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THE EFFECT OF POLITICAL CONNECTION ON THE PERFORMANCE OF SMALL AND MEDIUM ENTERPRISES

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ABSTRACT

This paper aims to examine the role of political connections on the performance of small and medium enterprises (SMEs) in Vietnam. Following the scope of the study, the panel fixed effect has been adopted to explore the impact of political connections on a firm's performance. The data was collected every two years from 2005 to 2015 from small and medium enterprises in Vietnam under the collaboration of the Central Institute for Economic Management (CIEM), the Institute of Labor Science and Social Affairs (ILSSA), and the Development Economics Research Group (DERG) of the University of Copenhagen (Denmark). The results show that political connections have a significantly negative effect on the performance of SMEs. In contrast, political ties can facilitate firms to obtain benefits such as bank loans, taxation, and time dealing with regulations. However, to gain benefits from political connections, connected SMEs also have to pay higher informal fees and higher labor costs, leading to inefficient resource allocation. Furthermore, political ties are more important to SMEs in regions where the institutional mechanism is less developed.

Keywords: *SMEs, Firm performance, Credit access, Political connection, Vietnam.*

INTRODUCTION

The literature on the relationship between political connections and private firms has grown in recent years. Many scholars point out that enterprises seek financial advantages by maintaining political ties. For example, they suggest that politicians use their power to help firms access bank loans (Boubakri *et al.*, 2012), increase firm value (Fisman, 2001), or improve performance (Li & Zhou, 2015).

In transition economies where the government controls the essential resources and less development of the regulation system, SMEs face many obstacles to running their business. A good relationship with the government can help firms obtain benefits in credit access, IPO market evaluation, firm performance, tax exemption, etc. (Mian & Khwaja, 2005; Facio, 2006; Li *et al.*, 2008; Boubakri *et al.*, 2012; Li & Zhou, 2015). However, studies indicate the "bad side" of political connections with lower firm performance due to the lack of managerial incentives to maximize shareholder wealth (Fisman, 2001; Facio, 2010). Motivated by such international evidence, this paper aims to figure out how political connections affect the performance of SMEs.

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We seek to answer the following questions: What are the costs and benefits of political links to SMEs? In which mechanism do political connections affect a firm's performance?

This paper analyzes the cost and benefit of political connections to the firm's operation. Notably, we explore the effect of Communist Party membership on a firm's performance. In an environment where discrimination and mistrust against SMEs, the relationship with the ruling party becomes vital. In the political mechanism where the Communist Party is the sole authority to govern the country, the membership can create an avenue for building relations with government officials and achieving a political status (Li *et al.*, 2008). We adopt unique panel data collected from 2005 to 2015 with different SMEs and business environments to test our hypotheses. The SME surveys provide information about various aspects such as enterprise background, financial structure, sales structure, employment, occupational history, and personal characteristics.

Our empirical results show that political connections play an essential role in SMEs enjoying more benefits. Although politically connected SMEs have lower performance than non-connected firms, they can still access and obtain more formal finance, pay lower taxes, and reduce time dealing with government regulations. Furthermore, we find evidence to explain the underperformance phenomenon through the informal fee channel and political objectives. More specifically, politically connected firms have to pay higher informal fee costs and hire more laborers than non-connected firms. Finally, the findings support the argument that political connections are more important in the less developed market regions.

Our paper contributes to the literature in some aspects. First, we add further evidence of how political connections affect small enterprises and different measurements of political relations in the business field. While some authors point out the value of ties (Mian & Khwaja, 2005; Facio, 2006; Li *et al.*, 2008; Boubakri *et al.*, 2012), our study provides not only benefits but also the cost of political connections by analyzing a unique and detailed database from Vietnam. Second, this study focuses on the emerging market where the influence of the government on business is solid and corporate governance is weak. Thus, the study allows us to understand the relationship between political connections and firm operation and contributes to agency theory in risk-taking decisions. Last but not least, our study adds to the existing literature by showing the mechanism that political connections affect firm performance and the potential cost they have to take to obtain economic benefits.

This paper has the structure as follows. Section 2 introduces the relationship between political connections and firm operation and proposes related hypotheses. Section 3 details data and econometric models. Sections 4 and 5 present empirical results and further discussion. The last section provides a conclusion.

