

**THE PERFORMANCE OF POLITICALLY
CONNECTED FIRMS IN LONG-RUN AND SHORT-
RUN: EVIDENCE FROM MALAYSIA**

WONG WAI YAN

UNIVERSITI SAINS MALAYSIA

2016

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FIRMS IN LONG-RUN AND SHORT-RUN: EVIDENCE
FROM MALAYSIA**

By

WONG WAI YAN

**Thesis submitted in fulfillment of the requirements for the
Degree of Master of Arts**

March 2016

ACKNOWLEDGEMENT

I would like to thank my supervisor, Associate Professor Dr. Hooy Chee Wooi, for his guidance, advice and help in completing this thesis. For, without his encouragement and constant tracking of my progress, this journey would have been more difficult. He has also constantly encouraged me to attend conferences to acquaint myself with presentations and getting constructive criticism from experienced academicians from other universities.

Secondly, I would also like to thank Universiti Sains Malaysia for awarding me USM Fellowship as this fellowship has tremendously helped me with my financials.

Thirdly, I would like to thank the School of Management for their effort in getting students more prepared for their research lives. I am grateful for the colloquiums, talks, and activities held to equip students with better knowledge and also the opportunity to listen to the experiences of other researches.

Fourthly, I would like to thank Wilson, Ping In, Poh Suan, Chin Yee, Jason Lee, Meng Horng and the fellow students in School of Management's PhD Room for their friendships and assistance.

Fifthly, I would like to thank my parents, sisters and friends for their support during the time of my studies. Last but not least, I would like to thank Jason, for his understanding and support.

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**PRESTASI SYARIKAT YANG MEMPUNYAI HUBUNGAN POLITIK DALAM
JANGKA MASA PANJANG DAN JANGKA MASA PENDEK: KAJIAN DARI
MALAYSIA**

ABSTRAK

Objektif tesis ini ialah untuk menyiasat perkaitan antara hubungan politik dengan prestasi syarikat-syarikat di Malaysia dalam jangka masa panjang dan jangka masa pendek. Tesis ini menggunakan data yang lebih terkini berbanding kajian sebelum ini. Ini adalah kerana kajian-kajian yang dilakukan sebelum ini terlalu bergantung kepada data yang disediakan oleh Gomez dan Jomo (1997), yang dikumpul hampir lapan belas tahun yang lalu, tanpa apa-apa pengemaskinian. Kajian ini berharap dapat membetulkan masalah ini kerana siasatan menggunakan data yang tidak sesuai akan menyebabkan keputusan yang tidak tepat. Selain itu, kajian ini juga mengasingkan hubungan politik kepada empat jenis yang berbeza. Sampel kajian ini ialah dari tahun 2002 – 2013, merangkumi sekitar 500 syarikat-syarikat Malaysia yang tersenarai. Untuk analisis jangka panjang, kajian ini menggunakan analisa GMM manakala panel regresi digunakan untuk memeriksa konsistensi keputusan yang dijana. Untuk analisis jangka pendek, metodologi ‘event study’ telah digunakan untuk mengira pulangan tambahan daripada setiap peristiwa yang dikaji. Dalam jangka masa panjang, didapati bahawa tiga jenis hubungan politik mempunyai kesan positif ke atas prestasi syarikat dan hubungan politik melalui GLC mempunyai kesan paling tinggi terhadap prestasi syarikat berbanding dengan hubungan lain. Dalam jangka masa pendek, hubungan politik tidak mempunyai kesan yang tinggi ke atas syarikat. Kajian ini mendapati peristiwa berjadual seperti belanjawan kerajaan dan pilihan raya tidak memberi kesan pada firma. Walau bagaimanapun, hubungan politik mempunyai kesan yang lebih besar ke atas prestasi syarikat semasa peristiwa tidak berjadual seperti peralihan kepimpinan dan pengumuman dasar-dasar ekonomi.

THE PERFORMANCE OF POLITICALLY CONNECTED FIRMS IN LONG-RUN AND SHORT-RUN: EVIDENCE FROM MALAYSIA

ABSTRACT

The purpose of this thesis is to examine whether political connection is important to firm performance in Malaysia in both the long-run and short-run. This thesis uses a more updated and reliable data compared to previous studies being done in this area in Malaysia. The issue with previous studies being done is that they are still relying on data provided by Gomez and Jomo (1997) which was collected almost eighteen years ago, without any forms of updating. This study hope to rectify that situation as investigations using an outdated data will cause the results to be inaccurate. Other than that, this study also separates political connection into four different types. The sample frame for this study is from year 2002 – 2013 covering about 500 Malaysian public listed firms. For long-run analysis, this study uses GMM methodology whereas panel regression is used as the robustness check. For short-run analysis, event study methodology was done to calculate the abnormal return from each type of events studied. In the long-run, it is found that three types of political connection have a positive impact on firm performance. However, GLCs have the highest impact on firm performance compared to the others. In short-run, political connection does not affect performance in every event studied. Political connection does not have impact during scheduled event like government budget and general election. However, political connection has a larger impact on firm performance during unscheduled events like leadership transition and economic policies announcement.

