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# Political Connection, Financial Distress and Cost of Debt: Empirical Evidence from Emerging Country

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## Abstract

**Objective:** This study aims to investigate the impact of political connections on financial distress and the firm's cost of debt.
**Design/Methods/Approach:** The research sample is all companies listed on the Indonesia Stock Exchange from 2010 to 2021, with 3072 observations obtained from OSIRIS Database. This study uses a quantitative approach with panel data regression analysis using E-Views 12 software program to test the hypothesis.
**Findings:** The results indicate that political connections significantly adversely affect financial distress, while political connections do not affect the cost of debt. In addition, this study also divides companies based on the nature of their political connections. Companies with political connections from the central government, local government, and the military affect financial distress. Meanwhile, only political connections from executive government employees and political connections from families affect the company's cost of debt.
**Originality:** This research developed the political connection based on its nature to measure the effect of political connection on financial distress and the cost of debt. It extends the previous understanding of the impact of political connections.
**Policy implication**: The findings are relevant for companies and other stakeholders to be more aware and utilize political connections to make better decisions and for the government to develop guidelines for better disclosure of political connections.

**Keywords**: Political connection, Financial distress, Cost of debt

**JEL Classification: D72, G32, M00**

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## 1. Introduction

The main goal of a company or business is to maximize shareholder wealth. Therefore, management, as an agent of the company's shareholders, must generate an optimal rate of return or profit by exercising strict control over all company activities, especially activities related to company finances. Political connections are considered a crucial factor in determining and maximizing company value. Business and politics are interrelated in several ways. Political actions should support commercial activities in a country. The relationship also applies to businesses where businesses can generate and fund political campaigns to uphold the sovereignty of a country.

A political connection has a strong attachment and may influence the business environment, especially in emerging economies, for several reasons. First, an emerging country such as Indonesia is led by a president with a military background for decades. Quite a number of firms in Southeast Asia, Central Asia, and Africa utilize military and political power by appointing political figures as boards of directors or commissioners to expand their operations (Harymawan, 2018; Shah, 2014; Widodo & Fanani, 2020). This is reasonable as many emerging economies have relatively weak legal protection systems and underdeveloped financial industries. The presence of political or military actors in the business will tend to provide convenience and confidence for successful business development, especially business development in remote and conflict-risk areas.

Secondly, investigating how a political relationship affects business can enable us to understand better why a listed company would want to appoint one or more board members with political expertise and experience. According to Harymawan (2018), Indonesia's Ministry of State-Owned Enterprises (SOEs) frequently appoints former political figures and ex-military officers as board members of Indonesian SOEs. What drives such companies to appoint board members with political ties remains an intriguing empirical topic, as existing research shows diverse empirical results. With the help of empirical data, this study is intended to close the gap in the literature on the topic. This study specifically looks at the cost of debt and financial distress of politically connected companies in Indonesia.

Indonesia is an attractive country to investigate the influence of political connections as it has an interesting political history. The political reform process of 1998 redistributed the power structure and clarified the duties, functions, and authorities between the legislative and executive bodies after previously being controlled by certain political and military elites. Politically connected firms in Indonesia have continued to grow over the years. Faccio (2006) shows that in the 1997-2001 period, only 22% of companies in Indonesia had political connections, while Nugrahanti et al. (2020) noted that in the 2014-2016 period, companies with political connections reached 41%. The data obtained by this study also shows that politically connected firms continued to grow between 2010-2021. There are a number of politicians in Indonesia who have entrepreneurial backgrounds. Some Indonesian political parties are also affiliated with a particular business group or conglomerate because the political party was founded by one of the company's shareholders or board members.

Studies that have investigated political connections with a number of firm variables or factors have continued to grow over the past decade. Political connection studies are particularly interesting to be explored because the documented findings show mixed results and do not indicate a conclusive conclusion. Several researchers have documented the benefits of political connections, where political connections in the firm can improve firm performance and value (Niessen & Ruenzi, 2010; Wong & Hooy, 2018). Political connections in the company are considered to provide several other benefits, such as ease of investment, easy access to capital, tax benefits, and getting greater government subsidies (Bliss & Gul, 2012a; Joni et al., 2020). In China, He et al. (2019) documented that political connections help companies increase loan financing and accelerate business recovery for companies experiencing financial distress. Political connections also allow companies to get government subsidies to get out of the financial distress zone (Ahmad et al., 2022; Halford & Li, 2020; Tao et al., 2017). The presence of political connections provides an implicit guarantee of these benefits. This causes politically connected firms to tend to have lower overall market risk compared to firms without political connections during periods of economic crisis, which lowers the correlation between the cash flows of politically connected firms and other firms and, as a result, lowers the firm's cost of capital (Bliss & Gul, 2012a). In other words, market mechanisms may believe that politically connected firms are less risky than their non-politically connected competitors, especially during economic crises, which causes investors or financiers to have a lower rate of return. Such advantages attract many entrepreneurs to become active in politics to utilize resources to maintain their businesses.