Literature Review and Hypothesis Development

More studies have explored the relationship between firms and government connections and how it affects firm performances and financing in developed and developing countries. Many studies indicated that firms connected to politicians could get more favors from lenders to access credit than non-connected firms (Sapienza, 2004; Mian & Khwaja, 2005; Claessens *et al.*, 2008; Boubakri *et al.*, 2012). Faccio (2010) used sample data from 47 countries and found that it is more likely for politically connected firms to access bank loans or lower taxes. The higher the

position of politicians, the more benefit that firms can get from this connection. Moreover, these benefits increase in a country with high corruption levels, inadequate laws, or low levels of democracy.

However, some studies discuss that political connections often lead to poor firm performances compared to their peers (Boubakri *et al.*, 2008; Faccio, 2010). This is because they have higher leverage and are considered high-default-risk firms (Bliss & Gul, 2012). Similarly, Wong and Hooy (2018) argued that only stable political connections, such as relationships with government officers or the board of directors, positively affect firm performance, while less long-lasting relationships, such as those with family members or business people, do not affect the firm. In contrast, analyzing the change in the Danish local government, Amore and Bennedsen (2013) found that political connection can improve the performance of enterprises; especially, the relationship between family members and politicians helps them gain favorable treatment from the local government. Therefore, the impact of political ties on firm performance and firm financing is still unclear, especially in developing countries. Thus, we propose a hypothesis:

Hypothesis 1: Political Connections Harm Firm Performance.

Especially in developing countries where institutions are weak, corruption and non-democracy are high, and bribery is an effective way to connect with politicians. However, to get these benefits, the cost of building and maintaining this relationship is also very high. Thus, it might be unaffordable for small firms (Shleifer & Vishny, 1994). Therefore, whether firms can access credit is based not just on the firm's performance but also on network connections, which may lead to market distortion and economic inefficiency. Therefore, we hypothesize that:

Hypothesis 2: The Politically Connected SME is a More Inefficient Allocation of Resources than the Non-Connected Peers.

The studies of how political connection benefits firms are often based on the resource dependence theory, which is about the impact of external resources on organizational behavior (Salancik & Pfeffer, 1978). Based on this theory, it is more likely that it is easier for connected firms to access financing or receive government contracts. For example, when studying the impact of political connections on SMEs in Indonesia, Leuz and Oberholzer (2006) found that firms are more likely to seek financial help from local governments if they have a relationship. By using firm-level data from more than 3,000 private enterprises in 2002, Li *et al.* (2008) illustrated the positive effect of being party members on firm performance, and it is more likely for them to get loans from banks. This connection can mainly help firms' access bank loans easier with lower interest rates and fewer collateral requirements (Fraser *et al.*, 2006; Boubakri *et al.*, 2012; Piotroski *et al.*, 2015).

In light of the preceding literature, it is reasonable to give a hypothesis that:

Hypothesis 3: Politically Connected Smes Enjoy More Preferential Treatment than Non-Connected Smes.

In general, the existing literature suggests that the effect of political connections on firm performance is still ambiguous. There are limited studies on the impact of political connections on enterprises in Vietnam. However, most of them just focused on one financial year or a small

area of Vietnam. Hence, the effect of political links on SMEs in Vietnam regarding financing and performance is still a question that needs to be answered.

MATERIALS AND METHODS

Data Collection and Processing

The panel data was collected from the Small and Medium Scale Manufacturing Enterprises (SMEs) survey in Vietnam. The survey was carried out every two years from 2005 to 2015 under the collaboration of the Central Institute for Economic Management (CIEM), the Institute of Labor Science and Social Affairs (ILSSA), and the Development Economics Research Group (DERG) of the University of Copenhagen (Denmark). The survey was conducted in nine provinces (including Hanoi, Ha Tay, Ho Chi Minh, Hai Phong, Phu Tho, Nghe An, Quang Nam, Khanh Hoa, Lam Dong, and Long An), which were not randomly chosen because it should cover both urban and rural areas. However, the sample is still good enough to represent Vietnam because those cities and provinces are located in different regions in Vietnam, describing each region's unique characteristics.

The data for this study will be on firms with less than 300 workers. Additionally, to reduce estimate bias, all organizations that were questioned constantly or only once in a year would be eliminated as part of the dimensional tracing of the data over time.

