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Article

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ACCOUNTING, CORPORATE GOVERNANCE & BUSINESS ETHICS | RESEARCH ARTICLE

Types of political connections, election years, and firm performance in Pakistan: Moderating role of external monitoring

Muhammad Saif Ul Islam^{1*}, Woei-Chyuan Wong² and Mohd Yushairi Bin Mat Yusoff¹

Abstract: The study aims to examine the impact of different types of political connections in Pakistan on the performance of firms. We further examine whether the presence of external monitors, such as foreign and institutional investors, can moderate the impact of political connections on the performance of firms in Pakistan. In addition, we explore the association between political connections and firm performance during election and non-election years. This study uses 2479 firm-year observations for firms listed on the Stock Exchange of Pakistan from 2010 to 2019 as the final sample and uses regression to test the hypotheses. The findings of this study show that political connections are negative and strongly significant across all three performance indicators, such as ROA, ROE, and Tobin's Q, indicating that political connections can harm firm value. Further analyses indicate that the detrimental impact of political connections on firm performance is attributable to CEOs who have political connections and is more pronounced during general election years in Pakistan. The findings further report some weak evidence of the monitoring roles played by foreign and institutional in mitigating the negative impact of political connections. Policymakers in Pakistan, therefore, ought to design stricter disclosure measures to limit the potential wealth expropriation in politically connected firms, given the lack of shareholder activism by outside shareholders in this country. Our results further suggest that external monitors, such as foreign and institutional ownership, play a relatively limited role in mitigating the adverse impact of political connections on the performance of firms.

Subjects: Political Economy; Economics; Finance; Business, Management and Accounting;

Keywords: Political connections; connected CEO; connected chairman; external monitoring; performance of firm; election years; non-election years

1. Introduction

This study investigates the relationship between various forms of political connections and firm performance in Pakistan, as measured by return on assets, return on equity, and Tobin's Q. Business organizations establish political connections in several ways. For example, business owners establish relationships with politicians through lobbying, campaign contributions, friendships, and family and social networking, or they opt to enter into politics (Blau et al., 2013;

Bunkanwanicha & Wiwattanakantang, 2009; Correia, 2014). Alternatively, businesses appoint former or current politicians and (former) top government officials on their boards of directors to obtain benefits from their current or former connections (Jackowicz et al., 2014).

The issue of corporate political connections is prevalent worldwide, and its impact has been investigated globally (Goldman et al., 2009). These connections are pervasive in advanced and emerging nations, including the United States (Ullah et al., 2021). Political connections are likely to pose a challenge in countries with high levels of corruption and multiple risks. These firms constitute a considerable portion of the overall market capitalization in various countries, such as 28 percent in Malaysia, 39 percent in the United States, 86 percent in Russia, and 8 percent globally (Faccio, 2006). In Pakistan, firms with political connections receive relatively large amounts of credit, although they have significantly higher default rates than firms without connections (Khwaja & Mian, 2005).

Different views exist on the effect of political connections at the firm level, leading to an academic discussion on politicians' involvement in viable firms' activities (Wang et al., 2017). Prior research has demonstrated that politically connected firms tend to have high agency costs (Wang et al., 2017). The involvement of politically connected individuals in a firm could double the agency's problems, i.e., it could lead to opportunistic behavior by politicians and managers (Wang et al., 2017; Wong, 2004). Therefore, politically connected individuals usually aim to maximize their private interests, which can harm the interests of stockholders. Shleifer and Vishny (1994) argue that politically connected individuals working in a company (such as a director) may bribe the firm's managers to further the political objectives. In support of the value-destructive nature of political connections, prior research has demonstrated that politically linked companies face a variety of problems, such as poor performance, low earnings quality, high corruption and operational incompetence, and lack of investor safety (Boateng et al., 2021; Cheema et al., 2016; Hashmi et al., 2018; Rusmin et al., 2012; Saeed et al., 2017).

On the contrary, research has demonstrated that political affiliations can grant entry to valuable resources such as capital, land, licenses, market power, and financing (Saeed et al., 2017), government support for financially weak firms (Faccio et al., 2006; Ha et al., 2020); protection from regulatory intervention (Kroszner & Stratmann, 1998); government contracts for the provision of goods and services (Goldman et al., 2013); access to finance with higher priority (Khwaja & Mian, 2005); reduced taxation (Faccio, 2010) and superior earnings quality (Batta et al., 2014). Therefore, companies with political connections exhibit improved performance compared to those that do not have such links (Ang et al., 2013; Goldman et al., 2009). Resource dependence theory proposes that a firm's external linkages are crucial in providing a strategic competitive advantage in the industry. Thus, political connections strengthen a firm's external linkages, providing a competitive edge over non-connected firms (Hashmi et al., 2018). Hence, the mixed empirical results on this issue provide an avenue that needs further examination.

The literature review indicates that several studies (Boubakri et al., 2008; Faccio, 2006, 2010) have utilized a cross-country methodology to investigate firms with political connections. Significant variations exist between nations regarding the nature and character of political affiliations, socio-political contexts, modes of governance, and cultural aspects. Several studies have opted for a country-specific approach to examine the influence of political affiliations on business entities, owing to the challenges and limitations posed by cross-national comparisons. These variations make it challenging and often unfeasible to compare across countries. However, these country-specific studies have primarily focused on the United States (Correia, 2014; Houston et al., 2014), some European states, including Germany, Poland, Spain, and Italy (Ferguson & Voth, 2008; Jackowicz et al., 2014) and some Asian states. In the Asian region, research on political connections has focused mostly on East Asian states such as Japan (Dow & McGuire, 2009), Indonesia (Leuz & Oberholzer-Gee, 2006), Malaysia (Bliss & Gul, 2012; Khan et al., 2022; Wahab et al., 2017), Thailand (Bunkanwanicha & Wiwattanakantang, 2009) and China (Fan et al., 2007; Su & Fung,

2013). Except for Khwaja and Mian (2005), who examine the relationship between political connections and loan access in Pakistan, there is no study on political links in the South Asian region. As a result, this study seeks to fill a vacuum in the literature by analyzing the impact of political connections on organizational performance using a sample of 257 companies listed on Pakistan's Stock Exchange.

Furthermore, in market economies, a company's ownership structure is an important component in terms of financial governance (Aggarwal et al., 2009). Indeed, the entire market governance system assumes that enterprises have a dispersed ownership structure with a clear demarcation between those who manage (managers) and those who possess money (shareholders). Companies with concentrated ownership (one owner or predominant shareholder) outnumber those with dispersed ownership in the Pakistani setting. Given that ownership often affects how a corporation is operated, ownership is likely to influence the company's governance. The above backdrop on the value-destroying of political connections in developing countries underscores the importance of monitoring roles played by institutional investors. These investors are increasingly playing an active role in the capital market given their considerable influence over investee firms (Grier & Zychowicz, 1994; Wahab et al., 2009). Empirical evidence documents that institutional investors could alleviate agency issues between stockholders and managers due to their large stockholdings (Gillan & Starks, 2003; Shleifer & Vishny, 1986) and their possess of superior firm-specific information (Edmans, 2009). Institutional investors influence firms' decision-making process by controlling the company's management (Shleifer & Vishny, 1986) and threatening to leave the investee firms (Admatii & Pflleiderer, 2009).

Similarly, the existence of foreign investors in a business is related to better performance (Haat et al., 2008). The study done by Hingorani et al. (1997) concludes that foreign investors lessen the agency issues because it aligns the interests of owners and managers. Gillan and Starks (2003) foreign investors are more effective than their domestic counterparts in enhancing corporate governance. Further, these investors increase investment productivity by initially minimizing asymmetries through enhanced information (Chen et al., 2017; Kang & Stulz, 1997) and improved monitoring (Islam et al., 2022). Peter et al. (2012) find that foreign ownership substantially increases a company's efficiency, whereas the domestic industry is not keeping pace with global efficiency requirements set by foreign businesses.

As such, institutional and foreign investors are likely to advocate for a higher level of monitoring that limits expropriation activities. However, research on the impact of institutional investors on mitigating expropriation activities in politically connected firms is lacking, despite evidence showing their effect on firm performance in relation to wealth expropriation. Additionally, as previously mentioned, existing evidence documenting the connection between political ties and the performance of firms yields mixed findings. Our study contributes to the growing body of research on this topic by examining how company performance is exaggerated by political connections and various forms of ownership. Although previous research in finance submits that politically connected organizations are more likely to experience agency problems (as shown by Boubakri et al., 2012; Faccio, 2006), there has been no investigation into whether institutional and foreign investors effectively monitor and mitigate these problems.

Furthermore, since gaining independence in 1947, Pakistan has experienced consistent political uncertainty and instability, which has remained a constant factor over time. Except for political governments braced by military dictators, many previously elected governments in Pakistan could not conclude their terms in office. The military authorities dismissed or overthrew the political regimes based on alleged incompetence, wrongdoing, favoritism, or corruption. Seven governments have fallen in the last 30 years due to allegations of corrupt practices in Pakistan. For instance, seven general elections were held in Pakistan over the past 30 years, i.e., 1990, 1993, 1997, 2002, 2008, 2013, and 2018.

