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## Political Connectedness, Firm Performance and Corporate Risk Taking: Are Emerging Markets Different?

Augustine Tarkom  
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POLITICAL CONNECTEDNESS, FIRM PERFORMANCE AND CORPORATE RISK  
TAKING: ARE EMERGING MARKETS DIFFERENT?

BY

AUGUSTINE TARKOM

A thesis submitted in partial fulfillment of the requirement for the degree

Master of Science

Major in Economics

South Dakota State University

2019

POLITICAL CONNECTEDNESS, FIRM PERFORMANCE AND CORPORATE RISK  
TAKING: ARE EMERGING MARKETS DIFFERENT?

AUGUSTINE TARKOM

This thesis is approved as a creditable and independent investigation by a candidate for the Master of Science in Economics degree and is acceptable for meeting the thesis requirement for this degree. Acceptance of this thesis does not imply that the conclusions reached by the candidate are necessarily the conclusions of the major department.

~~Nacasius Ujah~~, Ph.D.  
Thesis Advisor

Date

~~Eluned Jones~~, Ph.D.  
Head, Department of Economics

Date

~~Dean~~, Graduate School

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## ABSTRACT

POLITICAL CONNECTEDNESS, FIRM PERFORMANCE AND CORPORATE RISK  
TAKING: ARE EMERGING MARKETS DIFFERENT?

AUGUSTINE TARKOM

Existing literature exploring the effect of politically connected firms on their performance and risk-taking seems to offer decisive results for the emerging and the developed market. However, from professionals and anecdotal evidence, both markets do not exhibit similar characteristics. Considering these characteristics, instability of the government, lack thereof of adequate governance structure, I revisit the topic. This study comprises 27 advanced and 20 emerging economies for the years 1992 through 2016. I find that sound political environment drives risk-taking in advanced markets, while political connections drive corporate risk-taking in emerging markets. I also find that political institutions and political connections drive firm performance in advanced and emerging economies respectively. The results are robust controlling for country and year effect as well as through the propensity score matching technique, the 2007/2009 financial crisis and instrumental variable estimation technique.

**Keywords:** *Political Connectedness, Risk-taking, Firm Performance, Emerging Markets*

## CHAPTER ONE: BACKGROUND OF THE STUDY

### *1.0 Introduction*

Assessing political connectedness has been a topic of academic inquiry for decades, often focused on firm value, corporate governance and corporate risk-taking in a country (Boubakri, Mansi, & Saffar, 2013; Brockman, Rui, & Zou, 2013; Faccio & Hsu, 2017; Niessen & Ruenzi, 2010). While there have been gradual improvements in the conceptualizations and the analytical techniques of political connectedness, many researchers and practitioners continue to focus on the limited breadth of its contribution, particularly with regards to the advanced world. Emerging markets as a whole have not attracted such comprehensive attention (Boubakri et al., 2013; Brockman et al., 2013; Faccio, 2010).

Emerging markets have gained economic, management and political interest, but related research on them remains scanty. Sudhir et al., (2015) indicated that perhaps this could be attributed to the differences in the types of available and unavailable secondary data and the cost of these data sets. Understanding of these markets, which now account for 65% of the world's population and 40% of global economic output, is necessary to strengthen, perhaps even maintain, the importance of our academic enterprise. Reviewing the existing literature on the subject reveal gaps on emerging markets, as shown in Table 1. Thus, there is a need for country and industry-specific study that exploits the unique characteristics of a particular emerging market rather than the routine cross-country studies in the extant literature.

Kose and Prasad (2010) note that the emerging market's contribution to the world's gross domestic product (GDP) is enormous. Banco Bilbao Vizcaya Argentaria

(BBVA), they expect the contributions by emerging markets to grow more than those of by the advanced countries in the next five years (BBVA, 2014). Besides, multinational corporations around the world and across different sectors are seeking to invest heavily in these markets. Hence, conscious effort and attention should be given to these emerging markets to establish how prone or risk-free they are to the international investment scene.

A better grasp of the nature and impact of political constrictions on firms' strategic decisions is of prime importance to multinational corporations in their quest to invest internationally. The present research seeks to advance this discussion by addressing the limited breadth of research particularly to the advanced world and extending the literature on the existing conceptual and the analytic techniques of political connectedness while making a case for the dichotomy that exists between the advanced world and the emerging markets. The primary objective of this research is to document how political connections can affect firm performance and corporate risk-taking.

Findings suggest the oversimplification of extant papers is insufficient. The results are economically and statistically significant as well as robust. In effect, the findings suggest that countries with stable political institutions, firms are more likely to undertake risky ventures, whereas countries where firms have strong political connections, they are more likely to take risky ventures. Thus, strong political institutions or sound political environment lead to higher risk-taking in advanced markets than in emerging markets. On the other hand, due to the presence of high political connections in the emerging markets, my findings suggest that corporate risk-taking is high in emerging markets than in advanced markets.

Also, the findings show that in advanced markets, firm performance reduces as

the soundness of the political environment increase. I find that political constraints do not matter when it comes to firm performance in emerging markets. On the other hand, I find that political connections matter in emerging markets, and as political connections increases, firms do not perform well. I also find that political connections do not matter in the level of firm performance of firms in advanced markets. The results suggest that governments in both advanced and emerging markets should take necessary steps to control corruption to set fertile investment grounds and thus decrease political connections and extractions.

The main objective of this study is to assess the impact of political connections on firm performance and corporate risk-taking by disaggregating emerging economies from advanced economies. Not only do I also add on to the literature by looking at how the presence of good governance can affect the results, but also how the interaction of political connections with political institutions can affect the results. This approach is different from the extant literature in that this tries to separate emerging economies from advanced economies by studying the same effect.

The few studies (Boubakri et al., 2013; Brockman et al., 2013; Faccio, 2006) had combined emerging and advanced economies in their research. Aside from the 47 countries studied, I also have a larger sample pool and broader year range. Unlike (Boubakri et al., 2013; Faccio, 2006) who had only 211,794 and 20,202 observation respectively, I have 562, 867 set of observation which expands from 1996 through 2016.

## CHAPTER TWO: LITERATURE REVIEW

### 2.0 Literature Review

Table 1 summarizes selected publications on political connections. The Table shows there is a dearth of literature in country-specific studies. The table show that none of the studies explicitly consider differences among emerging market in terms of political connections. In this study I do. Some studies (e.g. Boubakri et al., 2013) control for year and country effects, but a large variance remains unaccounted for. By segregating countries into advanced and emerging, I revisit the topic of political connectedness and corporate risk-taking behavior. Table 1 shows the existing gap in the literature. The literature on political connectedness is limited to country-specific studies and the limited attention that has been giving to emerging markets. I infer from Table 1 that the role of political connections to firm performance and corporate risk-taking in emerging markets is scanty.

Some studies (Boubakri et al., 2013; Faccio, 2006) that looked at multiple countries tend to combine advanced and emerging markets in their inquiries. These markets do not exhibit the same characteristics regarding development and risk (see Figure 1). Hence, by their estimates, a general conclusion is formed, by forcing both economies into the same regression model, ignores variances and unique characteristics in these economies.

In Figure 1, I present a graph of the standard errors of the Worldwide Governance Indicators (WGI) for selected countries for both the advanced and the emerging markets. The WGI project reports aggregate and individual governance indicators for over 200 countries and territories over the period 1996–2016, for six dimensions of governance;

Voice and Accountability, Political Stability and Absence of Violence, Government Effectiveness, Regulatory Quality, Rule of Law, and Control of Corruption.

*Table 1: Summary of Literature by Top Journals*

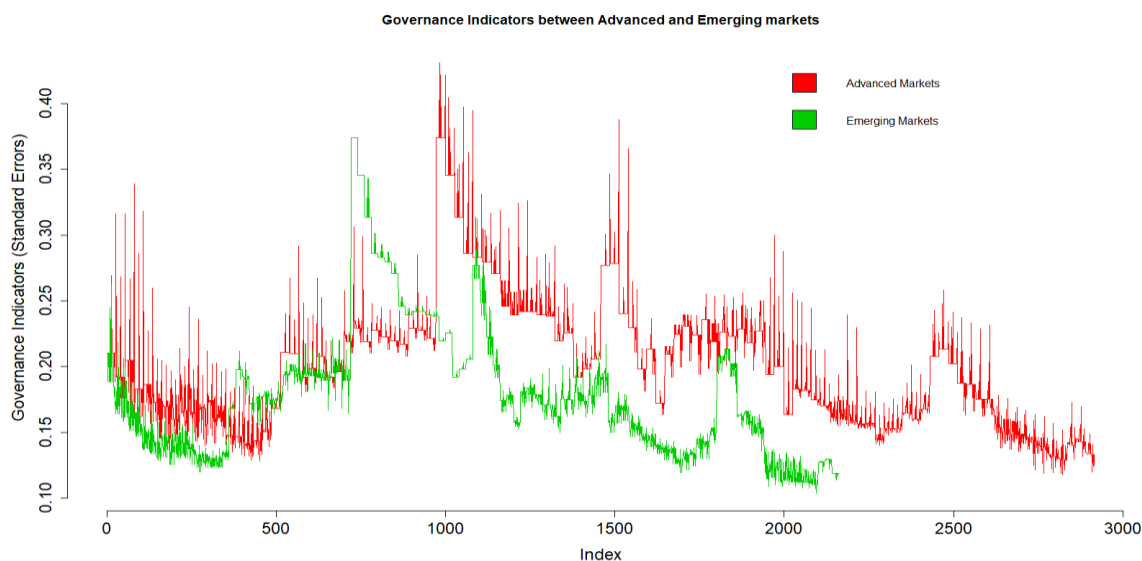
<b>Name (Year)</b>	<b>Title</b>	<b>Journal</b>	<b>Country/Location</b>
Michael J. Cooper, Huseyin Gulen, And Alexei V. Ovtchinnikov (2010)	Corporate Political Contributions and Stock Returns	<i>The Journal of Finance</i>	US
Mara Faccio And Hung-Chia Hsu (2017)	Politically Connected Private Equity and Employment	<i>The Journal of Finance</i>	US
Vikramaditya Khanna, E. Han Kim, And Yao Lu (2015)	CEO Connectedness and Corporate Fraud	<i>The Journal of Finance</i>	
Joseph P.H. Fan, T.J. Wong, Tianyu Zhang (2007)	Politically connected CEOs, corporate governance, and Post- IPO performance of China's newly partially privatized firms.	<i>Journal of Financial Economics</i>	China
Pat Akey (2015)	Valuing Changes in Political Networks: Evidence from Campaign Contributions to Close Congressional	<i>The Review of Financial Studies</i>	US