The dataset shows that over 15% of firm owners/managers in the sample are members of the Communist Party, and most of them have joined the party before starting their businesses. Therefore, the reverse causality issue will not be a big issue when entrepreneurs join the party after success in their business. Furthermore, many firm owners/managers worked for public organizations before starting their businesses, with almost 50% of the total sample. The dataset shows that SMEs have 16 employees, which is reasonable in Vietnam. Although the firm size varies across the sample, most SMEs in Vietnam are household enterprises with less than ten employees. The detailed information of the dataset will be described in **Table 1**.

Table 1. Summary Statistics

Variables	Observations	Mean	Std. Deviation	Min	Max
Entrepreneur's characteristics					
Party membership	14,351	0.1332	0.3398	0	1
Professional education level	14,351	3.3153	1.3069	1	5
Age	14,351	46.2391	10.0028	20	89
Former public employee	14,351	0.4715	0.4992	0	1
Former cadre	14,351	0.1220	0.32731	0	1
Firm's characteristics					
Employment (log)	10,980	1.8545	1.2109	0	5.7038
Total assets (log)	14,241	7.4666	1.4270	4.60517	13.06278
leverage	14,219	0.09948	0.2281	0	5.6735
ROA	14,141	0.15705	.3787	-9.5102	6.9077
ROE	14,132	0.16868	.39519	-9.5660	6.93375

Firm age	14,351	13.5482	8.6995	1	62
Total loan (log)	3,520	6.4024	1.7785	2.3026	11.7753
Informal fee rate	14,332	0.2678	0.3331	0.00659	14.3005
Time dealing with bureaucracies	9,473	2.1812	3.1376	0	50
PCI	14,043	58.1368	4.7297	38.8	67.12

Table 2 describes the characteristics of the owner/manager as a member of the Communist Party and a non-Party member and the differences between SMEs owned by Party members and non-Party members, as shown in the last column. The results were calculated using a t-test of the difference between the two groups. The differences in characteristics between party and non-party members and their SMEs are significant at 1%.

Table 2. Summary Statistic: Party Member vs. Non-Party Member

Variables	Party member	Non-Party member	Difference
	Mean (S.d)	Mean (S.d)	Mean (S.d)
	(1)	(2)	(1) – (2)
observations	1912	12439	
Entrepreneur's characteristics			
Professional education level	3.7960 (0.0287)	3.2414 (0.0116)	0.5546*** (0.0318)
Age	52.4702 (0.2355)	45.2813 (0.0861)	7.1889*** (0.2382)
Former public employee	0.8551 (0.0081)	0.4124 (.0044)	0.4426*** (0.0116)
Former cadre	0.3692 (0.0110)	0.0840 (0.0025)	0.2852*** (0.0077)
Firm's characteristics			
Employment	2.003 (0.0357)	1.8326 (0.0121)	0.1705*** (0 .0344)
Total assets (log)	7.7885 (0.0362)	7.4174 (0.0126)	0.3711*** (0.0351)
leverage	0.1064 (0.0054)	0.0984 (0.0020)	0.0080 (0.0056)
ROA	0.0556 (0.0093)	0.1724 (0.0034)	- 0.1168*** (0.0094)
ROE	0.0624 (0.0095)	0.1848 (0.0035)	-0.1223*** (0.0098)
Firm age	15.4739 (0.2162)	13.252 (0.0766)	2.2217*** (0.2129)
Total loan (log)	7.5681 (0.0721)	6.1791 (0.0313)	1.3890*** (0.0782)

Informal fee rate	0.3139 (0.0115)	0.2608 (0.0027)	0.0531*** (0.0081)
Time dealing with bureaucracies	13.0948 (0.2113)	15.4495 (0.0732)	- 2.3547*** (0.1993)

Standard errors in parentheses *** p < 0.01, ** p < 0.05, * p < 0.1

Table 3 describes the correlation matrix of the main variables. The multicollinearity is not a big concern because all the correlation coefficients are low; besides, most are significant at a 5 percent level. Further tests using the variance inflation factor (VIF) also report that all the coefficients are below 2, meaning that multicollinearity is not an issue in this study.