CHAPTER 1

INTRODUCTION

1.1 Background of the study

As an individual, it made sense to establish good relationship with people we deal with every day, both personally and in business. When we have good relationship with others, they are more willing to help us in return as the feel good factor is present. For firms, building good relationship surpasses beyond their relationships with customers. This includes good relationships between employees within the organization itself. Many successful businessmen such as Richard Branson have touched on the importance of building good relationships on every level of the business process. A few notable quotes on business relationships are mentioned below:

“Success in business is all about making connections.”

Richard Branson, founder of Virgin Group

“Business is not just doing deeds; business is having great products, doing great engineering, and providing tremendous service to customers. Finally, business is a cobweb of human relationships.”

Ross Perot, founder of Electronic Data System (EDS) and former US presidential candidate

“Build the right relationships with the right people and nurture them overtime and you will always have a leg up on the competition.”

Paul May, BuzzStream CEO

Besides having good relationships with customers and employees, many firms have also realized long ago that having good relationships with politicians is an added advantage, particularly in countries with weak legal and governance institutions. As mentioned by Alesina and Rosenthal (1995), establishing connections to political parties in power to gain economic advantage is an old practice in all societies. The incentive for firms to be politically connected is recognized by citizens of the affected countries (Faccio, 2006) as there is much to gain. As past literatures have pointed out, these advantages includes getting government contracts and monopolies (Friedman, 1999; Johnson & Mitton, 2003), less taxation (De Soto, 1989), preferential treatment by government-owned enterprises such as banks (Backman, 1999; Dinc, 2005; Claessen, Feijen & Laeven, 2008) and relaxed regulatory oversight of company in question (Stigler, 1971; De Soto, 1989).

The advantages mentioned above points to one thing, which is better firm performance. There are plethora studies about the positive impact of political connections on firm performance. One of the most significant studies was done by Fisman (2001) where he studied the value of political connections to President Suharto of Indonesia who held the office for 31 years since 1967. Fisman used the announcements of Suharto’s declining health to measure the value of the firms that are connected to President Suharto and found that over 20% of their value is derived from its political connection. Besides that, Ramalho (2003) investigated the 1992 presidential impeachment in Brazil to gauge the impact of an anti-corruption

campaign on politically connected firms. She concluded that the stock value of politically connected firms dropped around the dates of the campaign. Additionally, Faccio (2006) have also documented that the announcement of a new political connection resulted in a significant increase in value of the respective firm. Other studies include Faccio et. al (2006), Charumilind, Kali and Wiwwatanakantang (2006), Claessens et. al (2008), Li, Meng, Wang and Zhou (2008) and Dinc (2005).

Some researchers such as Niessen and Ruenzi (2010) have tried to point out the reasons as to why politically connected firms might have stronger performance than their non-connected peers. First, delegates might engage in non-parliamentary job activities to maintain contact to firms and voters in order to be informed about the needs and demands of the population. For reputational purposes, these delegates might only choose the best performing firm to work for. Secondly, politicians are often outsiders to the corporate world and might be beneficial to the firm by providing an independent view on the organization, which eventually positively affects performance.

Political connection also could bring disadvantages to firms as well. For example, Opper (2007) discovered that government-appointed CEOs experience lower sales performance, disadvantages in credit allocation and experiences further postponements in custom clearance. Jackowicz, Kozlowski and Mielcarz (2013) also found lower profitability in politically connected firms particularly in firm has many connections, have a politically connected supervisory board and those which hired former politicians with central government experience. Another study by Faccio (2006) concludes that politically connected firms do not perform as well as their non-connected counterparts in a sample of 42 countries. Furthermore, Fan, Wong and

Zhang (2007) also reported that politically connected CEO of listed firms in China has lower performance compared to non-connected CEOs. Boubakri, Cosset and Saffar (2008) also found that politically connected firms lacked motivation in increasing shareholder wealth and increased firm performance after privatization. Additionally, they also demonstrate poorer accounting performance compared to their non-connected counterparts.

There seems to be no consensus as to whether political connection is good or bad for firms, which in turn becomes the motivation of this research. This study hopes to contribute to the existing literature about the impact of political connection on firm performance in the short-run and long-run. There are studies on the effect of politically connected firms and their performance in Malaysia, but they are not in abundance. One of earliest and most significant study in this area in Malaysia is by Gomez and Jomo (1997) where they identified firms that are connected to politicians or political groups in power in Malaysia. Using the data provided by Gomez and Jomo (1997), Johnson and Mitton (2003) investigated the impact of the implementation of capital control during 1998 on politically connected firms and the evidence suggested Malaysian capital controls provided a screen behind which favoured firms could be supported. Besides that, Fazilah (1996) documented that politically connected firms received preferential treatment from government and they have higher performance during positive economic period. Other studies includes Rasiah (1998), Adhikari, Derashid and Zhang (2006), Gul (2006), Wahab, Zain, James and Haron (2009) and Bliss and Gul (2012).