	Elections		
Raymond Fisman (2001)	Estimating the Value of Political Connections	<i>The American Economic Review</i>	Indonesia
Mara Faccio (2006)	Politically Connected Firms	<i>The American Economic Review</i>	Mixed Countries
Alexandra Niessen and Stefan Ruenzi (2007)	Political Connectedness and Firm Performance - Evidence from Germany	<i>German Economic Review</i>	Germany
Simon Y.K. Fung, Ferdinand A. Gul, Suresh Radhakrishnan (2015)	Corporate political connections and the 2008 Malaysian election	<i>Accounting, Organizations, and Society</i>	Malaysia
Chansog (Francis) Kim, Liandong Zhang (2015)	Corporate Political Connections and Tax Aggressiveness	<i>Contemporary Accounting Research</i>	US
Maria M. Correia (2014)	Political connections and SEC enforcement	<i>Journal of Accounting and Economics</i>	
Effiezal Aswadi Abdul Wahab, Mazlina Mat Zain, Kieran James, Hasnah Haron, (2009)	Institutional investors, political connection and audit quality in Malaysia	<i>Accounting Research Journal</i>	Malaysia

Narjess Boubakri, Sattar A Mansi and Walid Saffar (2013)	Political institutions, connectedness, and corporate risk-taking	<i>Journal of International Business Studies</i>	Mixed countries
Paul Brockman, Oliver M Rui and Huan Zou (2013)	Institutions and the performance of politically connected M&As	<i>Journal of International Business Studies</i>	Mixed countries

*Notes: In Table 1, I summarize some key literature in some selected top journals in Economics and Finance that shows that the extant literature on emerging markets is limited. I see that most of the literature are country-specific with most focusing on the advanced countries. There are just a few extant works that sort to have pool studies on several countries. However, studies showing the separation of the emerging markets from advanced markets on similar studies are limited or not found at all.*

*Figure 1: Standard Errors of the Worldwide Governance Indicators (1996-2016) for Selected Advanced and Emerging Markets*



*Notes: Figure 1 shows a plot of the standard errors of the Worldwide Governance Indicators (WGI). The WGI covers over two hundred countries and territories, measuring six dimensions of governance starting in 1996: Voice and Accountability, Political Stability and Absence of Violence/Terrorism, Government Effectiveness, Regulatory Quality, Rule of Law, and Control of Corruption. The red line represents evidence in advanced markets*



*whereas, the green line represents evidence from emerging markets. This graph aids in a visual impression about the variations that exist in the two markets, therefore these markets should be studied independently.*

Several theories help to explain the existence and mechanisms of political connections. Two such theories are based on theories of reputation and rent-seeking. Reputation theory stresses the relevance of associations, and holds that politically connected executives serve as a substitute medium for creating a firm's reputation when quality disclosure is absent (Liu, Sun, & Liu, 2003; Yu & Pan, 2008). On the other hand, rent-seeking theory demonstrates political connections by suggesting that firms use them to partake in events that impact the government's endorsement decisions and government officials then exhibit preferences to firms whose boards pledge to offer personal favors (Fan, Wong, & Zhang, 2007).

To assess whether it is rewarding for firms to be politically connected, I revisit the existing literature. Firms get themselves connected to politicians in order to obtain preferential treatment, get access to government contracts and relaxed regulatory environment (Domadenik, Prašnikar, & Svejnar, 2016). While political connections have been shown in previous research to increase firm value (Faccio, 2006; Fisman, 2001; Hillman, Zardkoohi, & Bierman, 1999; Johnson & Mitton, 2003), recent studies show that such connections can be obstructive and unfavorable to firm value (Brockman et al., 2013; Faccio, 2010; Fan et al., 2007). For instance, a connected CEO embarking on an activity that is of private gains can be to the detriment of the firm in general. Such a decision leads to poorer performance by the connected firms relative to unconnected counterparts. Boubakri, et al. (2012) presented similar findings and concluded that

politically connected firms are typically considered less risky than their non-connected counterparts. The route through which firm connections leads to economic benefit or loss is also blurred (Brockman et al., 2013). The goal of this paper is not to solve the mixed evidence problem, instead, to ascertain how different, if at all, the evidence is in emerging markets from advanced markets.

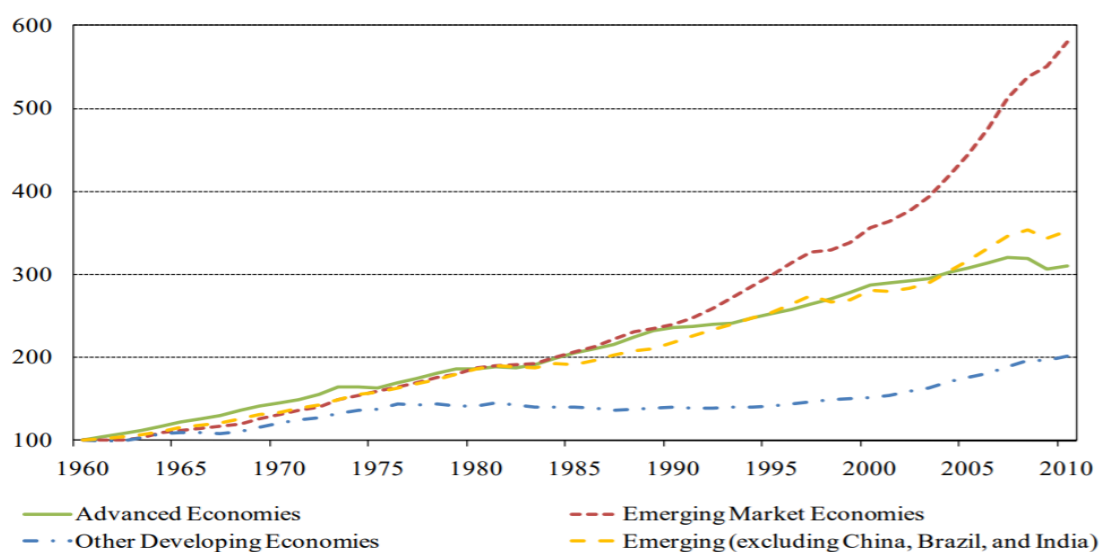
### **2.1 The Need to Consider Emerging Markets**

Since the early 1990s, emerging markets have gradually become notable on the world economic stage, accounting for a significant fraction of world growth and intensifying in importance by virtually any economic criterion (Kose & Prasad, 2010). Emerging markets' is driven by several strong secular trends: improving demographics provide a young and increasingly well-educated, growing workforce; while on the other side of the equation, a rising middle class, specifically in urban areas, will continue to propel strong consumption growth across many markets.

Many multinational corporations (MNCs) draw back from emerging markets when they should have engaged with them more closely. Khanna, Palepu, and Sinha (2005) asserted that corporations could lower cost by establishing manufacturing and service facilities in these markets, because these markets have inexpensive skilled labor and trained executives. They are now at the core when it comes to global economic growth. In Figure 2, it is observe a rise in GDP in the different markets from 1960-2010 (Kose & Prasad, 2010). According to the BBVA, 2014 report, the emerging markets broken into two groups based on their economic development, the EAGLEs (China, India, Indonesia, Russia, Brazil, Turkey and Mexico) and the NEST (Nigeria, Thailand, Colombia, the Philippines, Saudi Arabia, Iraq, Iran, Kazakhstan, Qatar, Malaysia,

Vietnam, Pakistan, Bangladesh, Poland, Egypt, Peru, South Africa, Chile and Argentina) countries are projected to contribute about 65% of global growth in the next ten years, led by China (30%) and India (11%), while the G7 (Canada, France, Germany, Italy, Japan, United Kingdom, and the United States) group will add 19%.

*Figure 2: Evolution of GDP of Different Groups: 1960-2010 (per capita, PPP weighted)*



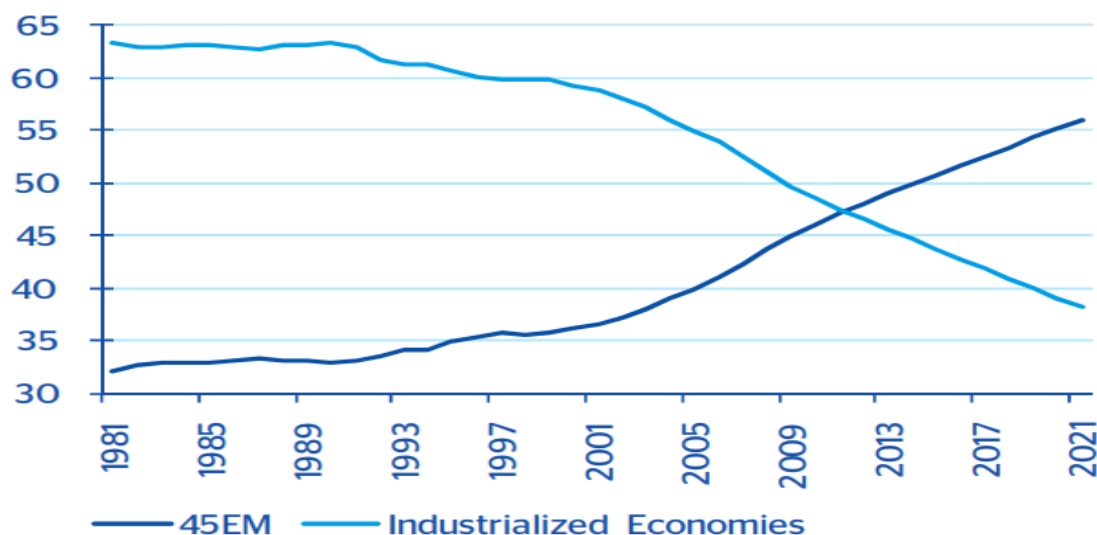
Source: (Kose & Prasad, 2010)

BBVA (2014) noted that the annual share of the world's GDP growth from the G7 countries is expected to remain below 2%, while the share of the world's GDP growth from emerging markets will outpace the industrialized countries in the next 5 years (Figure 3). By 2050, the EAGLES will be about 50% larger than G7 economies BBVA (2014). These developments are likely to have wide-ranging implications for the structure of the global and political economy. MNCs around the world and across different sectors are in a quest for opportunities in these markets, and they can offer the new consumers. Nonetheless, it is prudent to learn that even though there exist differences in these

emerging markets, the differences are primarily not so different from one another but could be different from developed countries, when it comes to how political connections impact firm performance and corporate risk-taking, especially as they mature.

In emerging markets where the formal institutional framework is not adequate, political connections play a critical role in facilitating economic exchange (Fan et al., 2007; Tsang, 1998). According to Tsang (1998), corporate political connections have become a useful way to lobby favors with government authorities. These authorities still have the power to approve projects, allocate resources and interfere in the corporate operations.

*Figure 3: Share of World GDP adjusted PPP: 45 Emerging Markets vs. Industrialized Economies*



Source: BBVA Research and IMF WEO

The study of the interaction between corporations and politics is still on the ascendancy and has gain momentum in academic research (see Table 1). In the course of such interactions, politicians may interfere in the firm's employment decisions to keep

enormous employment avenues and pay higher wages in order to gain their political support. Politicians for their part use their political power to grant favors to firms in the form of government subsidies (Shleifer & Vishny, 1994). Connected firms, in turn, have to pay a high political price, mostly in the form of high employment levels. Connected firms are always willing to balance their hiring and firing decisions in support of politicians who seek to maintain political power. These actions are mostly observable when firms exhibit more job creation and less destructive activities towards electioneering years. Specifically, (Desai & Olofsgård, 2008) noted that most connected firms, especially state-owned enterprises, tend to employ more surplus labor towards election periods. It is not surprising to see connected financial institutions lowering lending rates in election periods. Thus, being politically connected can be a two-edged sword; it presents itself with both benefits and costs.