Table 3. Correlation Matrix

	Education	Age	Employees	Assets	ROA	ROE	Firm age	Loan ratio	Informal fee rate	VIF
Education	1.0000									1.19
Age	-0.0597*	1.0000								1.23
Employees	0.1513*	-0.0594*	1.0000							1.22
Assets	0.1798*	-0.0009	0.2349*	1.0000						1.08
ROA	-0.1207*	-0.0892*	-0.0753*	-0.0323*	1.0000					1.04
ROE	-0.1184*	-0.0949*	-0.0722*	-0.0338*	0.9890*	1.0000				
Firm age	-0.1483*	0.4133*	-0.1058*	-0.0058	-0.0133	-0.0207*	1.0000			1.21
Loan ratio	0.1314*	0.2126*	0.0335	0.0283	-0.1285*	-0.1335*	0.0381*	1.0000		1.08
Informal fee rate	0.0370*	-0.0072	0.0398*	0.0215*	-0.0125	-0.0145	-0.0019	0.7362	1.0000	1.01

Econometric Models

There is only one party in Vietnam: the Communist Party leading the nation. The Communist Party of Vietnam is organized on the principle of democratic centralism. The highest authority is the National Congress, held once every five years. Congress elects the Central Executive Committee, which selects the General Secretary and the Political Bureau of the Central Committee. The Communist Party operates based on the party's mechanism to set the policy directions; the government implements it through different government sub-levels and organizations. At the provincial, district, and commune levels, the People's Council and the People's Committee are the highest legislative and executive institutions at each local government level. Therefore, one is needed to be a member of the Communist Party to participate in the Committee and Council. Besides, only Communist Party members have the right to vote for the People's Committee member under the consent of the People's Committee at a higher level. Therefore, to get a closer relationship with the local legislative and executive institutions, being a member of the Communist Party can be considered the first step entrepreneurs should take to affiliate their businesses.

The effect of political connection on firm performance came up with mixed findings. Some studies concluded that politically connected firms have better performance than non-connected firms (Facio, 2006; Li *et al.*, 2008; Goldman *et al.*, 2009; Boubakri *et al.*, 2012; Coulomd & Sangnier, 2014; Ling *et al.*, 2016). On the other hand, some authors found a negative effect of political connection on firm performance, such as Boubakri *et al.*, 2008; Faccio and Parsley, 2009; Faccio, 2010.

To test the first hypothesis, the following equation is adopted:

$$Profit_{it} = \beta_0 + \beta_1 P_{it} + \sigma X_{it} + \varepsilon_{it} \quad (1)$$

The dependent variable $Profit_{it}$ will be measured by return on assets (ROA) and return on equity (ROE). At the same time, P_{it} is a dummy variable of party membership (P_{it} takes the value of 1 if the owner/manager of firm i is a member of the party at time t, and 0 otherwise). Finally, the control variables X_{it} include owner/manager characteristics and firm characteristics that affect the credit access of firm i at time t.

To evaluate the efficiency of resource allocation in a firm, we follow the methodology of Hsieh and Klenow (2009) by comparing the marginal productivity of the factors of production among firms. If the less productive firms use more resources to produce, they are identified as inefficient resource allocation. The following model is adopted to test hypothesis 2:

$$\Delta l_{it} = \beta_0 + \beta_1 MPL_{it} + \beta_2 MPL_{it} * INF_{it} + \beta_3 INF_{it} + \delta X_{it} + \varepsilon_{it}$$
$$\Delta k_{it} = \beta_0 + \beta_1 MPK_{it} + \beta_2 MPK_{it} * INF_{it} + \beta_3 INF_{it} + \delta X_{it} + \varepsilon_{it} \quad (2)$$

Δl_{it} (Δk_{it}) is labor reallocation (capital reallocation), which is measured by taking the difference between the logarithms of a firm's share of employment (total fixed assets) in year t and year t-1. The firm's share of employment (total fixed assets) in a given year is calculated as the total employment (total fixed assets) of firm i divided by the total employment (total fixed assets) of all firms in the industry province. MPL_{it} (MPK_{it}) is the marginal productivity of labor (capital) of firm i in year t, computed by the logarithms of sales over total employment (total fixed assets). INF_{it} is the informal fee rate defined as the total informal fees of firm i in year t divided by the sales of firm i in year t. The control variables X_{it} include owner/manager characteristics and firm characteristics.

Although SMEs have accounted for the most significant proportion of total enterprises operating in the market, they still face difficulties accessing formal credit due to a lack of collateral or unclear and audited financial statements. As a result, most SMEs depend on self-capital or informal credit, which has a higher cost. However, as discussed above, if SMEs have close relationships with the local government or get a position on the Executive Committee of the Party, they can be affiliated to overcome those difficulties.

