

# Ethnic Diversity, Political Connection and Performance of the Company

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## Abstract

The objective of this research is to examine the relation of ethnic diversity and political connection towards firm performance. Our sample consist of listed firm in the Indonesian Stock Exchange for the year 2014-2016. We use multiple linear regression to prove our hypothesis. The results of this study shows that ethnic diversity has a negative relation towards firm performance. We also found that political connection is positively related to Firm performance. This result implies that to reach a higher firm performance, shareholder should maintain the ethnic diversity within their board. Furthermoere, hiring a politically connected person within the board is also a favorable choice for increasing the firm performance.

## Keywords

Ethnic Diversity, Political Connection, Firm Performance, Age firm, Size Firm, ROA.

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## Introduction

Recently, there has been growing research interest in understanding board diversity and board effectiveness. However, most of the previous studies focused on age and gender diversity (Felix & David, 2019; McGuinness, 2018), while the ethnicity of the council was rarely analyzed. Another issue of the developing board is its political affiliation. Politics is seen as an art of bargaining (Sanjaya, 2016). Previous literature shows that councils with political connections have a higher market share impact and lower tax rates than non-Political Connection (PCON) companies (Faccio et al., 2006; Number, 2019; Province, 2019; Saengchai et al., 2019). So this research will analyze the ethnic diversity and political connections in the board of Indonesian companies and their influence on the effectiveness of monitoring that can be monitored through company performance.

Ethnicity is a group of people because of similarities in race, religion, national origin, or a combination of these categories, which are bound to the cultural value system (Barth, 1969). In general, they can coexist well and benefit economically and socially. However, ethnic stereotypes still exist and develop in a society that is quite influential in the social relations of ethnic diversity in daily life. Having people from various cultures in the group leads to the idea of high quality, more effective and worthy than having people who are dominated by the same culture in the group (McLeod, Lobel & Cox 1996). The existence of a variety of information is considered to be able to improve the quality of information and provide many different choices in decision making (Carter et al, 2003; Westphal & Milton, 2000). On the other hand, the presence of ethnic diversity on the board increases the complexity of the interaction between directors and is feared to have a negative impact on their performance (Gul et al., 2016). So the influence of ethnic diversity on company performance is remain an open question. Firms that are said to have political connections are firms that have close relations with the government (Gomez and Jomo, 1997). The company, which has a close relationship with the government, has an exclusive business relationship with the government and has special access to every government policy (Gomez and Jomo, 1997). Goldman et al. (2009) show that politically connected boards are positively related to company performance. Previous research is in line with the theory of rent-seeking by Tullock (2006), where there is a political connection on the board that will facilitate company access in expanding corporate networks and be able to increase profits more. Based on this, we argue that strong political relations are a superior factor that can affect company performance. Therefore, we predict that there will be a relationship between political connections and company performance.

This study uses a sample of service sector companies listed on the Indonesia Stock Exchange. The number of samples in this study amounted to 383 observations from 140 different companies. Data were analyzed using multiple linear regression methods. From the results of this study, it was found that ethnic diversity has a non-linear relationship with the level of company performance. Whereas the existence of political connections shows a positive relationship to company performance. From the results of this study provide the implication that, hiring a politically connected person within the board is also a favorable choice for increasing the firm performance.

## Literature Review and Hypothesis Development

### Ethnic Diversity and Firm Performance

On the one hand, ethnic differences have a positive impact on the input of diverse perspectives and adding more complex sources of information. The existence of various ethnic groups within a group can lead to effective and high-quality ideas, compared to groups with people who are dominated by the same culture (McLeod, Lobel & Cox 1996). Unique information held by councils with diverse ethnicities will improve the quality of information (Carter et al. 2003). Westphal and Milton (2000) show that directors of minority groups can encourage different thoughts in the decision-making process. The existence of different views and information provides incentives to make decisions better and more precisely so that the presence of diverse ethnicities will improve company performance. On the other hand, the existence of ethnic diversity is considered capable of adversely affecting company performance. Ethnic differences can trigger different points of view that encourage differences of understanding. Gul et al. (2016) provide empirical evidence that ethnic diversity can be productive to a certain point when reaching the optimal point for increasing diversity will lead to the complexity of interactions within the board. The existence of diverse ethnicities can trigger the risk of empirical conflict within the group (Tsui et al.,

