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The Effect of Corruption and Political Instability on Firm's Performance: Evidence from Low Income Economies

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ABSTRACT

Low-income economies have characteristics of high corruption and political instability. The underdeveloped corrupt financial system of low-income nations with political instability may constrain firms' performance. The objective of the current study was to estimate the effect of corruption and political instability on firms' performance in low-income economies. The recent study used firm investment in human capital and exports as a proxy to measure the firm's performance. We have applied logistic regression to the World Enterprise Survey dataset to find the probability of firms' investment in human capital. The study concluded that corruption and political instability decrease the likelihood of a firm's human investment in human capital. Firm-specific characteristics increase the probability of firms' exports. For policy purposes, corruption must be reduced to increase firms' investment in human capital.

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1. Introduction

Low income economies have characteristics of high corruption and political instability. The underdeveloped corrupt financial system of low income nations with political instability may constraints firms' performance. The productivity and sustainability depends upon the firm's investment in exports. The empirical literature intensely argued for the policies to increase exports considering it an engine for sustainable growth (Kapri, 2019; Mendoza, Lim, & Lopez, 2015; Wu, 2009). The economic efficiency and growth of the firms depend upon the level of exports at firm's level. Black and Lynch (1996) and Bartel (1994) finds that firms which exports larger part of its output experience significant increase in productivity. The higher opportunity cost of entry into the export market is one of the major challenges for the growth of the firm. The greater incidence of corruption is one of the hurdles in growth of the firm.

The corrupt political system results into severe effect on the exports and human capital and it could be a severe obstacle to firms' performance and economic growth (Bai, Jayachandran, Malesky, & Olken, 2019; Doh, Rodriguez, Uhlenbruck, Collins, & Eden, 2003; Garmaise, 2008; Guthrie & Datta, 2008; Mo, 2001; Riaz & Cantner, 2020). A larger part of the literature has analyzed this issue for the developed economies. The earlier studies have also shown a connection between financial health and unemployment (Benmelech, Bergman, & Enriquez, 2012), but very little to say about the effect of corruption and political instability on human capital, especially in the case of low income economies. The corruption works as grease the wheel (M. Imran, Rehman, & Khan, 2020; S. M. Imran, Ur Rehman, & Khan, 2019). The corruption as well as the political instability may have an adverse effect on firms' level human capital and exports of the firms. The issue is not previously analyzed intensively by using the national level data of firms.

The current study is an attempt to empirically test the impact of corruption and political instability on firm's performance in low income economic. It distinguishes from the previous studies as it is based on a direct measure of corruption and political instability obtained from the World Enterprise Survey rather than measures derived indirectly. In this way it is a contribution to the existing literature.

2. Literature Review

At the firm level, the majority of literature highlighted the inverse impact of corruption and political instability on firm's performance (Fredriksson & Svensson, 2003; Jong-A-Pin, 2009; Kapri, 2019; Matta, Appleton, & Bleaney, 2018; Mo, 2001; Shleifer & Vishny, 1993). A variety of literature exists on the effect of corruption and financial constraints for the firms and output dimensions like the growth, investment, innovation, employment and human capital (Ahmad, Hussain, Umer, & Parveen, 2017; Awan, Ahmad, Hussain, & Marri, 2021; Hussain, Nawaz, & Ibraheem, 2021; Nawaz, Hussain, & Hussain, 2021).

In the earlier studies, Dupas and Robinson (2010) demonstrated that corruption depress firms' investment and growth. The study used the firm level data of 9655 enterprises from 27 emerging economies to found the effect of political instability on performance of the firm. The results show that most of the firms in less developing countries are unable to pay such a high cost due of training. The results also indicated that unavailability of bank credit, lack of access to finance and strict procedures reduce firms' performance. The study further investigated the impact of employer's investment in training. The study utilized the unbalanced panel of manufacturing firms of Europe taking survey data from business statistics. The study constructed the index of corruption by combing the survey and administrative data. The information on investment was taken from firm level survey while information on financial constraint was obtained from administrative data. The results revealed that corruption adversely affect investment in training and exports.

Kapri (2019) performed quasi-experimental and difference-in-differences analysis to measure the effect of political instability on employee training and firms' performance using measure of exports. The study utilized the firm level data of Portugal enterprises. The results of difference-in-differences model indicated that financially constrained firms spent less on employee training and have adverse effect on productivity and growth. The results showed that financial constraint has significant effect on human capital and growth. Even if firms are specialized in production and have surplus output, lack of sufficient liquidity and level of human capital prevent them from growing at exponential rate.