To test the third hypothesis, the following equation is used:

$$Y_{it} = \beta_0 + \beta_1 P_{it} + \sigma X_{it} + \varepsilon_{it} \quad (3)$$

Y_{it} represents different dependent variables to test this hypothesis. First, we use a loan ratio measured as total bank loans divided by total assets to test whether party membership facilitates SME access to formal credit. Second, we define tax rate as total tax and fee payment divided by total sales to explore the effect of political ties on firms in terms of taxation. Finally, the percentage of time spent dealing with government regulations is employed to examine the bureaucracy level. The p_{it} is the dummy variable, which it takes the value of 1 if the owner/manager of firm i is a member of the party at time t, and 0 otherwise. The control variables X_{it} include owner/manager characteristics and firm characteristics that affect credit access of firm i at time t.

RESULTS AND DISCUSSION

Party Membership and Firm Performance

First, we estimate the impact of political connections on firm performance. Two dependent variables measure a firm's performance: return on assets (ROA) and return on equity (ROE). **Table 4** reports estimation results that confirm Hypothesis 1. We first run a regression with only party membership dummy variables and other control variables, including the entrepreneur's and the firm's characteristics. The results are reported in the first column of **Table 4**. Similar to Faccio (2010), who indicated that connected firms underperform compared to their peers, our estimation result confirms the negative relationship between party membership and firm performance. Specifically, a party member lowers its ROA by six percentage points at a five percent significant level. For the control variables, firm size (measured by the total number of employees) and informal fee rate negatively affect ROA while leveraging associates with higher profit returns. Of all the entrepreneur's characteristics, the age of the owner/manager has a significantly negative effect on ROA.

We test whether party membership may affect ROA through other channels by including two dummy political connection variables (work experience in the public sector and former cadre experience). The estimation result is reported in column (2) of **Table 4**. It demonstrates that party membership again has a significantly negative impact on firm performance at a five percent significant level. Although we add more variables to the equation, the magnitude of the effect is almost the same as the previous estimation. Surprisingly, both new dummy variables do not significantly impact ROA.

In columns (3) and (4) of **Table 4**, we report the regression results with ROE as the independent variable. The effect of party membership on ROE shows the same sign and magnitude as in the first two columns of **Table 4**. In addition, they are all significant at five percent.

Table 4. Impact of Political Connections on Firm Performance

Variables	ROA	ROA	ROE	ROE
	(1)	(2)	(3)	(4)
Party membership	-0.0634**	-0.0639**	-0.0644**	-0.0649**
	(0.0276)	(0.0277)	(0.0288)	(0.0288)
Firm's attributes				
Employment (log)	-0.0153***	-0.0156***	-0.0161***	-0.0165***

	(0.00369)	(0.00369)	(0.00384)	(0.00385)
Total asset (log)	0.00378	0.00423	0.00334	0.00381
	(0.00286)	(0.00288)	(0.00298)	(0.00300)
Leverage	0.107***	0.107***	0.130***	0.130***
	(0.0194)	(0.0194)	(0.0203)	(0.0203)
Firm age	0.000689	0.000842	0.000454	0.000611
	(0.00219)	(0.00219)	(0.00228)	(0.00228)
Informal fee rate	-0.176***	-0.175***	-0.200***	-0.200***
	(0.0596)	(0.0596)	(0.0621)	(0.0621)
Entrepreneur's attributes				
Owner/Manager's age	-0.00290*	-0.00291*	-0.00314*	-0.00315*
	(0.00174)	(0.00174)	(0.00181)	(0.00181)
Professional education level	-0.00503	-0.00487	-0.00396	-0.00379
	(0.0384)	(0.0384)	(0.0400)	(0.0400)
Former public-sector employment		-0.0138		-0.0142
		(0.00882)		(0.00919)
Former cadre		0.0540		0.0458
		(0.126)		(0.132)
Constant	0.399**	0.396**	0.440***	0.437***
	(0.157)	(0.158)	(0.164)	(0.165)
Observations	10,411	10,411	10,405	10,405
R-squared	0.024	0.024	0.027	0.027

Standard errors in parentheses
*** p < 0.01, ** p < 0.05, * p < 0.1

Although Vietnam and China have similar political systems and economic structures, our empirical results contrast Li's study. Li *et al.* (2008) adopted a dataset of privately owned enterprises in 2002 and showed a positive relationship between party membership and firm profitability in China. However, they only examined the effect of party membership on a firm's profitability in one year (using data collected in 2002). In comparison, we have the advantage of using a panel dataset from 2005 to 2015 to examine this relationship. The regression results suggest that connected firms may have to pay more informal fees than non-connected firms to build political ties, resulting in lower performance. Besides, the poor performance of related SMEs in Vietnam may be explained by the costs of building the connection.

