Do Strong Corporate Governance Firms Still Require Political Connection? And Vice Versa?

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Abstract

This study investigates whether a firm with strong corporate governance (CG) requires the establishment of political connections (PC). Namely, we examine whether CG and PC substitute for or complement each other. Using 71,069 individual bank loan contracts from Taiwan, we examine how the loan contracts are affected by CG, PC and both of them. Our results show that firms with strong CG focus less on building PC. Similarly, politically connected firms are likely to demonstrate poor governance practices. Also, favorable terms decrease when both PC and CG are simultaneously considered. All of these evidences supporting the substitution effect.

JEL: G21, G31, G32, G34

Keywords: corporate governance, political connection, bank loan contracts, substitutes, complements.

1. Introduction

The effects of corporate governance (CG) and political connection (PC) on the activities of banks and firms have recently attracted considerable attention. Previous studies commonly investigated these two concepts and their respective relation with business activities separately. However, with a few exceptions,[1] their joint influence have been rarely discussed given that both concepts play the role as insurer as well as share significant commonalities in affecting bank loan contracts and firms' value.[2] Considering that both CG and PC could yield favorable loan contracts; the interesting question is whether a firm with strong CG still requires PC to obtain even better terms. Namely, is CG or PC itself enough for a firm as an insurance against loan? Or are CG and PC substitutes or complementary?

Previous studies reported that firms with positive CG are granted favorable loan contracts, such as lower interest rates or longer maturity, given the presence of financial ratios. For example, Bhojaraj and Sengupta (2003) state that lower bond yields and higher credit ratings are associated with higher institutional ownership and a larger fraction of the board composed of non-officers. Anderson et al. (2004) conclude that the cost of debt is inversely related to board independence, and that fully independent audit committees are associated with a lower cost of debt financing. Bae and Goyal (2009) illustrate that banks charge lower spreads and offer longer maturities to firms in countries with better property rights. In addition, creditor rights influence the determination of loan spreads. Lin et al. (2011) note that the cost of borrowing is lower in firms with a narrower divergence between their control and cash flow rights.

[1] Those works study both concepts include Chaney et al. (2011) demonstrate that among firms, those with PC reported lower quality of earning information and financial statements. Similarly, Wahab et al. (2011) argue that PC does not alter the positive relationship between CG and audit fees.

[2] The influence of PC on firm values could be found in Fisman (2001), Faccio et al. (2006), and Goldman et al. (2008); that of CG could be found in Eisenberg et al. (1998) and La Porta et al. (2002).

Results are also typically positive on whether politically connected firms (PC-firms) are charged favorable loan contracts. Sapienza (2004) determine that government-owned banks charge lower interest rates in regions where the bank-affiliated party obtained a higher voting rate. Khwaja and Mian (2005) also examine the political influence on preferential treatment using data from Pakistan. They demonstrate that politically connected firms could obtain twice the loan amounts of non-connected firms, and have 50% higher default rates on their loans. Using campaign contribution data in the 1998 and 2002 elections from Brazil, Claessens et al. (2008) discover that contributing firms substantially increase their loan growth in comparison with non-contributing firms after each election.

This study investigates whether a firm with strong CG still requires PC to obtain even better terms? They may be substitutes if firms with both strong CG and PC are charged the same loan rates as those for firms with only one of the two attributes. Namely, firms with strong CG need not establish PC for loan purposes. The substitution view suggests that engaging in either activity is sufficient in obtaining favorable loans. As substitutes, the benefits offered by one activity are similar or reduced when the other is considered. Hence, well-governed firms do not gain better terms by building PCs, which in some cases, could even produce a negative effect. By contrast, the two concepts may be complementary if banks charge lower rates to firms with both strong CG and PC than those with only one of the two. In this situation, firms would benefit from pursuing both CG and PC. The complementary view suggests that one activity enhances the effect of the other if they are simultaneously considered. For example, well-governed firms with PCs could obtain better loan terms than those without such connections.

We require detailed individual loan contracts and information of CG and PC to investigate this issue. This high data requirement is one of the reasons for selecting Taiwanese firms as our sample. Taiwan provides unique and reliable loan transaction data, because the

Financial Supervisory Commission (official authority) requires all listed firms to provide worksheets on loan contracts with annual official financial reports. We collect these worksheets as basis for a comprehensive analysis on bank loan contracts from all listed companies, and therefore avoid the possible sample selection bias encountered in previous studies.[3] While our study is Taiwan-specific, the result could provide a reference for other countries whose corporate finances similarly depend on banking systems. We further obtained CG data from the Taiwan Economic Journal (TEJ), the economic data bank providing detailed corporate information on ownership and board structures in Taiwan. Following the methods suggested in literature (Faccio, 2006; Faccio et al., 2006; Fan et al., 2007), we collect data on PC through the information provided by corporate websites and news.

The contribution of this study is twofold. First, we add to the increasing literature on CG and PC, given that earlier studies focus only on the individual concepts. Our approach is similar to the studies of Qi, Roth, and Wald (2010), Becher and Frye (2011), as well as Bliss and Gul (2012a). However, our discussion focuses more on the interaction of CG and PC when banks provide benefits in making loans. PC and CG are costly, and thus firms choose only one of the two. Alternatively, this study may relate to the perception of bankers on the "contributions" of CG or PC when processing loans. Second, our results have strong policy implications. Better CG is associated with lower costs of debt, but these benefits are similar to those of politically connected firms. Hence, this explains why firms with strong CG do not require PCs. Therefore, in a country where CG is emphasized, the influence of PC on the loan contract may be insignificant. Accordingly, governments could minimize political influence by strengthening CG.

The remainder of this paper is organized as follows. Section 2 illustrates our hypothesis development. Section 3 discusses the measures of CG versus PC. Section 4 presents empirical

[3] In prior studies, most bank loan data come from specific banks or bank loan structures during specific periods.

models and data statistics. Section 5 provides empirical results and robustness checks. Section 6 concludes the paper.

2. Hypothesis Development

2.1 Substitution or Complementary Concepts

Though no study directly investigates how CG and PC are substitutes or complementary, most investigate the similar concepts between the micro CG and the macro regulations. Bruno and Claessens (2010) argue that companies with positive governance practices operating in stringent legal environments gain a valuation discount relative to similar companies operating in flexible legal environments. Thus, the study suggests that CG and regulations are substitutes. Qi, Roth, and Wald (2010) explore the substitution relationship between political rights (from Freedom House) and creditor rights in bond issuing prices. Using data from the initial public offerings of regulated firms, Becher and Frye (2011) suggest that regulation and governance are complementary. They discover that regulators pressure firms to adopt effective monitoring structures. The results vary in that firms in a country with strict regulations may have either strong or weak CG. However, the above studies do not discuss the link between CG and PC.

We first discuss the two concepts of CG and PC as possible substitutes. CG stresses that although laws and regulations attempt to minimize agency problems between shareholders and managers, between shareholders and bondholders, or between large and small shareholders, these regulations have limitations and ambiguity, which could be complemented by focusing on CG. A firm with strong CG does not expropriate and will care for the benefits of small shareholders. Using the bank loan market to illustrate this substitution effect, a firm with strong CG may obtain favorable loan contracts with their positive reputation, and needs no connections with the government. On the other hand, PC is also valuable for firms, as politicians tend to explicitly or implicitly favor their supporters (Shleifer and Vishny, 1994).

For example, compared with a non-PC firm, a PC firm would more likely obtain preferential access to debt financing (Khwaja and Mian, 2005), a facilitated initial public offering (Fan et al., 2007), and government bailout when in financial distress (Faccio et al., 2006). PCs facilitate the acquisition of additional benefits from government authorities, commonly called *cronyism*, instead of following hard market criteria. Thus, political rents are provided to firms of friends and relatives. Chaney et al. (2011) found that the accounting information reported by politically connected firms is of significantly poorer quality compared with those of similar non-connected firms. This finding implies that investing in both CG and PC is costly; hence, a firm can either develop its CG or build its PC. Accordingly, the two concepts may act as substitutes for each other in the loan market.

CG and PC may become complementary when the emphases focus of market players differs. Companies with strong CG often obtain favorable loan contracts and possess higher stock returns. By contrast, companies with strong PC receive the explicit or implicit help from the government. For example, PC-firms may learn of future government projects before these are even announced. In addition, government officers have the power to appoint or approve the CEOs of government-owned banks, or even become these banks' CEOs when they retire (See Khwaja and Mian, 2005); thus, a firm with PCs may also obtain preferable loan contracts than those without. Accordingly, companies may strengthen both their CG and PC to ensure smooth business operations in both private and public sectors. Although engaging in both CG and PC is costly as well as possibly cause overlapping functions to a certain extent, conducting both increases the opportunity for a successful business. That is, firms are usually willing to strengthen CG to increase their value, and building PCs may be one of the considerations. Hence, to obtain a favorable loan contract, firms use both CG and PC, making the two concepts complementary.