Malaysia is an interesting country to investigate because (according to Table 1), Malaysia recorded the highest amount of firms that are politically connected through close relationship with a total of 65 firms, followed by Indonesia with 22 and Thailand with 19. Moreover, Malaysia is the country with third highest percentage of firms connected (or close relationship) with a minister or MP, losing only to Indonesia and Russia. Malaysia's score was 19.78%, Indonesia 22.08% and Russia 20.00%. Furthermore, in terms market capitalization of connected firms, Malaysia is the fourth among 47 countries with a market capitalization of 28.24%. Russia is the country with the highest market capitalization among connected firms with a whopping 86.75%, followed by Thailand with 41.62% and United Kingdom with 39.02%.

Although the issue of politically connected firms has been examined in the context of Malaysia, it requires a revisit as the political scenario has changed tremendously over the past decade. Studies like Johnson and Mitton (2003) and Mitchell and Joseph (2010) were conducted during the period of higher political stability and the value of political connection is postulated to be higher during this period. On the contrary, the political scene in Malaysia has matured over the past 10 years and political stability has become a concern compared to previously.

An important contribution of this study is the data collected. Firstly, most studies which focuses on the issue of political connection in Malaysia such as Johnson and Mitton (2003) and Joseph and Mitchell (2010) uses outdated data from Gomez and Jomo (1997). On the contrary with these studies, part of the data used in this study is updated from Gomez and Jomo (1997). The process of updating this data is to filter out firms which are no longer considered as connected so that the results

obtained will be accurate. Secondly, another set of data which records the firms which have a politically connected individual in its board of directors are being hand-collected from the annual reports available in Bursa Malaysia. To our knowledge, most studies in this area only focuses on connection through friends and family members, neglecting the possible effect of connection through board members. The lack of easily obtained data also made this type of connection less favourable to study.

Table 1: Country distribution of firms with political connections

Country	No. of firms with available data	No. of firms connected with a minister or MP	% of firms connected with a minister or MP	No. of firms connected through close relationship	% of firms connected with a minister or MP, or a close relationship	% of top 50 firms connected with a minister or MP, or a close relationship	Connected firms as % of market capitalization
Argentina	38	0	0.00	0	0.00	0.00	0.00
Australia	287	2	0.70	0	0.70	0.00	0.32
Austria	110	1	0.91	0	0.91	0.20	0.25
Belgium	157	6	3.82	0	3.82	0.80	18.77
Brazil	167	0	0.00	0	0.00	0.00	0.00
Canada	534	7	1.31	0	1.31	2.00	2.53
Chile	89	2	2.25	0	2.25	4.00	1.43
Colombia	32	0	0.00	0	0.00	0.00	0.00
Czech Rep.	63	0	0.00	0	0.00	0.00	0.00
Denmark	228	7	3.07	0	3.07	6.00	2.52
Finland	132	2	1.52	0	1.52	0.00	0.14
France	914	16	1.75	4	2.19	10.00	8.03
Germany	840	11	1.31	2	1.55	2.00	1.20
Greece	153	1	0.65	0	0.65	0.00	0.09
Hong Kong	405	3	0.74	5	1.98	6.00	2.33
Hungary	27	1	3.70	0	3.70	3.95	2.81
India	323	9	2.79	0	2.79	2.00	1.83
Indonesia	154	12	7.79	22	22.08	24.00	12.76
Ireland	82	2	2.44	0	2.44	4.00	22.83
Israel	55	2	3.64	0	3.64	4.26	8.13
Italy	233	24	10.30	0	10.30	16.00	11.27
Japan	2395	31	1.29	1	1.34	2.00	1.34
Luxembourg	23	1	4.35	0	4.35	4.55	10.48
Malaysia	445	23	5.17	65	19.78	44.00	28.24
Mexico	94	6	6.38	2	8.51	12.00	8.14
Netherlands	238	1	0.42	0	0.42	0.00	0.01
New Zealand	50	0	0.00	0	0.00	0.00	0.00
Norway	206	0	0.00	0	0.00	0.00	0.00
Peru	37	0	0.00	0	0.00	0.00	0.00