Party Membership and Resource Allocation

We estimate whether the informal fee rate may lead to resource allocation inefficiency to determine why political connections hurt firm performance. The dependent variable is capital reallocation, measured by the difference of logarithms of the firm's share of the industry fixed assets between year t and t-1, and labor reallocation, calculated as the logarithms of the firm's share of industry employment between year t and t-1. The marginal productivity of capital/labor is measured by the logarithms of sales divided by fixed assets/number of employees. The firm-

fixed effect will account for SMEs' higher productivity or growth for their specialization in some industries. The regression results are reported in **Table 5**.

Table 5. The Effect of Informal Fees on the Efficiency of a Firm's Resource Allocation

Variables	Labor reallocation		Capital reallocation	
	(1)	(2)	(3)	(4)
MPL	0.000844	0.00185**		
	(0.000682)	(0.000935)		
MPL*Informal fee rate		-0.00518*		
		(0.00311)		
Informal fee rate		0.00257		-2.542
		(0.0222)		(29.38)
MPK			-1.655	-1.879
			(1.039)	(1.534)
MPK*Informal fee rate				1.035
				(5.359)
Control variables	YES	YES	YES	YES
Constant	0.0401	0.0427	16.91	17.33
	(0.0470)	(0.0470)	(75.90)	(76.26)
Observations	10,455	10,732	10,347	10,334
R-squared	0.052	0.047	0.004	0.004

Standard errors in parentheses
*** p < 0.01, ** p < 0.05, * p < 0.1

According to the findings in columns (1) and (2) regarding informal fees on labor reallocation, businesses in sectors with greater marginal labor productivity employ more workers. Inefficient labor allocation will result, nonetheless, as the informal charge rate's cost rises. However, there is insufficient evidence in columns (3) and (4) to support the claim that informal charge rates increase the efficiency of capital allocation. Wu *et al.* (2012) clarified that the linked state-owned businesses are under pressure to meet the policy goals, which frequently results in them performing poorly and having a lower value. Therefore, connected SMEs may hire more labor to accomplish political goals. In summary, it confirms that political connections may help SMEs obtain political favors such as bank loans, tax reductions, etc. However, it also leads to inefficiency of labor reallocation, which lowers firm performance and harms the economy.

Further Test

Why Political Connection is Vital

We argue that firms seek to build a connection with politicians and government officials to overcome market obstacles. This section explores the benefits that political connections can provide to connected firms.

First, we employ a regression with a fixed effect to examine the impact of political connections in obtaining bank loans. The dependent variable is the ratio of the total amount of loans to total firm assets. The result is reported in the first column of **Table 6**. Our estimations are consistent

with other studies that politically connected firms can get more favors from lenders to access bank loans than non-connected firms (similar to Sapienza, 2004; Claessens *et al.*, 2008; Faccio, 2010; and others). For example, party membership facilitates connected firms to borrow more from banks by 11.8%.

Moreover, working experience at public organizations can also increase 3.56% of the total loan ratio. All results are significant at a one percent level. As described, half of the people in the sample have experience working for public organizations before starting their businesses. It is a significant advantage to build networks with local government and other organizations.