2.2 Debt Financing

Private debt financing has become a dominant source of external funding worldwide (Graham et al., 2008; Chava et al., 2009). In 2005, the total amount of new capital raised in the syndicated loan market for US enterprises was USD 1,500 billion, and the corporate bond issuance amounted to approximately USD 700 billion (Bharath et al., 2008). Similarly, for emerging countries characterized by bank-based financial systems, the transaction volumes of bank loan contracts are usually larger than those of equity and bond financing (Beck et al., 1999). Given the worldwide economic significance of bank loan markets, studies increasingly investigate the determinants of bank loan contracting from different viewpoints, such as borrower reputation (Sufi, 2007), borrower risk (Strahan, 1999), bank revolving credit agreements (Dennis et al., 2000), asset liquidation value (Benmelech et al., 2005), differences in law or institutions (Qian and Strahan, 2007; Bae and Goyal, 2009; Haselmann et al., 2010), and role of borrower accounting quality (Bharath et al., 2008).

2.3 Three Hypotheses

We address the question whether strong CG firms still require PC by first examining the separate effects of CG and PC on the bank loan terms, and then verify the interaction of these two concepts in determining loan contracts. Good governance practices bring about favorable bank loan terms by reducing the agency and information risks. Governance mechanisms alleviate agency problems and improve corporate disclosures.[4] Consequently, such practices likely favor the interests of creditors rather than those of shareholders. For example, Bhojaraj and Sengupta (2003) determine that a higher institutional ownership and a larger fraction of the board composed of non-officers are associated with lower bond yields and higher credit

[4] Weisbach (1988) suggests that firms with independent boards are more likely to remove poorly performing CEOs. Beasley (1996) reports that the probability of financial statement fraud is lower in firms with independent boards. Moreover, Stecher and Gronnevet (2009) argue in their theoretical study that the information disadvantage of outside board members cause these officers to focus more on the probability of default, but not on the expected project payoffs.

ratings. These findings are attributed to the reduction in the agency and information risks of the borrowers, caused by well-functioning governance mechanisms, thereby reducing the cost of debt. Lin et al. (2011) conclude that the cost of borrowing is higher in firms with wider divergence between the control and cash flow rights of the owner. Therefore, when making lending-related decisions, banks associate governance mechanisms with moral hazard activities. Hence, if improved governance mechanics lead to reduced agency costs, then we could expect more favorable contracting terms for better-governed borrowers.

Hypothesis 1a: Better-governed firms could obtain preferential treatments in bank loan prices.

Most literature report that politically connected firms are more likely to obtain preferential access to debt financing relative to non-connected firms. For example, Khwaja and Mian (2005) examine the effect of political influence on preferential treatment using data from Pakistan from 1996 to 2002. Compared with non-connected firms, politically connected firms could obtain twice the loan amounts and have 50% higher default rates on their loans. Sapienza (2004) explain that government-owned banks charge lower interest rates in regions where the bank-affiliated party obtained a higher voting rate. Using campaign contribution data from Brazil, Claessens et al. (2008) indicate that contributing firms substantially increase their loan growth relative to a control group after each election.[5] However, Bliss and Gul (2012a) obtain opposing results, indicating that politically connected firms in Malaysia are charged with higher interest rates than non-connected firms. Hence, most politically connected firms acquire favorable loan contracts. The hypothesis is formalized as follows:

Hypothesis 1b: Firms with stronger PCs could similarly obtain preferential treatments in bank loan prices.

[5] Li et al. (2008) and numerous other studies have shown that PCs enhance the preferential treatment granted to bank loan borrowers. Moreover, Shen and Lin (2012) considered the turnover of bank executives during election years as the political interference proxy in their investigation on the performance of government-owned banks.

After investigating whether well-governed firms acquire loans with better contract terms, we examine the correlation between CG and PC. Chaney et al. (2011) state that among politically connected firms, those with stronger political ties have the poorest accruals quality. The study suggests that managers of connected firms seem less sensitive to market pressures to increase their earning information quality. Hence, politically connected firms may be poorly governed, indicating that PC could substitute for CG when a firm is interested in obtaining benefits.

Hypothesis 2: The substitution view suggests politically connected firms have poorer governance, whereas the complementary view suggests that they have better governance.

We next analyze whether CG and PC are substitutes or complements in determining bank loan contracting. Being complementary means that one product could enhance the function of another. Hence, if CG and PC are complements, then firms incorporating both concepts would enjoy greater benefits in loan terms compared with those engaged in only one. Moreover, well-governed firms with PC would gain greater benefits compared with those without connections. On the other hand, substitution means that adding another feature while maintaining the original would not significantly improve and may even reduce the favorable effect. Hence, our substitutes consist of neutral and negative influences. Well-governed firms with PC could obtain loan terms similar or worse than those granted to firms without connections. This hypothesis is formalized as follows.

Hypothesis 3: The substitution view suggests that compared with considering only one concept, considering both PC and CG would not significantly reduce bank loan prices. The complementary view suggests that considering not only one but both concepts increases the loan term benefits.

3. Measures of CG versus PC

In this section, we introduce the proxies for CG and PC in our study. The selection of governance variables follows prior studies on CG in Asia and Taiwan (Claessens et al., 2000; Fan and Wong, 2002; Lee and Yeh, 2004; Yeh and Woidtke, 2005; Yeh et al., 2008) to ensure the sufficient reflection of CG practices in Taiwan. Moreover, the construction of PC is similar to that in Fisman (2001).

3.1. CG Measures

Given that CG has no universally accepted measures, we follow literature in examining different CG measures to ensure that our results are not biased to one specific CG. We consider the following four proxies for CG: deviation of cash flow rights from voting rights; shares pledged to total shareholdings in banks by the board of directors; board duality; and board independence. These four variables are described below.

Our first proxy for CG is the deviation of cash flow from voting rights (Deviation), which is defined as the difference between the values of voting right and cash flow right.[6] Deviation represents the extent to which the controlling shareholder may expropriate minority shareholders. Concentrated ownerships may lead to another type of agency conflict problem: when large shareholders enjoy the power over designating and monitoring managers, they may become entrenched and pursue personal interests by expropriating minority shareholders. Therefore, we proxy this expropriating effect with Deviation variables. Fan and Wong (2002) emphasize that the separation of voting from cash flow rights provides controlling shareholders with both the means and the incentive to engage in self-beneficial actions. A more severe expropriation effect is expected when the separation ratio is high. Lin et al. (2011)

[6] Voting rights is also called "control rights," which measures the ratio of voting rights under the controlling shareholder's control through the direct or indirect shareholdings to total voting rights. The calculation follows those of La Porta et al. (1999), Claessens et al. (2000), Yeh and Woidtke (2005), as well as Yeh et al. (2008). Cash flow rights is the controlling shareholder's percentage ownership of the profits/losses and dividends of a firm.

also determine that the cost of borrowing is lower in firms with a narrower divergence between the control and cash flow rights.

The second proxy for CG is share pledge (S_Pledge), which is defined as the ratio of shares pledged (stocks collateralized)[7] to total shareholdings in banks by the board of directors. Share pledging creates moral hazard problems. A high pledge ratio may reduce the board of directors' incentive to make efficient corporate decisions because most shares are already cashed out. Thus, the board of directors has not much to lose in case of bankruptcy. Lee and Yeh (2004) determine an empirical negative relationship between this ratio and firm performance.[8]

Third, the board duality (B_Duality) is used and given a value of one if the CEO is also the chairman of the board of directors; otherwise, the value is zero. Several studies assessed the board's monitoring ability and incentive by board duality. Dayton (1984) argues that board duality reduces the monitoring efficiency of the directors because of the excessive power of one person. Similarly, Jensen (1993) suggests that in the duality structure, the CEO could control the information available to other board members. Moreover, Shivdasani and Yermack (1999) report that duality further entrenches managers and increases the tendency to manipulate firm profit.

Finally, we consider board independence (B_Indep), which takes a value of one if firms have an independent member in their board, and zero otherwise. Board independence is usually considered as the most important board quality in related literature. Prior empirical studies also indicated that outside-dominated boards improve the decision-making efficiency of a firm. For example, outside-dominated boards are more likely to replace CEOs in response to poor performance (Weisbach, 1988) and to alleviate CEO over-compensation (Core et al.,

[7] Taiwanese law requires directors of listed firms to disclose their stocks collateralized in banks.
[8] Chen and Kao (2011) also discover that the value attributes of collateralized stocks reduce bank efficiency but increase bank profit.

1999). Moreover, Bhojraj and Sengupta (2003) and Anderson et al. (2004) demonstrate that board independence is negatively related to the cost of public debt.

We describe our empirical results by classifying the four CG measures into negative and positive and CGs, for simplicity. The first three CG measures of Deviation, S_Pledge, and B_Duality are referred to as the negative CG; hence, their larger values indicate poorer governance. By contrast, B_Indep is referred to as the positive CG, with larger measures indicating better governance.

3.2 PC Measures

Similar to CG, PC has no widely accepted operational definition. For example, Faccio (2006) consider firms to be politically connected when their executives are politicians. Fisman (2001) defines the strength of PC in Indonesia in terms of the closeness with Suharto and his family.