## *2.2 Conceptual Framework*

Corporate political connections represent a unique type of corporate resource in emerging markets (Chen, Ding, & Kim, 2010; H. Li et al., 2008; Peng & Luo, 2000; Sheng, Zhou, & Li, 2011). Specifically, in markets where the formal institutional framework is not well established, political connections play a critical role in facilitating economic exchange (J. P. H. Fan, Huang, Morck, & Yeung, 2009; Tsang, 1998).

I follow Faccio (2006); Faccio, Marchica, and Mura (2011); and Henisz (2010) and the following variables; political connections (CONN) - % of firms connected with a minister or MP, excluding cases of close relationships, divided by the total number of firms listed in a country, risk (RISK) - estimated as country-specific ROA in five-year overlapping periods beginning in 1992 and ending in 2016, return on assets (ROA) -

measured as the ratio of earnings before interest, taxes, depreciation, and amortization to total assets, and political institutions (POL) - measures the degree of political constraint of a country. These measures have also been used extensively in some related literature such as Ang, Ding, and Thong (2013); Boubakri et al. (2013); Domadenik et al. (2016); Jackowicz, Kozłowski, and Mielcarz (2014).

To study the impact of political institutions on corporate risk-taking, Boubakri, Mansi, and Saffar (2013) used pooled multivariate regressions in their analysis. They found that sound political institutions positively drive corporate risk-taking, which was exacerbated in countries where government extraction is higher. Their finding revealed that connected firms engaged in risk-taking, which suggests that close ties to government leads to less conservative venture decisions.

Well-connected firms present in either emerging or advanced markets may or may not see improved performance, even if they are earning political favors, because of the resources they may require in such a rent-seeking activity (Fisman, 2001). Irrespective of the fact that some research findings show a negative relationship between political connections and firm performance (Ling et al., 2016), several studies have shown that corporate political connections lead to improved firm performance in emerging markets, specifically in China (Goldman, Rocholl, & So, 2009; Haiyang & Zhang, 2007; Li, Meng, Wang, & Zhou, 2008).

The benefits of political ties are more significant in countries with relatively high intrusive governments and weak protection of property rights (Faccio, 2006). Wu et al. (2012) document that politically connected firms underperform their unconnected rivals. Khanna, Palepu, and Sinha, (2005) document that corporations could lower costs by

establishing manufacturing and service facilities in these markets. Again and Zhang (2007); Nee (1992); Peng and Luo (2000) document that corporate political connections improve firm performance in emerging markets.

## CHAPTER THREE: DATA DESCRIPTION AND METHODOLOGY

### 3.0 Research Design and Data

#### 3.1 Model

I estimate the following models to explore the effect of political connectedness and political constraints in emerging and developed countries. The two regression models represented in equations (1) and (2), utilize the full sample without segregating between emerging and advanced economies and subsequently disaggregate the emerging markets from advanced markets. Specifically, I estimate the following regression models:

#### 3.2 Pool OLS Models

$$\begin{aligned}
 RISK = & \\
 & \alpha + \beta_1 POL_{i,t} + \beta_2 CONN_{i,t} + \beta_3 DumCONN * POL_{i,t} + \beta_4 ROA_{i,t} + \beta_5 FSD_{i,t} \\
 & + \beta_6 RINF_{i,t} + \beta_7 CPINT_{i,t} + \beta_8 GDPPG_{i,t} + \beta_9 SIZE_{i,t} + \beta_{10} \ln GROWTH_{i,t} \\
 & + \beta_{11} LEV_{i,t} + \beta_{12} FF_{i,t} + \beta_{13} COUNTRY_{i,t} \\
 & + \epsilon_{i,t} \dots \dots \dots (1)
 \end{aligned}$$

$$\begin{aligned}
 RISK = & \\
 & \alpha + \beta_1 POL_{i,t} + \beta_2 CONN_{i,t} + \beta_3 DumCONN * POL_{i,t} + \beta_4 ROA_{i,t} + \beta_5 FSD_{i,t} \\
 & + \beta_6 RINF_{i,t} + \beta_7 CPINT_{i,t} + \beta_8 GDPPG_{i,t} + \beta_9 SIZE_{i,t} + \beta_{10} \ln GROWTH_{i,t} \\
 & + \beta_{11} LEV_{i,t} + \beta_{12} GOVERN_{i,t} + \beta_{13} FF_{i,t} + \beta_{14} COUNTRY_{i,t} \\
 & + \varepsilon \dots \dots \dots (2)
 \end{aligned}$$

where RISK is defined as, and measured as the country-adjusted volatility of firms' ROA over 5-years; POL is Henisz' (2010) index of political constraints; CONN is a proxy for political connections captured by Faccio (2006) as the percentage of firms connected with a minister or Member of Parliament (MP); and GOVERN is the proxy for the governance indicators. Some variables serve as country control variables, including real GDP per capita growth (annual %) (GDPPG), Financial system deposits to GDP (%) (FSD), Remittance inflows to GDP (%) (RINF). Firm controls refer to the set of firm-level control variables (SIZE - log of total assets in millions of US\$, LEV - the ratio of total debt to total assets, GROWTH - average assets growth over five years, where assets are converted into US\$, CPINT - calculated by dividing the total assets of a company by its sales, and ROA - measured as the ratio of earnings before interest, taxes, depreciation, and amortization to total assets.) Additional controls include country (COUNTRY) and industry (FF) fixed effects, and  $\varepsilon$  is an error term. I utilize the 48 industry indicators based on Fama and French's 48-digit industry classifications for the industry fixed effects (Fama & French, 1997). The 48-industry classification scheme is "defined with the goal of having a manageable number of distinct industries that cover all NYSE, AMEX and NASDAQ stocks" (p. 156)

My focus in this analysis is the coefficient,  $\beta_1$ , which measures the sensitivity of corporate risk-taking to the quality of the political institutions prevalent in a country. A positive directionality suggests that sound political institutions drives higher corporate risk-taking.  $\beta_2$  is another coefficient of importance. According to Faccio (2006), it is the number of firms connected with a minister or MP, excluding cases of close relationships, divided by the total number of firms listed in a country. This ratio ranges from a



minimum of 0 percent (denoting no connections) to a maximum of 12 percent (high connections), found for the country Russia. A positive coefficient indicates that political connectedness drives higher corporate risk-taking.

In addition to exploring if a divergence exists on the drivers of risk-taking in countries, I expand the testable inquiry to ascertain if the effect of sound political environment is dependent on the level of political connectedness in countries.  $\beta_3$  denotes the coefficient of the effect of the interaction between political connections and political institutions. I make use of a categorical-continuous interaction, where, the dummy variable, (DumCONN), denotes a dummy for CONN. Any value greater than the median (1.29) value, is captured as 1 for strong politically connected countries, otherwise 0 for weak politically connected countries. I interacted this dummy with a continuous variable, POL. Since the advanced markets have sound political institutions but less political connections, I expect a negative coefficient, but a positive coefficient for emerging markets since the political environment in these economies are unsound but with more political connections.

### *3.4 Variable Measurements*

Firms' financial data are obtained from COMPUSTAT Global, political institutions variable from Henisz (2010) political constraint index, political connectedness variable is based on Faccio (2006) data, and the macroeconomic variables are collected from the World Bank World Development Indicators as well as Financial Structure Database for the years 1992 through 2016. Also, included in the analysis are the six Worldwide Governance Indicators. These are voice and accountability (VA), control of corruption (CC), government effectiveness (GE), political stability and absence of

violence/terrorism (PSA), regulatory quality (RQ), and the rule of law (RL).

Estimates on governance range from approximately -2.50 (weak) to 2.50 (strong) governance performance. Due to the high correlation among the six governance indicators, also evident in Panel B, I applied the principal component analysis methodology to transform these variables into a single variable, GOVERN, which captures the transformed WGI indicators. Principal components analysis (PCA) was introduced by Harold Hotelling (1933) as a way to determine factors with statistical learning techniques when factors are not exogenous. PCA works best when asset variables are correlated, and also when the distribution of variables varies across cases (Vyas & Kumaranayake, 2006).

### *3.5 Risk-Taking Variables*

I follow Faccio et al. (2011) to estimate corporate risk-taking (RISK) as country-specific ROA in five-year overlapping periods beginning in 1996 and ending in 2016, (1992 - 1996, ..., 2012 - 2016) where ROA is calculated as the ratio of earnings before interest, taxes, depreciation, and amortization (EBITDA) to total assets. To check for robustness, I considered two other risk-taking measures. RISK1 is country-adjusted volatility of earnings for each firm over the entire sampling period (1992 - 2016), requiring at least five observations in cross-sectional regressions. RISK2 is the country-wide average of all RISK observations at the enterprise level.

### *3.6 Control Variables*

I check for the characteristics of firms and countries that have been shown to affect business risk-taking such as (Faccio et al., 2011; Johnson & Mitton, 2003). These

controls include asset growth, firm size, profitability, and leverage. Growth (GROWTH), is a substitute for the impact of firm-specific growth opportunities on business risk. It is calculated as the average increase in the company's total assets in US dollars for five years. Firm's size (SIZE), a proxy for economies of scale, is counted as the natural log of total assets in millions of dollars. Firm profitability [ROA], a performance representative, is measured as earnings before interest, taxes, depreciation, and amortization that are staggered from total assets. Fixed Leverage [LEV], a proxy for financial health, is measured as the ratio of total long-term and short-term debt, staggered by assets.

I also included data from the Financial Structure Database, which provides statistics on the size, activity, efficiency, and stability of banks, non-banks, equity markets, and bond markets across a broad spectrum of countries over time. It also contains various indicators of financial globalization, including statistics on international bond issues, international loans, offshore deposits and remittance flows (Beck, Demirgüç-Kunt, & Levine, 2010). The variables I include from this database are; financial system deposits to GDP (%) [FSD] and remittance inflows to GDP (%) (RINF). Finally, I also included GDP per capita growth (annual %) (GDPPG) from the World Development Indicators.

### *3.6 Data*

The sample I used to answer the research questions consists of 562, 867 observations, in 47 countries spanning 1996 – 2016. I considered the non-financial firms covered by COMPUSTAT Global and COMPUSTAT North America from the period 1992 through 2016. I exclude financial corporations with SIC codes between 6000 - 6999 and 4900 - 4999 because their profitability indices, leverage and growth rates, are

calculated differently from those of non-financial companies because they are regulated and then highly sensitive to the planning of a country's political institutions. The sample includes both active and non-active firms from 47 countries to mitigate concerns about breaches of survival by less risk-taking firms.

The sample selection process is as follows: I started by listing countries that are present in Faccio (2006). These comprise 47 countries of which 20 are emerging markets, and 27 are advanced economies. I went ahead to include countries from Faccio (2006) that are present in Henisz's (2010) political constraint index since this is another prime variable of interest and it is robust to capture the presence and effects of political institutions. I realized that Faccio (2006) had Zimbabwe as part of the countries she studied but excluded China. However, in the sample, I excluded Zimbabwe because Zimbabwe had many missing data for most of the variables which could have affected the number of observations significantly.