Table 6. Effect of Political Connections on SMEs

Variables	Loan/assets	Tax/sale	Time dealing with regulations
	(1)	(2)	(3)
Party membership	0.118***	-0.0158***	-1.314*
	(0.0306)	(0.00511)	(0.763)
Firm's attributes			
Employment (log)	-0.00240	4.85e-05	-0.0815
	(0.00417)	(0.000685)	(0.102)
Total asset (log)	-0.00573	-0.000325	0.0903
	(0.00372)	(0.000536)	(0.0700)
Firm age	-0.00239	-7.42e-05	0.00939
	(0.00238)	(0.000409)	(0.0750)
Informal fee rate	-0.00842	-0.00117	-1.310
	(0.111)	(0.0112)	(1.676)
Entrepreneur's attributes			
Owner/Manager's age	0.00248	-0.000119	-0.0166
	(0.00178)	(0.000326)	(0.0472)
Professional education level	0.00837	-0.00175	1.721
	(0.0353)	(0.00720)	(1.047)
Former public-sector employment	0.0356***	-0.000877	0.186
	(0.0113)	(0.00165)	(0.257)
Former cadre	0.0347	0.00192	-1.083
	(0.0937)	(0.0237)	(4.577)
Constant	0.265*	0.0376	10.32**
	(0.156)	(0.0296)	(4.360)
Observations	2,540	10,477	6,015
R-squared	0.062	0.005	0.020

Standard errors in parentheses
*** p < 0.01, ** p < 0.05, * p < 0.1

Next, we test whether party membership can benefit SMEs regarding taxes and fees and the time dealing with bureaucracy. We employ a fixed effects regression with the tax rate and percentage of time entrepreneurs spend coping with government regulations as dependent variables. The

estimation results are reported in columns 2 and 3 of **Table 6**. Our estimation results are consistent with previous studies such as Mian and Khwaja, 2005; Li *et al.*, 2008; Li and Zhou, 2015. More specifically, if the owner/manager of the SME is a member of the Communist Party, connected firms can enjoy a 1.58% lower tax rate than non-connected firms. In addition, connected SMEs can save 1.31% of their time dealing with government regulations per month. Therefore, although connected SMEs need to bear the higher cost of building political connections than non-connected firms, they can benefit from this relationship.

The political link might assist SMEs in receiving more favorable treatment, which may explain the process of becoming a party member. If the firm's owner/manager is a party member, they will be able to attend a higher-level party awareness training and engage in legislative actions. Furthermore, in the private sector, most Party members are under the administration of the Centrally-run Businesses' sector, which allows them to create further ties. Therefore, becoming a party member can be considered the first step closer to local legislative and executive institutions and building networks with other party members. Moreover, based on the connection with local regulators, the cost of doing business might be lower than with non-connected SMEs. Thus, politically connected firms can have a higher probability of obtaining loans from banks (Feghhi *et al.*, 2023; Saeed & Almendeel, 2023).

Effect of the Institutional Environment

This subsection examines the effect of political connections on firm performance in different business environments. First, we collect the provincial competitiveness index (PCI), designed to identify local governments' performance, willingness, and capacity to improve the business environment. It is surveyed annually by the Vietnam Chamber of Commerce and Industry (VCCI) and funded by the U.S. Agency for International Development (US-AID). This index (PCI) is more comprehensive than other previous studies to reflect the market environment and the development level of the institution in each region. The results are reported in **Table 7**.

Table 7. The Effect of Political Connections on Credit Access and Firm Performance of SMEs at Different Levels of the Business Environment

Variables	ROA	ROE
	(1)	(2)
Party membership	-0.464***	-0.475***
	(0.164)	(0.171)
Employment (log)	-0.0161***	-0.0170***
	(0.00374)	(0.00390)
Total asset (log)	0.00448	0.00405
	(0.00292)	(0.00305)
Leverage	0.107***	0.128***
	(0.0198)	(0.0207)
Firm age	0.00189	0.00172
	(0.00227)	(0.00236)
Informal fee rate	-0.177***	-0.202***

	(0.0599)	(0.0624)
Owner/Manager's age	-0.00315*	-0.00333*
	(0.00178)	(0.00186)
Professional education level	-0.00725	-0.00584
	(0.0385)	(0.0401)
Former public-sector employment	-0.0151*	-0.0155*
	(0.00897)	(0.00936)
Former cadre	0.0330	0.0219
	(0.133)	(0.138)
PCI	-0.000853	-0.000945
	(0.000933)	(0.000973)
PCI*Party membership	**0.00674****	**0.00689****
	(0.00277)	**(0.00289)**
Constant	0.456***	0.499***
	(0.167)	(0.174)
Observations	10,135	10,129
R-squared	0.026	0.029

Standard errors in parentheses
*** p < 0.01, ** p < 0.05, * p < 0.1

The results show that political ties are more important to SMEs in regions where the market environment is less developed. Columns (1) and (2) of **Table 7** illustrate the effect of party membership on firm performance in different business environments. The interaction term coefficient between party membership variables and PCI positively impacts ROA and ROE at a 5 percent significant level. The results suggest that party membership becomes less critical in the market where the local government is more willing to develop a business environment or, in other words, the market works more efficiently. In column (3), the regression result indicates that firms' characteristics, such as human capital and financial status, are more important for firms to access bank loans when the business environment is improved. At the same time, party membership is more valuable in less developed regions (Jongjai *et al.*, 2021).