Phillipines	114	1	0.88	4	4.39	8.00	16.16
Poland	57	0	0.00	0	0.00	0.00	0.00
Portugal	101	3	2.97	0	2.97	4.00	2.00
Russia	25	3	12.00	2	20.00	36.36	86.75
Singapore	229	18	7.86	0	7.86	4.00	2.59
South Africa	212	0	0.00	0	0.00	0.00	0.00
South Korea	313	7	2.24	1	2.56	4.00	8.95
Spain	200	3	1.50	0	1.50	0.00	0.82
Sri Lanka	18	0	0.00	0	0.00	0.00	0.00
Sweden	280	3	1.07	0	1.07	4.00	1.02
Switzerland	243	6	2.47	0	2.47	4.00	0.69
Taiwan	237	2	0.84	6	3.38	10.00	12.74
Thailand	279	23	8.24	19	15.05	34.00	41.62
Turkey	84	1	1.19	0	1.19	0.00	0.14
UK	2149	154	7.17	0	7.17	46.00	39.02
US	7124	6	0.08	8	0.20	6.00	4.94
Venezuela	18	0	0.00	0	0.00	0.00	0.00
Zimbabwe	8	0	0.00	0	0.00	0.00	0.00
All countries	2020 2	400	1.98	141	2.86	6.92	7.72

Source: Faccio, 2006

1.2 Relationships with Local Authority

The practice of building good relationship is not a new found knowledge. In fact, the act of forging good relationship with local authorities (government) existed in all countries hundreds of years ago. In setting of Malacca Sultanate back in the 1500s, foreign merchant from as far as China, Arabs, Indians and Persians came with gifts for the sultanate to forge good relationships with local monarchy. On the other hand, the ruler of the Malacca Sultanate also visited the emperor of China in order to create good relationship with them. To date, the practice of forging good relationships with local authority (government) still exist. However, the word ‘local authority’ is now more commonly termed as ‘government’ and the act of forging good relationship with local authority is more popularly being termed as political connection.

The types of political connection which exist in modern Malaysia are the result of the combinations of several events which unfolded during pre-independence and post-independence years. During the pre-independence years, there already cease to exist one type of political connection, which is connection between business leaders and politician (White, 2004) ¹. For example, during the pre-independence years, leader and tin-mining baron such as Henry Lee Hau Shik (or more popularly known as H. S. Lee) managed to get a banking licence to establish the Development & Commercial Bank which began its operation in 1966 through close links with politician². Mohammad Tahir Tan Tong Hye (or more

¹ More detailed information can be found in the work of N. J. White (2004). The beginnings of crony capitalism: Business, politics and economic development in Malaysia, c. 1955–70. *Modern Asian Studies*.

² Means, *Malaysian Politics*, pp.202, 214; E.T. Gomez, *Chinese Business in Malaysia: Accumulation, Accommodation and Ascendence* (Richmond: Curzon Press, 1999), p.33.

popularly known as T. H. Tan) also seemed to benefit from political ties. In 1956, he managed to obtain the support for an unofficial trade mission from the Federation to Japan which resulted in him securing a number of pioneer certificates from the Ministry of Commerce and Industry for joint ventures with Japanese manufacturing concerns (White, 2004)³. In the years succeeding independence, businessmen like T.H. Tan, Nik Kamil, Robert Kuok and Tengku Razaleigh demonstrated the importance of political connections for business success (White, 2004). For instance, Robert Kuok had already extended his business empire to hotels, timber and property development by the late 1960s. Brown (1994) showed that even before the affirmative actions are implemented, Kuok have already depended on close relationship with politicians to obtain pioneer position for his flour mining and sugar refining business.

The 1969 incident is one event which exacerbated the connection between business leaders and politician in Malaysia and brought about another type of connection. Firstly, the implementation of affirmative action after 1969 intensified the connection between business leaders and politician. During that period, the Chinese businessmen were forced into close alliance with politicians and bureaucrats to guarantee their business survival and success. Meanwhile, Malay businessmen were also pushed to establish good relationships with politicians so that they stand a better chance in getting government contracts. Secondly, the 1969 incident has brought about another type of political connection in Malaysia, which is political connection through board of directors. The implementation of affirmative action has led to large Chinese businesses to appoint “prominent Malays with a

³ Arkib Negara Malaysia, Kuala Lumpur (hereafter ANM) Tan Siew Sin papers, SP 45/867, T. H. Tan to Tan Siew Sin, 20 June 1956.

background in politics or the civil service as company directors, mainly to serve as avenues to secure access to the state or bypass bureaucratic red-tape in government” (Gomez, 2003, p.64).

Subsequently in 1982, Malaysia implemented the ‘Look East Policy’ which intends to learn from Japan, South Korea and Taiwan, where they are regarded as the superpowers of the East. Their advances in industrial and economic sectors at a much faster rate compared to its Western counterparts have been credited to their good work ethics, practices and policies. Part of the initiative of this policy was the emphasis to develop co-operatives projects in order to facilitate the transfer of technology where it was to benefit both sides. Thus, the adoption of ‘Look East Policy’ and the intellectual transfer between Malaysia and these three countries could very much have mitigated the adoption of business styles and practice from these countries as well. The Japanese have been doing business by zaibatsu and the Koreans by chaebol whom have always maintained a close proximity with influential government officers. This particular event could have somewhat exacerbated the issue of political connection between business leaders and politicians in modern Malaysia.