I included China in the sample because it was present in the Henisz (2010) data set. Adding China is suitable because it one of the chief drivers in emerging economies and because Henisz (2010) political constraint index is very robust concerning the role political institutions play in corporate decision making. This substitution still in a total of 47 countries in the study.

I disaggregate the sample into advanced and emerging economies based on Banco Bilbao Vizcaya Argentaria, (BBVA, 2014) classifications. In efforts to understand the significant transformation in the international investment scene and the search of giving transparency, flexibility, and dynamism to the identification of the most important economies in the emerging world, BBVA Research in 2010 created a grouping of

emerging economies called BBVA EAGLEs (Emerging and Growth-Leading Economies). Their classification groups a pool of 45 emerging economies into EAGLEs and NEST with the remaining categorized as other emerging markets. They defined the membership of the EAGLEs and NEST based on a reference variable used in their calculations as the incremental GDP, that is, the increase of real GDP in PPP-adjusted terms in the following ten years.

For this research, selection of emerging economies is driven by Faccio (2006) data and BBVA research. From BBVA, the EAGLEs countries are: China, India, Indonesia, Russia, Brazil, Turkey and Mexico, and the NEST countries are Nigeria, Thailand, Colombia, Philippines, Saudi Arabia, Iraq, Iran, Kazakhstan, Qatar, Malaysia, Vietnam, Pakistan, Bangladesh, Poland, Egypt, Peru, South Africa, Chile and Argentina. Based on BBVA classifications, countries present in Faccio (2006) were categorized as emerging markets. Due missing values present in the data, the data set is unbalanced data for the study. The definitions and sources of the data are provided in the Appendix.

## CHAPTER FOUR: RESULTS AND ANALYSIS

### *4.0 Univariate Analysis*

Panel A in Table 2 presents descriptive statistics of the variables based on the full sample. The statistics included are the sample size, mean, standard deviation, minimum and maximum value, 25<sup>th</sup> and 75<sup>th</sup> percentile as well as the median. Among the key variables, the mean (standard deviation) of RISK, POL, CONN and ROA are 0.19 (0.15), 0.71 (0.24), 2.08 (2.50) and -0.56 (61.19), respectively. The statistics for political institutions (POL) suggest that most of the countries contained in the sample have strong political constraints, that is, a sound political environment. The descriptive summary is closely consistent with what Boubakri, Mansi, and Saffar (2013) found in their study, that most of the countries had strong political constraints. The difference can be attributed to the large sample size of 562, 867 I used as against their 211, 794 sample size.

The statistics for political connections (CONN) as captured by Faccio (2006) as a percentage of firms connected with a minister or MP suggests that most firms in the sample may not suffer from political connectedness. The exception here is Russia and Italy with a double-digit value in connectedness. With regards to the RISK variable, most of the countries in the sample are less risky, hence, safe and sound for investment purposes. This is an indication that firms located in such countries are more likely to take risky ventures. Firm performance (ROA) also suggests that most firms in the sample receive negative returns on their assets.

The previous arguments based on the descriptive statistics presented in Table 2 – Panel A highlights the statistics that exist in the full sample. Next, I present the correlation matrix on the complete sample. All figures are significant at 1% level, except

those bolded. The correlation matrix presented in Panel B shows that POL, CPINT, GDPPG, and all the governance indicators are significant at 1% level and negatively correlated with RISK. On the other hand, CONN, ROA, FSD, RINF, lnGROWTH, and SIZE are significant and positively correlated with RISK. LEV is insignificant but positively correlated with RISK. All the observed correlation coefficients are weakly correlated with RISK.

*Table 2: Descriptive Statistics**Panel A: Pooled Summary Statistics*

Variable	N	Mean	SD	Min	25%	Median	75%	Max
RISK	562867	0.19	0.15	0.02	0.07	0.15	0.39	0.42
POL	562599	0.71	0.24	0.00	0.74	0.77	0.85	0.89
CONN	521552	2.08	2.50	0.00	0.08	1.29	2.79	12.00
ROA	546790	-0.56	61.19	-32577.29	0.01	0.08	0.14	1106.00
FSD	508193	85.75	51.75	0.07	54.94	65.11	98.71	479.67
RINF	528865	0.67	1.34	0.00	0.04	0.18	0.52	13.32
CPINT	549820	0.30	0.24	-1.65	0.09	0.25	0.44	3.68
GDPPG	539152	2.53	3.04	-14.35	0.87	2.11	3.63	24.76
SIZE	550115	6.42	3.35	-6.91	4.18	6.32	8.55	24.14
LEV	549313	0.92	100.44	-0.19	0.03	0.19	0.36	60446.50
lnGROWTH	534852	6.79	3.18	-8.52	4.55	6.63	8.85	23.37
VA	562599	0.75	0.84	-1.75	0.44	1.07	1.33	1.80
RQ	562599	0.99	0.76	-2.00	0.51	1.26	1.59	2.26
PSA	562599	0.34	0.81	-2.37	-0.21	0.52	1.01	1.76
CC	562599	1.00	0.92	-1.40	0.11	1.37	1.70	2.47
GE	562489	1.16	0.72	-1.29	0.48	1.49	1.68	2.44
RL	562572	1.06	0.80	-2.18	0.38	1.44	1.64	2.10



Panel B: Pearson's Correlation Matrix

	RISK	POL	CONN	ROA	FSD	RINF	CPINT	GDPPG	SIZE	LEV	GROWTH	VA	RQ	PSA	CC	GE	RL
RISK	1.00																
POL	-0.05	1.00															
CONN	0.03	-0.42	1.00														
ROA	0.00	-0.01	0.01	1.00													
FSD	0.08	0.14	<b>0.00</b>	<b>0.00</b>	1.00												
RINF	0.06	-0.11	0.12	0.00	-0.24	1.00											
CPINT	-0.03	-0.07	0.04	0.01	<b>0.00</b>	0.07	1.00										
GDPPG	-0.11	-0.48	0.07	0.00	-0.35	0.27	0.06	1.00									
SIZE	0.06	-0.20	0.07	0.03	0.29	0.10	0.16	0.05	1.00								
LEV	<b>0.00</b>	<b>0.00</b>	<b>0.00</b>	-0.32	<b>0.00</b>	<b>0.00</b>	-0.01	<b>0.00</b>	-0.02	1.00							
lnGROWTH	0.04	-0.19	0.07	0.01	0.28	0.07	0.15	0.04	0.90	-0.01	1.00						
VA	-0.11	0.83	-0.46	0.00	0.24	-0.21	-0.08	-0.56	-0.23	<b>0.00</b>	-0.20	1.00					
RQ	-0.09	0.49	-0.19	-0.01	0.30	-0.56	-0.10	-0.54	-0.31	<b>0.00</b>	-0.20	0.75	1.00				
PSA	-0.05	0.36	-0.26	<b>0.00</b>	0.47	-0.58	-0.04	-0.47	-0.11	<b>0.00</b>	-0.20	0.60	0.81	1.00			
CC	-0.10	0.50	-0.24	0.00	0.36	-0.53	-0.10	-0.52	-0.30	<b>0.00</b>	-0.20	0.77	0.95	0.82	1.00		
GE	-0.08	0.49	-0.22	0.00	0.38	-0.57	-0.11	-0.52	-0.27	<b>0.00</b>	-0.20	0.71	0.96	0.83	0.96	1.00	
RL	-0.08	0.63	-0.31	-0.01	0.35	-0.48	-0.11	-0.56	-0.30	<b>0.00</b>	-0.20	0.84	0.94	0.81	0.96	0.95	1.00

Panel C: Summary Statistics for Advanced Markets

Variable	N	Mean	SD	Min	25%	Median	75%	Max
RISK	397972	0.19	0.15	0.02	0.07	0.15	0.33	0.42
POL	397972	0.79	0.14	0.00	0.75	0.85	0.85	0.89
CONN	397972	1.69	2.31	0.00	0.08	1.29	1.31	10.30
ROA	386384	-0.77	69.90	-32577.29	-0.02	0.07	0.13	1106.00
FSD	343566	100.14	55.04	0.07	63.83	78.09	111.68	479.67
RINF	364238	0.19	0.30	0.02	0.04	0.07	0.22	3.58
CPINT	388476	0.28	0.24	-0.36	0.07	0.22	0.41	3.51
GDPPG	374525	1.39	2.00	-9.00	0.76	1.59	2.60	24.77
SIZE	388748	6.10	3.58	-6.91	3.56	5.79	8.65	19.38
LEV	388081	0.98	67.15	-0.19	0.02	0.18	0.35	29106.57
lnGROWTH	371413	6.54	3.39	-8.52	3.99	6.20	9.06	19.24
GOVERN	397862	0.57	0.43	-1.33	0.42	0.59	0.84	1.77

Panel D: Summary Statistics for Emerging Markets

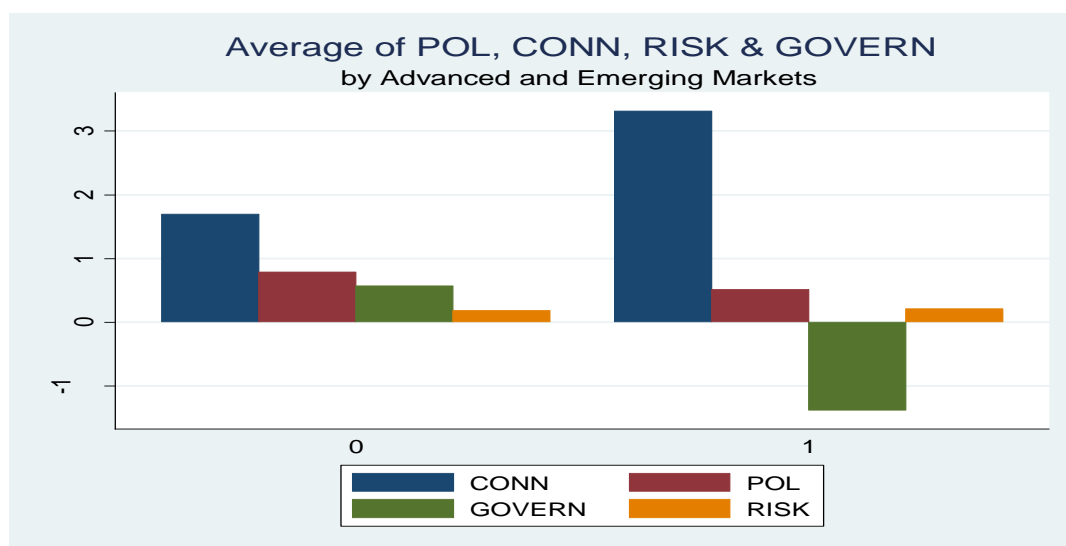
Variable	N	Mean	SD	Min	25%	Median	75%	Max
RISK	164627	0.21	0.15	0.02	0.07	0.15	0.40	0.42
POL	164627	0.51	0.31	0.00	0.27	0.72	0.77	0.85
CONN	123580	3.31	2.69	0.00	2.25	2.79	5.17	12.00
ROA	160140	-0.07	31.56	-11534.00	0.03	0.09	0.14	9.45
FSD	164627	55.73	24.70	11.48	41.72	48.91	60.70	126.37
RINF	164627	1.73	1.97	0.00	0.25	0.85	3.00	13.32
CPINT	161077	0.34	0.22	-1.65	0.16	0.32	0.50	3.68
GDPPG	164627	5.13	3.39	-14.35	3.17	5.53	7.24	16.23
SIZE	161100	7.19	2.56	-6.91	5.61	6.99	8.41	24.14
LEV	160965	0.78	153.48	-0.11	0.06	0.22	0.38	60446.50
lnGROWTH	163171	7.38	2.56	-6.03	5.79	7.12	8.55	23.37
GOVERN	164600	-1.37	0.56	-3.40	-1.74	-1.54	-1.14	0.24

