

Loans, Link and Leadership: Political Change and Borrower Discouragement in Connected Firms

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Abstract

This paper examines how political leaders change moderates the impact of corporate political activity (CPA) on borrower discouragement, using a global dataset of 24,167 firms. While CPA generally reduces discouragement, its effectiveness is significantly diminished during political transitions, as the “know-who” channel becomes unreliable.

Keywords: banking, political connection, borrower discouragement.

JEL Codes: G21, K38.

1. Introduction

Access to finance is a critical determinant of firm growth and economic development (Beck and Demirguc-Kunt, 2008). Yet, many SMEs face significant barriers in obtaining external financing (Ayyagari *et al.*, 2008). One reason is borrower discouragement—a phenomenon where firms in need of credit choose not to apply for loans, fearing rejection (Kon and Storey, 2003).

Corporate political activity (CPA), which is defined as corporate attempts to shape government policy in ways favorable to the firm, has been shown to reduce borrower discouragement by equipping firms with the resources and strategic knowledge needed to navigate the credit market effectively (Qi and Nguyen, 2021). The literature highlights two key channels through which CPA influences access to finance: the "know-who" and "know-how" channels (Ang and Jia, 2014). The "know-who" channel emphasizes the importance of networking and leveraging political connections to gain preferential access to resources. Conversely, the "know-how" channel focuses on the operational understanding firms gain through their political activities.

In the context of political change, however, the efficacy of the latter channel becomes less predictable. Indeed, a change of leaders may influence the relative importance of the "know-who" and "know-how" channels. While the "know-how" channel could remain relevant or even gain importance in politically volatile environments—enabling firms to navigate shifting political landscapes effectively—the "know-who" channel is more likely to be disrupted. Changes in government may indeed undermine established networks and shift political alliances, thereby reducing the reliability of connections in securing credit. On the contrary, firms relying on operational expertise through the "know-how" channel might better adapt to the uncertainty.

Thus, a change in political leader introduces an additional layer of complexity to the relationship between CPA and borrower discouragement, allowing us to start distinguishing the impact of the two channels – the "know-who" and the "know-how" - separately. This paper explores these dynamics, examining how leader changes moderate the impact of CPA on firms' discouragement. The results show that while CPA generally reduces borrower discouragement, its effectiveness is significantly moderated after a change of political leader. Our interpretation is that the "know-who" channel becomes less reliable during political transitions, whereas the

"know-how" channel retains its relevance, particularly for firms with experienced managers, foreign-owned firms or those operating in favorable credit environments.

The paper proceeds as follows. In section 2, the methodology and the data employed are explained. Section 3 presents the results. Finally, the article ends with relevant conclusions.

2. Data and methodology

This study employs data from the World Bank Enterprise Surveys (WBES), which provides a comprehensive dataset of firm-level information across numerous countries. For this analysis, we use a sample of 24,167 observations spanning multiple industries and countries, offering a robust platform to examine the interplay between corporate political activity (CPA), leader changes, and borrower discouragement.

The dependent variable, *Discouraged*, is a binary indicator equal to 1 if the firm needed credit but refrained from applying for a bank loan.

The main independent variables of interest include *CPA*, defined as whether senior management spends time addressing government regulatory requirements, in line with previous work (Liedong *et al.*, 2023). *Change Leader* indicates whether an election resulted in a change of political leadership and *Change Political Party* captures whether an election led to a shift in the ruling political party, representing broader ideological and policy changes that could increase uncertainty for firms. Control variables are selected in line with Bertrand *et al.* (2022) and are described in **Table 1**.

3. Results

Table 2 examines how leader changes affect the influence of political connection on borrower discouragement. Column (1) shows that having a political connection (*CPA*) in normal time significantly reduces borrower discouragement. The interaction term *CPA x Change Leader* is positive and significant, suggesting that political connections are less valuable after a leader change. The results are also economically significant. Having a connection reduces discouragement by 0.148 points (0.30 standard deviations), but the effect decreases by 80%

when there is a political change. Column (2) introduces *Change Political Party* as an alternative measure of leader changes, providing similar results. The robustness checks presented in following columns confirm the validity of the main results by addressing potential concerns related to clustering at the country-level (column 3), alternative definitions of CPA (column 4), and sample selection bias using a Heckman two-stage model in line with Léon (2015) (column 5).

