

Uncovering the Heterogeneity of Politically Connected Firms in Malaysia: A Novel Methodology

Zuraina Sal Salbila Mohamed

Multimedia University, Melaka, Malaysia

Coresponding Author Email: zuraina.mohamed@mmu.edu.my

Azlina Ahmad

Universiti Kebangsaan Malaysia, Selangor, Malaysia

Nurul Nadiah Ahmad

Universiti Tenaga Nasional, Pahang, Malaysia

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Abstract

This study presents an innovative methodology for assessing the heterogeneity of politically connected firms in Malaysia, especially in the context of significant political changes following the 2018 general election (GE14). While political connections in Malaysia have historically influenced corporate strategies and performance, previous categorization and analysis have often been inconsistent. Building on Wong & Hooy's (2018) framework, this study updates the classification of political connections through Government, Director, Family, and Crony, reflecting the shifts in Malaysia's political landscape post-2018. By analysing firm-level data from 2014 to 2021, this study examines how different types of political connections impact corporate behavior across various political regimes. The findings offer new insights into the effects of these connections on corporate strategies and financial outcomes, highlighting the necessity for accurate categorization in political business research. This updated methodology addresses gaps in the existing literature and provides a framework for future studies in emerging markets.

Keywords: Political Connections, Heterogeneity, Corporate Strategy, Malaysia GE14

Introduction

Political connections in Malaysia have played a crucial role in shaping the nation's economic and governance landscape, particularly through the New Economic Policy (NEP). Introduced to address socio-economic disparities, the NEP has fostered a symbiotic relationship between political power and business interests, creating a complex interplay within Malaysia's governance system (Gomez & Jomo, 1997; Tee & Rasiah, 2020).

Early research by Gomez and Jomo (1997), was instrumental in examining these political connections, identifying firms with direct ties to influential figures in UMNO, MCA, and MIC. Building on this foundation, Mitchell and Joseph (2010), categorized political connections into two primary types: government-linked investments (GLCs) and politically connected directors (PCDs). Bliss and Gul (2012), further refined this framework by identifying firms with informal ties to ruling politicians, using government-linked investment companies (GLICs) as proxies. These categorizations—GLCs, PCDs, and GLICs—are vital for understanding the varied nature and impact of political connections. GLCs reflect formal, institutionalized influence; PCDs denote individual-level influence within corporate governance; and GLICs serve as intermediaries for informal political ties. This differentiation allows for a comprehensive analysis of how different forms of political connections affect firms, contributing to a deeper understanding of the political-business nexus in Malaysia (Cheong, 2023; Tan & Wong, 2024).

Fung et al (2015), introduced the concept of "temporal dynamics" in political connections, which refers to the variation and evolution of political ties over time. They distinguished between short-term and long-term political connections, recognizing that the impact and nature of these ties can evolve based on their duration and stability. Phan et al (2020), adapted these temporal proxies to study how the duration and stability of political connections influence corporate investment decisions among Malaysian firms. This adaptation provides insights into how firms leverage or respond to their political relationships over time.

This study builds on the categorization framework established by Wong and Hooy (2018, 2021a), which includes four types of political connections (PCON): government-linked firms (PCON_GLC), politically connected board members (PCON_BOD), influential business leaders (PCON_BUS), and family members of political leaders (PCON_FAM). Recent research by Hoang et al (2022), Kamarudin et al (2021), and Nguyen et al (2023), has further refined and applied these categories.

Recent studies emphasize the need to accurately differentiate between types of politically connected firms (PCON) to fully understand their impact on corporate behaviour and financial performance. Each type of political connection interacts differently with business operations and governance structures, making precise categorization crucial for valid analysis. Significant political shifts, such as the Barisan Nasional coalition's loss of power in the 2018 general election (GE14), have introduced new dynamics that necessitate an update to existing frameworks. Wong & Hooy's (2018), study covered the period from 2002 to 2016, and this political upheaval calls for a re-evaluation of politically connected firms in the post-GE14 era.

The motivation of this study is to understand how political connections affect corporate economic decisions, especially in the context of the 2018 election in Malaysia. This political event represents a turning point in the country's political landscape, creating a unique opportunity to explore how political uncertainty impacts corporate strategy and behaviour. Elections, especially those with unpredictable outcomes like GE14, create an environment of uncertainty that can lead to shifts in corporate financial management, risk assessments, and decision-making processes. Thus, examining politically connected firms during this period is not only timely but also contributes to a deeper understanding of how such connections can shape corporate responses to political transitions.

Therefore, this study addresses this need by examining politically connected firms in Malaysia across two distinct periods: pre-GE14 and post-GE14, spanning from 2014 to 2021. The aim is to update the methodology for assessing the heterogeneity of politically connected firms in light of Malaysia's evolving political landscape, providing a current and relevant analysis of the political-business nexus. By exploring the evolving dynamics of these connections, this study contributes to both the academic discourse on political connections and offers practical insights for policymakers and business leaders navigating politically volatile environments.