Panel E: Independent Samples T-Test

Variable	Mean_Adv	Mean_Emerg	Mean_Diff.	SE_Diff	T-Stats	P-value
POL	0.79	0.51	0.28	0.00	349.24	0.00
CONN	1.69	3.31	-1.62	0.01	-190.99	0.00
GOVERN	0.57	-1.37	1.94	0.00	1272.59	0.00
RISK	0.19	0.21	-0.03	0.00	-59.40	0.00

*Note: Table 2 presents descriptive statistics for all the variables used in my empirical models. Panel A presents a pool descriptive of both advanced and emerging markets. Panel B exhibits the correlation matrix for my key variables. I observe a high correlation between the governance indicators, hence, in Panel C, D, and E where I disaggregate emerging markets from advanced markets, I used a new variable, GOVERN, as a proxy for the governance indicators which were transformed using principal component analysis. In Panel E, I conduct an independent sample t-test to show the difference in means between the two markets. The results show that there is a difference in the means of POL, CONN, GOVERN, and RISK between these two markets.*

Figure 4: Means Plot of POL CONN, RISK &amp; GOVERN



*Notes: This figure depicts a graphical representation of the difference that exists between the advanced and emerging markets based on the means of POL, CONN, GOVERN, and RISK variables. I used a dummy to reflect these markets. I capture advanced markets as (0) and emerging markets as (1). The graph depicts that there are more political connections in emerging markets than there is in advanced markets. Also, the political environment in the advanced markets is more stable than in the emerging market*

The correlation between RISK and POL as well as GDP per capita growth are not consistent with findings by (Boubakri et al., 2013). The correlation between RISK and POL tells us that firms that are located in countries with unsound political institutions are associated with less risk-taking. On the other hand, firms that are located in a more stable or sound political environment tends to take more risk. Again, the positive correlation between RISK and CONN is also expected. Also, aside from LEV, VA, RL that are significant and negatively correlated with ROA, the rest of the variables are significant and positively correlated with ROA. The variables that are insignificant to ROA are PSA and FSD.

The correlation between ROA and CONN tells us that on average, firms that are more politically connected achieve higher returns on their assets. This, suggests that connected firms may use their opportunities to seek preferential treatment and get governments approval for significant projects, leading to an increase in their ROA. This evidence confirms studies by Haiyang and Zhang (2007); Nee (1992); Peng and Luo (2000); and Tsang (1998). Also, governance indicators are strongly correlated with one another. The smallest correlation coefficient is 0.60 and the highest is 0.96.

Panel A shows the summary statistics for the key variables based on the full sample. I now disaggregate these markets to see how the statistics may vary. In Panel C and D, we present the summary statistics on advanced and emerging countries for the key

variables respectively. With regards to POL, the mean (0.79) for the advanced markets is higher than the mean (0.51) of the emerging markets, indicating that on average, political institutions in advanced markets are sounder than those in emerging markets.

Political connection (CONN) in the advanced markets has a mean of 1.69 which is a little less than half of the mean of political connections in the emerging markets with a value of 3.31 — suggesting, that on average, political connectedness in the emerging markets is more than those in advanced markets. Interestingly, an emerging (Russia) and a developed (Italy) economy had double digits value in political connections, suggesting that political connections (though prevalent in the emerging markets) may also occur advanced countries. Concerning RISK, I also observed that on average, advanced countries exhibit less risk compared to emerging markets.

The mean of the return on assets (ROA) for the two markets is -0.77 and -0.07 for advanced and emerging markets, respectively. On average, firms in emerging markets receive a higher return on assets do firms in advanced markets. The statistics for GOVERN, 0.57 and -1.37 for advanced and emerging markets, respectively, tells us that on average, there is strong governance in advance markets and weak governance in emerging markets.

To assess whether advanced markets are different from emerging markets regarding how political connections may or may not affect firm performance and corporate risk-taking, I performed an independent sample t-test. The t-test assesses whether the means of two groups (Advanced and Emerging markets) are statistically different from each other. Panel E presents the results of the four key variables: POL, CONN, GOVERN, and RISK. I assumed that the variance in the sample is unequal.

Hence, the Welch's t-test is applied.

Panel E shows a mean difference of 0.28, -1.62, 1.94 and -0.03 for the POL, CONN, GOVERN, and RISK respectively. All tests are significant at the 1% level. The corresponding t-test and p-value indicate that the difference in means in POL, CONN, GOVERN and RISK between advanced and emerging markets are significantly different from 0, allowing for differences in variances across groups. This result is supported graphically in Figure 4. This chart shows the disparities that exist between these two markets. Advanced markets are denoted by dummy of zero (0) and emerging markets by one (1). Interestingly, firms emerging markets have lower outcomes regarding world governance but are more politically connected. Suggesting that firms are more likely to be politically connected in countries with weak governance indicators.

#### *4.1 Multivariate Analysis*

This section reports findings of the impact of political institutions, and connectedness (in addition to firm characteristics) on corporate risk-taking in advanced and emerging markets, using the combined multivariate regression framework. Table 3 provides the regression results of models 1 and 2 using robust standard errors corrected for the grouping at the firm level.

#### *4.2 Evidence for Risk Taking*

Results in column (1) of Panel A indicate that except for LEV, all the variables included in the model are significant at the 1% level in explaining the variations in risk-taking, and ROA is also significant at the 10% level. The results show that corporate risk-taking increases as political constraints increase. Thus, an increase of one standard deviation in political constraints (institutions) causes an increase of 14.8% ( $=0.0925*0.24/0.15$ ) of a standard deviation in increased risk-taking in the full sample. The evidence is consistent with Boubakri et al. (2013) and Murphy, Shleifer, and Vishny (1991) who also found a positive relation between political institutions (POL) and corporate risk-taking (RISK). I also find a significant and negative relationship between political connections (CONN) and corporate risk-taking (RISK). In other words, a one standard deviation increase in political connections leads on average to about 67% ( $= -0.0404*2.5/0.15$ ) decrease in risk-taking in the full sample. This is inconsistent with the findings by (Caprio, Faccio, & McConnell, 2013). Again, these results indicate that all the financial variables that are statistically significant, have negative effects on risk-taking. Likewise, gross domestic product per capita growth (GDPPG), except SIZE which has a positive effect.

Column (2) modifies column (1) to include the proxy for governance indicators (GOVERN). To the best of my knowledge, none of the previously related literature has considered governance in their analysis. Hence, including this variable serves as one of the contributions to the literature. The results are the same as those as in column (1). Therefore, if there is a one standard deviation point increase in POL, risk-taking increases by about 14.9% ( $= 0.0931 * 0.24 / 0.15$ ). Again, risk-taking decrease by about 15% ( $= -0.0411 * 2.5 / 0.15$ ) for every one-standard deviation point increase in political connections. This tells us that the POL and CONN increase with the introduction of governance indicators. The governance variable introduced in this model is significant at 1% level and negatively related to corporate risk-taking. The evidence suggests that firms located in countries with relatively low governance outcomes compared to those with relatively high governance outcomes are relatively less likely to engage in risk-taking. Thus, for a one standard deviation increase in governance performance, there is a reduction of about 7.9% ( $= -0.0119 * 1 / 0.15$ ) standard deviation in risk-taking.

For primary motivation for this paper, I run a separate regression for the advanced and emerging markets. These are shown in columns (3) – (6). Columns (3) and (4) replicate results of columns (1) and (2) to study the effect mainly in advanced markets. The results are very similar to the pooled regression models in the first two columns. The results confirm the overly generalized conclusions in the extant literature. Thus, when combined, the effects expressed in the regression models are driven by the advanced economies. The findings show that in advanced economies, corporate risk-taking is significant and positively related to political institutions but negatively related to political connections, which is inconsistent with (Caprio et al., 2013) findings.



These findings imply that without controlling for governance performance, a one standard deviation point increase in political constraints and connections lead to an increase on average of about 29.9% ( $= 0.3202 * 0.14 / 0.15$ ) and a decrease of about 25.9% ( $= -0.0168 * 2.31 / 0.51$ ) for every one-standard deviation point increase in advanced markets respectively. I find statistical and economic significance for the interaction term. This indicates that increasing POL by one standard deviation point leads to an increase in risk-taking by 29.9% of a standard deviation with low political connections (DumCONN = 0). Also, average risk-taking is lower (DumCONN = 25.9%) and increasing POL by one standard deviation point decreases risk-taking by 19.4% ( $= (-0.1124 + 0.3202) * 0.14 / 0.15$ ) when there is a political connection (DumCONN = 1).

These findings are consistent and statistically and economically significant when controlling for governance performance. This is illustrated in column (4). Risk-taking increases by about 29.4% ( $= 0.3146 * 0.14 / 0.15$ ) for a standard deviation point increase in POL. In a similar fashion, risk-taking declines by approximately 27.4% ( $= -0.0178 * 2.31 / 0.15$ ) per one standard deviation point increase in CONN. The interaction between POL and DumCONN in column (4) is significant at the 1% level and negatively related to the level of risk-taking. The results are economically significant. The coefficient of this interaction term means that when there are low political connections (DumCONN = 0): increasing POL by one standard deviation point lead to an increase in risk-taking by 29.4% standard deviations. Also, when there is a political connection (DumCONN = 1): average risk-taking is lower (DumCONN = 27.4%) and increasing POL by one standard deviation point decreases risk-taking by 19.2% ( $= (-0.1092 + 0.3146) * 0.14 / 0.15$ ). The results indicate that in the model for the advanced markets, ROA,

RINF, SIZE, and lnGROWTH are not significant, but LEV is significant and positive in explaining the level of corporate risk-taking. The results suggest that in advanced countries, strong or sound political institutions lead to higher corporate risk-taking. On the other hand, I find that high political connections lead to lower corporate risk-taking in these advanced economies.

