms must be selective in using these funds because the government determines the budget obtained by a firm. Also, a firm's investment pattern can only depend on available funding and must comply with government regulations and policies. A firm is also expected to be able to limit loans to avoid bankruptcy. This expectation can be fulfilled by changing a firm's management system internally to look for opportunities to get greater profits so that the proportion of debt is not far above the firm's assets. Future research is expected to be able to add other variables beyond this research that can affect corporate investment, such as corporate governance mechanisms or a firm's financial performance in the previous year.

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