

Political Connections and Corporate Decisions: Evidence From Indian Firms

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ABSTRACT

The associations between firms and political parties have been a crucial topic of discussion and research among academicians, practitioners and regulators over the last two decades. The implications of political connections on firms are complex in countries with multi-political party systems. The value propositions and benefits of such linkages among firms and political parties are primarily indirect and tend to materialize over time.

This dissertation explores the impact of political connections on the corporate decisions of Indian firms by examining four questions, using a sample of 1,953 firms listed on the National Stock Exchange (NSE) India obtained from the ProwessIQ and Election Commission of India (ECI) databases. The four questions are: a) How do the firm's political connections and cash holding patterns impact its performance? b) Do politically connected firms gain access to lower-cost capital, and how does it affect their leverage? c) How does the political connection of the firm influence its investment decisions? and d) Do politically connected corporations adopt the same CSR policies as non-connected counterparts?

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The empirical analysis addressing the first research question shows a positive association between political connections and firm performance. Around 25.4 percent of firms are politically connected in the final sample, while 12.3 percent of firms are connected via donations channel whereas 16.6 percent are connected through promoter channel. The amendment in Finance Bill 2017 resulted in a substantial increase in political donations. Politically connected firms in India outperform their non-connected counterparts. Interestingly, the study also reveals that the presence of the dual channel, connection through both donations and promoters, diminishes the positive effect of being politically connected, which is more pronounced for larger firms. Furthermore, the study also reveals that larger firms effectively utilize political connections better to show higher performances than mid-size or smaller-size firms.

The second objective of this study investigates the relationship between a firm's political connections, the cost of capital, and its impact on leverage. The findings suggest that

politically connected firms get access to cheaper debt and equity capital. Additionally, the study reveals that political connections can influence firms to have higher leverage than their non-connected peers, particularly in capital-intensive sectors.

The third research objective of this dissertation is to investigate the impact of political connections on firms' investment decisions. The result shows that politically connected firms do not suffer from investment cash flow sensitivity and overcome underinvestment problems. The possible reason could be that politically connected firms do not rely on internal cash as firms can easily access loans and external capital at a lower cost. This study finds substantive evidence showing that political connections assist financially constrained firms in mitigating dependence on internal cash flows while not altering their investment decisions.

In addition, the fourth research objective of this dissertation investigates the link between firms' political connections and their investment in Corporate Social Responsibility (CSR) activities. The findings suggest that politically connected firms are strongly associated with CSR spending activities that are consistent with earlier studies conducted in different countries. Moreover, the study measures CSR spending activities through the governance score of the ESG (Environmental, Social, Governance) Index and shows that politically connected firms have higher governance scores.

This dissertation presents novel insights into the intricate relationships between corporations and political parties in India and their impact on corporate decision-making. The findings can aid regulatory bodies in establishing fair competition among firms, as political connections can distort healthy and natural market competition. Therefore, the corporate-political network may be of interest to Indian regulators in developing better policies that safeguard the interests of shareholders.

Keywords: Political Connections, Political Donations, Promoter, CSR, Investment Cash Flow Sensitivity, Governance score