However, there are some arguments in favor of the negative role of political connections. One such argument attributes the poor transparency and efficiency of corporate governance mechanisms to politically connected firms in many emerging economies (Harymawan, 2018; Wang et al., 2022). The study conducted by Azmi et al. (2020) also explains that political connections can have a disastrous effect on a country. Politically connected firms are often involved in corruption, collusion, and nepotism cases. Transparency International data shows Indonesia has a corruption perception index (CPI) score of 38 in 2021, up 1 point from 37 in 2020 but still below the 40 obtained in 2019 (Mikrefin, 2022). Meanwhile, in Malaysia, Azmi et al. (2020) explain that political connections can create mega corruption that affects the country.

A different view also emerges when companies with political connections will tend to conduct excessive debt-funded investments that will, in turn, deteriorate company performance (Bliss & Gul, 2012b; Chkir & Toukabri, 2022;

Ling et al., 2016; Saeed et al., 2015) Furthermore, Bryan et al. (2013) and Seppa (2014) state that the high leverage can lead the firm to experience financial distress. Boubakri et al. (2013) indicate that politically connected firms appear to be cash buffers or "cash cows" for political parties or social organizations to advance their political agenda. This influence is even stronger when the company has a poor corporate governance mechanism. This indicates that politically connected companies tend to have high agency costs.

Additionally, the performance of politically connected firms will be strongly influenced by the stability of politics in the country where the firm does business. Such political instability may lead to volatility in company performance, especially in companies operating in countries with unstable political cycles or frequent changes in power from one party to another (Wu et al., 2022). The volatility of firm performance due to risky market factors is the basis for banks to provide higher interest rates to politically connected companies because these companies have greater risks compared to companies that do not have political connections (Liedong & Rajwani, 2018).

Based on the prior explanation, this study aims to investigate the effect of political connections on financial distress and the cost of debt of companies in public companies listed on the Indonesia Stock Exchange (IDX) between 2010 and 2021. This study differs from existing research as it develops political connections in companies by dividing them based on their characteristics and nature. This research applies quantitative analysis with panel data regression to examine the research hypothesis. This research will contribute to companies, policymakers, and stakeholders utilizing political connections to manage companies. The researcher expects stakeholders to make wiser decisions. For academics, this research is interesting reading material for further research, especially regarding the influence of politics on company characteristics.

This study consists of five sections. Background and research motivation are presented in the first section. Hypothesis development and theoretical review are presented in the second section, while the research methodology is discussed in the third section. The fourth section contains the findings and discussion, and the fifth section contains the conclusion of this study.

## 2. Literature Review and Hypotheses Development

There are numerous arguments regarding the relationship between political connections and financial distress. First, companies with political connections tend to experience agency problems (Boubakri et al., 2013; Chaney et al., 2011). Jensen and Meckling (1976) explain agency problems as conflicts that emerge due to disagreements due to information differences held by the principal or shareholders and the agent, namely the management of the company. The management of politically connected firms tends to exploit the company to accomplish political agendas beyond the company and take more risks. Ding et al. (2015) argue that when the company's shareholders do not have a strong political connection, politically connected boards tend to be rewarded with higher compensation for better company performance. In addition, previous studies have also found that political connections also contribute to poor quality of information disclosure, lack of corporate governance mechanisms and may lead to financial distress (Nguyen et al., 2021; Nugrahanti et al., 2020; Ramly et al., 2019).

Second, political connections can also be seen as an exceptional resource for companies to avoid various corporate issues, including financial distress. A theory that explains the merits of political connections is the resource dependence theory. Johnson Jr (1995) explains resource dependence theory as organizational and inter-organizational behavior in terms of essential resources that organizations must have to maintain and function optimally. According to this perspective, a person with plentiful resources will act as the company's strategic policymaker for certain purposes or issues. The studies on this theory divide the resource dependency view into social capital (networks, channels) and human capital (expertise, experience, knowledge, advice, and reputation) (Hillman et al., 2009; Pfeffer & Salancik, 2003).

Companies that have political connections will utilize the resources of political figures in the company to obtain various benefits, such as getting government subsidies so that they are invulnerable to financial distress (Ahmad et al., 2022; Kharis & Nugrahanti, 2022; Wijantini & Afsal, 2007). The support package in the form of incentives and loans provided by the government allows the company to develop its business and improve its performance to avoid financial difficulties. This shows how important political connections are for companies, especially those operating in emerging countries. The findings of several previous studies have shown the effect of political connections on financial distress, which is conflicting, so the relationship is still a long way from clarity. This study develops the following research hypothesis based on the theoretical explanation and previous studies.

H1: Political connection affects financial distress

Several studies also have investigated the political connections' influence on the cost of debt and found contradictory results. First, from the resource dependence theory perspective, political connections offer benefits in terms of ease of access to capital, lower cost of debt, and government subsidies (Junus et al., 2022; Le, 2020; Tee, 2019). However, the benefits received by the company are strongly influenced by the political power of the political figures in the company. In the case of Central Asian countries, absolute political power, such as government or royal family ownership, can reduce the cost of debt and facilitate and increase the amount of capital borrowed by the firm (Almarhabi et al., 2022). In the case of Indonesia, Arifin et al. (2020) explain that politically connected firms in Indonesia experience

a lower cost of debt if they have transactional political relationships rather than relational political relationships. The study conducted by Wellalage et al. (2022) explains other benefits obtained by politically connected companies. Companies with political connections will prefer to obtain funds from bank loans because these companies have a high probability of credit acceptance and more favorable loan terms.