Our definition of PC includes those used in literature but accommodates Taiwan's special political environment. Literature typically uses the connection of top managers or board directors to political offices.[9] In Taiwan, many CEOs publicly support presidential candidates on TV and newspapers, or voluntarily support elections. These activities are crucial because elections are highly competitive, and most politicians dichotomize the CEOs into supporters and non-supporters based on such activities. Supporters are either explicitly rewarded, such as by promotion of their CEOs to high-ranking offices in the government, or implicitly rewarded through policy support. Thus, an additional proxy for PC is created, namely, the political party tendency, which involves not only the commonly used PC but also their revealed behavior.

Our PC involves two measures. First is the political party tendency, which apart from the

[9] For example, Khwaja and Mian (2005), Faccio (2006), Faccio et al. (2006), Fan et al. (2007), Goldman et al. (2009), and Francis et al. (2009).

above rewards, includes top managers who served as central committee members of the two political parties, namely, the Kuomintang Party and the Democratic Progressive Party. The second measure is political appointment, which suggests that top managers were either appointed as government officials or served as CEOs, general managers, or board directors in government-owned enterprises from 1997 to 2009. The background of all top managers in each listed firm was traced to identify their previous and present connections with the government.

After defining the two political measures, the PC dummy, $D_{PC,}$ is created. This dummy variable is equal to one if top managers are qualified through one of the above two PC measures, and equal to zero otherwise. Firms with and without PCs are hereafter referred to as PC- and non-PC-firms, respectively. PC is assumed stable during our sample period because most public firms in Taiwan are owned by families, who tend to form lasting relationships with politicians.

4. Empirical Model and Data Statistics

4.1 Empirical Model

4.1.1 Hypothesis 1: Influence of CG or PC on Loan Contract

We examine the three hypotheses sequentially. Equation (1) examines the first hypothesis. Explanatory variables are selected based on the suggestions of Graham et al. (2008).

$$\begin{aligned} \text{Spread}_{it} = \beta_0 + \beta_1\, CG_{,it}\ (\text{or } D_{PC,it}) + \alpha\ \mathbf{Firm}_{it} + \gamma\ \mathbf{Loan}_{it} \\ + \text{Year, Industry and Bank dummies} + \varepsilon_{it} \end{aligned} \tag{1}$$

Where, subscripts *i* and *t* denote the *i*th contract at time *t*; the dependent variable is interest rate (spread). The Spread is the interest rate that a borrower pays in basis points over a risk-free rate.

The explanatory variables and vectors are explained as follows. *CG* denotes corporate governance. We use the four CG proxies of Deviation, S_Pledge, B_Duality, and B_Indep. D_{PC} denotes the PC of the firms. The explanatory vector **Firm** denotes the vector of six firm characteristic variables, namely, LnAsset, Leverage, Tobin's q (*Q*), Tangibility, Profitability, and Z-score: LnAsset is the log of total firm assets; Leverage is the ratio of long-term debt plus debt in current liabilities to total assets; *Q* is the ratio of the market value of equity plus book value of debt to total assets; Tangibility is the ratio of net property, plant, and equipment to total assets; Profitability is the ratio of EBITDA to total assets; and Z-score is the modified Altman's (1968) Z-score.[10] All firm characteristic variables are estimated one year prior to the loan initiated year. Moreover, **Loan** denotes the vector of two loan characteristic variables: LoanSize, which is the natural logarithm of loan sizes (amounts); and Maturity, the natural logarithm of the loan period. Finally, the dummies of years, industries, and banks are considered in the equation to control the fixed effects of year, industry, and bank, respectively.[11] We use White's (1980) heteroskedasticity consistent standard errors and Petersen's (2009) approach to adjust heteroskedasticity and clustering at the firm level. See Table 1 for the definition of each variable.

[Insert Table 1]

Hypothesis 1 suggests that firms with strong CG or PC should obtain preferential loan contracts. Hence, CG and PC should gain beneficiary effects on loan contract. The coefficient β_1 (coefficient of CG) should be positive when the negative CG proxies (i.e., Deviation, S_Pledge, and B_Duality) are used, and negative when the positive CG proxy (i.e., B_Indep) is used. Moreover, the coefficient β_1 should be negative when PC (i.e., D_{PC}) is used. Hence, a better CG- or PC-firm would likely have lower bank loan prices.

[10] The modified Z-score equals (1.2Working capital + 1.4Retained earnings + 3.3EBIT + .999Sales)/Total assets.
[11] Throughout the paper, year effect, industry effect, and bank effect indicate the fix effects of year, industry, and bank, respectively.

4.1.2 Hypothesis 2: Substitution or Complementary (Direct Test)

We examine Hypothesis 2: A firm with a strong CG does not require PC. The dependent variable is CG (which has four proxies). Our model is as follows.

$$CG_{it} = \beta_0 + \beta_2 \, \mathrm{D}_{\mathrm{PC},it} + \alpha \, \mathbf{Firm}_{it} + \text{Year and Firm dummies} + \varepsilon_{it} \tag{2}$$

The hypothesis focuses on the D_{PC} coefficient. This equation does not examine the cause-and-effect between CG and PC, but rather their association in the presence of control variables. We also use Heckman's two-step method to consider the endogeneity of D_{PC} by adding inverse Mills ratio in the robust section. However, the results remain similar. Accordingly, we expect the coefficient β_2 to be positive when the negative CG proxies (i.e., Deviation, S_Pledge, and B_Duality) are used, and to be negative when the positive CG proxy (i.e., B_Indep) is used. Therefore, a strong CG-firm has no or little PCs.

4.1.3 Hypothesis 3: Substitution and Complementary Views (Indirect Test)

Qi et al. (2010), Bruno and Claessens (2010), as well as Becher and Frye (2011) use the interaction term to decide the substitution and complementary relationships. Accordingly, we also examine the interaction between CG and PC to determine their influence on each other.

$$\begin{aligned} \mathrm{Spread}_{it} = {} & \beta_0 + \beta_1 \, \mathrm{CG}_{it} + \alpha \, \mathbf{Firm}_{it} + \gamma \, \mathbf{Loan}_{it} \\ & + \text{Year, Industry and Bank dummies} + \varepsilon_{it} \ , \\ \beta_1 = {} & \beta_2 + \beta_3 \, \mathrm{D}_{\mathrm{PC},it} \end{aligned} \tag{3}$$

Hence, Equation (3) is the extended model of Equation (1) with the additional interaction between CG and PC. Qi et al. (2010) similarly use the interaction term to determine the substitution or complementary relationship. They identify substitution between political and creditor rights in bond-issuing prices. If the substitution effect holds, banks consider only CG

(PC) for the beneficiary loan contract. Thus, the additional variable of PC (CG) provides little help in obtaining further beneficiaries. The substitution view suggests that coefficients β_2 and β_3 have opposite signs. For instance, β_2 and β_3 are positive and negative, respectively, when negative CG proxies (i.e., Deviation, S_Pledge, and B_Duality) are used, whereas β_2 and β_3 are negative and positive, respectively, when the positive CG proxy (i.e., B_Indep) is used. The complementary view suggests the same directions of β_2 and β_3, whereas the sign of β_2 remains as aforementioned.

4.2 Data Sources of Bank Loan Contracts

We consider the firms listed in the Taiwan Stock Exchange Corporation, excluding the financial institutions. Eliminating data without the beginning and expiration dates of bank loans produce a final sample that contains 8,774 firm-year observations with 758 individual firms involved in 71,069 bank loan contracts. In Taiwan, listed firms are required by law to record all bank loan contracts in their yearly financial reports. These loan-level data contain detailed information, including the amount, period (i.e., beginning and expiration times), interest rate, and type (i.e., fixed or floating and syndicated or single) for each corporate loan contract granted within 1997–2009. We gather these data from the TEJ bank loan database. Financial and CG variables are also collected from the TEJ. As mentioned in Section 3, PC is collected from various media, websites, and other sources. Especially, the numbers of PC- and non-PC-firms are 131 (17.28%) and 627 (82.72%) in our sample, respectively.

4.3 Basic Statistics

Table 2 presents the descriptive statistics of bank loan contracts (Panel A), CG (Panel B), PC (Panel C), and exogenous variables (Panel D). In Panel A, on average, Spread is low at approximately 2.45% with a standard deviation of 2.15, LoanSize is approximately 5.77, and maturity is approximately 7.82 years. In Panel B, on average, board members hold

approximately 24.4% of the total shares of a company; Deviation is approximately 5.58%. The CEO, who is also the chairman of the board, accounts for 27% of total companies, whereas 14% of the board members are independent directors. These numbers are consistent with previous studies that examined the governance practices in Taiwan. In Panel C, politically connected firms account for 30% of the bank loan sample. Panel D summarizes the statistics for the following control variables: LnAsset, Leverage, Tobin's q (Q), Tangibility, Profitability, and Z-score.