Literature Review

Malaysia's economic environment is characterized by a unique form of capitalism influenced by the symbiotic relationship between the government and politicians, particularly evident in the management of major firms. This relationship-based capitalist system often involves "rent-seeking," where entities or individuals in the corporate sector seek patronage and protection from political figures (Abdul Wahab et al., 2018). Such interactions contribute to global issues such as corruption, protection-seeking behaviour, and entrenched capitalist.

The influence of political connections on corporate behavior is multifaceted. Previous studies in the Malaysian context have documented various impacts of political connections on corporate outcomes. For instance, research has shown that political connections can affect corporate financial performance, risk management, and debt costs (Aldhamari et al., 2020; Wong & Hooy, 2018; Nguyen et al., 2023; Tee, Pak, et al., 2021). Other studies have explored how political ties influence stock price volatility, risk of stock price crashes, and the quality of financial reporting (Tee, 2019; Tee, Lee, et al., 2021; Wong et al., 2022; Wong & Hooy, 2021a). Recent study by Salehi and Norouzi (2023) has further refined these findings, examining the nuanced effects of political connections on corporate governance and financial stability and concluded that such connections contribute to global issues such as corruption, protection-seeking behaviour, and entrenched capitalist relations.

Moreover, political connections have been linked to corporate governance aspects such as institutional investor monitoring (Tee & Rasiah, 2020; Phan et al., 2020). The influence extends to dividend payment policies and the practices of tax avoidance and income forecasting (Zainudin & Khaw, 2021; Hoang et al., 2022; Kamarudin et al., 2021; Tee, 2020; Tee et al., 2022).

The majority of recent studies refer to PCON from Wong's study except for (Peranginangin & Lee, 2021) study which updated PCON by focusing on one year, which is 2018 as the period they highlight the evolving impact of political connections on corporate governance and finance decision making in the post-GE14 political landscape

The existing literature underscores the complex interplay between political connections and various corporate strategies. However, there remains a need for further exploration into how these connections affect firms in the evolving political landscape of Malaysia.

Methodology

This study investigates the relationship between politically connected firms and earnings management using a sample of non-financial firms listed on Bursa Malaysia from 2014 to 2021. To ensure accurate measurement of earnings management, the sample was restricted

to firms with complete data for the calculation of earnings management using (Kothari et al., 2005), resulting in a final sample of 492 firms.

The data collection process involves a comprehensive content analysis of annual reports, previous literature, formal documents, media sources, and official websites of both firms and relevant government departments. The procedure began with identifying politically connected firms based on established definitions from prior research. The study then updated these political connections using the latest data from formal and informal sources to reflect the current political landscape.

Overview of Wong's Methodology 2018

Wong & Hooy (2018) considered as pioneered on a methodology for categorizing politically connected firms in Malaysia by defining four types of political relationships and their effects on financial performance. Their sample included both financial and non-financial firms from 2002 to 2016. This methodology is foundational for understanding political connections and has been referenced by subsequent studies, including Kamarudin et al (2021), and Hoang et al. (2022).

Wong & Hooy (2018), used a dummy variable approach to measure political connections. For example, a firm was coded as '1' if it had a political relationship through government ownership (GLC), and '0' otherwise. Table 1 summarizes the operational definitions used by Wong & Hooy (2018).

Table 1

Operational definitions by Wong & Hooy (2018)

Types of political relations	Data Source	Operational definition (Source: Wong & Hooy, 2018)
Government ownership	Company annual reports, financial reports and official website	Percentage of shares owned by a government entity or government-linked institution (GLC)
Directors with political rank	Annual reports, company announcements and public records	Presence of politicians on the board of directors (former or current)
Directors holding public offices	Director biographies, public records and news articles	Directors who have served in public positions or government agencies before joining the company
Family ties with politicians	Executive profiles, news, case studies and official website	Directors or major shareholders with direct family ties to politicians
Business cronyism and social relations	News articles, media analysis and business reports	Social or business relationships between firms and politicians

Innovations in Current Research

This study introduces several methodological innovations to enhance the analysis of political connections:

- 1- **Government Ownership:** This study includes ownership by state governments in addition to federal GLCs, reflecting broader levels of government influence (Jacoby et al., 2019; Nawawi & Somchit, 2014; PwC, 2015). Recent research by Nakhmurina, (2024) and Haustein et al., (2024) explored the impact of different government level (federal, state and local) financial quality, highlighting its significance in the broader government context.
- 2- **Director with Political Rank:** The definition of politicians is updated using MASCO (2021), which includes legislators coded as 1111, encompassing a broad range of political positions. Chung et al. (2024) studied on this by analyzing the influence of different between executive and legislative roles on corporate governance, providing updated insights into political roles in business.
- 3- **Directors Holding Public Offices:** Bureaucrats or high government officials are now defined according to MASCO (2021) as senior government officials coded as 1112, encompassing 43 specific job positions. Recent studies by Wang et al. (2024) have examined the effects of bureaucratic backgrounds on corporate decision-making, enriching the understanding of bureaucratic influence.
- 4- **Family and Cronyism Relations:** The scope is refined to focus on direct family ties with the Prime Minister from 2014 to 2021, aligning with changes in Malaysia's political landscape. Tessema et al.(2024) have investigated how family ties with political leaders impact corporate governance and performance

Table 2 provides an updated operational definition of political connections, incorporating new methodologies and categories to reflect recent changes in Malaysia's political landscape and enhance the accuracy of our analysis.