Last but not least, the privatization of government entities in 1991 under the Seventh Malaysia Plan could have brought about the existence of political connection through government-linked companies (GLC) in Malaysia. The intention of the privatization was to ‘facilitate the country’s economic growth, reduce the financial and administration burden of the government, reduce the government’s presence in the economy, lower the level and scope of public spending and allow market forces to govern economic activities and improve efficiency and

productivity⁴. The process of privatization has been rather successful in alleviating government's burden but the rise of quasi-state corporations pushed politicians and bureaucrats into the business world (White, 2004). Thus, this has also led to the exacerbation of political connection through board of directors.

From the discussion above, it can be concluded that three types of political connection exist in Malaysia. Firstly is political connection between business leader and politician (BUS). Secondly is the political connection through board of directors (BOARD). Thirdly is the political connection through government-linked companies (GLC). However, this study intends to study another type of political connection, which is political connection through the family ties (FAM). Although this type of connection is seldom being researched especially in Malaysia due to its sensitivity, this study will incorporate this type of connection because by doing so make our result more reliable and robust as it portrays a more accurate situation of the issue of political connection in Malaysia. The next section discusses the types of political connection in more detail.

⁴ See the official website of Economic Planning Unit, Prime Minister's Department of Malaysia.

1.3 Types of Political Connection in Malaysia

1.3.1 Government-linked Companies

As mentioned in the previous section, political connection through GLC in Malaysia was spurred by the initiative of the government to privatize government entities in 1991 under the Seventh Malaysia Plan. A firm is considered a GLC when government has a direct (or indirect) controlling stake in it. In other words, the government has the authority to elect its senior management, board of directors and decide on big decisions (eg. acquisitions and divestments, restructuring and financing, strategy and contract awards). GLCs can be controlled by the government directly or via Government-Linked Investment Companies (GLICs). GLICs are government's investment arms that distribute government funds to the GLCs. There are currently five GLICs in Malaysia namely Khazanah Nasional Berhad (KNB), Kumpulan Wang Simpanan Pekerja (KWSP), Lembaga Tabung Angkatan Tentera (LTAT), Lembaga Tabung Haji (LTH), and Permodalan Nasional Berhad (PNB).

A little information on the GLICs is provided as follows; KNB is Malaysia's sovereign wealth fund and it is also the investment holding arm of the government. Its objective is to promote economic growth and make strategic investments on behalf of the government. All the shares of KNB are owned by the Ministry of Finance of Malaysia which in turn is headed by the Prime Minister. As of 2012, KNB's total asset is approximately US\$29 billion.

KWSP is a major institutional investor in Malaysia and it is also under the directive of Ministry of Finance. It is in charge of the compulsory savings plan and retirement planning for employees in the private sector in Malaysia. KWSP's total

assets size is about US\$184 billion by the end of 2013, a colossal amount which constitutes more than half of Malaysia's gross domestic product (Thillainathan, 2000). KSWP have a sturdy government control where under the law, 70 per cent of its funds have to be invested in Malaysian government securities (Wahab et. al, 2009). Currently KWSP is allowed to invest up to 23% of its portfolio overseas where it is not allowed to do so in the past.

PNB was established in 1978, which is the first unit trust set up in Malaysia to encourage Bumiputera shareholdings in the corporate sector. In the beginning, PNB only have one unit trust known as Amanah Saham Nasional but since then it has expanded to several unit trust which also caters for other groups. For instance, youths can purchase the Amanah Saham Didik while the non-Bumiputerans can opt for Amanah Saham Nasional which pays a handsome dividend of about 8 percent a year. By the end of 2003, its net worth is approximately US\$4 billion.

LTAT was established in 1972 and it functions as a retirement fund for the Armed Forces of Malaysia. Its process is also similar to KWSP where it is compulsory for its employees to pay ten percent of their monthly salary to LTAT while their employer (the government) is required to pay fifteen percent every month. LTAT's dividend payment has also been historically high (approximately 8 percent per year not including special bonuses).

LTH is a premiere Islamic financial institution in Malaysia which was formed in 1963. With a fund of more than RM41billion, it is the country's biggest Islamic fund manager with the intention of encouraging Malaysian Muslims to save for pilgrimage journeys to Mecca. More recently, it has also ventured into

investment sector in accordance with Islamic principles and is able to provide competitive returns to its stakeholders annually. All their investments are in accordance with syariah by roping in the help of investment advisory board which includes Islamic scholars.