[Insert Table 2]

Table 3 presents the correlation coefficient matrix of the variables. Results indicate that the correlations among all variables are below 0.537, eliminating the issue of multicollinearity. Specifically, Table 3 reveals a significantly negative correlation between Spread and PC as well as between Spread and CG, suggesting that firms with strong governance practices or PC could acquire a lower bank loan price.

[Insert Table 3]

5. Estimation Results

5.1 H1: CG and PC in Bank Loan Contracts

Table 4 presents the estimated results on the effect of CG and PC on loan contracts. The first specification (column 1) controls the characteristics of borrowing firms as well as the year, industry, and bank fixed effects. The second specification (column 2) includes the controls of loan characteristics. Our results demonstrate that firms with strong CG obtain better loan contracts after controlling the firm and loan characteristics as well as the year, industry, and bank fixed effects.

First, we discuss the case where CG is proxied by negative CG proxies (i.e., Deviation,

S_Pledge, and B_Duality). The coefficients of Deviation, S_Pledge, and B_Duality in the second specification are 0.006, 0.007, and 0.186, respectively, which are all significant. A larger Deviation implies a higher likelihood of engagement in morally hazardous activities by the controlling shareholders. A higher pledge ratio may reduce the incentive of the board of directors to make efficient corporate decisions because most of the shares are already cashed out, and thus they would have little to lose in case of bankruptcy. Similarly, firms with B_Duality suggest that the dual role of the CEO may hamper the effectiveness of the board. Therefore, these three negative CG proxies are positively associated with Spread.

We then discuss the case when CG is proxied by a positive CG (i.e., B_Indep). When Spread is the dependent variable, the coefficients of B_Indep in the two specifications are -0.246 and -0.235, respectively, both of which are significant. The negative signs indicate that independent directors on the board strengthen the firm governance. Thus, banks charge these firms with lower rates.

In summary, the results support our hypothesis (H1a) that better-governed firms could obtain preferential treatment in bank loan prices.

[Insert Table 4]

Table 5 examines the effect of PC on bank loan contracts, which is proven to be similarly significant. The D_{PC} coefficients in specifications 1 and 2 are -0.212 and -0.184, respectively, both of which are significant. Thus, PC-firms obtain lower rates than non-PC-firms, supporting our hypothesis (H1b) that firms with better connections in politics could obtain lower bank loan prices.

The coefficients of control variables in Tables 4 and 5, such as firm and loan characteristics, exhibit similar patterns that are consistent with our expectations and to those in previous discussions (Lee and Yeh, 2004; Yeh and Woidtke, 2005; and Yeh et al., 2008). For

example, lower prices were charged to firms with larger sizes, lower leverage, higher profitability, higher Q, and higher Z-scores. Moreover, larger amounts and longer periods of loans are associated with higher loan prices.

[Insert Table 5]

5.2 H2: Substitution or Complementary (Direct Test)

In this section, we examine the association between CG and PC using a direct test.

Table 6 presents the cross distributions of PC- and CG-firms to examine whether PC-firms are related to poor CG. We first define better CG-firms as those with lower Deviation, lower S_Pledge, B_Indep, and without B_Duality, whereas worse CG-firms are the opposite. For the first two CG proxies, we employ a sample median as the cutoff to classify firms as a high or low CG, whereas we employ dummies to classify firms as high and low ones for the latter two CG proxies. The results are interesting in that PC-firms tend to be poor CG-firms except for the measure of B_Duality. The percentages of PC-firms, which also exhibit poor CG, are 23.77%, 26.69%, 17.04%, and 26.78% for the four CG proxies, respectively. By contrast, the percentages of PC-firms, which also exhibit better CG, are much lower at 19.35%, 16.43%, 23.32%, and 15.01%, respectively. Thus, except for the B_Duality measure, the results suggest that PC-firms are prone to having poor CG.

[Insert Table 6]

Table 7 reports the basic statistics of the four CG proxies between PC- and non-PC-firms (Panel A) and the corresponding characteristic variables (Panel B). Panel A compares the distribution of the four CG proxies within PC- and non-PC-firms, which have significantly different results. With respect to negative CG proxies, PC-firms exhibit higher Deviation and higher S_Pledge, and thus poor CG, relative to those of non-PC-firms. Hence, the incentive for

controlling shareholders of PC-firms to entrench minority shareholders is higher than that of non-PC-firms. In addition, controlling shareholders of PC-firms with higher share pledge ratios may reduce the efficiency of corporate decisions because most of the shares are already cashed out.

Regarding the positive CG proxy, PC-firms exhibit lower B_Indep than non-PC-firms, and thus, PC-firms have poor CG in terms of board independence. This finding suggests that PC-firms employ fewer independent-dominated boards to improve the decision-making efficiency of the firm.

Overall, except for the B_Duality measure, PC-firms have poor CG. Thus, PC and CG tend to be substitutes, which modestly support H2.

Panel B of Table 7 indicates that PC-firms have larger sizes, consistent with previous findings in PC literature. Compared with non-PC-firms, PC-firms have higher leverage, lower Tobin's q, lower tangibility, lower profitability, and lower Z-Score. However, the substitution relationship may be affected by the missing third variable problem. We therefore conduct a regression analysis below.

[Insert Table 7]

Table 8 presents the regression results of Equation (2). First, when negative CG proxies (Deviation, S_Pledge, and B_Duality) are used as the dependent variables, the D_{PC} coefficients in three equations are 3.630, 36.217, and 0.759, respectively, which are all significant. Hence, PC-firms have higher divergence between voting and cash flow rights, higher share pledge ratio, and a greater tendency to feature the duality role of the CEO after controlling the firm and loan characteristics as well as year and firm fixed effects. Next, when the positive CG proxy (B_Indep) is used as the dependent variable, the D_{PC} coefficient is significantly negative at -0.849, indicating that PC-firms have fewer independent directors on

board than in non-PC-firms.

Thus, the results in Table 8 support H2, which proposes that politically connected firms are poorly governed (i.e., substitution view). The results are slightly different from those using basic statistics (Table 7), where PC-firms are determined to have low B_Duality. When regression analysis is adopted, the sign and the significance of coefficients indicate that the substitution holds regardless of the CG measures.

[Insert Table 8]

5.3 Testing H3: Substitution or Complementary (Test through Bank Loan Contract)

Following Qi, Roth, and Wald (2010), Bruno and Claessens (2010), as well as Becher and Frye (2011), this section examines H3 using the interaction term.

Table 9 adopts the estimated results using Equation (3), where Spread is the dependent variable. Our concerned variable is the interaction term between CG and D_{PC} (i.e., CG×D_{PC}). The four CG measures are used in turn in each specification. First, the CG proxy coefficients still indicate the expected signs as reported in Table 4 even in the presence of the interaction terms. The coefficients of Deviation, S_Pledge, B_Duality, and B_Indep are 0.002, 0.008, 0.260, and -0.015, respectively. The coefficients of the negative CG proxies remain positive, whereas those of the positive CG proxies are negative.

Furthermore, the results are striking because the coefficients of CG×D_{PC} again fully support the substitution view. The interaction terms between D_{PC} and negative CG proxies exhibit consistent negative impacts on Spread. That is, the coefficients of Deviation×D_{PC}, S_Pledge×D_{PC}, and B_Duality×D_{PC} are -0.018, -0.001, and -0.257, respectively, which are all significant. Similarly, the coefficient of B_Indep×D_{PC} is significantly positive at 0.098, confirming the substitution effect. Hence, firms could focus on strong CG without the need for

PC. Moreover, PC may adversely affect the loan rate for these firms with strong CG. Accordingly, PC is useful only for those firms with poor CG.

[Insert Table 9]

5.3.1 Government versus Private-Owned Banks (GOBs vs. POBs)

Khwaja and Mian (2005) argue that government-owned banks (GOB**s**) are more susceptible to political coercion due to their organizational design; thus, GOBs are expected to provide greater rents to politically connected firms than privately-owned banks (POB**s**). Accordingly, PC is more likely to have stronger influence on GOBs than POBs, and therefore one might expect that the observed substitution effect should be mitigated in GOBs rather than in POBs. Following the studies of Dinç (2005) and Khwaja and Mian (2005), we refer banks with the total shares of the government exceeds 20% to GOBs, otherwise they are POBs. We re-estimate Equation (3) by using GOB and POB subsamples where the Spread is the dependent variable.

Panels A and B of Table 10 present the estimated results using either GOB and POB samples, respectively. First, using both GOB and POB sample exhibit similar results except for the coefficient of B_Indep×D_{PC}. For example, in both samples, the CG coefficients still indicate the expected signs as those reported in Table 4. Also, the coefficients of negative CG proxies remain positive and those of the positive CG proxies maintain negative, respectively. Furthermore, coefficients of three interaction terms display the same signs and similar sizes in both samples. Among the three interaction terms, coefficients of Deviation×D_{PC} and B_Duality×D_{PC} are still significantly negative, supporting the substitution effect, whereas S_Pledge ×D_{PC} is insignificant. Hence, PC exerts equal influence on GOBs and POBs in these three CG measures.