Moreover, Pakistan has consistently experienced political uncertainty and instability, further compounded by its poor rankings on Transparency International's Corruption Perception Index and World Governance Indicators (WGI). These indicators place Pakistan among the most corrupt nations in the world in 2021 (ranked 140 out of 180) and highlight its poor performance in governance respectively. Additionally, a small number of influential families dominate Pakistan's political system, potentially using their power to favor their business interests (as pointed out by Saeed et al., 2019). Therefore, Pakistan presents a unique setting to investigate the impact of political connections on business performance.

Consequently, the current paper seeks to contribute to the existing literature. First, this paper aims to investigate the influence of different types of political connections on a firm's performance measured by Tobin's Q, return on assets, and return on equity. We chose Pakistan as our target due to politicians' presence and powerful influence on businesses in this country. As discussed in the results section, 76.8% of Pakistan's listed corporations are politically connected. Second, we add to the existing papers which have examined the effects of political connections on firm performance in Pakistan, unlike previous studies in Pakistan (see, e.g., Niazi et al., 2021; Saeed et al., 2016, 2019; Ullah et al., 2021) than focus on a broad connection dummy, we decompose the connection variable into connection arises to from a chief executive officer (CEO) and connected chairman. We expect the impact of connection on firm value (if any) to be driven by the connected CEO or chairman since they are the key decision-makers in a company (Cherkasova & Ivanova, 2019; Sun & Zou, 2021). Sun and Zou (2021) and Cherkasova and Ivanova (2019) contend that CEOs with political connections tend to appoint bureaucrats, rather than directors with appropriate professional expertise, to their company's board of directors. This practice weakens the overall value of the firm. Third, this study investigates whether external monitors (institutional and foreign investors) moderate the effect of political connections on the performance of companies in Pakistan. Fourth, following the 2018 general elections, Pakistan's gross domestic product decreased from 5.836% in 2018 to 0.989% in 2019, as each political party pursued vastly different economic policies that significantly impacted business activities and the nation as a whole. However, the impact of these frequent changes on company value is uncertain. Thus, we explore the connection between political connections and firm performance during both election and non-election years, which, to the best of our knowledge, has not been studied in finance. Finally, the study's findings help to address previous literature's mixed findings by providing evidence of the impact of political connections on organizational performance in an environment characterized by political instability, high levels of corruption, and a weak regulatory environment. The study's findings can be applied to countries with similar socioeconomic, political, and regulatory structures. The study's findings also give vital insights for policymakers and regulators.

To achieve the research objectives, 2479 observations have been obtained from the Pakistani context to investigate the association between different types of political connections and firm performance and the moderating role of external monitoring in this relationship. The coefficients for political connections are negative and strongly significant across all three performance indicators tested in Table 4, indicating that political connections can harm firm value. This paper further examines the incremental effects of connected CEO and chairman on the association between PC and firm performance. The findings revealed that politically connected CEO is strongly negative and significantly supporting the incremental value-destroying effects of connected CEOs on firm performance and is more pronounced during general election years in Pakistan. However, we do not find value destroying the impact of connected chairman. This confirms the results of prior research showing that PCs through top officers had no beneficial impact on the profitability of the firm (e.g., Eissa & Eliwa, 2021). Further, we document some weak evidence of the monitoring roles played by foreign and institutional in mitigating the negative impact of political connections.

The structure of this article is as follows: Section 2 discusses the background. Section 3 discusses the theocratic literature review. Section 4 outlines the development of our hypotheses. Section 5

details the research design, including data and the study's empirical method. Section 6 presents and discusses the empirical results. Finally, Section 7 offers concluding remarks.

2. Background

Since its independence in 1947, Pakistan has been ruled by several military dictatorships which came into power after overthrowing civilian governments. Over the past few decades, seven democratic governments have been overthrown by the military. The resulting uncertainty negatively affects businesses, the corporate governance environment, and the economy. During the 1960s, the government facilitated the development of import substitution industries through support for industrial projects. As a result, several family-owned companies emerged, especially in the textile sector. These family-owned businesses achieved phenomenal industrial growth through special privileges granted by the government in the form of preferential access to finance, subsidies, and tariff protection (White, 1974). Moreover, financial assistance from foreign countries has been vital for the country's development.

During the 1970s, there was a strong public reaction to the market-friendly policies of the 1960s because they were considered inequitable. Zulfikar Ali Bhutto's government led the nationalization wave sending many private family-owned enterprises into the hands of the state. When commercial banks were nationalized in 1974, industrial loan financing was provided to politically connected firms and individuals with a blatant disregard for the country's economic well-being (Rehman, 2006). During this period, the government launched a number of development finance institutions, such as the National Development and Finance Company, to finance industrial projects. Shortly afterward, in 1977, the civilian government was overthrown through a military coup, and nationalized institutions continued under the management of the state (Rehman, 2006).

In the 1990s, there was a rapid expansion in the capital markets, and many new corporations registered on the stock exchange. The total amount of firms registered on the stock exchange increased from 314 to 487 during this period. The nationalization decision continued to haunt in the 1990s as there were massive loan defaults by politically connected industrialists while government support for loss-making nationalized industries continued (Rehman, 2006). During the past decade, Pakistan took steps to curb political corruption and cronyism. It was now mandatory for politicians to disclose the details of their assets to the public.

From the general elections in 1988 until the peaceful military coup led by the Army Chief in 1999, Pakistan was ruled by a series of ineffective democratic administrations. Four civilian administrations were created during this time of inadequate democracy (1988–1999), but none survived for five years. Either the President or the Army Chief overthrew the political governments. 2008 marked the conclusion of Pervez Musharraf's autocratic rule. Since 2006, however, the dictator has been losing government control. The reasons for the decline in public support included the adoption of transparently questionable political expediences, pursuing unsound economic policies, and indulging in the war on terrorism. The ultimate cause of Pervez Musharraf's resignation was the dismissal of Pakistan's then-chief justice. General Pervaiz Musharraf's military administration launched the National Anti-Corruption Strategy in 2002 to eradicate political corruption in the country. As the Constitutional Bill and the National Reconciliation Ordinance impeded the accountability process, skeptics questioned the effectiveness of such initiatives in reducing corruption in the nation. The Constitutional measure exempted serving members of the military and judiciary from accountability, while the National Reconciliation Ordinance granted amnesty to corrupt politicians.

In March 2008, the political administration took over the country through a peaceful power transfer. After its establishment in 2008, the civilian government completed its politically unstable five-year mandate, successfully becoming the first elected civilian administration to transfer power to another civilian government in 2013. On 25 July 2018, general elections, the Pakistan Tehreek-e-Insaf (PTI), led by Imran Khan, gained the most seats in the National Assembly but did not win a majority.

However, the party later formed a coalition government with other minor parties. One of the Imran Khan regime's strengths has been its commitment to accountability and anti-corruption. The administration initiated several steps to strengthen governance and decrease corruption, including forming a new anti-corruption agency and passing a whistleblower protection law.

Imran Khan also promised a five-year tax holiday for overseas investors to encourage investment in Pakistan. As a result, the government has initiated efforts to make doing business in Pakistan easier, such as streamlining regulatory processes, simplifying tax procedures, and digitizing government services. According to a Geo News (2022) story, the government has also created several incentives to entice international investors, including tax cuts, duty-free import of machinery, and streamlined procedures for profit repatriation. Another plus point of the Imran Khan rule has been its emphasis on social welfare and poverty eradication. The government launched several projects to improve poor areas' access to healthcare, education, and housing. The government also launched the Ehsaas program, which aims to reduce poverty and provide social protection to vulnerable people. However, there have been several challenges to Imran Khan's political regime. The military's growing role in politics has been one of the primary issues. There have been charges that the military put pressure on the administration to make specific decisions, particularly on national security and foreign policy concerns.

After the 2022 Pakistani constitutional crisis, incumbent Prime Minister Imran Khan faced a vote of no confidence; opposition parties nominated Sharif as a candidate for Prime Minister on 10 April 2022. As a result, the Pakistani Parliament chose opposition leader Shehbaz Sharif to be the country's prime minister on 11 April 2022, bringing in a new administration following Imran Khan's dismissal and ending a week of political instability that brought the country's fragile democracy to the brink. Hence, Pakistan provides a unique setting for exploring the effect of different political ties on firm performance.