1992). Besides, a group with homogeneous members is considered to have better team engagement (Horwitz and Horwitz, 2007) and have smoother interactions (Tsui and O'Reilly, 1989). This characteristic is considered important to be able to solve problems in the group. So based on the description above the hypothesis of this study are:

### **H1: Ethnic diversity is related to firm performance**

#### **Political Connection and Firm Performance**

Companies can be said to have political connections when they have close relations with the government (Gomes and Jomo, 1997). Companies that have a close relationship with the government can be interpreted as a state-owned company, which is a company in the form of BUMN or BUMD. Meanwhile, owners who have a close relationship with the government are corporate conglomerates (owners) who are political figures, both serving in the government and political party members (Gomez and Jomo, 1997). Directors who have political connections provide a way for organizations to get special treatment (Cull and Xu, 2005; Faccio, 2006; Johnson and Mitton, 2003), allowing lighter taxes (De Soto, 1989) and preferential treatment in competition for government contracts (Goldman, Rocholl, and So, 2009), preferential access to credit (Khwaja and Mian, 2005) and obtaining concessions in various regulations (Faccio et al., 2006). In line with this, Hope et al. (2017) research show that politically connected companies have easy access to finance and get more flexible regulations.

Rent-seeking theory by Tullock (2006) has two approaches, an approach from a classical economic perspective and a political economy perspective. The traditional economic view, rent-seeking, is interpreted neutrally, or does not harm the economy or can have positive benefits and impacts. Rent-seeking is considered neutral because the income earned by individuals because they invest their capital or sell their services and energy. Meanwhile, from a political economy perspective, the statement is considered to have a negative impact, because the interest groups want to maximize profits or profit as much as possible by minimizing their efforts to achieve these benefits. Based on this theory, it shows two conflicting perspectives. From previous theory and research, this study will analyze the influence of the political connections of the board can be tested to find out more significantly, which positive or negative impact on company performance. Based on the description above, this research hypothesis is:

### **H2: Political connection is related to firm performance**

## **Methodology**

### **Data dan Sample**

This study uses a sample of service companies listed on the Indonesia Stock Exchange (IDX) for the period 2014-2016. Our initial sample consists of 140 service companies listed on the Exchange with a total observation of 420 samples. After reducing the missing variable, our final sample was 383 observational samples. Data from this study were obtained from annual reports accessed from the IDX website and the company's website.

### **Measurement of Firm Performance**

The dependent variable in this study is firm performance. Firm performance is measured using return of assets (ROA). Firm performance has been discussed widely in Indonesia (Widiyanti et al., 2019; Alam et al., 2019; Munizu et al., 2017; Akmal & Matondang, 2018; Sembiring et al., 2019). According to Lestari and Sugiharto (2007) ROA is a ratio that can be used to measure net profits derived from the use of assets. In other words, the higher this ratio, the better the productivity of assets in producing performance for the company. ROA in this study is the ratio of net income divided by total assets.

### **Measurement of Ethnic Diversity**

The first independent variable is ethnic diversity (ETHNIC). Board ethnic diversity consists of various

ethnicities, such as Malay, Indian, Chinese, and foreigners. Ethnic members of the board will be identified based on information presented in the profile section of the directors in the annual report. Our meriturement of ethnic diversity follows Lee et al (2013). Ethnic councils are identified based on their names and photos. The information is a good indicator of the council's ethnic group because the names and characteristics of the Malays, Indians, Arabs and Chinese are very distinctive. In addition, foreigners can be identified based on the citizenship information disclosed in the board of directors' profile section of the annual report. To be more reliable, researchers will find out the biography of the council through Google. Ethnic diversity is a proportion between the number of ethnicities and the number of board members.

### Measurement of Political Connection

The second independent variable is political connection (PCON). According to Primasari (2013), firms that have political connections are firms that have close relations with the government. Measurement of this variable uses a dummy variable. Score 1 is given to the companies that have political connections and 0 for companies that do not have political connections (Harymawan et al., 2009a; Harymawan et al., 2009b). The company will be identified as having a political connection when the company is an BUMN or BUMD registered with a political party or the owner of the company is a politician affiliated with a political party or the board of the company is serving or is a former official in the government.