In numerous studies, political connections have been shown to favor firms with a lower cost of debt when a country has a poor legal protection system and an underdeveloped financial industry (Khelil, 2023). Furthermore, different documentation, such as the study conducted by Bliss & Gul (2012a), explains that the cost of debt will be higher for firms with political connections because these firms are seen as riskier than firms without political connections. High levels of corporate leverage are also found in companies with political connections, which indicates that these companies are more willing to take risks (Bliss & Gul, 2012b; Chkir & Toukabri, 2022). Borisova et al. (2015) explain that government ownership is often associated with a higher cost of debt, which is consistent with government-induced investment distortions, but is associated with a lower cost of debt during financial downturns and for firms that are more likely to experience financial distress when implicit government guarantees become the dominant effect.

The influence of political connections on the cost of debt is often unclear, with some research finding a negative effect while others finding a beneficial benefit. Based on the theoretical explanation and previous studies, this study develops the following research hypotheses.

H2: Political connection affects the cost of debt

## 3. Method

This study will use purposive sampling to examine the influence of political connections on financial distress and cost of debt in non-financial companies listed on the Indonesia Stock Exchange (IDX) from 2010-2021 with a total of 3072 firm-year observations for the first hypothesis and 2472 firm-year observations for the second hypothesis. The period 2010-2021 was chosen because during this period, economic growth in Indonesia experienced both highs and lows (Badan Pusat Statistik, 2023), and Indonesia has also experienced a presidential turnover. Due to these macro factors, businesses in Indonesia can endure financial distress and shifts in the strength of their political ties.

The data is taken from company annual reports and the OSIRIS database. This study does not consider SIC No 6 (SIC 6), which consists of financial companies and real estate development, due to differences such as assets in the form of cash and cash equivalents held by third parties or customers and different performance measurements with other industry sectors. The researcher then removed observations that did not have the complete data required for regression analysis and performed winsorizing to overcome outliers at the 1st and 99th percentile. The panel data regression method will be used to test the research hypothesis.

The dependent variables to be examined are financial distress and the cost of debt. Financial distress (FD) is measured by the Altman Z-Score value. The firm is less likely to be in financial distress if its Altman Z-Score is high, and vice versa. Altman Z-Score is used due to the simplicity of using accounting data which is more reliable than market data. Although its simplicity, the Altman Z-Score model showed high accuracy in tests in various countries (Altman et al., 2019). The Altman Z-Score model in Altman (1968) is as follows.

$$Z - Score = 0{,}012X_1 + 0{,}014X_2 + 0{,}033X_3 + 0{,}006X_4 + 0{,}099X_5 \quad (1)$$

Explanation:
X1: Working capital to total assets
X2: Retained earnings to total assets
X3: Earnings before interest and taxes to total assets
X4: Market value of equity to book value of debt
X5: Sales to total assets

Cost of debt (COD) is measured as the proportion of interest expense on average interest-bearing debt for the year. The cost of debt indicates the rate of return expected by lenders on debt-financed assets. A company is considered a politically connected firm if it has one or more shareholders, a board of commissioners, a board of directors, or a company secretary who has served or is currently serving as (a) president/vice president/minister/governor/regent/mayor/member of central or regional parliament/official in a government organization or engaged in a political party; or (b) have a close relationship or a family relationship with politicians; or (c) officials or have a military background (Faccio, 2006; Tao et al., 2017; Wu et al., 2022). This study also divides political connections based on the nature of political connections held by the company, including political connections from the central government level (PCON_CENTRAL) consisting of the president, ministers, and members of the central parliament, local government level (PCON_LOCAL) consisting of governors, regents, mayors, and local parliaments, military connections (PCON_MILITARY), executive government employees (PCON_GOVEX), a person who active in community organizations or political parties (PCON_ORG) and political connections originating from close or family

relationships (PCON_FAMILY). This study also divides political connections based on company structure at the level of shareholders (PCON_OWN), board of commissioners (PCON_BOC), and board of directors (PCON_BOD).