Many businesses in Pakistan are owned and controlled by politicians involved in policymaking. For example, First, Jahangir Tareen is a prominent Pakistani businessman who is also active in politics. He established and directed several profitable businesses, including the JDW Group, a sugar manufacturing and agricultural conglomerate. Tareen entered politics and served in Pakistan's National Assembly. His economic skills and CEO experience affected his policy positions, notably in the agricultural sector. Second, Shahid Khaqan Abbasi, an engineer, and businessman, worked in the energy sector for many years before entering politics. He was the CEO of Air Blue, a private airline, and an executive in other energy companies. Abbasi later became Pakistan's Prime Minister from 2017 to 2018. During his tenure, his knowledge of the energy sector and business dynamics influenced his policymaking judgments.

Third, Abdul Razzaq Dawood is a well-known Pakistani industrialist and entrepreneur. He has held several positions in business, including CEO of Descon Engineering Limited. Dawood has also been appointed Prime Minister's Advisor on Commerce and Industry in Pakistan. His knowledge has aided policymakers in the fields of commerce and trade. Lastly, before entering politics, Shaukat Aziz was the CEO of Citibank Pakistan. He served as Pakistan's Finance Minister from 1999 to 2007 and then Prime Minister from 2004 to 2007. Aziz's experience as a CEO gave him a unique perspective on economic policies and changes, which he executed during his term to stabilize the economy and attract international investment.

3. Theoretical literature review

The study contributes to the literature related to two prominent theories: agency theory and resource dependence theory. Studies have shown that in politically connected firms, the agency's cost tends to be high (Shleifer & Vishny, 1994; Wang et al., 2017). The involvement of politically connected individuals in a firm could double the agency's problems, i.e., it could lead to opportunistic behavior by politicians and managers (Wang et al., 2017; Wong, 2004). Politically connected individuals usually aim to maximize their private interests, which can

harm the interests of stockholders (Wang et al., 2017). For instance, politically connected individuals may provide access to confidential information on government policy and regulations or set up linkages between key public institutions and the business in exchange for financial incentives, including welfare expenditures, donations, campaign contributions, and bribes (Claessens et al., 2008; Hillman & Hitt, 1999).

There are also possibilities for negotiations and bargaining between politically connected individuals and the managers of a firm, both of whom wish to maximize their private interests. Shleifer and Vishny (1994) develop a bargaining model between politically connected individuals and managers of a business. Their study suggests that politically connected individuals working in a company (such as a director) may bribe the firm's managers to further the political objectives. Moreover, managers may also bribe politically connected individuals to prevent them from pursuing political objectives through the firm. In both ways, politically connected individuals in a business may affect its managerial decision-making and economic performance.

In addition, Shleifer and Vishny (1994) propose a rent-seeking theory, arguing that politicians will not provide a firm with free benefits. They want the firm to "pay them back" so that they will extract rents from political connections. The corporate value will be enhanced only when the marginal benefits of the connections exceed their marginal costs. Therefore, political dominance is closely tied to the rent-seeking behavior of politically connected company executives, especially when they are eager to reach key performance indices linked to their promotion (Chen et al., 2011b). Furthermore, the rent-seeking effect of executives' political interests affects the link between political connections and firm value, which may or may not be consistent with maximizing firm value (Wang et al., 2018).

On the other hand, under the resource dependence theory, connections are value-enhancing. Political connections help enterprises establish a good reputation and achieve sustainable growth (Eissa & Eliwa, 2021). In this aspect, earlier research showed that politically-linked enterprises had greater market power than unconnected firms resulting in greater market value (N. Boubakri et al., 2012; Goldman et al., 2009; Houston et al., 2014; Maaloul et al., 2018). Previous studies have also reported that political connections offer precious resources to firms in terms of favorable relationship-based contracts and greater access to external finance (Claessens et al., 2008; Houston et al., 2014; Nuswantara et al., 2023; Piotroski & Zhang, 2014) which in turn improve firm performance. Furthermore, according to the resource dependence theory, a firm's competitive advantage lies in obtaining valuable tangible and intangible assets that are difficult or at least excessively costly for competitor firms to obtain. The political economy literature has long noted that political relationships are valuable resources to individual firms that positively impact profitability (e.g., Faccio, 2010; Fisman, 2001; Saeed et al., 2015).

Based on the underpinning theories, political connections and external monitors (ownership structure) were included as the independent variables. Prior research suggested that firms linked with politicians typically sacrifice minority shareholder interests and suffer from serious agency issues (Ashraf & Ghani, 2005; Khwaja & Mian, 2005; Rashid, 2012; Siddiq, 2007; Wang et al., 2017). Furthermore, prior studies also showed that politically connected firms adversely affected firm value (Chen et al., 2011a), which suggested that agency costs were high in politically connected firms (Mustafa, 2012; Rashid, 2012; Shleifer & Vishny, 1994; Siddiq, 2007; Wang et al., 2017). Moreover, ownership structure such as external monitors is a significant component in the internal corporate governance process. It affects a firm's decision-making, shareholder voting in selecting the board, management behavior, and firm performance (Kumar & Zattoni, 2014) and is strongly connected with the agency problem. External monitors were also utilized as a moderating variable on the relationship between political connections, and firm performance

4. Empirical literature review and hypotheses development

4.1. Political connections and firm performance

Under the agency theory, these connections are expected to negatively affect firm performance. Prior research has demonstrated that politically connected firms tend to have high agency costs (Wang et al., 2017). This is because politically connected firms may face pressures that deflect them from their primary objective of maximizing shareholder wealth (Roe, 2003). Faccio (2010) indicates that politically connected firms are prone to engage in managerial rent extractions, which adversely influence business value, particularly firms located in more corrupt nations. Similarly, Tu et al. (2013) document that connected political firms are more likely to engage in excessive tunneling through expropriate minority shareholder wealth, monetary kickbacks from business transactions, and direct exploitation of firms resources. According to Fan et al. (2007), firms with political connections are more likely to engage in nepotism by appointing bureaucrats rather than directors with relevant professional backgrounds to their boards. As a result, these connected firms may experience poor management and inefficiency, as noted by (Shleifer & Vishny, 1994).

In contrast, studies have shown that political connections help enterprises establish a good reputation and achieve sustainable growth (Eissa & Eliwa, 2021). Earlier research has demonstrated that politically linked enterprises have greater market power than unconnected firms, resulting in higher market value (Houston et al., 2014; Maaloul et al., 2018). Harianto (2020) argued that companies bring politicians onto their boards so that they can benefit from their insight into the policymaking, procurement, and government planning processes, as well as their political networks and technical expertise, which in turn enhances firm value (Nuswantara et al., 2023). Several studies have documented that political connections enable firms to access bank loans and other sources of funds, ultimately leading to improved firm performance (Ang et al., 2013; Goldman et al., 2009).

However, previous studies have shown that political connections negatively affect firm value in Pakistan (Haris et al., 2019; Hashmi et al., 2018; Saeed et al., 2016). This may be because, in Pakistan, the legal framework does not provide sufficient protection for investors, making it common for corporations to be managed by large shareholders. For example, the conflict of interest of laws was frail, which encouraged the retired civil servants and politicians to obtain private gains through loans, funds from the government, and banks (Daily-Dawn, 2004; Noorani, 2015; Rehman, 2011) which in turn harm the firm performance. Hence, this leads to the following testable hypothesis:

H1: *Politically connected firms have a significant impact on firm performance than non-connected firms.*

In addition, when politically connected CEOs are appointed based on their political ties rather than their qualifications and expertise, the concepts of meritocracy are undermined (Piotroski et al., 2015; Tee et al., 2021). In such scenarios, CEOs may lack the requisite competencies or expertise to proficiently oversee the organization, formulate strategic decisions, or tackle intricate commercial challenges. This can lead to poor performance and lower firm value. In this way, firms managed by politically connected CEOs are more likely to nominate bureaucrats rather than directors with relevant professional expertise to their boards of directors, potentially lowering the firm's worth. Fan et al. (2007) document that the accounting performance of a company led by a politically connected CEO is consistently worse than that of otherwise similar firms. This means politically connected CEOs may put their political goals ahead of the company's and its shareholders' best interests. Instead of focusing on increasing shareholder value, they may engage in activities that benefit their political connections or use corporate resources for personal gain. This conflict of

interest can undermine investor confidence and reduce the firm's value. As a result, CEOs with strong political ties may wield excessive power over the board of directors, reducing their ability to conduct effective monitoring (Tee & Rasiyah, 2020). This can result in weak internal controls, inadequate risk management, and a lack of accountability, which can harm firm value. However, as per the findings of Wu et al. (2018), political ties held by CEOs are strategically essential for firms seeking political legitimacy and access to government resources, ultimately leading to improved performance. It is essential to observe that not all politically connected CEOs have a negative impact on firm value. In some instances, political connections may facilitate access to valuable resources, networks, or market opportunities that positively impact firm performance. This leads to the following testable hypothesis:

H2: *Firms with politically connected CEO exhibit significantly lower firm performance than firms that do not have connected CEO.*

While the CEO is often more powerful than the chairman in executing a company's policies, in emerging nations such as Pakistan, the chairman of the board of director hold an important decision-making authority. This is evidenced by previous literature showing the chairman's significant impact on firm performance. When a politically connected chairman is appointed, independence and accountability may be compromised (Chen et al., 2023). The chairman may place the interests of political allies or personal connections above the company's and shareholders' best interests. This can lead to decisions not aligned with the maximization of shareholder value, negatively impacting firm value (Li et al., 2022). Furthermore, politically connected chairmen can exert disproportionate influence over board decisions, reducing corporate governance mechanisms' efficacy. They may be able to manipulate the board's composition, silence dissenting opinions, and discourage robust discussions. This can impede effective oversight and decision-making, possibly resulting in subpar strategic decisions (Florou et al., 2021) and negative outcomes for the company's performance and value.