## Methodology

To analyze the relationship between ethnic diversity and political connections, this study uses multiple linear regression techniques. The test was carried out using SPSS 20.0 software. The regression model used to test the hypothesis will be formulated as follows:  $ROA = a + \beta_1 \text{ ETHNIC} + \beta_2 \text{ PCON} + \beta_3 \text{ SIZE} + \beta_4 \text{ AGE} + e$  This research involves firm size and firm age as control variables. SIZE is measured using the natural logarithm of total assets. Harymawan et al (2017) shows that politically connected companies are big companies. The AGE variable shows the age of the company, i.e. how long the company has been operating since the company was founded. Over time, companies learn to get better and more efficient and have a competitive advantage in the core business and encourage organizational success and prosperity (Jovanovic, 1989). AGE is measured using the difference between the observation year and the company standing year. The level of trust ( $\alpha$ ) used in this study was 5% (0.05).

## Result

Table 1 shows the descriptive statistics of the sample. Based on Table 1, the average ROA varies from -0.1143 to 0.2488. Ethnic diversity has an average of 0.2765. For the AGE variable, it has an average value of 29.09 and a standard deviation of 19.499. Variable Size has an average value of 28.6723 and with a standard deviation of 1.6610 based. Table 2 shows the distribution of the sample with political connection variables. From 383 samples it was shown that there were 195 observations that had political connections and the rest did not have political connections. In the sample in this study, 50.9% had political connections.

### Descriptive Statistic

**Table 1**  
Descriptive Statistic

	N	Minimum	Maximum	Mean	Std. Deviation
ROA	383	-0,1143	0,2488	0,0390	0,0610
ETHNIC	383	0,0667	0,7500	0,2765	0,1074
AGE	383	2	157	29,09	19,499
SIZE	383	23,7648	32,8218	28,6723	1,6610

## Main Analysis

### Ethnic Diversity and Firm Performance (ROA)

Hypothesis 1 (one) states that ethnic diversity affects company performance. Table 3 shows that ETHNIC has a significance value of 0,000 and has a negative coefficient of 0.202. Thus hypothesis 1 (one) can be accepted. Ethnic diversity has a negative and statistically significant relationship to the level of company performance. These results indicate that diversity within the board can encourage the possibility of emotional conflict within the group for the presence of diverse ethnicities (Tsui et al., 1992). This will cause complexity in the interaction of the council council (Gul, 2016). The existence of bad discussion will cause problem solving in the group to be ineffective, and hence lowering the firm performance.

**Table 2.**

Political Connection Frequency

Categories		Percentage
Without Political Connection	188	49,1
With Political Connection	195	50,9
TOTAL	383	100,0

**Table 3**

Coefficient of Multiple Linear Regression Test Results

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
(Constant)	-0.094	0,058		-1,612	0,108
ETHNIC	-0.115	0,030	-0,202	-3,864	0,000
PCON	0,013	0,006	0,106	2,047	0,041
AGE	-3,3655	0,000	-0,011	-0,213	0,832
SIZE	0,006	0,002	0,151	2,802	0,005

### Political Connection and Firm Performance

Hypothesis 2 states that political connections affect company performance. The regression results in table 3 show that the PCON variable has a significant value of 0.041 with a positive coefficient of 0.106. Thus hypothesis 2 (two) can be accepted where PCON has a positive and statistically significant relationship to company performance. This is in line with previous research which states that the existence of political connections can provide a positive impact into the company through its ability to provide a way for organizations to get special treatment (Cull and Xu, 2005; Faccio, 2006; Johson and Mitton, 2003), allowing tax lighter (De Soto, 1989) preferential treatment in competition for government contracts (Dinc, 2004; Goldman, Rocholl, and So, 2009) In line with this, Hope et al (2017) research shows that politically connected companies have easy access financing and obtaining looser regulations, this makes companies with political connections able to have better performance.

## Conclusion

This study found that ethnic diversity was negatively related to company performance and political connections were positively related to company performance. These results indicate that the existence of ethnic diversity still makes a difference which then causes the complexity of interaction in the council (Gul, 2016). The existence of bad discussion will cause problem solving in the group to be ineffective, and hence lowering the firm performance. Whereas political connections show favorable results for companies. This result indicates that the network owned by the council with political connections can be utilized by companies to gain access to various resources and then improve their performance. These results indicate the existence of more value for the council that has political connections.

Limitations in this study are on the ethnic diversity and general political connections measurement. Future studies can analyze deeper about each ethnic diversity and its impact on the company. In addition, further research can classify existing political connections based on their affiliation with the government for later analysis of their relationship to performance within the company.

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