Table 3: Regression Results

Panel A: Evidence for Risk-taking

Variable	Dependent Variable = Risk-Taking					
	(1) Pooled Reg	(2) Pooled Reg with Govern	(3) Advanced Markets	(4) Advanced Markets with Govern	(5) Emerging Markets	(6) Emerging Markets with Govern
POL	0.0925*** (0.0046)	0.0931*** (0.0046)	0.3202*** (0.0112)	0.3146*** (0.0114)	-0.1770*** (0.0064)	-0.1712*** (0.0064)
CONN	-0.0404*** (0.0028)	-0.0411*** (0.0028)	-0.0168*** (0.0035)	-0.0178*** (0.0035)	0.0416*** (0.0072)	0.0426*** (0.0071)
ROA	-0.0000* (0.0000)	-0.0000** (0.0000)	-0.0000 (0.0000)	-0.0000 (0.0000)	0.0000 (0.0000)	0.0000 (0.0000)
FSD	0.0030*** (0.0000)	0.0030*** (0.0000)	0.0028*** (0.0000)	0.0028*** (0.0000)	0.0094*** (0.0000)	0.0093*** (0.0000)
RINF	0.0389*** (0.0009)	0.0383*** (0.0009)	-0.0006 (0.0032)	-0.0008 (0.0032)	-0.0013* (0.0008)	-0.0002 (0.0008)
CPINT	-0.0260*** (0.0011)	-0.0261*** (0.0011)	-0.0186*** (0.0013)	-0.0187*** (0.0013)	-0.0244*** (0.0018)	-0.0243*** (0.0018)
GDPPG	-0.0106*** (0.0001)	-0.0105*** (0.0001)	-0.0133*** (0.0002)	-0.0132*** (0.0002)	-0.0070*** (0.0002)	-0.0074*** (0.0002)
SIZE	0.0027*** (0.0002)	0.0027*** (0.0002)	0.0002 (0.0002)	0.0002 (0.0002)	0.0040*** (0.0003)	0.0039*** (0.0003)
lnGROWTH	-0.0023*** (0.0002)	-0.0023*** (0.0002)	0.0002 (0.0002)	0.0002 (0.0002)	-0.0014*** (0.0002)	-0.0012*** (0.0002)
LEV	0.0000 (0.0000)	0.0000 (0.0000)	0.0000*** (0.0000)	0.0000*** (0.0000)	-0.0000 (0.0000)	-0.0000 (0.0000)
GOVERN		-0.0102*** (0.0013)		-0.0082*** (0.0014)		0.0391*** (0.0025)
DumConn*POL			-0.1124*** (0.0075)	-0.1092*** (0.0076)	0.2811*** (0.0079)	0.2746*** (0.0079)

Constant	-0.0172 (0.0333)	-0.0119 (0.0333)	-0.1340*** (0.0346)	-0.1254*** (0.0347)	0.0969*** (0.0063)	0.1628*** (0.0074)
Observations	420,551	420,525	302,517	302,517	118,034	118,008
R-squared	0.1810	0.1812	0.1866	0.1867	0.3082	0.3098
Industry & Country FE	YES	YES	YES	YES	YES	YES

Panel B: Evidence for Firm Performance

Dependent Variable = Firm Performance (ROA)						
Variable	(1) Pooled Reg	(2) Pooled Reg with Govern	(3) Advanced Markets	(4) Advanced Markets with Govern	(5) Emerging Markets	(6) Emerging Markets with Govern
POL	-0.0167 (0.4207)	-0.0166 (0.4174)	-1.5606** (0.7429)	-1.8123** (0.8049)	1.3117 (1.3978)	1.2957 (1.3983)
CONN	0.2065 (0.2311)	0.2264 (0.2483)	-0.0721 (0.2127)	-0.1193 (0.2505)	-0.2082* (0.1111)	-0.2063* (0.1096)
RISK	-1.8213*** (0.6427)	-1.8145*** (0.6415)	-0.1517 (0.6933)	-0.1588 (0.6857)	0.3782 (0.5376)	0.3775 (0.5367)
FSD	-0.0023 (0.0046)	-0.0027 (0.0049)	-0.0014 (0.0031)	-0.0014 (0.0032)	-0.0597 (0.0386)	-0.0599 (0.0389)
RINF	-0.3653** (0.1840)	-0.3539** (0.1755)	0.6569 (0.6343)	0.6441 (0.6222)	-0.0244 (0.0640)	-0.0208 (0.0716)
CPINT	-0.2833 (0.5160)	-0.2819 (0.5166)	-1.3448** (0.6796)	-1.3487** (0.6812)	1.1787 (0.7535)	1.1795 (0.7541)
GDPPG	-0.0023 (0.0212)	-0.0061 (0.0237)	0.0262* (0.0157)	0.0312* (0.0177)	-0.0426 (0.0397)	-0.0432 (0.0416)
SIZE	1.4939*** (0.3026)	1.4947*** (0.3031)	0.9253** (0.4525)	0.9238** (0.4540)	1.0742 (0.6734)	1.0747 (0.6736)
lnGROWTH	-0.9534*** (0.2054)	-0.9540*** (0.2056)	-0.7045*** (0.2052)	-0.7030*** (0.2063)	-0.7781 (0.5180)	-0.7786 (0.5178)

LEV	-0.1939 (0.1861)	-0.1938 (0.1861)	-0.5912** (0.2955)	-0.5912** (0.2955)	-0.0175*** (0.0011)	-0.0175*** (0.0011)
GOVERN		0.2721 (0.2887)		-0.3748 (0.4462)		0.0491 (0.2226)
DumCONN*			0.7293 (0.8338)	0.8748 (0.7770)	-1.5588 (1.3121)	-1.5438 (1.3143)
POL						
Constant	-2.8805*** (1.0302)	-3.0393*** (1.1685)	0.1548 (2.0775)	0.5492 (2.4838)	-1.5264 (1.1904)	-1.4293 (1.0410)
Observations	420,551	420,525	302,517	302,517	118,034	118,008
R-squared	0.1530	0.1530	0.4883	0.4883	0.0097	0.0097
Industry & Country FE	YES	YES	YES	YES	YES	YES

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Robust standard errors in parentheses

\*\*\* p<0.01, \*\* p<0.05, \* p<0.1

*Notes: These regression results show evidence of how political connections and institutions affect corporate risk-taking and firm performance. The results are based on robust standard errors corrected for the grouping at the firm level. The standard errors are presented in parenthesis below the coefficients. My key risk model in Panel A is significant at the 1% level. On the other hand, my performance model in Panel B is significant when there is an interaction between political connection and institutions but insignificant at the individual levels.*

Columns (5) and (6) replicates results from columns (3) and (4) to reflect evidence in emerging markets. Interestingly, the results indicate that the soundness of political institutions (POL) is significant and negatively related to corporate risk-taking. Connections to politics (CONN), is also significant and positively affect risk-taking. In effect, I postulate that when not controlling for governance performance, risk-taking by firms in emerging markets present in the sample decreases by about 36.6% (= -0.1770\*0.31/0.15) standard deviation points for every one-standard-deviation point increase in POL. With respect to how political connections affect risk-taking in emerging

markets by firms in the sample, I look at the coefficient of CONN in column (5). When there is a one-standard-deviation point increase in CONN, risk-taking increases on average by about 74.6% ( $= 0.0416 * 2.69 / 0.15$ ).

The interaction between POL and DumCONN is significant at 1% level and positively related to risk-taking. Again, the findings for emerging markets on this interaction show that when there are low political connections (DumCONN = 0): increasing POL by one standard deviation point lead to a decrease in risk-taking by 36.6% standard deviations. But when there is a political connection (DumCONN = 1): average risk-taking is more (DumCONN = 74.6%) and increasing POL by one standard deviation point increases risk-taking by 21.5% ( $= 0.2811 + -0.1770 * 0.31 / 0.15$ ). Column (6) introduces the effect of governance performance as I did in the earlier models. I find similar evidence as in column (5). In effect, the finding indicates that risk-taking declines on average by about 35.4% ( $= -0.1712 * 0.31 / 0.15$ ). However, risk-taking increases in emerging markets on average by about 76.4% ( $= 0.0426 * 2.69 / 0.015$ ) when there is one standard deviation point increase in CONN. The interaction term reveals that with low political connections (DumCONN = 0): increasing POL by one standard deviation point leads to a decrease in risk-taking by 35.4% standard deviations. But when there is a political connection (DumCONN = 1): average risk-taking is more (DumCONN = 76.4%) and increasing POL by one standard deviation point increases risk-taking by 21.4% ( $= 0.2746 + -0.1712 * 0.31 / 0.15$ ).

The findings for the emerging markets are inconsistent with Boubakri et al. (2013) and Murphy et al. (1991), but consistent with Caprio et al. (2013). They show that the inability of credible commitment on the part of the government not to interfere with

private property rights leads, among other things, to a delayed investment and, therefore, to a lower risk-taking by corporations. Governance is negatively and positively related to risk-taking in advanced and emerging markets, respectively, indicating that as governance improves in emerging markets, corporate risk-taking increases but risk-taking in advanced markets decreases. In terms of magnitude, governance performance in advanced and emerging markets decreases and increases risk-taking by about 5.5% and 26%, respectively.

The study reveals that whilst both political connections and political constraints matters in emerging markets on impacting the level of risk-taking, the magnitude, and directionality changes. The results indicate that the more the connectedness, the higher the risk-taking and the higher the political constraints, the lesser the risk-taking by firms in the sample.

In effect, the findings suggest that countries (advanced economies) with strong political institutions, firms are likely to undertake risky ventures, whereas countries (emerging markets) where firms have unsounded political institutions, they take less risky ventures. On the other hand, countries (advanced economies) where political connections are less, firms are less likely to take risky ventures, whereas, those found in emerging economies where political connections are more, firms are more likely to pursue risky ventures. As such, strong institutions or sound political environment lead to higher risk-taking in advanced markets than in emerging markets, whereas, strong political connections lead to higher risk-taking in emerging markets than in advanced markets.

I also observe that firms located in economies with high political connections and strong or sound political institutions, corporate risk-taking is higher as against firms

located in low politically connected economies. The results also conclude that emerging markets are different from advanced markets with regards to political institutions and corporate decision making regarding risk-taking. Thus, these markets are different and the overly generalized conclusion about the political environment and connections may be very well overstated.

#### *4.3 Evidence for Firm Performance*

Results in the pool regression and controlling for governance indicators show that political institutions and connections captured as POL and CONN are not significant in explaining how firms perform. Nonetheless, it is evident that in advanced economies, soundness of the political environment matters. The findings show that returns on assets for firms in the sample decreases by approximately 0.31% ( $= -1.5606 * 0.14 / 69.9$ ) standard deviation points for every one-standard deviation point increase in POL. The effect size of this increases when I control for governance performance. I observe that returns on assets, ROA, fall by about 0.36% ( $= -1.8123 * 0.14 / 69.9$ ). Also, there is no significance in the interaction between political connections and the soundness of the political environment. The results show that as the political environment deteriorates, firms do not perform well as their return on assets falls. In emerging markets, it is evident that the political environment does not matter.

As political connections do not matter in advanced markets, it does matter in the emerging markets. The evidence shows that in emerging markets, as political connections increases, firms do not perform well as their return on assets fall. The detrimental effect is computed to be about 0.20% ( $= -0.2082 * 0.31 / 31.56$ ) standard deviation point when POL increases by one standard deviation point. Again, I show that when I control for



governance performance, the effect size 0.20% ( $= -0.2063 \times 0.31 / 31.56$ ). The findings show that as the risk level increases, firm performance falls in the pool model. The effect size is estimated to be about 44.4% standard deviation point decrease in firm performance. The results confirm the findings by (Ling, Zhou, Liang, Song, & Zeng, 2016).