Overall, our results suggest that while CPA continues to reduce discouragement, its effect is greatly diminished following a political change. We interpret this finding as an indication that political connections reduce borrower discouragement mainly through "know-who" benefits, which becomes less effective when political leaders change.

Table 3 presents further estimations exploring the moderating role of specific firm-level and country-level variables on the relationship between CPA, leader changes, and borrower discouragement. *Manager Experience* (Column 1) negatively interacts with the *CPA x Change Leader* relationship, suggesting that experienced managers can better leverage the "know-how" channel of CPA to mitigate discouragement even in politically unstable environments. The triple interaction with *Foreign Ownership* (Column 2) yields negative and significant coefficient, which could stem from foreign firms' reliance on international networks rather than local political connections. This reduces their dependence on the "know-who" channel, making CPA less impactful in addressing borrower discouragement. For *Getting Credit* (Column 3), the interaction term *CPA x Change Leader* is negative and significant, reflecting how better credit environment reduces discouragement during political instability. In this context, the "know-how" channel may be particularly relevant, as firms benefit from both operational expertise and institutional support in credit markets that function more efficiently. Finally, *Democracy* (Column 4) reduces discouragement overall, as democratic institutions enhance transparency and accountability, thereby mitigating the risks posed by political instability. However, the negative and significant interaction term *CPA x Change Leader x Democracy* indicates that the "know-who" channel of CPA becomes less effective in democratic settings, likely because such systems limit the extent to which personal political connections can yield preferential treatment.

4. Conclusion

This study investigates the interaction between corporate political activity (CPA), leader change, and borrower discouragement, shedding light on the distinct roles of the "know-who" and "know-how" channels. Specifically, the "know-who" channel is particularly vulnerable to disruptions during political transitions, whereas the "know-how" channel remains more robust, providing firms with tools to navigate uncertain regulatory landscapes. Our findings reveal that while CPA generally reduces borrower discouragement, its effectiveness falls by four fifths during political changes, showing the central role of "know-who" to explain the role of political connections on borrower discouragement. Further estimations underscore the "know-who" channel is less predominant for foreign-owned firms and those managed by experienced managers as well as in countries where access to credit is easier and in democracies. These results emphasize the need for policies that strengthen institutional frameworks and financial systems, particularly in politically volatile environments, to ensure equitable access to credit for all firms.

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Table 1. Descriptive Statistics

This table presents the definitions and descriptive statistics of all the variables used in the regressions.

| Variables | Description | Mean | Std. Dev. |
|------------------------|---|--------|-----------|
| Discouraged | =1 if the firm needed credit and refused to apply for bank credit | 0.438 | 0.496 |
| Change Leader | =1 if an election takes place during the year and a new leader was elected | 0.382 | 0.486 |
| Change Political Party | =1 if an election resulted in a shift of the ruling political party | 0.246 | 0.511 |
| CPA | =1 if the senior management spends time on dealing with requirements imposed by government regulations. | 0.644 | 0.479 |
| CPA 2 | =1 if the firm has secured or attempted to secure a government contract over the last year. | 0.209 | 0.406 |
| Manager Experience | Manager experience in years. | 19.136 | 11.722 |
| Female | =1 if the firm's top manager is a woman. | 0.356 | 0.479 |
| Log(Size) | Number of permanent full-time employees (log). | 3.483 | 1.396 |
| Log(Age) | Firm age (log year). | 2.845 | 0.915 |
| Sole Ownership | =1 if the firm has only one owner. | 0.417 | 0.493 |
| Limited Corp. | =1 if the firm is a limited corporation. | 0.117 | 0.322 |
| Foreign Ownership | =1 if the firm has a foreign owner. | 0.068 | 0.251 |
| Certified | =1 if the firm's annual financial statements are checked or certified by an external auditor. | 0.570 | 0.495 |
| Account | =1 if the firm has a checking or savings account. | 0.908 | 0.289 |
| Politic Main Obstacle | =1 if the firm identifies politic as their main obstacle. | 0.093 | 0.291 |
| Getting Credit score | World bank access to credit index, the higher the index is, the easier access to credit should be. | 70.430 | 17.455 |
| Democracy | =1 if the political system is a democracy. | 0.665 | 0.472 |
| Rule of Law | Index used to measure perceptions related to the extent to which people have confidence in and abide by the rules of society. | -0.348 | 0.524 |
| Inflation | Rate of inflation. | 6.604 | 9.176 |
| Financial Development | Domestic banking credit to the private sector, as a share of GDP. | 42.662 | 20.176 |