On the other hand, a politically connected chairman can enhance the firm's credibility and reputation. Political ties or associations with influential figures can boost the perception of a company's stability, dependability, and legitimacy. This can attract investors, customers, and business partners, increasing market value and enhancing capital access. To the best of our knowledge, previous studies have not investigated the impact of a politically connected chairman on firm performance. This leads to the following testable hypothesis:

H3: *Firms with a politically connected Chairman exhibit significantly lower firm performance than firms that do not have a connected Chairman.*

4.2. External monitoring and firm performance

The involvement of institutional and foreign investors has been found in the literature to reduce the potential for conflict of interest between owners and management, which mitigates agency issues. The protection of minority stockholders and the inclusion of investors in strategic decision-making are two of the most important benefits of institutional ownership. Due to their greater management abilities and extensive funds, institutional investors (as large owners) can eliminate information asymmetries, mitigate agency issues, and maximize stockholder value. Moreover, institutional investors can use their ownership rights to push the management to enhance corporate governance by exerting pressure (Lin & Fu, 2017).

Donnelly and Mulcahy (2008) suggested that institutional investors serve as a key corporate governance mechanism for various reasons. (1), They have more power and resources than small stockholders to gain access to more information (Smith, 1976). (2), When it comes to determining the decisions of a corporation and analyzing the information taken from a company's annual

reports, they have considerable knowledge and expertise (Chung et al., 2002). (3) their voting rights encourage them to take action when required (Donnelly & Mulcahy, 2008). Thus, these investors are highly driven to scrutinize the disclosure policies of firms (Barako et al., 2006). Moreover, Lin et al. (2007) illustrated that these investors are regarded as more sophisticated and better informed about the company's facts and situation than individual investors (Belghitar et al., 2011). Therefore, these investors significantly influence the decision-making of corporate governance in several ways, which include controlling the management of the company, expressing their views (Shleifer & Vishny, 1986), and threatening to leave (Admatii & Pflideerer, 2009). Moradi et al. (2022) argue that institutional investors possess the capacity to oversee a company's management by furnishing information to shareholders and efficiently monitoring the company's performance. This efficacy is reflected in the company's financial performance, resulting in heightened efficiency. Moreover, proponents of effective monitoring in academia contend that larger business proprietors possess greater knowledge and skill, enabling them to actively supervise managers compared to their smaller counterparts (Dau et al., 2020). Some empirical findings have reported a positive connection between institutional ownership and an organization's stock performance (Alodat et al., 2021; Queiri et al., 2021).

The effectiveness of institutional investors as observers of politically linked firms is less evident. On the one hand, institutional investors in connected firms are supposed to encourage a stronger reporting climate and improve corporate transparency (Benjamin et al., 2016), thereby improving firm performance. Based on the notion that institutional investors act as a monitoring mechanism to monitor the expropriation behavior of politically connected firms (reduce agency costs), we expect that a higher proportion of institutional investors' shareholding is likely to moderate the relationship between political connections and firms performance which previous studies had neglected to conduct.

Similarly, Companies that attract foreign investors are more likely to adopt global best practices in corporate governance and management, diversify their holdings, and enhance their monitoring capacities, decreasing the asymmetries through greater information level (Jackson & Strange, 2008). Therefore, Foreign investors are often associated with more sophisticated governance practices that can help improve companies' performance and transparency. Foreign investors typically have greater engagement with companies than domestic investors. Foreign investors are often seen as more active shareholders willing to engage with management and provide constructive feedback on the company's strategy and performance. This can lead to more effective monitoring of the company's management, which can help to improve governance and performance. Normally, foreign investors have diversified collections or portfolios and better monitoring capabilities. Foreign investors are more likely to encourage emerging-market companies to participate in risky projects (Filatotchev et al., 2007). Aggarwal et al. (2011) found that foreign investors insist on higher governance standards and protection of minority rights. Foreign investors also contribute to strategic decision-making and assist in monitoring and disciplining management (Chen et al., 2006). Ownership proportions become important, especially for foreign ownership (Driffield et al., 2018). Chen et al. (2017) argue that foreign investors are more effective than domestic investors in mitigating information asymmetry and controlling managers; therefore, they can help the firm improve their firm value. They find that foreign ownership is positively related to firm value. Positive results of foreign ownership are also confirmed by Alodat et al. (2021) and Nguyen et al. (2020). Based on this notion, we expect that a higher proportion of foreign investors' shareholding is likely to moderate the relationship between political connections and a firm's performance which previous studies had neglected to conduct.

Hence, the existence of foreign and institutional investors, which mitigate agency problems, arises from the contexts described above. Hence, we investigate the interactive effects of institutional and foreign ownership on the association between political connections and the performance of firms. The positive value of the ownership-connection interaction terms will support agency theory. This leads to the following testable hypothesis:

H4: *Institutional and foreign ownership weakens the negative relation between political connections and firm performance.*

4.3. The impact of general elections

Election-induced political uncertainty has been observed to negatively affect asset prices and corporate investments, particularly in countries with high levels of corruption, low transparency, and significant state intervention in the economy (Jens, 2017; Pastor & Veronesi, 2012). This adverse impact is noticeable during the election year and the year leading up to the general elections (Botchkova et al., 2012). Firms with political connections face an elevated risk of failure during elections, as politicians cannot count on post-election financial support. The ability of incumbent governments to bail out struggling corporations during politically uncertain times is also hindered by the possibility of a new incoming administration. As a result, politically connected organizations in Pakistan face greater business risk during elections than non-connected organizations (Ahmad et al., 2022).

The civil political economy in Pakistan is more unstable, and exposed to media, judicial, and regulatory scrutiny, as Siddiq (2017) notes. The high scrutiny and oversight of politicians may lead to a decrease in the stability of benefits gained by companies with ties to politically-linked businesses. Therefore, during the election period, it is plausible that conflicts of interest within connecting firms would intensify, making them more susceptible to exploitation by connected parties. Political uncertainty has remained a constant phenomenon in Pakistan, with each political party pursuing diverse economic policies that significantly impact firms' operations and the lives of citizens. Moreover, limited information is available on the economic implications for organizations with political connections during and after the general elections in Pakistan. This situation leads to the formulation of the following hypothesis that can be tested:

H5: *The relationship between political connections and the performance of the firm differs significantly between election and non-election years*

5. Research design

5.1. Data and sample

This study's sample comprises nonfinancial firms registered on the Pakistan Stock Exchange between 2010 and 2019. Consistent with Ciftci et al. (2019), this study focused on non-financial firms due to the difference in the regulatory framework and financial reporting between financial and non-financial sectors. The selection of the beginning period of the study was due to data unavailability issues. Annual reports before 2010 were mostly unavailable on the firm and stock exchange websites. Secondary data was collected from the firms' audited annual reports and the Datastream financial time series database. Table 1 shows the sample selection criteria for the current study.

Table 2 presents a sample of 257 companies that belong to twenty-four different industry sectors. Companies' audited annual reports and the websites of the national and provincial assemblies are manually combed for information on the political affiliations of the listed company's senior management and directors. Since 1970, these websites have provided an exhaustive list of all provincial and federal candidates. A firm is considered politically connected if (1) any of its board members or top executives' names appeared in the national and provincial assemblies or election commission of Pakistan's websites as contested candidates for the general election in Pakistan or (2) they are Pakistan's present or past presidents, prime ministers, cabinet ministers, government officials, or assembly members as stated in the annual report's directors profile

Table 1. Sample selection criteria

Particulars	Total Firms
Total number of firms listed at PSX	531
Less: Total Number of Financial firms	(131)
Total Non-finical firms listed at the Pakistan stock exchange	400
Less: Firms with incomplete information	(143)
Final Sample	257

section. We further refine our measure of connection by further decomposing the connection arising from a connected CEO or chairman.

5.2. Variable measurement

5.2.1. Dependent variable: firm performance

Using Return on Assets (ROA), Return on Equity (ROE), and Tobin's Q as our dependent variables. Furthermore, ROA is measured by "net income divided by total assets". ROE is measured by "net income divided by total equity". Tobin's Q is measured by the ratio of "the market value of equity plus the book value of debt divided by the book value of assets". These ratios have been extensively employed as proxies for a firm's performance in previous research (Aldhamari et al., 2020; Mohamed et al., 2014; Eissa & Eliwa, 2021; Maaloul et al., 2018).