SIZE is significant at 5% level in the pool and advanced market models. The average asset growth over five years, lnGROWTH, is also found to be negative and significant at 5% level. Remittance flow to GDP, RINF, is found to be significant at 5% level and also affect firm performance negatively. The only control variable that is significant in the emerging market model is leverage, LEV which affects firm performance negatively as it increases. This evidence presupposes that in a politically corrupted environment, firms do not perform well. This finding confirms the assertion made by Fisman (2001) that well-connected firms may or may not see better performance due to the resources they may require in such a rent-seeking activity. Also, the evidence supports my argument that emerging markets are significantly different from advanced markets.

The evidence shows that while the soundness of the political environment matters in advanced markets, it does not matter in an emerging market in explaining how firms perform. Also, the findings show that political connections matter in emerging markets but does not have any significant impact in advanced markets. Hence, in advanced markets where the political environment is more stable, firms located in such markets pursue more risky ventures. These firms might see negative returns if their risky ventures do not pay-off, as against emerging markets where the political environment seems to be

unstable and hence, firms do not take more risky ventures.

#### *4.4 Robustness Test*

To justify the arguments keenly, I perform some sensitivity tests to buttress and access the robustness of the main findings highlighted in Table 3. Some tests were left unreported for the sake of brevity. For instance, using the country-adjusted volatility of earnings for each firm over the entire sampling period (1992 - 2016), requiring at least five observations in cross-sectional regressions, captured as RISK1 and the country-wide average of all RISK observations at the enterprise level, captured as RISK2, I find the same evidence as that presented in Panel A of Table 3 for the risk-taking model.

Additional tests presented in Table 4 reinforces and supports the main findings that with regards to risk-taking and firm performance, emerging markets are different from advanced markets.

Since OLS is misspecified when the linearity assumption is violated (Jha & Cox, 2015), an approach to tackle such concerns is by the use of propensity score matching technique which has been expounded extensively by (Rosenbaum & Rubin, 1983). In this regard, I assert that countries with good or better governance are more likely to provide a sound political environment which will, in turn, attract firms. I split the sample into two based on the median value (0.45) of GOVERN. Good governance countries are classified as the treated group whereas the bad governance countries are classified as the control groups. The propensity score for each category of the observation, which is the probability of belonging to a good governance area is computed using a logit model.

The results are presented in Panels A of Table 4. I find that the results are still

significant and robust using the propensity score matching. The evidence presented in Panel A are significant and shows the difference that exists in advanced and emerging markets. Also, in Panel A, I observe vast differences in the means of the main variable, POL and CONN based on the median value of governance for the two markets. This difference is significant at 1% level. Except for GDPPG, other control variables included in this test are significant as well. As observed earlier on, on average, political connections are more in emerging markets than in the advanced markets. The same effect is seen in the soundness of the political environment.

#### *4.5 Evidence in EAGLEs and NEST and Others*

Since the focus is primarily on emerging markets, I decided to further split the emerging markets component into EAGLEs and NEST as proposed by BBVA, 2014. The idea is basically to evidently show that although the various countries in emerging markets are the same in terms of economic development, governance structure and so on, yet they might exhibit similar characteristics due to how they are classified. In Table 4 Panel B, I document the evidence that exists when I take into a closer look at EAGLEs and the NEST. Essentially, column (1) is a modified version of column (2) of Table 3 Panel A after controlling for the interaction between connectedness and political constraints. Likewise, column (2) is just a repetition of column (4) of Panel A of Table 3, in order to aid a clear comparison between these markets.

The evidence presented is economically and statistically significant. As expected, the full sample model and that of the advanced markets has a positive effect on the POL variable but a negative effect in both the EAGLEs and the NEST. I posit that for a one standard deviation point increase in POL, risk-taking by firms in the sample increases by

almost 22.6% and 29.4% standard deviation points in the pooled regression and advanced markets respectively. Consequently, in both EAGLEs and NEST, risk-taking declines by about 106.4% and 8.5% standard deviation points for every one-standard deviation point increase in POL respectively. It is not surprising to see the effect size in EAGLEs to be so large if I have the likes of China, Russia, Brazil and so on. These countries make up the major drivers of most economic activities not in emerging economies alone but in the world at large.

With regards to political connections, again, the results in the full sample model and advanced markets are consistent with my expectations. I argue that risk-taking falls approximately by about 39.7% and 24.7% standard deviation points for a one standard deviation point increase in CONN. The dynamics flip a bit for the EAGLEs and the NEST. Nonetheless, this difference is expected. Whilst in the EAGLEs I observe a positive effect of CONN on risk-taking, I record a negative coefficient for the NEST. As mentioned earlier, the country with the highest political connections happens to be Russia which falls in the EAGLEs. Therefore, I believe that Russia and other similar economies have a major pull on the directionality leaving the NEST economies with a negative sign. The findings reveal that on average, when there is a standard deviation point increase in CONN, firms operating in the EAGLEs economies increases their level of risk-taking by about 70.3% standard deviation point increase whereas firms located in the NEST economies reduce risk-taking by on average 26.0% standard deviation point when there is a one standard deviation point increase in CONN. Again, I find consistent results for controlling for the interaction term and the introduction of governance performance. Interpretation of these coefficients and their magnitudes and effects are like the previous

interpretations.

#### *4.7 Controlling for the 2007/2009 Financial Crisis*

I am of the opinion that the effect of the financial crisis could be widespread that can affect both households and firms in both advanced and emerging economies. Hurd and Rohwedder (2010) argued that the crisis left many people unemployed and in the long run, expectations about stock prices and housing prices cynical. Based on the foregoing arguments, I decided to control for the financial crisis to show that even though the effects of the 2007/2009 financial crisis could be widespread, the dynamics wouldn't impact or change the results. To do this, I partition the data into three categories: before the financial crisis (Pre-Crisis), within the financial crisis (In-Crisis), and after the financial crisis (Post-Crisis). I utilize equation (1) and run nine models capturing the full sample, advanced markets, and emerging markets for the three categories mentioned and the results are shown in Panel C and D of Table 4. Panel C presents evidence for the full sample estimates. For POL, I observe that before the financial crisis, firms included in the sample reduce their level of risk-taking by about 7.23% standard deviation points. Interestingly, within the financial crisis and after the financial crisis, firms do increase the level of risk-taking which is consistent with the a priori expectation. On average, risk-taking increases by about 8.4% and 5.7% during and after the financial crisis. Before the financial crisis, political connections did not matter in my full sample. Nonetheless, within and after the financial crisis, the effect size, magnitude, and directionality of the CONN are what I expect. I interpret the coefficients as that before.

To my main motivation, Panel D of Table 4 shows the results for the advanced and emerging markets. Columns (1) – (3) presents the evidence in advanced markets and

evidence for the emerging markets are presented in columns (4) – (6). The results for the advanced markets reinforce the results I obtain for the full sample model. Column (1), before the financial crisis, deviates from my expectation but within and after the financial crisis hold consistent with what I expect. In columns (3) – (6) the effect of POL on risk-taking is statistically and economically significant as well as coincides with my expectation. Therefore, in the presence of the financial crisis, I see that firm behavior regarding the level of risk-taking differs for the advanced and emerging markets for an increase in political constraints.

The same evidence is found for the level of political connections in both markets. In advanced markets, I observe that within the financial crisis, political connections did not matter. Similarly, before the financial crisis, political connections did not matter in emerging markets. All else is consistent, significant and confirms my postulations. Once again, the magnitude of the effects is interpreted in the same manner as I have done before. It is key to point out that the interaction term and the introduction of the governance performance alternate signs in the models presented.

Table 4: Robustness Test

## Panel A: Propensity Matching Score

Advanced_Mkt	Coef.	Std. Err.	z	P>z	[95% Conf. Interval]
POL	-4.087	0.017	-243.790	0.000	-4.119 -4.054
CONN	-2.342	0.061	-38.590	0.000	-2.461 -2.223
ROA	0.090	0.003	28.390	0.000	0.084 0.096
CPINT	1.054	0.059	17.900	0.000	0.939 1.169
GDPPG	0.000	0.000	2.070	0.038	0.000 0.001
SIZE	1.906	0.037	52.060	0.000	1.835 1.978
lnGROWTH	0.347	0.003	102.280	0.000	0.341 0.354
LEV	-0.025	0.005	-4.690	0.000	-0.036 -0.015
_CONS	-0.187	0.006	-33.320	0.000	-0.198 -0.176

Variable	Sample	Advanced_Mkt	Emerging_Mkt	Difference	S.E.	T-stat
GOVERN	Unmatched	-1.342	0.600	-1.943	0.002	1195.130
	ATT	-1.342	-0.068	-1.275	0.254	-5.010
		Mean		T-Test		
Variable	Advanced_Mkt	Emerging_Mkt	t	p>t		
POL	-1.343	-0.068	-450.370	0.000		
CONN	0.658	0.747	-148.660	0.000		
ROA	3.328	3.870	-43.000	0.000		
CPINT	0.207	0.306	-159.460	0.000		
GDPPG	-0.109	-0.072	-0.340	0.731		
SIZE	0.349	0.695	-297.340	0.000		
lnGROWTH	4.036	14.651	-302.210	0.000		
lev	7.142	5.274	171.810	0.000		

Panel B: Splitting Emerging Markets into EAGLEs and NEST and Others

Dependent Variable = Risk-Taking				
Variable	(1) Pooled Reg with Interaction	(2) Advanced Markets	(3) EAGLEs	(4) NEST & Others
POL	0.1412*** (0.0070)	0.3146*** (0.0114)	-0.4838*** (0.0101)	-0.0611*** (0.0080)
CONN	-0.0238*** (0.0037)	-0.0178*** (0.0035)	0.0447*** (0.0070)	-0.1250*** (0.0010)
DumCONN*POL	-0.0750*** (0.0071)	-0.1092*** (0.0076)	0.6712*** (0.0122)	0.0935*** (0.0097)
ROA	-0.0000** (0.0000)	-0.0000 (0.0000)	0.0000*** (0.0000)	-0.0001*** (0.0000)
FSD	0.0031*** (0.0000)	0.0028*** (0.0000)	0.0081*** (0.0001)	0.0123*** (0.0001)
RINF	0.0392*** (0.0010)	-0.0008 (0.0032)	0.0112*** (0.0015)	0.0040*** (0.0012)
CPINT	-0.0258*** (0.0011)	-0.0187*** (0.0013)	-0.0214*** (0.0024)	-0.0341*** (0.0028)
GDPPG	-0.0104*** (0.0001)	-0.0132*** (0.0002)	-0.0139*** (0.0003)	0.0007*** (0.0002)
SIZE	0.0028*** (0.0002)	0.0002 (0.0002)	-0.0008** (0.0003)	0.0101*** (0.0004)
lnGROWTH	-0.0024*** (0.0002)	0.0002 (0.0002)	0.0054*** (0.0003)	-0.0071*** (0.0004)
LEV	0.0000 (0.0000)	0.0000*** (0.0000)	-0.0000*** (0.0000)	0.0000*** (0.0000)
GOVERN	-0.0075*** (0.0013)	-0.0082*** (0.0014)	0.0561*** (0.0036)	0.0026 (0.0030)
Constant	-0.0423 (0.0335)	-0.1254*** (0.0347)	0.2396*** (0.0120)	-0.0255*** (0.0095)
Observations	420,525	302,517	71,292	46,716
R-squared	0.1822	0.1867	0.3336	0.3539