Contrary to the above three interaction terms, B_Indep×D_{PC} coefficients are insignificantly negative but significantly positive for GOB and POB samples, respectively. Hence, given the same independent directors, GOBs offer PC-firms the similar rate as that of non-PC-firms, whereas POBs offer PC-firms with higher loan rates than non-PC-firms. Accordingly, when the CG is proxied by B_Indep, PC indeed exhibits stronger influence in GOB than POBs.

In sum, three of four CG measures indicate that PC plays the same roles across GOBs and POBs and only one measure indicates that the PC has stronger effect on GOBs than POBs, of which the last one demonstrates similar results as those of Sapienza (2004) and Khwaja and Mian (2005). Though PC has shown slightly stronger effect on GOBs, it does not refute the substitution effect. Accordingly, the substitution effect is still supported regardless of bank's ownership.

[Insert Table 10]

5.3.2 Ruling vs. Opposition Party

This section distinguishes the party affiliations of PC-firms when the party is in opposition or in ruling. Literature suggests that the connections to the ruling party are more influential than connections to the opposition on loan contracts. For example, Sapienza (2004) finds that Italian GOBs charge lower interest rates in the regions where the bank-affiliated party got a higher voting rate. We expect than PC has stronger influence when the affiliated party is power.

There are two major political parties, Kuomintang (KMT) and Democratic Progressive Party (DPP) in Taiwan. Before May 2000, the KMT had been the ruling party, but they lost power in the 2000 election. The DPP won the 2000 and 2004 elections and held the reins of the government from 2000–2008. And then KMT won the 2008 and 2012 elections. Therefore, we

refer 2000–2008 as the DPP ruling sample and other sample periods (i.e., 1997–1999 and 2009) as the KMT ruling sample. We create two dummy variables, $D_{PC\text{-}KMT}$ and $D_{PC\text{-}DPP}$ to refer firms as connected to KMT and DPP.

Panel A and B of Table 11 presents the estimated results based on KMT ruling and DPP ruling samples, respectively. Results are mixed. First, in both panels, the CG coefficients still show the expected signs as reported in Table 4 except for Deviation in the KMT ruling sample. Next, that PC strongly reduces the loan rates when the affiliated party is in power is sensitive to the CG measure used. When CG measure is B_Duality, PC-firms connecting for DPP ruling party exhibit stronger effect, whereas when CG measure is S_Pledge, PC-firms connecting for KMT ruling period show the stronger effect. Third, when CG measure is Deviation, PC-firms obtain favorable rates regardless of parties. Last, when CG measure is B_Indep, PC-firms connecting to DPP get counter-intuitive results. In sum, our results using Taiwanese data demonstrate that connecting to the ruling party does not ensure the beneficial loan contract after controlling the CG effect. Unlike Sapienza's (2004) study, connecting to the ruling party does not exhibit stronger influence in Taiwan. Though ruling party effect is sensitive to the CG measures used, the substitution effect still holds and robust to the ruling party consideration.

[Insert Table 11]

5.4 Robustness Checks

5.4.1 Different Risk-level Firms

The previously observed relation between CG and PC may be attributed to the missing data of firm risk levels. For example, high-risk firms may simultaneously have strong CG and PC, causing superficial relation between the two concepts. However, once the risk level is controlled in the regression, the observed relationship disappears. Following Strahan (1999)

and Graham et al. (2008), we calculate the Z-Score[12] as the proxy for the risk levels of firms. A higher Z-score denotes a higher risk.

Table 12 presents the regression results of PC and its effect on the CG of firms at varying risk levels. Panel A indicates the regression results based on high-risk firms, whereas Panel B indicates those based on low-risk firms. We find that the D_{PC} coefficients remain similar in the four CG proxies to those reported in Table 8 regardless of the risk levels of firms. For example, the D_{PC} coefficients based on Deviation, S_Pledge, B_Duality, and B_Indep are 3.271, 0.257, 0.698, and -0.850, respectively, in high-risk firms, as well as 1.882, 0.457, 0.163, and -0.145, respectively, in low-risk firms. The only difference is the D_{PC} coefficient when CG is proxied by S_Pledge. The coefficients become insignificant in both high- and low-risk firms and significant in the early portions of Table 8.

Accordingly, regardless of control on firm risk levels, PC-firms demonstrate poor CG when three of four CG proxies are adopted. Even the fourth proxy S_Pledge indicates an insignificant result. Thus, the results support the substitution view that politically connected firms are poorly governed (H2).

[Insert Table 12]

5.4.2 Endogeneity

The decision of top managers to establish PC may result from motives to overcome certain business limitations (Li et al., 2006; Cooper, et al., 2010). Thus, the motivation to build PCs may be endogenously determined, which leads to inconsistent estimates and spurious interpretation.

We employ the conventional method of Hackman's two-stage regression to address this

[12] The z-score is modified Altman's (1968) Z-score, which equals (1.2Working capital+1.4Retained earnings + 3.3EBIT + 0.999Sales)/Total asset. We use a sample median to differentiate between high- and low-risk firms.

problem. In the first stage, we perform a probit regression with PC (D_{PC}) as the dependent variable. Six characteristic variables at the firm level, namely, LnAsset, Leverage, Tobin's q (*Q*), Tangibility, Profitability, and Z-score, are included as independent variables to assess the possible motives of top managers in building PC to obtain preferential bank loan contracts. The resulting inverse Mill's ratio (IMR) is inserted in the second-stage regressions to correct any potential bias. Table 13 presents the estimated results of the second-stage regressions based on Equation (3). The new results remain similar to those reported in Table 9, and still support the substitution effect.

[Insert Table 13]

5.4.3 Identification Test

Our estimation may also be subject to the simultaneous bias problem. Previous studies suggested that loan spread and other loan terms, such as loan size and loan period, are simultaneously determined (e.g., Melnik and Planut, 1986) and correlated with D_{PC}. In such cases, simple OLS regressions may be inappropriate. We follow Asquith et al. (2005) and employ the two-stage least square regression to counter any potential simultaneity bias. In the first stage, we estimate a structural model for all loan characteristics other than the Spread. The dependent variables are the loan characteristics (i.e., LoanSize and Maturity), and the independent variables include D_{PC} and firm characteristics. In the second stage, we regress Spread on D_{PC}, firm characteristics, and the predicted values of loan characteristic variables obtained from the first-stage regression. Table 14 reports the results of the second-stage regression, which indicate that all coefficients are similar to the results in Table 9. This similarity suggests that our main results are not biased by the simultaneity of multiple loan terms.

[Insert Table 14]

5.4.4 Using Political Donation as Proxy for PC

Several studies used political donation as a proxy for PC. Claessens et al. (2008) determine that Brazilian firms who contributed to federal deputies during the 1998 and 2002 elections experienced higher stock returns than other non-contributing firms. Contributing firms were observed to substantially increase their loan growth. In the present study, we examine if firms that provided political donations gained bank loan benefits that are inaccessible to poorly governed firms. We collect data on political donations from 2005 to 2009 by Taiwanese listed firms from the Control Yuan (top supervisory office in Taiwan). We introduce a political dummy variable, $D_{PC\text{-}Donation}$, which is equal to one if the firm donated to political parties or campaign candidates and zero otherwise. Equation (3) is re-estimated by replacing D_{PC} with $D_{PC\text{-}Donation}$ (Table 15). The result remains supportive of our hypothesis. For example, when B_Duality is positively associated with bank loan price, corporate political donation eases these disadvantages. Thus, the effects of PC on substituting CG in bank loan price similarly hold for political donations.

[Insert Table 15]

6. Conclusion

Both corporate governance (CG) and political connection (PC) have attracted considerable attention in literature and practice. These concepts significantly affect various issues related to individual firms, such as market valuation, long-term performance, bailout events, and financing behavior. However, the relationship between CG and PC has not been extensively discussed. We attempt to bridge this gap in the present study.

We address the following questions: Do firms with strong CG still require PCs? Are CG and PC substitutes or complements? In addition, we discuss whether better-governed or

politically connected firms acquire benefits in bank loan contracts. These questions are addressed using detailed firm-level PC data and 71,069 individual bank loan contracts of listed firms in Taiwan from 1997 to 2009.

First, the empirical results are consistent with those of most studies, indicating that firms with strong CG and PC gain favorable loan rates. Second, politically connected firms tend to demonstrate poor governance practices. Inversely, a firm with a strong CG does not prioritize the establishment of PC. Third, favorable terms decrease when both PC and CG are simultaneously considered, supporting the substitution effect. Therefore, this result may also explain why firms with strong CG do not require PC.

Our results have strong policy implications. A strong CG is associated with lower cost of debt, but these benefits are reduced for politically connected firms. Thus, firms with strong CG do not require PC. Moreover, establishing either CG or PC is usually costly. Thus, a firm can often engage in only one of them. Therefore, if a country values CG, then the government should minimize the influence of the PC of firms.