Table 1. Variables Definition

| Variables | Names of Variables | Definitions | Sources |
|---|---|---|---|
| **Dependent Variables** | | | |
| Financial Distress | FD | Firm condition is experiencing economic problems such as failure, insolvency, default, and bankruptcy as measured by the Altman Z-Score. | OSIRIS |
| Cost of Debts | COD | The firm's expected rate of return by lenders on assets obtained using debt measured by interest expenses in year t divided by the average of short-term and long-term debt at year t. | OSIRIS |
| **Independent Variables** | | | |
| Political Connections | PCON | Firms with at least one member of shareholder, board of commissioners, board of directors, or secretary who is politically connected are measured using a dummy variable, and the value is 1 if there is a political connection within the firm and 0 otherwise. | Annual Report |
| **Control Variables** | | | |
| Firm Size | SIZE | The total number of assets owned by the firm is measured by the natural logarithm of the firm's total assets. | OSIRIS |
| Financial Leverage | LEV | The firm's ability to finance the firm's resources is obtained using debt is measured by dividing total debt by total assets. | OSIRIS |
| Liquidity | CASH | The firm's ability to cover its obligation is measured by its cash proportion in its assets. | OSIRIS |
| Profitability | ROA | The firm's ability to generate profit from its assets. | OSIRIS |
| Covid-19 | COVID | A dummy variable takes a value of 1 if the observation year is the Covid-19 pandemic year, namely 2020 and 2021, and 0 otherwise. | Annual Report |

This research also employs control variables such as firm size, financial leverage, profitability, and liquidity, as well as adding control variables for Covid-19 because Covid-19 emerged during the 2020-2021 period. The natural logarithm of the company's total assets will be the method of measuring the firm size variable (SIZE) (Bliss & Gul, 2012a; Tee, 2019). This study uses the debt ratio measured by comparing total debt to total assets to estimate a company's financial leverage (LEV). The ratio explains the debt proportion used to finance the company's assets (Setiawan & Navianti, 2020). The firm's profitability is measured by return on assets (ROA), while the firm's liquidity (CASH) is measured by comparing total cash and cash equivalents to the firm's total assets (Harymawan et al., 2017; Setiawan & Rachmansyah, 2019). Based on the previous explanation, the empirical model used to test H1 and H2 is as follows.

$$FD_{i,t} = \alpha + \beta_1 PCON_{i,t} + \beta_2 SIZE_{i,t} + \beta_3 LEV_{i,t} + \beta_4 CASH_{i,t} + \beta_5 ROA_{i,t} + \varepsilon_{i,t} \quad (2)$$

$$COD_{i,t} = \alpha + \beta_1 PCON_{i,t} + \beta_2 SIZE_{i,t} + \beta_3 LEV_{i,t} + \beta_4 CASH_{i,t} + \beta_5 ROA_{i,t} + \varepsilon_{i,t} \quad (3)$$

## 4. Result and Discussion

This study applies panel data regression as the analysis method with a purposive sampling method to obtain the research data. The number of samples not included in this study is explained in Table 1. This research objects were all companies listed on Indonesia Stock Exchange (IDX) between 2010 to 2021. This research excluded companies from SIC Code 6 due to differences in measurement and recognition of some variables compared to other industries. Before conducting the analysis, researchers performed winsorization to overcome outliers at the 1st and 99th percentile. Tables 3 and 4 of this study's data are summarized using descriptive statistics, which provide the data's mean, minimum, maximum, and standard deviation. According to the descriptive statistical test findings, the mean value of the financial distress variable measured using Altman Z-Score shows a value of 0.96 with a minimum value of -0.00066 and a maximum

value of 4.44. The mean Z-Score value obtained is less than 1.8, which, according to Altman et al. (2019), indicates that the average Indonesian firm is in financial trouble. The cost of debt is measured by dividing interest expense by the average interest-bearing debt for the year. The descriptive analysis also found that the mean value of the cost of debt in Indonesian companies is 0.092, with a minimum value of 0.0006 and a maximum value of 0.598. Based on its distribution, the mining industry with SIC number 1 is the industry that has the largest proportion of politically connected companies in the industry and contributes the second largest politically connected firms in the sample after the manufacturing industry with SIC number 2. The descriptive analysis indicates the growth of politically connected companies in Indonesia by comparison with the findings documented by Nugrahanti et al. (2020).

Table 2. Sample Selection

| Information | Model 1 | Model 2 |
|---|---|---|
| Firm in 2010-2021 | 6439 | 6439 |
| Firm with SIC 6 codes | (1535) | (1535) |
| Missing and incomplete data | (1832) | (2432) |
| Number of samples used | 3072 | 2472 |

Table 3. Political Connection Distribution

| SIC | PCON | Non PCON | Total | %PCON |
|---|---|---|---|---|
| 0 | 73 | 47 | 120 | 60.8% |
| 1 | 322 | 110 | 432 | 74.5% |
| 2 | 427 | 545 | 972 | 43.9% |
| 3 | 232 | 380 | 612 | 37.9% |
| 4 | 254 | 130 | 384 | 66.1% |
| 5 | 147 | 165 | 312 | 47.1% |
| 7 | 107 | 109 | 216 | 49.5% |
| 8 | 17 | 7 | 24 | 70.8% |
| Total | 1579 | 1493 | 3072 | 51.4% |