Industry & Country	YES	YES	YES	YES
FE				

Robust standard errors in parentheses

\*\*\* p<0.01, \*\* p<0.05, \* p<0.1

*Note: In Table 4, I present my robustness test using Propensity Matching Score and splitting the markets (emerging) into EAGLEs and NEST. Panel A shows the result using a Propensity Matching Score approach. My main variable is significant as well as consistent with my a priori expectation. In Panel B, I split my emerging markets into EAGLEs and NEST and still find consistent results.*

Panel C: Controlling for Financial Crisis – Full Sample

Variable	Dependent Variable = Risk - Taking		
	(1)	(2)	(3)
	Pre-Crisis	In-Crisis	Post-Crisis
POL	-0.0455*** (0.0053)	0.0522*** (0.0090)	0.0357*** (0.0086)
CONN	0.0023 (0.0018)	-0.0079*** (0.0011)	-0.0122*** (0.0021)
DumCONN*POL	-0.0382*** (0.0045)	0.0062* (0.0037)	-0.0094 (0.0059)
ROA	-0.0000** (0.0000)	-0.0000** (0.0000)	-0.0000* (0.0000)
FSD	0.0005*** (0.0000)	0.0004*** (0.0000)	0.0011*** (0.0000)
RINF	0.0235*** (0.0008)	0.0087*** (0.0006)	-0.0100*** (0.0025)
CPINT	0.0013 (0.0012)	0.0023*** (0.0005)	-0.0038*** (0.0014)
GDPPG	-0.0211*** (0.0003)	-0.0079*** (0.0001)	-0.0238*** (0.0004)
SIZE	-0.0021*** (0.0002)	-0.0002** (0.0001)	0.0009*** (0.0002)
lnGROWTH	0.0009*** (0.0002)	0.0002*** (0.0001)	-0.0005** (0.0003)
LEV	-0.0000	0.0000	-0.0000

	(0.0000)	(0.0000)	(0.0000)
GOVERN	0.0182***	-0.0479***	-0.0645***
	(0.0012)	(0.0018)	(0.0021)
Constant	0.2349***	0.0582***	0.3139***
	(0.0344)	(0.0105)	(0.0614)
Observations	204,188	64,281	152,056
R-squared	0.1407	0.5385	0.1122
Industry & Country FE	YES	YES	YES

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Robust standard errors in parentheses

\*\*\* p<0.01, \*\* p<0.05, \* p<0.1

*Note: In panel C of Table 4, I show robustness test results by controlling for the 2007/2009 financial crisis. Columns (1) – (3) are the results for the full sample model. Again, I find consistent results for the full model as presented in Panel C.*

Panel D: Controlling for Financial Crisis – Advanced vs Emerging Markets

Dependent Variable = Risk - Taking						
Variable	(1) Advanced Markets with Pre-Crisis	(2) Advanced Markets with In-Crisis	(3) Advanced Markets with Post-Crisis	(4) Emerging Markets with Pre-Crisis	(5) Emerging Markets with In-Crisis	(6) Emerging Markets with Post-Crisis
POL	-0.0258*** (0.0087)	0.0497*** (0.0065)	0.3095*** (0.0132)	-0.0492*** (0.0091)	-1.1039*** (0.0440)	-0.0747*** (0.0116)
CONN	-0.0148*** (0.0024)	0.0015 (0.0027)	-0.0273*** (0.0026)	0.0106 (0.0125)	0.0659*** (0.0026)	-0.0206*** (0.0078)
DumCONN*POL	0.0433*** (0.0054)	-0.0048 (0.0050)	0.0206*** (0.0064)	-0.0444*** (0.0110)	1.4643*** (0.0438)	-0.2323*** (0.0220)
ROA	-0.0000 (0.0000)	0.0000 (0.0000)	0.0000 (0.0000)	-0.0012*** (0.0002)	-0.0000*** (0.0000)	0.0000 (0.0000)
FSD	0.0001*** (0.0000)	0.0004*** (0.0000)	0.0014*** (0.0000)	0.0056*** (0.0001)	0.0016*** (0.0001)	0.0040*** (0.0001)
RINF	-0.0215*** (0.0024)	-0.0377*** (0.0039)	-0.0141** (0.0061)	0.0241*** (0.0009)	0.0296*** (0.0006)	-0.0386*** (0.0029)
CPINT	0.0056*** (0.0013)	0.0029*** (0.0006)	-0.0029 (0.0018)	0.0058** (0.0023)	0.0000 (0.0009)	-0.0063*** (0.0022)
GDPPG	-0.0407*** (0.0004)	-0.0093*** (0.0001)	-0.0192*** (0.0005)	-0.0101*** (0.0002)	-0.0032*** (0.0001)	-0.0291*** (0.0003)
SIZE	-0.0039*** (0.0002)	-0.0002*** (0.0001)	0.0011*** (0.0003)	0.0009*** (0.0003)	0.0005*** (0.0001)	0.0013*** (0.0004)
lnGROWTH	0.0032*** (0.0002)	0.0003*** (0.0001)	-0.0007** (0.0003)	-0.0016*** (0.0003)	-0.0006*** (0.0001)	-0.0004 (0.0004)
LEV	-0.0000 (0.0000)	0.0000 (0.0000)	0.0000*** (0.0000)	-0.0001 (0.0001)	0.0001*** (0.0000)	-0.0000*** (0.0000)
GOVERN	0.0153*** (0.0013)	-0.0425*** (0.0017)	-0.0748*** (0.0030)	0.0882*** (0.0036)	-0.0561*** (0.0041)	-0.0651*** (0.0035)
Constant	0.3538*** (0.0407)	0.0491*** (0.0083)	0.0787 (0.0599)	0.1714*** (0.0094)	0.4341*** (0.0159)	0.2226*** (0.0104)
Observations	155,723	44,530	102,264	48,465	19,751	49,792
R-squared	0.2482	0.5676	0.0720	0.1751	0.5942	0.2455

Industry & Country FE	YES	YES	YES	YES	YES	YES
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Robust standard errors in parentheses

\*\*\* p<0.01, \*\* p<0.05, \* p<0.1

*Note: Panel D of Table 4 show results after controlling for the financial crisis in the two markets. Columns (1) – (3) highlight results in the advanced markets for the before, in, and post financial crisis. Results for emerging markets are represented in columns (4) – (6). Again, I find consistent results supporting my claim that emerging markets differ from advanced markets.*

## CHAPTER FIVE: SUMMARY, CONCLUSION, AND RECOMMENDATION

In this paper, I investigate the impact of political connections on firm performance and corporate risk-taking and make a case that emerging markets are different from advanced markets. The research questions were: Do a firm's political connections affect their performance? How do political connections affect corporate risk-taking? Are emerging markets different from advanced markets? The results are economically and statistically significant as well as robust. The results suggest strong political institutions or a sound political environment lead to higher risk-taking in advanced markets but lower risk-taking in emerging markets. Specifically, on average, risk-taking in advanced markets increases by about 30% standard deviation points for every standard deviation point increase in political constraints, whereas in emerging markets, risk-taking decreases by about 37% standard deviations for every standard deviation point increase in political constraints. On the other hand, strong political connections lead to higher risk-taking in emerging markets but lower levels in advanced markets. In terms of magnitude, for an every one-standard-deviation point increase in political connections, risk-taking in advanced and emerging markets decrease (increase) by about 26% (75%) standard deviation points, respectively.

The results also indicate that political institutions have an insignificant effect in emerging markets but have adverse effects in advanced markets when it comes to firm performance. Similarly, political connections are found to be insignificant in advanced markets but have an adverse effect in emerging markets. These findings illustrate that these two markets are distinctively different; hence, studies that combine them into a single group will ignore such realities and lead to overgeneralized findings. These findings are consistent after controlling for the 2007/2009 financial crisis, running a

Propensity Matching Score, splitting the emerging markets into EAGLEs and NEST, as well as running an endogeneity test. The results suggest that governments in both advanced and emerging markets need to take necessary steps to control corruption to set a fertile investment ground and thus decrease political connections and extractions.

This research contributes to the extant literature by analyzing the impact of political connections on firm performance and corporate risk-taking, and by separating emerging economies from advanced economies, and by controlling for the effect of governance. This approach is different from the extant literature that sort to combine all markets in a single study (Boubakri et al., 2013; Faccio, 2006). Another contribution of this study is to analyze of interacting high political connected areas with the soundness of the political environment. To the best of my knowledge, I have a more sample pool and broader year range than most of most of the literatures reviewed. I have 47 sample size which spans from 1996 – 2016 with a total observation of 562, 867, unlike (Boubakri et al., 2013; Faccio, 2006) that had only 211,794 and 20,202 observation respectively.

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## APPENDIX: VARIABLE DEFINITIONS

Variable	Definitions	Data Source
<b>Dependent Variable</b>		
RISK	Estimated as country-specific ROA in five-year overlapping periods beginning in 1992 and ending in 2016.	COMPUSTAT
RISK1	Computed as the country-adjusted standard deviation of the firm's profitability (ROA) over 5-year overlapping periods starting in 1992 and ending in 2016.	COMPUSTAT
ROA	Measured as the ratio of earnings before interest, taxes, depreciation, and amortization to total assets.	COMPUSTAT
RISK2	Computed as the country-wide average of all RISK observations at the enterprise level.	COMPUSTAT
<b>Testing Variable</b>		
POL	Measures the degree of political constraint of a country. Derived from a model of political interaction that incorporates information on the number of independent branches of government with veto power, and the distribution of preferences across and within those branches. Government branches considered are chief executives, the lower house of the legislature, the higher house of the legislature, judiciary, and sub-federal branches. Higher scores indicate stronger political constraints and sound political institutions.	Henisz (2010)
CONN	% of firms connected with a minister or MP is the number of firms connected with a minister or MP, excluding cases of close relationships, divided by the total number of firms listed in a country.	Faccio (2006)
LEV	The ratio of total debt to total assets.	COMPUSTAT

GROWTH	Average assets growth over five years, where assets are converted into US\$.	COMPUSTAT
CPINT	It is a measure of the amount of capital needed per dollar of revenue. It is calculated by dividing the total assets of a company by its sales.	COMPUSTAT
SIZE	Log of total assets in millions of US\$	COMPUSTAT
FSD	Financial system deposits to GDP (%)	Financial Structure Databases
GDPPG	GDP per capita growth (annual %)	World Governance Indicators
GOVERN	A proxy for the governance indicators computed from Principal Component Analysis.	Worldwide Governance Indicators
RINF	Remittance inflows to GDP (%)	Financial Structure Databases
VA	VOICE AND ACCOUNTABILITY: ESTIMATE	Worldwide Governance Indicators
RQ	Regulatory quality: estimate	Worldwide Governance Indicators
PSA	Political stability and absence of violence/terrorism: estimate	Worldwide Governance Indicators
CC	Control of corruption: estimate	Worldwide Governance Indicators

GE	Government effectiveness: estimate	Worldwide Governance Indicators
RL	Rule of law: estimate	Worldwide Governance Indicators

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