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Table 1. Variable definitions

Variable names	Variable definition	Source
Panel A: Bank Loan Variables		
Bank Loan price (Spread)	Loan spread over risk-free rate at loan origination	TEJ_bank
LoanSize	The natural logarithm of loan sizes (amounts)	TEJ_bank
Maturity	Natural logarithm of loan period	TEJ_bank
Panel B: Corporate Governance Measures		
Deviation	Value of Voting Right: Cash Flow Right; Cash Flow Right refers to the percentage ownership of the controlling shareholder of firm profits/losses and dividends.	TEJ_G
S_Pledge	The ratio of shares pledged for bank loans over total shares held by the board of directors at the end of the year	TEJ_G
B_Duality	Equal to one (1) if the CEO fulfills the functions of both CEO and chairman of the board of directors, and zero (0) otherwise	TEJ_G
B_Indep	Equal to one (1) if firms have independent directors in their boards and zero (0) otherwise	TEJ_G
Panel C: Political Connection Measures		
$\mathbf{D_{PC}}$	Dummy variable is equal to one (1) if the top managers of firms established PCs from 1997 to 2009. Here, PC means political party tendency.	By us
$\mathbf{D_{PC\text{-}Donation}}$	Dummy variable is equal to one (1) if firms or top managers contributed to political parties or presidential candidates from 2005 to 2009 and zero (0) otherwise.	By us
Panel D: Firm Characteristics		
LnAsset	Natural log of total assets	TEJ
Leverage	Total debts, including long-term and short-term debts, over firm book assets	TEJ
Tobin's q (Q)	Ratio of the firm market value over book value of assets	TEJ
Tangibility	Property, plant, and equipment plus inventories over assets	TEJ
Profitability	Net income over total sales	TEJ
Z-Score	Z-score is modified Altman's (1968) Z-score, which equals (1.2Working capital+1.4Retained earnings + 3.3EBIT + 0.999Sales)/Total asset.	TEJ

Notes:

1. TEJ = Taiwan Economic Journal; TEJ_bank = TEJ bank loan database; TEJ_G = TEJ corporate governance database
2. By us: Data contain the detailed firm-level political and business connections for each public firm in Taiwan. Data are manually collected, and the variables are contrasted by the authors.

Table 2. Descriptive statistics of the variables

This table presents the descriptive statistics of all variables (see Table 1 for definitions). The sample includes 758 firms and 71,069 loan-year observations from 1997 to 2009.

	Mean	Median	Minimum	Maximum	S.D.
Panel A: Bank Loan Variables					
Spread	2.4503	1.9200	0.0005	14.0200	2.1540
LoanSize	5.7704	5.8972	0.0000	8.9953	1.3902
Maturity	8.3133	7.8240	0.6931	17.8024	2.3617
Panel B: Corporate Governance					
Deviation	5.5765	1.0300	0.0000	95.5900	10.1673
S_Pledge	21.3765	9.5800	0.0000	100.0000	26.5630
B_Duality	0.2691	0.0000	0.0000	1.0000	0.4435
B_Indep	0.1398	0.0000	0.0000	1.0000	0.3468
Panel C: Political Connection					
$\mathbf{D_{PC}}$	0.3008	0.0000	0.0000	1.0000	0.4586
Panel D: Firm Characteristics					
LnAsset	16.0449	15.9020	10.3186	20.5809	1.2957
Leverage	0.5259	0.5237	0.0155	2.0488	0.1420
Tangibility	0.3621	0.3672	0.0003	0.9630	0.1963
Profitability	0.0747	0.0752	0.0001	0.4753	0.0779
Q	2.0011	1.1200	0.0001	15.2700	2.5419
Z-Score	1.1234	1.0011	-5.8569	5.7744	0.7525

Table 3. Correlation coefficient matrix of the variables

This table presents the correlation coefficient matrix of the variables (see Table 1 for definitions). The sample includes 758 firms and 71,069 loan-year observations from 1997 to 2009. Superscripts *, **, and *** denote significance at 10%, 5%, and 1%, respectively.

	Spread	**D_{PC}**	**Deviation**	**S_Pledge**	**B_Duality**	**B_ Indep**	**LnAsset**	**Leverage**	**Q**	**Tangibility**	**Profitability**	**Z-Score**
Spread	1.000											
D_{PC}	-0.049***	1.000										
Deviation	-0.078***	0.089***	1.000									
S_Pledge	0.223***	0.108***	-0.133***	1.000								
B_Duality	0.070***	-0.037***	-0.151***	-0.021***	1.000							
B_ Indep	-0.258***	-0.117***	0.011***	-0.148***	0.019***	1.000						
LnAsset	-0.131***	0.283***	0.128***	0.221***	-0.150***	-0.061***	1.000					
Leverage	0.109***	0.062***	0.004	0.221***	0.004	-0.044***	0.233***	1.000				
Q	-0.041***	-0.066***	0.022***	-0.029***	-0.012***	-0.044***	0.078***	-0.170***	1.000			
Tangibility	-0.174***	-0.011***	0.079***	-0.223***	-0.050***	0.173***	0.022***	-0.331***	0.122***	1.000		
Profitability	0.218***	-0.077***	0.090***	-0.221***	0.075***	-0.041***	-0.309***	-0.045***	-0.021****	0.266***	1.000	
Z-Score	-0.135***	-0.079***	-0.017***	-0.266***	0.025***	0.235***	-0.197***	-0.248***	-0.319***	0.529***	0.230***	1.000

Table 4. Corporate governance and bank loan price

This table presents the regression results of CGs and their effect on bank loan price and non-price terms. The dependent variable is bank loan price (Spread), which is the all-in spread drawn defined as the amount the borrower pays in basis points over the risk-free rate. For the definitions of all variables, see Table 1. We use White's (1980) heteroskedasticity consistent standard errors as well as Petersen's (2009) approach to adjust heteroskedasticity and clustering at the firm level. Superscripts *, **, and *** denote significance at 10%, 5%, and 1%, respectively.

	(1)	(2)
Constant	7.513***	7.711***
	(71.46)	(73.33)
Deviation	0.005***	0.006***
	(8.34)	(8.95)
S_Pledge	0.007***	0.007***
	(28.99)	(30.15)
B_Duality	0.193***	0.186***
	(15.90)	(15.38)
B_Indep	-0.246***	-0.235***
	(-6.71)	(-6.40)
Firm Characteristics		
LnAsset	-0.231***	-0.245***
	(-41.62)	(-43.96)
Leverage	1.941***	1.883***
	(42.65)	(41.56)
Tangibility	0.295***	0.178***
	(7.75)	(4.70)
Profitability	-1.202***	-1.205***
	(-12.13)	(-12.17)
Q	0.019***	0.014***
	(6.66)	(5.05)
Z-Score	0.008	0.007
	(0.59)	(0.52)
Loan Characteristics		
LoanSize		0.001***
		(4.44)
Maturity		0.001***
		(31.99)
Control For		
Year	Y	Y
Industry	Y	Y
Bank	Y	Y
Adjusted R^2	0.618	0.623
N	71,069	71,069

Table 5. Political connections and bank loan price

This table presents the regression results of PCs and their effect on bank loan price and non-price terms. The dependent variable is bank loan price (Spread), which is the all-in spread drawn defined as the amount the borrower pays in basis points over the risk-free rate. D_{PC} is a dummy variable equal to one if a firm is politically connected and zero otherwise. For the definition of all variables, see Table 1. We use White's (1980) heteroskedasticity consistent standard errors as well as Petersen's (2009) approach to adjust heteroskedasticity and clustering at the firm level. Superscripts *, **, and *** denote significance at 10%, 5%, and 1%, respectively.

	(1)	(2)
Constant	7.209***	7.377***
	(68.63)	(70.38)
D_{PC}	-0.212***	-0.184***
	(-17.12)	(-14.96)
Firm Characteristics		
LnAsset	-0.174***	-0.187***
	(-33.85)	(-36.37)
Leverage	1.822***	1.776***
	(40.68)	(39.83)
Tangibility	0.074*	-0.034
	(1.95)	(-0.90)
Profitability	-1.459***	-1.472***
	(-14.30)	(-14.44)
Q	-0.006***	-0.012***
	(-2.41)	(-4.40)
Z-Score	-0.055***	-0.056***
	(-4.27)	(-4.38)
Loan Characteristics		
LoanSize		0.001***
		(4.59)
Maturity		0.001***
		(28.71)
Control For		
Year	Y	Y
Industry	Y	Y
Bank	Y	Y
Adjusted R^2	0.608	0.613
N	71,069	71,069

Table 6. Descriptive statistics: Politically connected firms in different corporate governance types

This table presents the distributions of politically connected firms in better or worse CG firms. We define better CG firms as those with lower Deviation, lower S_Pledge, without B_Duality, and with B_Indep. For the first two CG proxies, we employ a sample median to differentiate between high and low CG-firms, whereas we employ dummies to differentiate between them for the latter two CG proxies. The sample includes 758 firms and 8,774 firm-year observations from 1997 to 2009. For the definitions of all variables, see Table 1.