GLCs and GLICs have an imperative part to play in the country's economic structure. In terms of market capitalization, GLCs account for approximately RM260 billion or almost 36% of Bursa Malaysia. Moreover, GLCs employs for a projected 5% of the domestic labor force as they are involved in much aspects of the country such as in the area of water and sewerage, telecommunication, electricity, postal services, airports, banking, financial services and public transport⁵. Furthermore, GLCs play an imperative part in implementing government policies and also in building knowledge and competencies in important areas. On the aspect of global economic liberalization, GLCs and GLICs are gradually playing a more dynamic and major role by establishing global economic connections through investments in overseas projects and investments in new growth areas.

1.3.2 Board of Directors

Politically connected board of directors (BOARD) can be classified as firms which have indirect political connection. Politically connected board of directors is defined as former government servant or politicians who holds directorship in a firm's board of directors. According to Lim (1981), they are commonly appointed to execute 'extra-economic functions' such as facilitating dealings with the

⁵ Refer to the Putrajaya Committee on GLC High Performance (PCG) website for further information.

government, specifically to help these firms bypass bureaucratic red-tape. Past literatures which are related to this study are papers like Hermalin and Weisbach (2001) which investigated whether board of directors can add value to the firm. In recent years, there are growing investigations which looked into the aspects of director characteristics. For example, Adams and Ferreira (2004) examined boards that have female directors. Ferris et al. (2003), Perry and Peyer (2005), and Fich and Shivdasani (2006) investigated the effects of having board of directors with numerous board seats. Lastly, Kroszner and Strahan (2001) and Guner et al. (2006) emphasized on boards of directors that possessed banking background. In accordance with the investigations done by these previous researches, this thesis focuses on directors with the unique characteristic of having a political background.

As mentioned by Kakabadse, Ward, Korac-Kakabadse and Bowman (2001), directors with a well-established network of contacts within the city is recognized by numerous CEOs and chairmen as particularly useful. In addition, Goldman, Rocholl and So (2009) investigated how each board member's past political affiliation affect the value of procurement contracts awarded to their respective firms in the U.S.. Their result suggested that firms which are connected to the winning team side are more likely to receive an increasing amount of procurement contracts.

In the context of this study, Gomez (2003) has mentioned about the politically connected board of directors. For example, Mohammed Hanif Omar, the former Inspector-General of Police, is a director of companies in Lim Goh Tong's gaming group, Genting, and Azman Hashim's financial group, AMMB Holdings; he also holds directorships in a number of quoted companies outside the top 100 list. Alwi Jantan, another prominent ex-senior bureaucrat – he was Director of Public Service

in the Public Services Department – sits on the boards of foreign-owned Guinness Anchor and Resorts World, of the Genting group. Mohd Ghazali Seth, a director of Chinese-owned Magnum and the foreign-owned firms, Carlsberg and Nestle', was chief of the armed forces, as was Mohd Ghazali Che Mat who serves as a director of the politically well-connected Malakoff and the government-controlled Kumpulan Guthrie. Yahya Ismail, who holds directorships in the Chinese firms, YTL Corp and Southern Bank, foreign controlled Shell, and the politically well-connected UEM, served in a number of key government posts, including Director General of the Livestock Authority and Chairman of the Totalisator Board.

However, the author did not conduct studies on how these politically board of directors could affect the performance of the firm. Thus, this thesis hopes to fill this gap. One of the challenges faced while conducting this study is defining and identifying firms which engage the service of politically connected board of directors. This will be further explained in Chapter 3.

1.3.3 Business Ties

According to Gomez and Jomo (1997), there are two types of political favouritism that exist in Malaysia. The first type is the official status that is given to firms that are owned by ethnic Malays. The second type is the informal relations that existed between leading politicians and firms that are run by both Malay and Chinese business people. Relationships between businessman in Malaysia and politicians sometimes happened even before the politicians stepped into the office. In Gomez and Jomo (1997), the connection between firm and politicians appeared to have been primarily on chance personal histories. Most of the time, connections with

politicians happened even before they were elected into office as ministers. Some were forged during childhood years and some were during their university days. However, not all relationships happen before politicians stand for office. Some of them were forged after they have been elected. Thus, there are reasonable evidence to propose political connections – similar to family control and state control – is another dimension of control that appears to create economic value (Chen, Ariff, Hassan & Mohamad, 2013).