CONCLUSION

This paper explores the role of political connections on firm performance by employing a unique and representative panel dataset of SMEs in Vietnam. Our findings contrast with most previous empirical studies to point out a negative effect of political connections on profit return. It may be explained that politically connected SMEs have to pay a higher informal fee to build links. Besides, the connected firms may accomplish the political objectives that lead to inefficient resource allocation and underperformance.

Our estimation results also suggest that one of the most effective channels to obtain preferential treatment is the relation to the ruling Communist Party. As a result, the connected firms can access bank loans, enjoy lower tax rates, and reduce the percentage of time dealing with government regulations. However, when the institutional environment is well developed, the vital role of political connections diminishes. Therefore, in the context of the transition economy

in Vietnam, where the institutional system is still far from perfect, political ties are still one of the most important factors for SMEs to overcome market constraints.

Table 1 reports summary statistics of the main variables. The sample comprises 14,351 firm-year observations over the period 2005-2015. Variables are divided into two groups: owner's attributes (party membership, former public employee, former cadre, education level, age) and firm's attributes (total employment, total assets, ROA, ROE, firm age, total loan, value-added, informal fee rate, time dealing with bureaucracies).

Table 2 reports the characteristics of the entrepreneurs and firms for party members and non-party members in terms of the owner's attributes and the firm's attributes. The t-test of the difference between the two groups is also reported. The t-statistics are reported in parentheses. ***, ** and * denote statistical significance at the 1%, 5%, and 10% levels, respectively.

Table 3 reports the correlation matrix of the explanatory variables. It describes Pearson's correlation coefficients for all the variables used in the regressions. The * denotes statistical significance at the 5% level.

Table 4 presents panel regression fixed effects estimation results. Columns (1) and (2) report the effect of political connections on ROA, while columns (3) and (4) describe the estimation for ROE. Columns (1) and (3) report estimation using only the party membership dummy variable and other variables of the firm's attributes and the entrepreneur's attributes. In columns (2) and (4), we add two more political connection variables, including work experience in the public sector and a former cadre. The t-statistics are reported in parentheses. ***, ** and * denote statistical significance at the 1%, 5%, and 10% levels, respectively.

Table 5 studies the effect of informal fees on the efficient allocation of resources. The unit of observation in this estimation is firm-year. The dependent variable in both panels is measured by the log form of the firm's share of industry employment between year t and year t-1 in columns (1) and (2) and the log form of the firm's share of the industry assets between year t and year t-1 in columns (3) and (4). Control variables are assets (log form), employment (log form), leverage, firm age, former cadre, former public employee, education level, and age, but the coefficients are not reported. The t-statistics are reported in parentheses. ***, ** and * denote statistical significance at the 1%, 5%, and 10% levels, respectively.

Table 6 presents panel regression fixed effects estimation results. Column (1) reports the effect of political ties on helping connected SMEs access formal credit. The dependent variable is measured as total bank loans divided by total assets. Columns (2) and (3) describe other benefits that connected SMEs may receive. The dependent variables are the amount of taxes divided by sales of firm i at time t in column (2) and the percentage of time firm i spent each month dealing with regulations in column (3). The t-statistics are reported in parentheses. ***, ** and * denote statistical significance at the 1%, 5%, and 10% levels, respectively.

Table 7 studies the effect of political connections on credit access and firm performance of SMEs in different business environments. Columns (1) and (2) present the effect on firm performance measured by ROA and ROE, respectively. The dependent variable in column (4) is the loan rate over assets that a firm can obtain. The business environment is measured by the provincial competitiveness index (PCI). This index comprises ten sub-indices that measure different aspects of economic governance: entry cost for business start-ups, access to land and security, a transparent business environment, informal charge, etc. All estimations use both fixed effects

and industry fixed effects. The t-statistics are reported in parentheses. ***, ** and * denote statistical significance at the 1%, 5%, and 10% levels, respectively.

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