The research employs a panel data regression model to determine the suitable research model; this research conducts the Chow test, Hausman test, and Lagrange Multiplier test as regression model selection methods. Based on the Chow and Hausman test results, the fixed effect model is a better estimation approach, so that the model will be used in this study. Furthermore, after determining a suitable research model, this study also conducted a classical assumption analysis to evaluate whether the regression model produces an unbiased estimate. The results of multicollinearity testing in this study show that the variant inflation index (VIF) value is less than 10 for each variable in each research model, so it can be stated that there are no multicollinearity problems. The results of the autocorrelation test show a probability value of 0.000 < 0.05 in each model so that it can be interpreted that there are autocorrelation problems. Normality testing shows results with a probability value of 0.000 < 0.05 in each research model, which indicates that the data used are abnormal. While the results of the Glejser test to check heteroscedasticity show a probability value of 0.000 < 0.05 in each research model, meaning there are heteroscedasticity problems. Based on the classical assumption test conducted, researchers use the generalized least square (GLS) estimation model to address the problem of unsatisfied classical assumptions. Gujarati and Porter (2009) explain that the GLS method can produce BLUE estimators because this model considers the information contained in the inequality of the variability of the dependent variable.

Table 4. Descriptive Analysis of Model 1

| | N | Minimum | Maximum | Mean | Std. Deviation |
|---|---|---|---|---|---|
| FD | 3072 | -0.001 | 4.440 | 0.961 | 0.776 |
| PCON | 3072 | 0.000 | 1.000 | 0.514 | 0.500 |
| SIZE | 3072 | 9.957 | 18.556 | 14.725 | 1.823 |
| LEV | 3072 | 0.062 | 3.711 | 0.579 | 0.493 |
| CASH | 3072 | 0.001 | 0.628 | 0.113 | 0.124 |
| ROA | 3072 | -0.576 | 0.394 | 0.027 | 0.119 |
| Valid N (Listwise) | 3072 | | | | |

Table 5. Descriptive Analysis of Model 2

| | N | Minimum | Maximum | Mean | Std. Deviation |
|---|---|---|---|---|---|
| COD | 2472 | 0.000 | 0.599 | 0.092 | 0.076 |
| PCON | 2472 | 0.000 | 1.000 | 0.553 | 0.497 |
| SIZE | 2472 | 10.692 | 18.645 | 14.964 | 1.774 |
| LEV | 2472 | 0.095 | 4.788 | 0.622 | 0.561 |
| CASH | 2472 | 0.001 | 0.494 | 0.096 | 0.099 |
| ROA | 2472 | -0.640 | 0.378 | 0.021 | 0.121 |
| Valid N (Listwise) | 2472 | | | | |

This study uses panel data regression, especially generalized least squares (GLS), to test the research hypothesis with the assistance of the E-Views 12 application. The regression result in Table 5 shows that political connection has a positive regression coefficient of 0.060 which is significant at alpha (α) 0.01 on the Altman Z-Score. The finding indicates that the greater the political connection owned by the company, the greater the Altman Z-Score value generated by the company. Consistent results are also shown after researchers include the Covid-19 control variable, where political connections significantly and positively impact the Altman Z-Score at a significance level (α) of 0.01.

Table 6. Regression Result: The Effect of Political Connection on Financial Distress