5.2.2. Independent variables

Political connections is a dummy variable that takes the value of 1 for connected firms and 0 for non-connected firms (Hashmi et al., 2018) and is used as the main independent variable of this paper. In addition, institutional ownership and foreign ownership are measured as the percentage of shares owned by institutional and foreign investors, respectively, divided by the total number of outstanding shares (see, for instance, Azhar et al., 2019; Chen et al., 2017; Shahzad et al., 2019) are also used as independent and moderating variable in this paper.

5.2.3. Control variables

Note the focus of this paper; we also control for family ownership since this variable has been found to influence firm performance (Wang & Sahiler, 2015). Firm Age, leverage, and firm size (firm level-characteristics) are control variables (Saeed et al., 2017; Ullah et al., 2021). The age of a company is quantified as the natural log of the number of years since its founding. Leverage is calculated by dividing total debt by total assets, while the firm size is calculated using the natural log of total assets. Further, Table 3a, 3b, 3c, and 3e shows the operationalization of all variables used in the existing study.

5.3. Model specification

A fixed effect panel regression model is used to assess the impact of political connections on Pakistani firm performance. The regression model is estimated as follows:

$$\text{FirmPerformance}_{it} = \beta_0 + \beta_1 \text{PC}_{it} + \beta_2 \text{Ownership}_{it} + \beta_3 \text{Control variables}_{it} + \mu_{it} \quad (1)$$

Where, *i* show the firm and *t* shows the year. The performance of a company is evaluated through various indicators such as ROA, ROE, and Tobin's Q. If the coefficient of political connection (PC) is found to be negative, it would provide evidence in favor of agency theory, which suggests that firms can be subject to expropriation through political connections. The ownership structure of a company can be analyzed based on variables such as institutional, foreign, and family ownership, where institutional and foreign owners are used as external monitors. Additionally, certain controlled variables like leverage, family ownership, firm size, and firm age are considered while evaluating a company's performance.

Table 2. The breakdown of the final sample based on the sector

Sector	Total Firms	Observations.	%
Textile	61	589	23.77
Allied Industries & Sugar	26	246	9.92
Chemical	21	210	8.47
Cement	17	170	6.86
Automobile	16	160	6.46
Personal Care Products & Food	11	110	4.44
Power Generation & Distribution	11	103	4.15
Oil & Gas Companies	10	96	3.87
Engineering	10	96	3.87
Miscellaneous	9	86	3.47
Technology & Communication	10	82	3.31
Pharmaceuticals-	8	76	3.07
Glass & Ceramics	7	70	2.82
Rayon & Synthetic	7	68	2.74
Paper & Board	6	60	2.42
Fertilizer	7	59	2.38
Electrical-Goods & Cable	5	50	2.02
Refinery	4	40	1.61
Transport	4	38	1.53
Leather & Tanneries	2	20	0.81
Tobacco	2	20	0.81
Jute	1	10	0.40
Vanaspati	1	10	0.40
Woolen	1	10	0.40
Total	257	2479	100.00

The regression model in Equation (2) is an extension of the base model that breaks down the PC variable into two separate variables: PC_CEO and PC_Chairman. The PC_CEO variable takes the value of 1 for CEO with political connections and 0 for those without any connections. Similarly, the PC_Chairman variable takes the value of 1 for Chairman with political connections and 0 for those without any connections. Controlling for PC dummy, PC_Chairman and PC_CEO dummies essentially measure the incremental effects of connected Chairman and connected CEO on firm performance.

$$\text{FirmPerformance}_{it} = \beta_0 \text{it} + \beta_1 \text{PC}_{it} + \beta_2 \text{PC_CEO}_{it} + \beta_3 \text{PC_Chairman}_{it} + \beta_4 \text{Ownership}_{it} + \beta_5 \text{Control variables}_{it} + \mu_{it} \quad (2)$$

Equation (3) examines how institutional and foreign ownership moderates the association between political connections and performance of firm. The noteworthy variables of interest in this equation are the interaction terms between ownership and connection variables, denoted as PC*Ownership. Analyzing these interaction terms will enable us to determine whether the presence of external monitors weakens the effect of connection variables on firm performance, as predicted by agency cost theory.

$$\text{FirmPerformance}_{it} = \beta_0 \text{it} + \beta_1 \text{PC}_{it} + \beta_2 \text{PC}_{it} * \text{Ownership} + \beta_3 \text{PC_CEO}_{it} * \text{Ownership} + \beta_4 \text{PC_Chairman}_{it} * \text{Ownership} + \beta_5 \text{Ownership} + \text{Control variables} + \mu_{it} \quad (3)$$

The last step in our empirical approach involves studying how the relationship between PC and firm performance is influenced by general elections. We rerun Equation (1) on subsamples of

Table 3a. Dependent variable and measurement: firm performance

Variable	Description	Source
Return on Assets	net income divided by total assets	(Aldhamari et al., 2020; Mohamed et al., 2014; Eissa & Eliwa, 2021; Maaloul et al., 2018).
Return on Equity	net income divided by total equity	
Tobin's Q	the market value of equity plus the book value of debt divided by the book value of assets	

Table 3b: Independent variables and measurements: Types of political connections

(1) Political Connections (2) Connected CEO (3) Connected Chairman	(1) Political Connections = 1 if the firm is politically connected, 0 otherwise (2) Political Connections = 1 if the firm's CEO is politically connected, 0 otherwise (3) Political Connections = 1 if the firm's Chairman is politically connected, 0 otherwise	Chen et al. (2018), Fan et al. (2007), Hashmi et al. (2018), and He and Kyaw (2018)
--------------------------------------------------------------------------	--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------	-------------------------------------------------------------------------------------

Table 3c: moderating variables and measurements: External monitors

Institutional Ownership	The number of shares owned by institutional investors divided by the total number of stocks	Azhar et al. (2019), Cao et al. (2018), and Lei and Chen (2019)
Foreign Ownership	The number of stocks owned by foreign investors divided by the total number of stocks	Chen et al. (2017) and Tran (2020)

Table 3e : Control variables and measurements

Firm Age	The natural log of the number of years when the firm started its operation	Shahzad et al. (2019)
Family Ownership	The percentage of shares owned by family members divided by the total number of outstanding shares	Anderson et al. (2012), Shyu (2011), and Shahzad et al. (2019)
Firm Size	The natural log of total assets	Chen et al. (2011b)
Leverage	Total debt to total assets	Shahzad et al. (2019)

observations during election years (2013 and 2018) and non-election years. We expect the coefficient of PC in election years subsample to be more negative and significant than subsample during non-election years as wealth expropriation of political connection could be more significant during the election years.

6. Empirical results and discussion

6.1. Descriptive findings

Table 4 provides a presentation of the descriptive statistics for each variable that was included in a regression model. The average values of ROE and ROA are 12.942 % and 4.903%, respectively. The average value of Tobin's Q ratio is 1.113, indicating that share prices are adequately priced relative to their book value. Out of all the firms in the sample, a majority of 76.8% have political connections. This is greater than Malaysia's 48% (Wong & Hooy, 2018) and China's 60% (Wang et al., 2018), but less than Indonesia's 89 (Sakti et al., 2020). In addition, 25.8% of firms are connected through CEO, and 33.1% of firm's are connected through chairman of the firm.

The average value for institutional ownership is 9.22%. The average value for foreign ownership is 5.35%. The average value for family ownership is 25.505%. These values are comparatively lower

than those reported in the literature for other Asian countries. For instance, according to Chen et al. (2017) and Mai and Hamid (2021), family and foreign ownership in China are 35% and 8.17%, respectively. Ng et al. (2015) found that family ownership in Malaysia is 38%, while Lin and Fu (2017) reported that institutional ownership in China is 22.55%. The mean firm age is 37.25, and the mean firm size is 14.793 billion Rs. Additionally, the average leverage is 58.7%, indicating that, on average, most Pakistani firms have high levels of leverage.

6.2. Correlation matrix

According to the Pearson correlation matrix in Table 5, multicollinearity is not a significant problem. In the same vein, variance inflation factor (VIF) values for all regression models that are lower than two provide additional support for the idea that there is no significant problem with multicollinearity within the scope of this research.

6.3. Regression analysis

Table 6 contains the findings obtained using the two-way fixed effect estimator. The Hausman specification test was carried out to identify the estimator that should be used for our panel dataset. Based on the test results, the fixed effect estimator should be utilized.