Table 2

Updated Operational Definition

Types of political relations	Data Source	Operational definition
Government ownership	Company annual reports, financial reports and official website	Percentage of shares owned by by government entity or Federal and owned by the state Government-linked institution (GLC)
Directors with political rank	Annual reports, company announcements, public records and MASCO documents (2021)	Presence of politicians on the board of directors of the Company (former or current)
Directors holding public offices	Director's biography, public records, news articles and MASCO documents (2021)	Directors who have served in public positions or government agencies before joining the company

Family ties with politicians	Executive profiles, news, case studies and official website	Directors or major shareholders who have direct family ties with politicians (Prime Minister for the year 2014 - 2021)
Business cronyism and social relations	News articles, media analysis and business reports	Identify social or business relationships between firms and politicians (Prime Minister for the year 2014 - 2021)

Analysis and Discussion

Table 4 presents a comparative analysis of politically connected firms as identified in Wong and Hooy's (2018) study and the current study.

Table 4

Descriptive Analysis

Types of connection	Wong & Hooy (2018)	Current study
	No. of firms	No. of firms
Government	32	63
Board Members	188	197
Family	24	9
Cronies	14	33
Total	258 (out of 493)	302 (out of 492)

Wong and Hooy (2018), reported 32 government-linked firms (GLCs), 188 firms with politically connected board members, 24 family-related firms, and 14 firms with crony connections. Their study, which spanned from 2002 to 2016, included both financial and non-financial firms.

In contrast, this study, which focuses on the period from 2014 to 2021 and excludes financial firms, shows an increase in the number of government-linked firms to 63, incorporating Federal, GLC, and State entities. The count of politically connected board members has also risen to 197. However, the number of family-related firms has decreased to 9, while the number of crony firms has increased to 33. These changes reflect updated definitions and classification criteria of political connections and shifts in Malaysia's political and economic landscape.

Furthermore, this study introduces an innovative approach by categorizing firms based on the number of political connection types that they hold. This uses a scale from 1 to 4, where firms are assigned a scale of 1 for having only one type of political relationship and up to 4 for holding all types of political connections. This approach contrasts with previous research that utilized binary dummy variables to indicate political connections (Hoang et al., 2022; Kamarudin et al., 2021; Wong & Hooy, 2018; Tan & Wong, 2024). By employing this scale, this study provides a more nuanced understanding of the varying degrees of political influence and its implications for earnings management. Furthermore, this study reveals notable shifts in the prevalence of political connections within firms. Specifically, an increase in Government

and Crony Connections will reflect changing political and economic dynamics meanwhile reduction in family connections indicates a shift like political influence. These findings underscore the dynamic nature of political connections and their impact on corporate governance and earnings management. These innovations in methodology offer deeper insights into how political connections impact firm behavior and financial performance, highlighting the evolving nature of political affiliations in the Malaysian corporate sector.

Conclusion

This study refines the methodology for identifying politically connected firms in Malaysia, building on Wong & Hooy's (2018), framework by updating the categories to Government, Director, Family, and Crony. This enhancement addresses significant shifts in Malaysia's political landscape post-2018, ensuring that the political-business nexus is accurately represented in the contemporary context.

Key findings indicate notable changes in the prevalence of different types of political connections, reflecting shifts in political and economic dynamics. Specifically, the increase in Government and Crony connections, alongside a reduction in Family connections, highlights evolving patterns of political influence in the corporate sector. These insights underscore the dynamic nature of political connections and their impact on corporate governance and earnings management.

The study contributes to the literature by providing updated operational definitions and proxies for politically connected firms, which improves transparency and accountability. These updates are crucial for enhancing investment climate, ensuring fair competition, and fostering sustainable economic development by mitigating systemic risks and preventing power abuses.

Practically, policymakers and regulators can benefit from the refined methodology to assess political influence in firms better and implement policies that promote fair practices. Investors may also find this updated framework valuable for making more informed investment decisions. These findings can also help formulate policies to increase financial transparency and reduce the political risks faced by companies in an uncertain environment, for example during the election period.

Future research should apply the revised list of political firms and consider the evolving political landscape in post-PRU2018 Malaysia. While this study addresses the impact of political connections on earnings management, limitations in sample selection and data completeness should be noted. Future studies could expand the sample size and refine data collection methods to further validate and enhance the methodology.

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