| | (1) FD | (2) FD | (3) FD | (4) FD | (5) FD | (6) FD | (7) FD | (8) FD | (9) FD | (10) FD | (11) FD |
|---|---|---|---|---|---|---|---|---|---|---|---|
| PCON | 0.060 *** | 0.052 *** | | | | | | | | | |
| | (5.82) | (4.77) | | | | | | | | | |
| PCON_BOC | | | 0.037 *** | | | | | | | | |
| | | | (3.84) | | | | | | | | |
| PCON_BOD | | | | 0.034 ** | | | | | | | |
| | | | | (2.56) | | | | | | | |
| PCON_OWN | | | | | -0.143 | | | | | | |
| | | | | | (-1.59) | | | | | | |
| PCON_CENTRAL | | | | | | 0.021 ** | | | | | |
| | | | | | | (2.23) | | | | | |
| PCON_LOCAL | | | | | | | 0.103 * | | | | |
| | | | | | | | (1.81) | | | | |
| PCON_MILITARY | | | | | | | | 0.019** | | | |
| | | | | | | | | (2.02) | | | |
| PCON_GOVEX | | | | | | | | | -0.002 | | |
| | | | | | | | | | (-0.19) | | |
| PCON_ORG | | | | | | | | | | -0.012 | |
| | | | | | | | | | | (-0.79) | |
| PCON_FAMILY | | | | | | | | | | | 0.02 |
| | | | | | | | | | | | (0.95) |
| COVID | | -0.082*** | -0.082*** | -0.088*** | -0.087*** | -0.083*** | -0.087*** | -0.087*** | -0.088*** | -0.086*** | -0.088*** |
| | | (-14.2) | (-14.26 ) | (-15.37) | (-15.37) | (-13.36) | (-15.35) | (-15.46) | (-15.47) | (-14.81) | (-15.44) |
| SIZE | -0.170*** | -0.172*** | -0.171*** | -0.169*** | -0.168*** | -0.167*** | -0.168*** | -0.168*** | -0.168*** | -0.168*** | -0.17*** |
| | (-32.22) | (-28.72) | (-28.46) | (-28.24) | (-28.27) | (-27.4) | (-28.17) | (-28.34) | (-28.14) | (-28.2) | (-28.64) |
| LEV | 0.047*** | 0.052*** | 0.056*** | 0.051*** | 0.053*** | 0.054*** | 0.055*** | 0.055*** | 0.054*** | 0.053*** | 0.052*** |
| | (2.77) | (3.08) | (3.25) | (3.00) | (3.15) | (3.11) | (3.26) | (3.28) | (3.26) | (3.17) | (3.07) |
| CASH | -0.234*** | -0.186*** | -0.17*** | -0.158*** | -0.142*** | -0.18*** | -0.142*** | -0.144*** | -0.143*** | -0.148*** | -0.151*** |
| | (-7.26) | (-5.25) | (-4.84) | (-4.74) | (-4.26) | (-5.03) | (-4.26) | (-4.3) | (-4.29) | (-4.41) | (-4.51) |
| ROA | 1.001*** | 0.941*** | 0.943*** | 0.93*** | 0.929*** | 0.924*** | 0.932*** | 0.933*** | 0.924*** | 0.93*** | 0.932*** |
| | (25.40) | (23.48) | (23.51) | (23.06) | (23.24) | (22.65) | (23.27) | (23.38) | (23.09) | (23.21) | (23.25) |
| CONSTANT | 3.412*** | 3.440*** | 3.432*** | 3.426*** | 3.414*** | 3.390*** | 3.404*** | 3.412*** | 3.408*** | 3.412*** | 3.445*** |
| | (42.42) | (37.87) | (37.57) | (37.49) | (37.67) | (36.61) | (37.45) | (37.63) | (37.55) | (37.57) | (37.97) |
| N | 3072 | 3072 | 3072 | 3072 | 3072 | 3072 | 3072 | 3072 | 3072 | 3072 | 3072 |
| R-Squared | 0.952 | 0.951 | 0.951 | 0.952 | 0.952 | 0.95 | 0.952 | 0.953 | 0.952 | 0.952 | 0.952 |
| Adjusted R-Squared | 0.947 | 0.947 | 0.947 | 0.948 | 0.948 | 0.945 | 0.948 | 0.948 | 0.947 | 0.948 | 0.948 |

Level of significance *10%, **5%, ***1%

This study also investigates the outcome of political connections based on their nature of financial distress. The findings based on the management structure show that the political connection between the board of commissioners and the board of directors generates a positive regression coefficient of 0.037 and 0.034 with a significance level of 1% and 5%. Meanwhile, political connection in ownership produces an insignificant negative regression coefficient of -0.143 (> 10%). Furthermore, political connections from or have a background in the central government and the military have positive regression coefficients of 0.021 and 0.019 with a significance level of 5%. Political connections from or with a local government background have a significant positive impact with a 10% significance level. Meanwhile, political connections that originated or had a background in government executive employees and political party involvement showed an insignificant negative regression coefficient on financial distress. In contrast, political connections from family relationships with politicians showed an insignificant positive regression coefficient.

This research shows that companies with political connections produce better Altman Z-Score values than companies that do not have political connections. The regression results suggest that political connections negatively affect financial distress. According to the result, this finding confirms the documentation of Kharis & Nugrahanti (2022),

who discovered that the existence of political connections in the company increases the company's resilience to financial distress. This study also confirms the effect of political connections that may improve company performance (Ahmad et al., 2018; Idris et al., 2020). The findings of this study provide contradictory results to the studies conducted by Istan (2021) and Kalbuana et al. (2022), who did not find the effect of political connections on financial distress. This study also documents different outcomes from Nugrahanti et al. (2020), which shows an unfavorable impact of political connections on corporate financial distress.

The results of this study also confirm the benefits of political connections based on resource dependence theory, where companies can use competitive resources derived from their political connections to step out and evade the financial distress zone (Ahmad et al., 2022). Furthermore, a study conducted by Tao et al. (2017) explained that companies with political connections are easier to get subsidies from the government, especially when facing financial distress. This incentive allows the company to survive and maintain business continuity because the government supports it well. The research also explains the nature of political connections that affect financial distress in politically connected companies with political figures with backgrounds from the central government, local government, and military connections. This explains that state officials such as the president, vice president, ministers, parliament, governors, regents, and military officials have considerable resources and influence to affect companies to keep them out of financial distress. This relationship offers a competitive advantage to the firm due to its ability to access resources and information flows that align with resource dependency theory (Hillman et al., 2009; Pfeffer & Salancik, 2003). The results of this study may also indicate political power from central government, local government, and military connections as a resource for firms to improve performance and gain the benefits offered by these connections. These results indicate that companies with political connections can influence the government's policies to provide convenience for companies to conduct business, especially during economic crises.