This study's dependent variable of interest is firm performance, with PC being the key variable. The coefficients for PC are negative and strongly significant across all three performance indicators tested, indicating that political connections can harm firm value. Additionally, connected firms get a 12.29 percent poorer return on assets than nonconnected firms. To bolster this finding, the model is reestimated using an alternate measure of firm performance, ROE, and Tobin's Q. Political links are also proven to have a negative impact on ROE and Tobin's Q. The data in Columns 2–3 suggest that firms with political links outperform enterprises with no political affiliations. This implies that politicians exacerbate agency difficulties by coercing management to participate in self-interested acts that defend politicians' interests, hence worsening business performance. These findings are consistent with prior studies (see for instance, Boubakri et al., 2008; Ha et al., 2020; Pang & Wang, 2021; Shleifer & Vishny, 1994; Wang et al., 2017). These findings further support the arguments that politically connected individuals working in a company may bribe the firm's managers to further the political objectives. Moreover, managers may also bribe politically connected individuals to prevent them from pursuing political objectives through the firm. In both ways, the involvement of politically connected individuals in a business may affect its managerial decision-making and economic performance (Shleifer & Vishny, 1994), which in turn increases the agency issues and corruption in the country as a whole (Boateng et al., 2021). Therefore, these

Table 4. Descriptive statistics

Variable's	Mean	Standard Deviation	Minimum	Maximum
ROA	4.903	6.415	-5.221	15.831
ROE	12.942	13.672	-11.221	34.248
Tobin's Q	1.113	0.435	0.609	2.022
Political Connections	0.768	0.422	0	1
PC_CEO	0.258	0.438	0	1
PC_Chairman	0.331	0.471	0	1
FamilyOwnership	25.505	27.333	0	98.8
InstitutionalOwnership	9.220	10.32	0	98.81
ForeignOwnership	5.350	14.252	0	89.23
Firm Age	37.259	16.927	2	106
Firm Size (Rs in Billion)	14.793	16.608	0.906	52.099
Leverage	0.587	0.291	0.004	3.146

Table 5. Correlation matrix

	1	2	3	4	5	6	7	8	9	10	11	12
ROA(1)	1											
ROE(2)	0.729**	1										
Tobin's Q(3)	0.337**	0.373**	1									
Political Connections (4)	0.03	0.028	0.129**	1								
PC_CEO (5)	-0.049*	-0.012	-0.002	0.119**	1							
PC_Chairman (6)	0.027	0.069**	0.077**	0.206**	0.503**	1						
InstitutionalOwnership (7)	0.075**	0.087**	-0.044*	0.105**	0.017	0.046*	1					
ForeignOwnership (8)	0.205**	0.129**	0.207**	0.117**	-0.090**	0.017	0.011	1				
FamilyOwnership (9)	-0.133**	-0.114**	-0.220**	-0.201**	-0.133**	-0.259**	-0.246**	-0.212**	1			
FirmAge (10)	-0.013	-0.034	0.048*	0.077**	0.008	-0.028	0.076**	0.053**	-0.011	1		
FirmSize (11)	0.155**	0.198**	0.110**	0.214**	0.104**	0.153**	0.147**	0.157**	-0.313**	-0.01	1	
Leverage (12)	-0.502**	-0.117**	0.072**	0.077**	0.032	0.089**	0.000	-0.127**	0.035	-0.088**	.057**	1

Note: **, denotes $p < 0.05$.

findings confirm the predictions of agency theory, which holds that the presence of politically linked important personnel in a corporation diverts management’s attention away from the ultimate goal of maximizing shareholder wealth.

Moving on to matters of ownership, the findings show that institutional ownership has a positive and significant effect on ROE, indicating the importance of these investors in mitigating agency issues within a company. This supports the argument that institutional ownership has a significant supervisory role in minimizing agency costs (How et al., 2014). Likewise, foreign ownership is positively associated with Tobin’s Q and ROA, suggesting that external capital sources can significantly enhance a company’s performance by strengthening its corporate governance practices (Gillan & Starks, 2003). In contrast, family ownership has a negative and substantial influence on both ROE and Tobin’s Q. This outcome lends credence to the assertion that family owners are more prone to abuse their position to the detriment of minority stockholders (Wang & Sahiler, 2015). Hence, The present finding aligns with the assertions made by Boateng et al. (2021) that weak corporate governance frameworks foster corrupt practices, whereas robust governance systems are linked to heightened supervision, enhanced accountability, improved disclosure, and increased transparency. These factors serve to limit conflicts of interest and diminish the prevalence of corruption, thereby mitigating agency problems.

As per the findings on the control variables, the age of the company has an influence that is both beneficial and substantial on the operating performance of the company, which is assessed by ROA and ROE. This shows that older companies have a tendency to outperform their younger counterparts (Coad et al., 2013). This is presumably because older companies have a longer track record (reputation), as well as greater access to finance. When it comes to a company’s operational performance, leverage has a negative impact, but it has a favorable impact on Tobin’s

Table 6. The impact of political connections, external monitoring on performance of firm

Model	1	2	3
Variable's	ROA	ROE	Tobin's Q
PC	-12.29*** (-34.57)	-27.43*** (-31.55)	-0.323*** (-15.54)
InstitutionalOwnership	0.0239 (1.00)	0.0748* (2.01)	-0.000374 (-0.26)
ForeignOwnership	0.0575** (2.14)	0.0727 (1.01)	0.00595*** (2.84)
Firm Age	9.510*** (2.99)	25.15*** (2.98)	-0.0676 (-0.26)
FamilyOwnership	-0.00301 (-0.18)	-0.0947*** (-2.47)	-0.00210** (-2.44)
FirmSize	-5.106*** (-3.42)	-5.191*** (-1.58)	-0.101 (-1.40)
Leverage	-9.581*** (-6.95)	-6.664*** (-2.47)	0.476*** (8.04)
Constant	55.35*** (3.79)	53.67** (1.56)	1.992** (2.40)
Observations	2,479	2,479	2,479
R ²	0.152	0.036	0.240
Year effects	Yes	Yes	Yes
Wald chi2	4962.83***	3586.10***	1121.31***

Note: Standard errors are clustered at the firm level, *** p < 0.01, ** p < 0.05, * p < 0.1

Q. Tobin's Q, a measure of market capitalization, reveals no influence of company size, despite a negative and statistically significant association between firm size and operating performance.

Table 7 further examines the incremental effects of connected CEO and chairman on the association between PC and firm performance. We insert PC_CEO and PC_Chairman dummy variables into the base regression. PC_CEO (PC_Chairman) is a dummy equal to one if the CEO (Chairman) is politically connected and zero otherwise. PC's coefficient values remain negative and statistically significant under this specification. The coefficient of PC_CEO is strongly negative in Columns 1 (ROA) and 2 (ROE), supporting the incremental value-destroying effects of connected CEOs to firm performance. This supports the argument that firms with political connections are more likely to engage in nepotism by appointing bureaucrats rather than directors with relevant professional backgrounds to their boards, lowering firm performance (Fan et al., 2007). These findings also agree with the findings of Menozzi et al. (2012), who revealed that politically connected directors had an adverse impact on the firm's performance. However, we do not find value in destroying the impact of a connected chairman (PC_Chairman). These findings are consistent with those of Eissa and Eliwa (2021), who suggested that connections based on top officers have an insignificant effect on a firm's profitability. This is also consistent with the findings of Berkman and Galpoththage (2016), who find no evidence that political connections increase firm value.

This section investigates the role of external monitoring as a moderator of the association between political connections (PC) and firm performance. To examine this relationship, we separately estimate the effects of PC, PC_CEO, and PC_Chairman on firm performance. The regression results are presented in Table 8. In Panel A, Columns 1–3, we observe that PC's negative and strongly significant coefficients persist under the expanded regression model. None of the other interaction terms are statistically significant, despite the fact that the interaction term of Foreign ownership*PC is positive and significant at the 10 percent level in Column 3 (Tobin's Q). This lends credence to the notion that the ownership structure has a limited influence on the extent to which agency concerns connected with political connections are mitigated or exacerbated. The positive and substantial PC*Foreign ownership interaction term suggests that the presence of foreign investors weakens the agency issues produced by political connections, supporting the positive monitoring functions of this class of investors. This supports the arguments that politically-connected firms and firms with significant foreign ownership performed better than locally-owned firms, which showed better investment by a firm (Rusmin et al., 2012). The above statement suggests that foreign investors have a responsibility beyond overseeing managerial operations. They are also expected to act as representatives for minority shareholders to safeguard their interests. This finding corroborates the assertion that political affiliations have the potential to augment corporate investment endeavors and amplify firm worth (Fisman, 2001). This interaction term shows that the involvement of foreign investors lowers the agency issues generated by political connections.

The results of Panel B demonstrate that the coefficients of PC_CEO continue to be negative and statistically significant in Column 1(ROA) and Column 2(ROE). In Column 1 (ROA), the only interaction term statistically different from zero is the PC_CEO * Family Ownership term, which has a positive value and is significant at the 10 percent level. Besides that, none of the other interaction terms have a statistically significant difference from zero. This hints that family ownership mitigates the detrimental effect of PC on a company's overall performance. This finding is inconsistent with past empirical research that finds powerful political parties to exploit the power accorded to them for the benefit of their family and close associates (Shleifer & Vishny, 1994), leading to the prediction of the negative and significant PC*Family ownership term.