Table 2. Main Results and Robustness Checks

This table presents the results using probit models. *Discouraged* is the dependent variable. All the models contain our control variables, presented in table 1. P-values are reported in parentheses. *, **, and *** denote statistical significance at the 10%, 5%, and 1% levels.

| | <i>Main analysis</i> | | <i>Robustness</i> | | |
|---------------------------------|----------------------|----------------------|----------------------|----------------------|----------------------|
| | Change Leader | Change Party | Cluster Country | Alternative CPA | Heckman |
| | (1) | (2) | (3) | (4) | (5) |
| Change Leader | 0.187*** (0.000) | | 0.187*** (0.000) | 0.233*** (0.000) | 0.197*** (0.000) |
| CPA | -0.148*** (0.000) | -0.154*** (0.000) | -0.148*** (0.000) | | -0.147*** (0.000) |
| CPA x Change Leader | 0.117** (0.045) | | 0.117** (0.048) | | 0.112** (0.044) |
| Change Political Party | | 0.225*** (0.000) | | | |
| CPA x Change Political Party | | 0.142*** (0.008) | | | |
| CPA2 | | | | -0.221*** (0.000) | |
| CPA2 x Change Leader | | | | 0.128*** (0.005) | |
| λ | | | | | -0.128*** (0.002) |
| Control variables | All | All | All | All | All |
| Industry, Year, Country dummies | Yes | Yes | Yes | Yes | Yes |
| Cluster | | | Country | | |
| Constant | 0.272*** (0.005) | 0.381*** (0.000) | 0.272*** (0.005) | 0.219** (0.023) | 0.373*** (0.000) |
| Observations | 24,167 | 24,167 | 24,167 | 23,976 | 24,167 |
| Pseudo R ² | 0.156 | 0.139 | 0.156 | 0.158 | 0.156 |

Table 3. Further Estimations

This table presents the results using probit models. *Discouraged* is the dependent variable. All the models contain our control variables, presented in table 1. P-values are reported in parentheses. *, **, and *** denote statistical significance at the 10%, 5%, and 1% levels.

| Z = variable | Manager Experience | Foreign Ownership | Getting Credit | Democracy |
|---------------------------------|----------------------|----------------------|----------------------|----------------------|
| <i>Discouraged</i> | (1) | (2) | (3) | (4) |
| Change Leader | 0.117* (0.054) | 0.201*** (0.000) | 1.647*** (0.000) | 0.484 (0.107) |
| CPA | -0.216*** (0.000) | -0.137*** (0.000) | -0.386*** (0.000) | -0.290** (0.019) |
| Z | -0.006*** (0.002) | 0.059 (0.448) | -0.003*** (0.004) | -0.479*** (0.003) |
| CPA x Change Leader | 0.356*** (0.000) | 0.074* (0.060) | 1.143*** (0.000) | 0.186** (0.016) |
| Change Leader x Z | 0.005* (0.065) | -0.142 (0.326) | -0.020*** (0.000) | 0.644** (0.040) |
| CPA x Z | 0.003 (0.114) | -0.146 (0.114) | 0.004*** (0.005) | -0.001 (0.986) |
| CPA x Change Leader x Z | -0.016*** (0.000) | -0.067** (0.020) | -0.016*** (0.000) | -0.058*** (0.001) |
| Control variables | All | All | All | All |
| Industry, Year, Country dummies | Yes | Yes | Yes | Yes |
| Constant | 0.292*** (0.004) | 0.261*** (0.007) | 0.412*** (0.001) | -0.377 (0.376) |
| Observations | 24,167 | 24,167 | 24,167 | 24,167 |
| Pseudo R ² | 0.157 | 0.156 | 0.159 | 0.191 |

“Sur quoi la fondera-t-il l'économie du monde qu'il veut gouverner ? Sera-ce sur le caprice de chaque particulier ? Quelle confusion ! Sera-ce sur la justice ? Il l'ignore.”

Pascal

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