Table 7. Regression Result: The Effect of Political Connection on Cost of Debt

| | (1) COD | (2) COD | (3) COD | (4) COD | (5) COD | (6) COD | (7) COD | (8) COD | (9) COD | (10) COD | (11) COD |
|---|---|---|---|---|---|---|---|---|---|---|---|
| PCON | 0.002 | 0.002 | | | | | | | | | |
| | (1.21) | (1.15) | | | | | | | | | |
| PCON_BOC | | | 0.002 | | | | | | | | |
| | | | (1.33) | | | | | | | | |
| PCON_BOD | | | | 0.010*** | | | | | | | |
| | | | | (4.13) | | | | | | | |
| PCON_OWN | | | | | 0.006 | | | | | | |
| | | | | | (0.26) | | | | | | |
| PCON_CENTRAL | | | | | | 0.000 | | | | | |
| | | | | | | (0.11) | | | | | |
| PCON_LOCAL | | | | | | | 0.007 | | | | |
| | | | | | | | (0.98) | | | | |
| PCON_MILITARY | | | | | | | | 0.001 | | | |
| | | | | | | | | (0.33) | | | |
| PCON_GOVEX | | | | | | | | | 0.005*** | | |
| | | | | | | | | | (2.71) | | |
| PCON_ORG | | | | | | | | | | -0.004 | |
| | | | | | | | | | | (-1.41) | |
| PCON_FAMILY | | | | | | | | | | | -0.004* |
| | | | | | | | | | | | (-1.41) |
| COVID | | -0.004*** | -0.004*** | -0.004*** | -0.004*** | -0.004*** | -0.004*** | -0.004*** | -0.004*** | -0.004*** | -0.004*** |
| | | (-3.65) | (-3.65) | (-3.89) | (-3.66) | (-3.80) | (-3.73) | (-3.66) | (-4.01) | (-3.71) | (-3.71) |
| SIZE | -0.004*** | -0.003*** | -0.003*** | -0.003*** | -0.003 | -0.003*** | -0.003*** | -0.003*** | -0.003*** | -0.003*** | -0.003*** |
| | (-3.96) | (-2.72) | (-2.75) | (-2.99) | (-2.8) | (-2.96) | (-2.71) | (-2.75) | (-2.68) | (-2.79) | (-2.79) |
| LEV | -0.011*** | -0.010*** | -0.010*** | -0.010*** | -0.010*** | -0.010*** | -0.010*** | -0.010*** | -0.01*** | -0.010*** | -0.010*** |
| | (-4.48) | (-4.11) | (-4.13) | (-4.30) | (-4.18) | (-4.02) | (-4.16) | (-4.19) | (-4.02) | (-4.20) | (-4.20) |
| CASH | -0.005 | -0.002 | -0.001 | -0.003 | -0.002 | -0.004 | -0.001 | -0.001 | -0.001 | -0.002 | -0.002 |
| | (-0.6) | (-0.23) | (-0.13) | (-0.38) | (-0.21) | (-0.45) | (-0.18) | (-0.18) | (-0.07) | (-0.20) | (-0.20) |
| ROA | -0.012* | -0.013* | -0.014** | -0.015** | -0.014** | -0.013** | -0.015** | -0.014** | -0.015** | -0.014** | -0.014** |
| | (-1.78) | (-1.92) | (-2.01) | (-2.25) | (-2.11) | (-1.99) | (-2.16) | (-2.11) | (-2.16) | (-2.09) | (-2.09) |
| CONSTANT | 0.155*** | 0.140*** | 0.140*** | 0.145*** | 0.142*** | 0.145*** | 0.141*** | 0.141*** | 0.138*** | 0.142*** | 0.142*** |
| | (10.36) | (8.78) | (8.83) | (9.15) | (8.95) | (9.16) | (8.90) | (8.94) | (8.81) | (9.03) | (9.03) |
| N | 2472 | 2472 | 2472 | 2472 | 2472 | 2472 | 2472 | 2472 | 2472 | 2472 | 2472 |
| R-Squared | 0.719 | 0.72 | 0.721 | 0.722 | 0.721 | 0.718 | 0.721 | 0.722 | 0.723 | 0.722 | 0.721 |
| Adjusted R-Squared | 0.693 | 0.694 | 0.695 | 0.696 | 0.695 | 0.691 | 0.695 | 0.696 | 0.697 | 0.696 | 0.695 |

Level of significance *10%, **5%, ***1%

The regression results shown in Table 6 explain the second research hypothesis that investigates the impact of political connections on the cost of debt. The research findings showed that political connection has a positive regression coefficient of 0.002 with a greater than 10% significance level. This result shows that political connection has no significant effect on the company's cost of debt. Based on the management structure, only a politically connected board of directors has a significant positive impact with a significant level of 1%. At the same time, political connections between shareholders and the board of commissioners have positive regression coefficients of 0.006 and 0.002, which are insignificant to the cost of debt. Based on the nature of political connections on the cost of debt, only political connections with executive government employee backgrounds show a significant positive coefficient of regression of 0.005 with alpha (α) of 1%, while political connections from politicians' family relationships have a negative coefficient of regression of -0.004 with alpha (α) of 10%. While the regression results show that political connections with

backgrounds in the central government, local government, and military have positive regression coefficients with a significance level higher than 10%.