Panel C shows the coefficients of PC_Chairman to be negative and statistically significant in Column 2 (ROE). This suggests the presence of a a connected Chairman is value destroying as in their CEO counterpart. This is, however mitigated by the presence of institutional investors where

Table 7. Types of political connections and performance of firm

Model	1	2	3
Variable's	ROA	ROE	Tobin's Q
PC	-12.37*** (-35.31)	-27.53*** (-32.29)	-0.324*** (-15.64)
PC_CEO	-2.378*** (-3.37)	-4.589** (-2.25)	-0.0201 (-0.46)
PC_Chairman	0.0145 (0.01)	1.188 (0.46)	-0.00321 (-0.07)
InstitutionalOwnership	0.0182 (0.78)	0.0614 (0.98)	-0.000416 (-0.29)
ForeignOwnership	0.0593** (2.18)	0.0746 (1.03)	0.00597*** (2.84)
FamilyOwnership	-0.00156 (-0.09)	-0.0943** (-2.38)	-0.00208** (-2.40)
Firm Age	8.943*** (3.00)	24.26*** (3.01)	-0.0730 (-0.28)
Firm Size	-5.064*** (-3.36)	-5.234 (-1.59)	-0.101 (-1.39)
Leverage	-9.477*** (-6.90)	-6.520** (-2.43)	0.477*** (8.03)
Constant	56.42*** (3.88)	56.33* (1.66)	1.999** (2.40)
Observations	2,479	2,479	2,479
R ²	0.147	0.049	0.270
Year effects	Yes	Yes	Yes
Prob > F	4785.52***	3316.80***	745.72***

Notes: Standard errors are clustered at the firm level, *** p < 0.01, ** p < 0.05, * p < 0.1.

the PC_Chairman * InstitutionalOwnership interaction term is positive and significant in Columns 2 (ROE) and 3 (Tobin's Q). The presence of institutional investors could have exposed connected firms to extensive scrutiny from the media, investors, and policymakers, thus mitigating This finding supports the assertion that institutional investors can monitor company management by efficiently providing to shareholders and monitoring tmonitoring. As a result of our findings, institutional investors are increasing their monitoring intensity on connected firms to agency difficulties, leading tleading. In addition, the PC_Chairman * Family Ownership interaction term is also positive and significant at the 5 percent level in Column 2 (ROE), implying these firm insiders' monitoring roles in reducing the negative effects of political connection. These findings support the hypothesis that family businesses are more likely to have longer investment horizons and are less likely to be affected by managerial myopia due to their concern for family reputation (Anderson et al., ; Ben-Amar & André, 2006; Ghosh & Tang, 2015; Maury, 2006). Family involvement in management and regular monitoring by family members may assist in aligning owners' (shareholders') and managers' incentives in a family enterprise (Shleifer & Vishny, 1986).

The results of the impact of PC on the performance of firms during election years and non-election years are presented in Table 9. Elections are known to increase the agency costs of political connections, as connected parties may use corporate resources to fund election campaigns. Research has shown that uncertainty during political elections can negatively affect a company's investment and lead to lower firm performance. Hence, election years are expected to intensify the

Table 8. Moderating effect of external monitoring on firm performance

Panel A: PC interaction			
Model	1	2	3
Variable's	ROA	ROE	Tobin's Q
PC	-12.32*** (-32.57)	-27.51*** (-30.00)	-0.332*** (-15.62)
PC* Institutional Ownership	0.0160 (0.26)	0.0450 (0.29)	0.00410 (1.07)
PC* Foreign Ownership	0.0434 (0.81)	0.0544 (0.41)	0.00749* (1.91)
PC* Family Ownership	0.0303 (0.82)	0.0676 (0.83)	0.00239 (1.19)
Constant	55.62*** (3.79)	54.03** (1.57)	2.016** (2.40)
Control	Yes	Yes	Yes
Observations	2,479	2,479	2,479
R ²	0.143	0.047	0.273
Year effects	Yes	Yes	Yes
Prob > F	1051.83***	5.69***	175.24***
Panel B: PC_CEO interaction			
PC_CEO	-3.295*** (-3.29)	-6.091* (-1.90)	-0.0560 (-0.87)
PC_CEO* Institutional Ownership	0.0461 (0.77)	0.0153 (0.08)	0.00201 (0.57)
PC_CEO * Foreign Ownership	-0.00247 (-0.05)	0.0171 (0.11)	0.00314 (0.67)
PC_CEO * Family Ownership	0.0333* (1.78)	0.0970 (1.46)	0.000651 (0.48)
Constant	47.07*** (3.23)	33.99 (1.00)	1.763** (2.13)
Control	Yes	Yes	Yes
Observations	2,479	2,479	2,479
R ²	0.143	0.046	0.269
Year effects	Yes	Yes	Yes
Prob > F	9.79***	4.71***	21.65 ***
Panel C: PC_Chairman interaction			
PC_Chairman	-1.616 (-1.30)	-6.160** (-2.01)	-0.0820 (-1.31)
PC_Chairman * InstitutionalOwnership	0.0472 (1.57)	0.254*** (3.05)	0.00302* (1.86)
PC_Chairman * ForeignOwnership	0.0336 (0.69)	0.218 (1.65)	0.00547 (1.38)

(Continued)

PC_Chairman * FamilyOwnership	0.0502 (1.45)	0.193** (2.26)	0.00119 (0.72)
Constant	45.87*** (3.12)	33.02 (0.98)	1.778** (2.14)
Control	Yes	Yes	Yes
Observations	2,479	2,479	2,479
R ²	0.140	0.053	0.272
Year effects	Yes	Yes	Yes
Prob > F	9.31 ***	5.01 ***	22.03 ***

Notes: Standard errors are clustered at the firm level, *** $p < 0.01$, ** $p < 0.05$, * $p < 0.1$.

harmful effects of political connections on the performance of firms (Amore & Corina, 2021; Pástor & Veronesi, 2012; Roe & Siegel, 2009).

We find support for the above contention where the size of coefficients of PC during election years is visibly higher value the non-election years across all the estimated performance equations. This suggests that agency issues are higher in election years than in non-election years, which is consistent with the findings of Harymawan et al. (2020). These negative effects of political uncertainty are more pronounced in nations with high corruption levels, low transparency levels, and significant state involvement in the economy (Ahmad et al., 2022). Turning to the ownership variables, we find foreign ownership to be negatively and significantly related to firm performance during election years but flip to positive during non-election years. This reinforces the political uncertainty during election years that muted the monitoring roles of foreign investors. Hence, the adverse outcomes of political uncertainty are visible during the election year and the year preceding the general elections (Boutchkova et al., 2012).

6.4. Additional analysis

6.4.1. Two-stage Heckman selection technique: effect of political connections and external monitoring on firm's performance in Pakistan

In order to take into account, the possible endogeneity problem, the regressions are re-estimated using the Heckman (1979) two-stage model in Table 10. The first stage of the procedure is the same for both models, which involves a probit estimation in which a dummy variable indicating the political connection (PC) in column 1 is regressed against the same independent variables used in Equation (1).

Furthermore, in the second-stage analysis, the variable PC in Equation (1) is replaced with the fitted value of political connections (inverse Mills ratio, k), obtained from the first-stage probit model, re-running the previous regressions separately. Results for the second stage of regressions are displayed in Table 9. Columns 2–4 show that the coefficients values of political connections (column 2, 12.76, $p < 0.1$; column 3, 0.306, $p < 0.01$, and Column 3, 27.82, $p < 0.01$) and military connections (column 2, 0.301, $p < 0.05$; column 4, 0.0341, $p < 0.1$) remain negative and significant in second stage regressions respectively. Therefore, the findings of second-stage regressions are consistent with the findings reported in Table 4. Importantly, the inverse Mills ratio (k) is insignificant for all models, suggesting that the self-selection bias is not a problem in our sample. According to Greene (2018), if the IMR is statistically insignificant, this suggests no endogeneity in the dataset. Furthermore, if the findings from the Heckman selection model are consistent with the results from the base regression, this provides additional evidence to support the absence of

Table 9. Elections years vs non-election years effect on political connections and firm performance

Model	1	2	3	4	5	6
	Elections Years	Non-Election Years	Elections Years	Non-Election Years	Elections Years	Non-Election Years
Variable's	ROA	ROA	ROE	ROE	Tobin's Q	Tobin's Q
PC	-18.48*** (-24.52)	-12.17*** (-32.39)	-38.76*** (-18.10)	-26.88*** (-29.26)	-0.598*** (-18.83)	-0.116*** (-5.44)
InstitutionalOwnership	0.00545 (0.11)	0.0351 (1.39)	-0.0515 (-0.31)	0.101* (1.67)	0.00137 (0.51)	-0.00102 (-0.67)
ForeignOwnership	-0.0391 (-0.97)	0.0834** (2.46)	-0.203* (-1.76)	0.145* (1.92)	0.000714 (0.23)	0.00730*** (3.13)
FamilyOwnership	0.0168 (0.68)	-0.00736 (-0.39)	-0.0377 (-0.54)	-0.115*** (-2.78)	-0.00119 (-0.73)	-0.00253*** (-2.75)
Constant	29.28 (1.07)	61.75*** (4.24)	-6.559 (-0.09)	62.76* (1.83)	1.051 (0.88)	1.982** (2.29)
Control	Yes	Yes	Yes	Yes	Yes	Yes
Observations	505	1,974	505	1,974	505	1,974
R ²	0.162	0.140	0.067	0.050	0.119	0.303
Year effects	Yes	Yes	Yes	Yes	Yes	Yes
Prob > F	384.84***	4331.26***	252.04***	3872.09***	66.81***	105.40***

Notes: Standard errors are clustered at the firm level, *** $p < 0.01$, ** $p < 0.05$, * $p < 0.1$.

endogeneity in the dataset. Hence, it may be concluded that an endogeneity problem does not distort our results.