		Deviation	**S_Pledge**	**B_Duality**	**B_Indep**
Panel A: Better CG firms					
PC-firms	Obs.	849	721	1,469	583
	Percent	19.35%	16.43%	23.32%	15.01%
Non- PC-firms	Obs.	3,538	3,666	4,829	3,300
	Percent	80.65%	83.57%	76.68%	84.99%
All firms	Obs.	4,387	4,387	6,298	3,883
	Percent	100%	100%	100%	100%
Panel B: Worse CG firms					
PC-firms	Obs.	1,043	1,171	422	1,310
	Percent	23.77%	26.69%	17.04%	26.78%
Non- PC-firms	Obs.	3,344	3,216	2,054	3,581
	Percent	76.23%	73.31%	82.96%	73.22%
All firms	Obs.	4,387	4,387	2,476	4,891
	Percent	100%	100%	100%	100%

Table 7. Differences in descriptive statistics: Politically connected and non-politically connected firms

This table presents the differences in descriptive statistics between politically connected firms and non-politically connected firms. The sample includes 758 firms and 8,774 firm-year observations from 1997 to 2009. For the definitions of all variables, see Table 1. We use White's (1980) heteroskedasticity consistent standard errors as well as Petersen's (2009) approach to adjust heteroskedasticity and clustering at the firm level. Superscripts *, **, and *** denote significance at 10%, 5%, and 1%, respectively.

	Political Connection Firms	**Non-political Connection firm**	**Difference**	***t*-value**
Panel A: Corporate Governance Variable				
Deviation	7.7029	6.1572	1.5457***	(5.20)
S_Pledge (%)	15.7087	11.8307	3.8780***	(6.97)
B_Duality	0.2253	0.2978	-0.0725***	(-6.23)
B_Indep	0.1226	0.2523	-0.1296***	(-12.08)
Panel B: Firm Characteristics				
LnAsset	16.5973	15.8016	0.7958***	(78.69)
Leverage	0.5391	0.5201	0.0191***	(16.52)
Q	0.3425	0.3707	-0.0281***	(17.65)
Tangibility	0.0735	0.0752	-0.0018***	(2.81)
Profitability	1.7045	2.1318	-0.4273***	(20.72)
Z-Score	1.0343	1.1627	-0.1284***	(21.03)

Table 8. Corporate governance in politically connected firms

This table presents the regression results of political connection and its effect on the corporate governance of firms. The dependent variables are the CG proxies, namely, Board Shareholding, Deviation, Board Duality, and Board Independence. D_{PC} is a dummy variable equal to one if a firm is politically connected and zero otherwise. For the definitions of all variables, see Table 1. We use White's (1980) heteroskedasticity consistent standard errors as well as Petersen's (2009) approach to adjust heteroskedasitiicy and clustering at the firm level. Superscripts *, **, and *** denote significance at the 10%, 5%, and 1% levels, respectively.

	Deviation	**S_Pledge**	**B_Duality**	**B_Indep**
	(1)	(2)	(3)	(4)
Constant	14.308***	-28.002***	0.881***	-0.828***
	(6.42)	(-4.646)	(6.48)	(-3.787)
D_{PC}	3.630***	36.217***	0.759***	-0.849***
	(4.45)	(3.33)	(5.39)	(-4.347)
Firm Characteristics				
LnAsset	-0.892***	1.816***	-0.064***	0.092***
	(-5.68)	(8.71)	(-6.59)	(12.48)
Leverage	7.383	23.212***	0.997	-0.236***
	(1.36)	(12.15)	(0.75)	(-2.367)
Tangibility	-1.229*	7.336*	-0.037	0.030
	(-1.84)	(1.72)	(-0.73)	(0.83)
Profitability	-3.223**	-2.413	0.145**	-0.226***
	(-1.97)	(-0.47)	(1.98)	(-3.57)
Q	0.097	-1.230***	-0.003	-0.015***
	(1.42)	(-3.07)	(-0.71)	(-4.25)
Z-Score	0.785***	-1.723*	-0.041***	0.023**
	(4.34)	(-1.73)	(-3.49)	(2.22)
Control For				
Year	Y	Y	Y	Y
Firm	Y	Y	Y	Y
Adjusted R^2	0.876	0.588	0.585	0.673
N	8,774	8,774	8,774	8,774

Table 9. Corporate governance vs. political connection: Bank loan price

This table presents the OLS regression results, simultaneously investigating the effects of borrower CG and PC on bank loan price. The dependent variable is bank loan price (Spread), which is the all-in spread drawn defined as the amount the borrower pays in basis points over the risk-free rate. For the definitions of all variables, see Table 1. We use White's (1980) heteroskedasticity consistent standard errors as well as Petersen's (2009) approach to adjust heteroskedasticity and clustering at the firm level. Superscripts *, **, and *** denote significance at 10%, 5%, and 1%, respectively.

	(1)	(2)	(3)	(4)
Constant	7.019***	7.244***	7.127***	7.361***
	(66.55)	(69.89)	(68.09)	(70.39)
Deviation	0.002**			
	(2.23)			
Deviation $\times$ $\mathbf{D_{PC}}$	-0.018***			
	(-18.60)			
S_Pledge		0.008***		
		(30.12)		
S_Pledge $\times$ $\mathbf{D_{PC}}$		-0.001***		
		(-3.18)		
B_Duality			0.260***	
			(18.88)	
B_Duality $\times$ $\mathbf{D_{PC}}$			-0.257***	
			(-11.18)	
B_Indep				-0.015
				(-0.86)
B_Indep $\times$ $\mathbf{D_{PC}}$				0.098***
				(2.65)
Control For				
Control Variables	Y	Y	Y	Y
Year	Y	Y	Y	Y
Industry	Y	Y	Y	Y
Bank	Y	Y	Y	Y
Adjusted $\mathbf{R^2}$	0.609	0.613	0.609	0.607
N	71,069	71,069	71,069	71,069

Table 10. Corporate governance vs. political connection: GOB vs. POB

This table presents the OLS regression results, simultaneously investigating the effects of borrower CG and PC on bank loan price. The dependent variable is bank loan price (Spread), which is the all-in spread drawn defined as the amount the borrower pays in basis points over the risk-free rate. We refer banks with the total shares of the government exceeds 20% to GOB sample. For the definitions of all variables, see Table 1. We use White's (1980) heteroskedasticity consistent standard errors as well as Petersen's (2009) approach to adjust heteroskedasticity and clustering at the firm level. Superscripts *, **, and *** denote significance at 10%, 5%, and 1%, respectively.

Panel A: GOB sample				
	(5)	(6)	(7)	(8)
Constant	6.655***	6.757***	6.728***	6.698***
Deviation	0.001			
Deviation $\times$ $\mathbf{D_{PC}}$	-0.016***			
S_Pledge		0.007***		
S_Pledge $\times$ $\mathbf{D_{PC}}$		0.001		
B_Duality			0.198***	
B_Duality $\times$ $\mathbf{D_{PC}}$			-0.200***	
B_Indep				-0.103***
B_Indep $\times$ $\mathbf{D_{PC}}$				-0.076
Adjusted $\mathbf{R^2}$	0.641	0.645	0.640	0.636
N	29,691	29,691	29,691	29,691
Panel B: POB sample				
	(1)	(2)	(3)	(4)
Constant	9.633***	9.864***	9.641***	10.126***
Deviation	0.001			
Deviation $\times$ $\mathbf{D_{PC}}$	-0.015***			
S_Pledge		0.007***		
S_Pledge $\times$ $\mathbf{D_{PC}}$		0.001		
B_Duality			0.250***	
B_Duality $\times$ $\mathbf{D_{PC}}$			-0.211***	
B_Indep				-0.228***
B_Indep $\times$ $\mathbf{D_{PC}}$				0.329***
Adjusted $\mathbf{R^2}$	0.614	0.618	0.614	0.603
N	44,469	44,469	44,469	44,469
Control For				
Control Variables	Y	Y	Y	Y
Year	Y	Y	Y	Y
Industry	Y	Y	Y	Y
Bank	Y	Y	Y	Y

Table 11. Corporate governance vs. political connection: Effect of ruling party

This table presents the OLS regression results, simultaneously investigating the effects of borrower CG and PC on bank loan price. The dependent variable is bank loan price (Spread), which is the all-in spread drawn defined as the amount the borrower pays in basis points over the risk-free rate. We refer to 2000–2008 as the DPP ruling sample and 1997–1999 and 2009 as the KMT ruling sample. Specially, we create two dummy variables, $D_{PC\text{-}KMT}$ and $D_{PC\text{-}DPP}$ to refer firms connected to KMT and DPP. For the definitions of all variables, see Table 1. We use White's (1980) heteroskedasticity consistent standard errors as well as Petersen's (2009) approach to adjust heteroskedasticity and clustering at the firm level. Superscripts *, **, and *** denote significance at 10%, 5%, and 1%, respectively.