In the second model, the first two results in Table 6 indicate that political connection has no significant effect on the company's cost of debt. This result contradicts previous studies that found a significant influence between political connections on the cost of debt (Bliss & Gul, 2012a; Harymawan, 2018). This study also confirms the weak relationship found by Min Kyung Park & Seong Il Jeon (2020) and Chkir & Toukabri (2022) between political connections and the cost of debt. This research also explores the influence of political connections on a company's board of directors and commissioners on the cost of debt. This study did not find the effect of a politically connected board of commissioners on the company's cost of debt. However, different things are shown by the politically connected board of directors. Political connections on the board of directors significantly positively affect the company's cost of debt. The findings demonstrated to investigate political connections in the corporate structure of this study show contradictory results with previous studies. Harijanto & Supatmi (2022) documented the negative effect of a politically connected board of commissioners and an insignificant positive effect on a politically connected board of directors on the cost of debt. Meanwhile, Junus et al. (2022) documented slightly different findings that independent commissioners and independent directors with political connections negatively affect the cost of debt.

The results of this study explain that political connections on the board of directors provide unfavorable signals to the lender or the capital provider as the company is managed by directors who also have political interests outside of their role as an agent for shareholders. This finding might confirm Liedong & Rajwani's (2018) explanation that political connections are associated with poor corporate governance, which increases the company's cost of debt due to increased perceptions of company risk. The findings of this study that show the effect of a politically connected board of directors might provide support for the agency theory hypothesis, which explains that boards of directors with strong political connections have more risks and charge their companies higher interest rates than companies that do not have such political connections.

Based on the nature of political connections, companies with political connections originating from executive management of government agencies have a significant positive effect on the cost of debt, while political connections originating from family relationships have a negative effect on the cost of debt but with a smaller effect than the positive effect of political connections of the executive management of government agencies. This finding may indicate that political connections originating from family relationships may not be as strong as other political relationships that can increase company risk so that companies have a low cost of debt. Meanwhile, companies with political connections from government employees get a higher cost of debt because the company is considered to have a higher risk. This finding can confirm the studies done by Borisova et al. (2015), who documented a detrimental effect of political connections on the firm’s cost of debt. This can be explained where many government employees, both at the central government, ministry, and regional levels, who are civil servants (PNS), also become the executive management of public companies. Based on Law No. 5 of 2014 concerning The State Civil Servant, there is no explicit prohibition for civil servants to become members of the board of directors or commissioners of a company (Indonesia, 2014). Based on this, politically connected companies that come from government employees will tend to have agendas or interests outside the company's interests and a lack of focus on the company, thereby increasing agency costs and company risk.

## 5. Conclusion

The purpose of this research is to investigate the advantage or disadvantages of political connections by investigating the influence of political connections on financial distress and the cost of debt. Based on the research results and analysis explained earlier, it can be summarized that political connections have a significant adverse effect on financial distress, while political connections have no significant effect on the cost of debt. The findings of this study also agree with several previous research that explain the positive effect of political connections to avoid and overcome financial distress (Ahmad et al., 2022; Kharis & Nugrahanti, 2022). This study also divides political connections based on their nature to examine their influence on financial distress. The research findings explain that political connections originating from the central government, local government, and the military have a significant and negative effect on financial distress. This can clarify political connections as one of the resources for firms to overcome financial distress. The findings of this study indicate that politically connected firms can influence government policies, thus giving firms assurance and convenience in running their business.

In general, this study proves the benefits of political connections, and it cannot provide strong evidence of the disadvantages of political connections, as indicated by the high cost of debt. The findings in this study also differ from previous studies that discuss the impact of political connections on the cost of debt (Bliss & Gul, 2012a; Harymawan, 2018; Tee, 2018). Based on the regression analysis results, this study documented that political connections have a minor or insignificant effect on the cost of debt. The positive regression coefficient may indicate that political connections lead to agency conflicts for the company but with a minimum degree of significance. Based on their nature, political connections on the board of directors and political connections from executive government employees positively influence the cost of debt. Meanwhile, political connections from close relationships or family have a negative effect on the cost of debt.

This study has limitations because political connections were only observed directly from direct shareholders, the board of commissioners, the board of directors, and the company secretary. The observations are limited to annual reports and other media, such as company and government websites. Further studies can develop research using broader political connection criteria, more complete data, and moderating variables. This study also has other limitations because it does not consider endogeneity issues that may cause failure to identify and calculate correctly. Future research can use additional regression methods, such as two-stage least squares and instrument variables, to overcome endogeneity problems (Gippel et al., 2015). This research can be a valuable reference for companies, regulators, and other stakeholders to assess and utilize political connections wisely to develop business and avoid companies from financial distress.

## Author Contribution

Author 1: conceptualization, writing original draft, data curation, formal analysis, visualization, investigation, methodology.
Author 2: Review and editing, writing review and editing, supervision, validation

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## Conflict of Interest

The authors declare that the research was conducted without any commercial or financial relationships that could be construed as a potential conflict of interest.

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