6.4.2. System GMM estimation technique

To ensure the robustness of our results, we conducted a re-estimation of our main findings using the system GMM technique (Arellano & Bond, 1991), a commonly utilized estimation method in finance. The System Generalized Method of Moments (GMM) is widely regarded as a superior econometric technique because it effectively addresses issues related to unobservable heterogeneity, simultaneity, and dynamic endogeneity in the relationship between board structure and corporate outcomes. Using system GMM to address unobservable firm heterogeneity involves incorporating firm fixed effects and considering the influence of previous levels of political connections and control variables on their current values. This constitutes a significant element of a dynamic panel estimator.

In addition, theoretically, a company appoints a politically connected director to improve firm performance; however, the converse may also be true. One approach to address the issue of endogeneity arising from simultaneity is to employ a system of equations to gauge the impact of a connected director's appointment on a firm's performance. The process of estimating the system of equations necessitates using exogenous instruments, which can be generated by utilizing lagged values of the original regressors via system GMM. The system Generalized Method of Moments (GMM) approach considers the dynamic interplay between firm performance (or other financial decisions), political connections, and control variables. Consequently, the utilization of previous values and alterations of political connection and control variables is employed as instruments. The important assumption for the GMM technique is that the error term must not be serially correlated, which indicates the validity of instruments. For this purpose, we consider the Sargan test of over-identifying restrictions test and the second-order (AR-2) test. Table 11 shows that political connections continue

Table 10. Two-stage Heckman selection technique: Effect of political connections and external monitoring on firm's performance in Pakistan

Two-stage Estimation	First-stage regression results	Second-stage regression results	Second-stage regression results	Second-stage regression results
	(1)	(2)	(3)	(4)
VARIABLES	Political connections	ROA	Tobin's Q	ROE
PC		-12.76*** (0.351)	-0.306*** (0.0220)	-27.82*** (0.900)
Institutional Ownership	0.887*** (0.317)	3.219 (3.089)	-0.0467 (0.181)	9.367 (7.945)
Foreign Ownership	1.023*** (0.319)	7.459** (3.568)	0.567* (0.292)	10.57 (10.23)
Firm Age	0.565*** (0.115)	10.78*** (4.115)	-0.139 (0.326)	27.07** (10.79)
Family Ownership	-0.603*** (0.110)	-2.495 (2.697)	-0.177 (0.177)	-13.04* (7.798)
Firm Size	0.367*** (0.0465)	-1.297 (1.880)	-0.212 (0.131)	-1.013 (5.760)
Leverage	0.748*** (0.157)	-15.15*** (3.293)	0.432* (0.230)	-12.61 (8.428)
Inverse Mills Ratio		6.641 (8.628)	-0.0862 (0.557)	11.28 (22.67)
Constant	-3.990*** (0.511)	18.08 (24.65)	3.211* (1.803)	10.41 (75.33)
Observations	2,479	2,479	2,479	2,479
R-squared	0.0861	0.183	0.235	0.058
Year effects	Yes	Yes	Yes	Yes
Wald chi2	182.56 ***	16.10 ***	19.34 ***	5.42***

Notes: Robust standard errors in parentheses. ***, **, and * denote statistical significance at the 1%, 5%, and 10% levels, respectively.

to exert a negative and statistically significant effect on firm performance. In sum, it indicates that our main results are robust to the sophisticated estimation techniques.

7. Conclusion, implications, and future directions

This study investigates the influence of political connections and firm performance in Pakistan. 76.8% of our sample firms are political connections firms, of which 25.8% are connected through CEO and 33.1% are connected through the chairman. Panel regression analysis reveals a negative and significant impact of political connection on firm performance, which supports the arguments of agency theory. Further tests reveal that the negative relationship is driven by connected CEOs and during the periods when general elections were held in Pakistan. We find some evidence to support the monitoring roles played by external (foreign and institutional investors) and internal (family ownership) in mitigating the negative impact of political connections in the base results.

Our results further suggest that external monitors, such as foreign and institutional ownership, play a relatively limited role in mitigating political connections' negative impact on firm performance. Of the 27 tested PC*Ownership interaction terms, only five are statistically significant, with a positive sign suggesting the monitoring roles of foreign and institutional shareholders. The lower

Table 11. System GMM estimation technique

	(1)	(2)	(3)
VARIABLES	ROA	ROE	Tobin's Q
PC	-20.67*** (4.624)	-220.6** (101.4)	-0.715*** (0.155)
Institutional Ownership	-0.0240 (0.0533)	3.641* (3.285)	-0.000817 (0.00176)
Foreign Ownership	0.163*** (0.0607)	-1.768 (4.257)	0.00396** (0.00195)
Firm Age	7.973 (5.397)	431.1 (352.2)	-0.0692 (0.161)
Family Ownership	-0.0459 (0.0297)	-3.612* (1.964)	0.000680 (0.000981)
Firm Size	-0.766 (0.983)	-121.8* (63.96)	-0.0360 (0.0309)
Leverage	-17.37*** (2.684)	149.4 (182.0)	0.105 (0.0883)
Observations	2,222	2,222	2,222
Number of Firms	257	257	257
Sargan Test	0.17	0.13	0.24
AR 2	0.27	0.38	0.11
Wald test (P value)	0.0000	0.0000	0.0000

Notes: Robust standard errors in parentheses. ***, **, and * denote statistical significance at the 1%, 5%, and 10% levels, respectively.

shareholder activism by these external monitors may be due to their low ownership in Pakistani firms that muted their monitoring roles. To enhance the capital market, the Pakistani government should aim to increase the involvement of these categories of investors. Although we believe our results could apply to other developing nations with similar socio-economic circumstances as Pakistan, we defer the empirical investigation to future studies.

In summary, the results of this study indicate that political connections have an adverse effect on firm performance. Policymakers should therefore consider implementing more effective regulations to prevent potential conflicts of interest that may arise from such connections, especially in companies where the CEO has political ties, and particularly during election periods. The top management needs to make objective and unbiased business deals that maximize shareholders' value. Policymakers ought to design guidelines to monitor business dealing between firms and their politically connected insiders to minimize wealth expropriation of firms by the connected parties. For instance, regulations that mandate significant related party dealing (arise due to political connection, in particular) need to be immediate disclose to the stock exchange and subject to shareholders' approval irrespective of board of directors (BOD) approval, such as in Pakistan which needs the BOD approval.

Further, the study highlights the need to review the effectiveness and efficiency of corporate governance regulations. The outcomes of this study demonstrate that strengthening governance systems is critical for improving the judicial and equitable execution of laws and regulations. Finally, the study's findings have implications for the economy. Because politically connected enterprises account for a sizable sector of the economy, their poor performance has significant consequences for the economy. As a result, the study proposes that these politically connected enterprises be effectively monitored to improve their performance.

The paper has certain limitations that readers should bear in mind. The study includes only non-financial listed companies from Pakistan from 2010–2019. This was because financial companies have a different nature of business and separate regulatory supervision compared to non-financial companies. Politically connected firms are usually identified based on whether they have direct or indirect ties to politicians. In practice, direct political connections are relatively simple to observe, whereas indirect political connections are significantly more challenging to identify.

The analysis of this study could not discern the impact of political connectedness according to geographic regions. As prior research (Li et al., 2008) has shown, the effect of political connections depends on the institutional environment and regional development; the lack of access to institutional variables constrained us to pursue this research avenue. Nevertheless, investigating whether political connections are more important in regions with weaker markets and inefficient legal systems remains a fruitful avenue for further study. Future research may include private, non-publicly traded companies in the analysis. Future research may also investigate the relationship between political connections and stock performance. While this study found a negative correlation between political connections and organizational performance, future research may investigate the factors underlying this correlation. While this study has focused on a single country, i.e., Pakistan, future research may conduct a cross-country analysis that comprehensively examines the determinants of firm performance in other economies with a similar socio-economic and institutional environment.

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