When the affirmative action was implemented in 1970 to correct the economic imbalance between races in Malaysia, Chinese businessman immediately felt the pinch because this means they are going to lose their shares in some of the future economic development in the country. In order to overcome the possibility of bad performance of their firm, they began to forge good relationships with leading politician so that they could protect what they have, or in some cases perhaps to even increase the value of their firm. Consistent with the rent-seeking theory, the objective of Chinese businessman in Malaysia is to secure profit maximization. They obtain advantages from rent-seeking behaviour through connections to politicians in power. Such advantages include higher opportunity to undertake very valuable projects, convenience to funding and monopoly control of the trade. Besides Malaysia, developing countries like India, Brazil and Mexico have also relied on politically connected firms to bring out economic development through state-funded schemes during the period of pre-war (Woo, 1998). However, such activities create disorientation in the market place particularly where private sector is non-existence at the initial phase of economic growth. Rent-seeking is a tactic to generate additional value by these Chinese businessmen because according to Krueger's (1974) model, rent seeking firms will try to create a barrier to entry and monopolize the production

line. This distortion will create an artificial market price for a product, which in turn will earn a high profit margin. One of the Chinese businessmen who gained tremendously from his political tie with leading politicians is Vincent Tan Chee Yioun. He has been described by the late Australian journalist Barry Wain in his book “Malaysian Maverick: Mahathir Mohammad in Turbulent Times” as the chief non-Malay crony in Malaysia. Vincent Tan is the founder and former Chairman and Chief Executive Officer of Berjaya Corporation Berhad which covers a wide businesses area of property, resorts, and gambling, food and beverage and education. Other Chinese businessman includes Quek Leng Chan, Ting Pek Khiing, Yeoh Tiong Lay and Robert Kuok.

Besides Chinese businessman, Malay businessman have also benefited from close relationship they have with leading politicians. One of them is Syed Mokhtar Al-Bukhary, who is arguably one of the most successful Malay businessmen in Malaysia. His business empire covers industries like property, plantation, transportation, defense and even power generation. He also owns the Heavy Industries Corporation of Malaysia (also known as Hicom) which was set up by the government in 1980. Hicom later on invested in the cement, steel and automotive business. Hicom is one of the largest developments where government picks which private sector firms will obtain access to investment funds from the government (Perkins and Woo, 2000). Besides Syed Mokhtar Al-Bukhary, other notable Malay businessman includes Halim Saad, Tajuddin Ramli and Rashid Hussain. Halim Saad owns public-listed companies such as Renong, United Engineers (M) (UEM), Kinta Kellas, Time Engineering and Ho Hup Construction. Throughout the 1997 financial crisis, funds were channeled to a privileged few such as the likes of Halim Saad through state or well-connected businessman’s financial institutions. According to a

report by *Euromoney*, about 45 percent of the RM39 billion lent by banks for stock purchase, were given to individuals (Gomez, 2003). During that period, Renong, had already amassed around RM20–28 billion of debts and this figure is more than 5 percent of loans by the Malaysian banking system (Gomez, 2003). According to government leaders, assistance should be given to Renong as this big expanded enterprise was a representation of the progress of Malay capital (Gomez, 2003). As the government is being more active in distributing favours to firms, businessmen have gradually used personal connections to influence the distribution of those favours (Gomez & Jomo, 1997).

1.3.4 Family Ties

Political connection can also exist through family ties with government leaders. In the case of Indonesia, where political and economic power should be practicing the arm's length relationship, lines have been blurred as politician's families began to be involved in the economy. According to Gomez (2003), Suharto family owns approximately US\$5 billion worth of private and publicly listed business in Indonesia in 1996. Following the financial crisis in 1997, companies owned by Suharto's children reportedly had debts amounting to US\$4 billion (Gomez, 2003). Besides Suharto, other members of Indonesia's ruling elite, or their relatives, had also managed to develop a huge stake in the country's corporate sector. The family members of Kenya's President Uhuru Kenyatta have interest in various industries such as oil, insurance, banking, media, manufacturing, maritime, education, real estate and transport where their wealth ranged between US\$100 million and US\$1 billion. In the case of Xi Jinping, the current President of Republic of China, his extended family members have business interest in real

estate, minerals and mobile-phone industry. According to reports by Bloomberg, Xi's family's assets were traced to his sister, his brother-in-law and his niece. In India, powerful families such as the Nehru-Gandhi family have dominated its political arena, making only a few families extremely rich from its 40 years of dominance. Sonia Gandhi who belongs to the Nehru-Gandhi family by marriage and is also serving as the President of the Indian National Congress since 1998, have a net worth of approximately US\$2 billion.

In Malaysia, family members of government leaders are also involved in businesses or holds directorship in public-listed companies. For example, sons of the fourth Prime Minister, Mokhzani Tun Mahathir, sits on the board of Opcom Holdings Berhad and Maxis Berhad while Mukhriz Tun Mahathir, sits on the board of Reliance Pacific Berhad. Besides that, the current Prime Minister of Malaysia Najib Razak, also have immediate family members who sit on the board of several firms. For example, his brother Ahmad Johari Razak, sits on the board of five firms namely Ancom Berhad, British American Tobacco (Malaysia), Nylex Berhad Berhad, Hong Leong Industries and Daiman Development Berhad.