Panel A: KMT ruling sample

	(1)	(2)	(3)	(4)
Constant	6.069***	6.804***	6.685***	6.291***
Deviation	-0.001			
Deviation $\times$ $\mathbf{D_{PC\text{-}KMT}}$	-0.012***			
S_Pledge		0.006***		
S_Pledge $\times$ $\mathbf{D_{PC\text{-}KMT}}$		-0.003***		
B_Duality			0.263***	
B_Duality $\times$ $\mathbf{D_{PC\text{-}KMT}}$			-0.049	
B_Indep				-1.783***
B_Indep $\times$ $\mathbf{D_{PC\text{-}KMT}}$				0.002
Adjusted $\mathbf{R^2}$	0.748	0.750	0.749	0.748
N	15,462	15,462	15,462	15,462

Panel B: DPP ruling sample

	(5)	(6)	(7)	(8)
Constant	2.271***	2.388***	2.280***	2.501***
Deviation	0.001			
Deviation $\times$ $\mathbf{D_{PC\text{-}DPP}}$	-0.018***			
S_Pledge		0.004***		
S_Pledge $\times$ $\mathbf{D_{PC\text{-}DPP}}$		0.001		
B_Duality			0.180***	
B_Duality $\times$ $\mathbf{D_{PC\text{-}DPP}}$			-0.097***	
B_Indep				-0.036***
B_Indep $\times$ $\mathbf{D_{PC\text{-}DPP}}$				0.456***
Adjusted $\mathbf{R^2}$	0.572	0.573	0.572	0.572
N	52,496	52,496	52,496	52,496

Control For				
Control Variables	Y	Y	Y	Y
Year	Y	Y	Y	Y
Industry	Y	Y	Y	Y
Bank	Y	Y	Y	Y

Table 12. Robustness check I: Different risk-level firms

This table presents the regression results of PC and its effect on the CG of firms at different firm risk levels. Following Strahan (1999) and Graham et al. (2008), we define high-risk firms as those with smaller Z-Scores. We use a sample median to differentiate between high- and low-risk firms. The dependent variables are the CG proxies, namely, Board Shareholding, Deviation, Board Duality, and Board Independence. D_{PC} is a dummy variable equal to one if a firm is politically connected and zero otherwise. For the definitions of all variables, see Table 1. We use White's (1980) heteroskedasticity consistent standard errors as well as Petersen's (2009) approach to adjust heteroskedasticity and clustering at the firm level. Superscripts *, **, and *** denote significance at 10%, 5%, and 1%, respectively.

	Deviation	**S_Pledge**	**B_Duality**	**B_Indep**
Panel A: High-risk Firms				
	(1)	(2)	(3)	(4)
Constant	11.190***	-6.872	0.757***	-0.091
	(3.76)	(-1.19)	(3.59)	(-0.38)
D_{PC}	3.271***	0.257	0.698***	-0.850***
	(3.22)	(0.30)	(4.65)	(-4.42)
Adjusted R^2	0.861	0.589	0.557	0.645
Panel B: Low-risk Firms				
	(5)	(6)	(7)	(8)
Constant	-11.504***	-23.025***	1.026***	0.342***
	(-3.33)	(-6.29)	(5.03)	(3.32)
D_{PC}	1.882***	0.457	0.163*	-0.145***
	(3.54)	(0.60)	(1.68)	(-8.34)
Adjusted R^2	0.904	0.599	0.651	0.688
Control For				
Firm Characteristics	Y	Y	Y	Y
Year	Y	Y	Y	Y
Firm	Y	Y	Y	Y
N	4,387	4,387	4,387	4,387

Table 13. Robustness check II: Control self-selection bias

This table presents the results of Heckman's two-stage regression of the effects of borrower CG and PC on bank loan price. In the first stage, we perform a Probit regression with D_{PC} as the dependent variable. Six firm characteristic variables, namely, LnAsset, Leverage, Tobin's q (*Q*), Tangibility, Profitability, and Z-score, are included as independent variables to assess the possible motivation of top managers in establishing PC to obtain better prices and non-price terms in bank loan contracts. The inverse IMR is computed and introduced in the second-stage regression to correct any potential bias. In the second-stage regression, the dependent variable is bank loan price (Spread), which is the all-in spread drawn defined as the amount the borrower pays in basis points over the risk-free rate. D_{PC} is a dummy variable equal to one if a firm is politically connected and zero otherwise. For the definitions of all variables, see Table 1. We use White's (1980) heteroskedasticity consistent standard errors as well as Petersen's (2009) approach to adjust heteroskedasticity and clustering at the firm level. Superscripts *, **, and *** denote significance at 10%, 5%, and 1%, respectively.

	(1)	(2)	(3)	(4)
Constant	6.982***	7.319***	6.982***	7.203***
	(65.94)	(70.21)	(66.12)	(68.30)
Deviation	0.001			
	(0.68)			
Deviation $\times$ **D_{PC}**	-0.014***			
	(-13.06)			
S_Pledge		0.019***		
		(50.65)		
S_Pledge $\times$ **D_{PC}**		-0.004***		
		(-6.416)		
B_Duality			0.217***	
			(15.31)	
B_Duality $\times$ **D_{PC}**			-0.095***	
			(-3.61)	
B_Indep				-0.067***
				(-3.89)
B_Indep $\times$ **D_{PC}**				0.278***
				(7.23)
Control For				
Control Variables	Y	Y	Y	Y
Year	Y	Y	Y	Y
Industry	Y	Y	Y	Y
Bank	Y	Y	Y	Y
Adjusted R^2	0.610	0.614	0.610	0.609
N	71,069	71,069	71,069	71,069

Table 14. Robustness check III: Replace loan characteristics by structure estimations

This table presents the two-stage least square regression results, simultaneously investigating the effects of borrower CG and PC on bank loan price. In this model, the loan characteristics in control variables are replaced by those obtained from structure estimations. The dependent variable is bank loan price (Spread), which is the all-in spread drawn defined as the amount the borrower pays in basis points over the risk-free rate. For the definitions of all variables, see Table 1. We use White's (1980) heteroskedasticity consistent standard errors as well as Petersen's (2009) approach to adjust heteroskedasticity and clustering at the firm level. Superscripts *, **, and *** denote significance at 10%, 5%, and 1%, respectively.

	(1)	(2)	(3)	(4)
Constant	7.027***	7.252***	7.134***	7.369***
	(66.51)	(69.84)	(68.07)	(70.36)
Deviation	0.002**			
	(2.25)			
Deviation $\times \mathbf{D_{PC}}$	-0.018***			
	(-18.61)			
S_Pledge		0.008***		
		(30.12)		
S_Pledge $\times \mathbf{D_{PC}}$		-0.001***		
		(-3.21)		
B_Duality			0.260***	
			(18.91)	
B_Duality $\times \mathbf{D_{PC}}$			-0.257***	
			(-11.21)	
B_Indep				-0.015
				(-0.86)
B_Indep $\times \mathbf{D_{PC}}$				0.098***
				(2.65)
Control For				
Control Variables	Y	Y	Y	Y
Year	Y	Y	Y	Y
Industry	Y	Y	Y	Y
Bank	Y	Y	Y	Y
Adjusted $\mathbf{R^2}$	0.609	0.613	0.608	0.606
N	71,069	71,069	71,069	71,069

Table 15. Robustness check IV: Using political donation as political proxy

This table presents the OLS regression results, simultaneously investigating the effects of borrower CG and PC on bank loan price. In this model, we employ a political donation dummy variable to test the robustness of our results. $D_{PC\text{-}Donation}$ is equal to one if one firm ever donated to political parties or campaign candidates and zero otherwise. The dependent variable is bank loan price (Spread), which is the all-in spread drawn defined as the amount the borrower pays in basis points over the risk-free rate. For the definitions of all variables, see Table 1. We use White's (1980) heteroskedasticity consistent standard errors as well as Petersen's (2009) approach to adjust heteroskedasticity and clustering at the firm level. Superscripts *, **, and *** denote significance at 10%, 5%, and 1%, respectively.

	(1)	(2)	(3)	(4)
Constant	2.012***	1.841***	1.813***	2.035***
	(14.34)	(13.30)	(13.00)	(14.62)
Deviation	-0.001			
	(-0.91)			
Deviation $\times$ $\mathbf{D_{PC\text{-}Donation}}$	0.006***			
	(2.50)			
S_Pledge		0.005***		
		(14.54)		
S_Pledge $\times$ $\mathbf{D_{PC\text{-}Donation}}$		-0.005***		
		(-6.33)		
B_Duality			0.169***	
			(8.47)	
B_Duality $\times$ $\mathbf{D_{PC\text{-}Donation}}$			-0.159***	
			(-4.27)	
B_Indep				-0.028
				(-1.42)
B_Indep $\times$ $\mathbf{D_{PC\text{-}Donation}}$				-0.277***
				(-6.27)
Control For				
Control Variables	Y	Y	Y	Y
Year	Y	Y	Y	Y
Industry	Y	Y	Y	Y
Bank	Y	Y	Y	Y
Adjusted $\mathbf{R^2}$	0.164	0.171	0.167	0.166
N	25,439	25,439	25,439	25,439