1.4 Problem Statement

Calomiris and Ramirez (1996) once said that almost all countries, including the United States have at some point in their history relied heavily on relationships, particularly in earlier stages of development. Relationship-based system works better than arm's-length system in relatively less developed economies – those where contracts are ineffective and price signals from the market relatively uninformative (Rajan & Zingales, 2005). In emerging countries, relationship-based economy is a common practice and Malaysia is not an exception Gomez (2003). This is further substantiated by Faccio, Masulis and McConnell (2006) which documented the total politically connected (PCON) firms in Malaysia to be 81. This amount is only second to the United Kingdom, which have 118 PCON firms. However, Malaysia's capital market size is much smaller compared to that of the United Kingdom. Therefore, the percentage of PCON firms in Malaysia is considered high (Wahab & Rahman, 2009). Even though the proportion of PCON firms is high, the number of studies which focuses on Malaysia is low compared with the likes of the United States. Moreover, findings from previous studies could not specifically pinpoint whether political connection have positive or negative effect on firm performance. Examples of past literatures which found the positive effect of political connection on firm performance are Gomez and Jomo (1997), Johnson and Mitton (2003), Mitchell and Joseph (2010), Fazilah (1996) and Fraser, Zhang and Derashid (2006). Past literatures which found negative relationship between political connection and firm performance are Wahab et al. (2009), Bliss, Gul and Majid (2011) and Bliss and Gul (2012). As such, the relationship between political connections and firm performance is still very much debatable. Part of the motivation of this study is to contribute to the existing literatures on the effect of political connection on firm performance in the

context of Malaysia. A stronger understanding of the advantages and disadvantages of political connection is imminent to determine their impact of firm performance which may lead to better corporate governance in Malaysia.

Secondly, most, if not all of the studies conducted on this subject in Malaysia hails from only one source which is Gomez and Jomo (1997). Such studies include Johnson and Mitton (2003), Mitchell and Joseph (2010), Bliss and Gul (2012), Wahab et al. (2009), Chen et al. (2013) and Ebrahim, Girma, Shah and Williams (2014). These studies adopt the list of PCON firms from Gomez and Jomo (1997) without examining whether the connected person is still with the company. The study done by Gomez and Jomo (1997) was done almost 18 years ago and an update in the data provided by them is necessary to ensure the results obtained are reliable. Unfortunately, most studies have overlooked this concern. This study attempts to rectify this situation by using updated data from Gomez and Jomo (1997) and also by adding several other measures on political connection. More detailed description on how the data are updated is described in Chapter 3.

Thirdly, as mentioned by Fisman (2001) and Faccio (2006), political connection can be divided into several types such as connection through family relationship, childhood friends, minister or MP (Member of Parliament) and state-owned enterprise. Previous studies like Gomez and Jomo (1997), Johnson and Mitton (2003) and Chen et al. (2013) does not study into such detailed relationship. While there are studies like Mitchell and Joseph (2010) and Ebrahim et al. (2014) which attempts to look into this aspect, their classification of connection types is confusing and unclear. For example, the study of Mitchell and Joseph (2010) classified GLC and Khazanah as two separate categories of PCON when they should be classified

under the same category because Khazanah is only of the five GLICs (Government-linked Investment Companies) which controls the listed GLCs in Malaysia. This study attempts to rectify this situation by categorizing PCON firms into a more accurate and organized group. This study classifies PCON firms into four categories and they are government-linked companies (GLC), politically connected board of directors (BOARD), political connection with businessman (BUS) and political connection through family members of leading politician (FAM).

This study also covers the period of twelve years (2002 – 2013). Previous studies like Johnson and Mitton (2003) covers the period of two years (1997 – 1998), Gul (2006) utilizes three years (1996 – 1998), Wahab et al. (2009) utilizes five years (1999- 2003), Faccio et al. (2006) covers six years (1997 – 2002), Mitchell and Joseph (2010) uses seven years (2000 – 2006). A longer period of study is expected to increase the accuracy of the result and also to examine the effect of political connection after year 2006, which wasn't covered by most of the studies mentioned above. Political landscape in Malaysia has also changed in the past ten years and a new study would provide a new insight into the impact of political connection on firm performance.

1.5 Research Questions

Based on the discussion in problem statement, the following questions are raised.

- 1) Is there any connection between politically connected firms and firm performance in the long-run?
- 2) Do connection types affect firm performance differently in the long-run?
- 3) Under specific events, does political connection influence firm performance?

1.6 Research Objectives

The above research questions indicate the need of the study to be conducted to achieve the following objectives.

- 1) To examine the relationship between political connection and firm performance in the long-run.
- 2) To examine how types of connection among politically connected firms influence firm performance differently in the long-run.
- 3) To examine the influence of political connection on firm performance under specific events.