3. Methodology

The study used the following model.

$$\mathrm{FP} = \alpha + \pi_1\mathrm{PI} + \pi_2\mathrm{COR} + \pi_3\mathrm{FAGE} + \pi_4\mathrm{FSIZE} + +\pi_5\mathrm{SEC}$$

$$\pi_6\mathrm{PI.COR} + \pi_7\mathrm{PI.SIZE} + \pi_8\mathrm{COR.SIZE} + e_i \quad \ldots\ldots\ldots\ldots\ldots \ \ldots\ldots..1$$

Where, FP is performance of the firm, PI is political instability, COR is corruption, FAGE is age of the firm, FSIZE is size of the firm and SEC is sector of the firm. In the current analysis the human capital of firms is used as a proxy to measure the firm's performance and it is included as a binary variable and defined as one if the firm is investing in the formal training programs for its permanent, full-time employees, otherwise zero. PI.COR is interaction term of political instability and corruption, PI.SIZE is interaction term of political instability and size of the firm, COR.SIZE is interaction term of corruption and size of the firm. The likelihood of firms' performance can be shown in logit specification in Equation 2.

$$L_i = Ln\left(\frac{P_i}{1-P_i}\right) = \beta_0 + \beta_1 PI + \beta_2 COR + \beta_3 X_i + u_i \quad \ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots. 2$$

Where, $P_i = 1$ is the probability of firm's performance. PI = political instability, COR = corruption, and X_i is the vector of control variables that includes firm-specific characteristics. It is hypothesized that political instability (PI) and corruption (COR) have a negative effect on firms' performance in low income economies. Firms' specific control variables like age of the firm (FAGE), size of the firm (FSIZE), domestic firm (DOM) and sector of the firm (SEC) are assumed to have a positive impact on firms' performance. The same methodology was adopted by Imrana, Asgharb, and Rasulc (2021) and Kazmi, Imran, and Khan (2020).

3.1 Data

The study utilized the World Bank Enterprise Survey data from 27 low income economies. After screening for missing values, the study finally regressed the model with 7109 observations. The variable of corruption (COR) is defined as "percent of firms giving gift to public official to get things done", the variable the political instability (PI) is measured through the question given as "percent of firms consider political instability as a hurdle in the growth of their business", Age of the firm (FAGE) is defined as "The years since the establishment begin operations in the country", Size of the firm (SIZE) is measured as "The size of the firm is defined by "the number of permanent workers". Firm with workers greater than 5 but less than 19 is small firm, greater than 20 but less than 99 is medium firm and that with greater than 100 is larger firm" Sector of the firm (SEC) is defined as "Firm is working in manufacturing or services sector" It is coded as Manufacturing =1 Services =0. PI.COR is interaction term of political instability and corruption, PI.SIZE is interaction term of political instability and size of the firm, COR.SIZE is interaction term of corruption and size of the firm.

4. Empirical Results

Table 1 provides the descriptive statistics of the variables used in the empirical analysis.

Table 1: Descriptive Statistics

Variable	Observation	Mean	Std. Dev.	Min	Max
FP	7109	0.8518	.355246	0	1
COR	7102	0.8600	.6914367	0	2
PI	6977	14.726	13.15965	1	97
FAGE	7109	0.5021	.7006324	0	2
SIZE	6948	0.8035	.3973485	0	1
SEC	6715	0.7146	.4516057	0	1

Table 2 shows the correlation between the variables. It shows negative relationship between corruption, political instability and firm's performance.

Table 2: Correlation Matrix

Variables	FP	COR	PI	FAGE	SIZE	SEC
FP	1.0000					
COR	-0.0553	1.0000				
PI	-0.0179	-0.0524	1.0000			
FAGE	0.1374	-0.0508	0.2169	1.0000		
SIZE	-0.0421	-0.0292	0.0516	-0.1268	1.0000	
SEC	0.0646	-0.0681	0.0470	-0.0802	0.0430	1.0000

Table 3 shows the results of the logistic regression model.

Table 3: Result of the Logistic Regression Model

Variables	Coefficient	Robust Standard Error	T-Statistics	Prob
Corruption (COR)	-.3327437	.0812859	-4.09	0.000
Political Instability (PI)	-.4068833	.102241	-3.98	0.000
Age of the Firms (AGE)	-.0040065	.0026217	-1.53	0.126
Size of the Firms (SIZE)				
Small firm = Reference category Size of the Firms (SIZE)				
Medium Firms	.7198648	.0900847	7.99	0.000
Larger Firms	1.148055	.15034	7.64	0.000

Sector of the Firms (SEC)	.3816516	.0827359	4.61	0.000
Constant	2.168355	.1339068	16.19	0.000
Observation	6,452			
Wald chi2(7)	163.84			0.0000

Source: STATA Output

Table 4: Result of the Logistic Regression Model with Interaction Terms

Variables	Coefficient	Robust Standard Error	T-Statistics	Prob
Corruption (COR)	-.2851891	.1826278	-1.56	0.018
Political Instability (PI)	-.3093376	.3339479	-0.93	0.354
Age of the Firms (AGE)	-.0040581	.0026218	-1.55	0.122
Size of the Firms (SIZE)				
Small firm = Reference category Size of the Firms (SIZE)				
Medium Firms	.6762598	.1222194	5.53	0.000
Larger Firms	1.064503	.2236994	4.76	0.000
Sector of the Firms (SEC)	.37632	.1403233	2.68	0.007
Political Instability*Corruption (PI.COR)	-.0706976	.1456093	-0.49	0.627
Political Instability*Size (PI.SIZE)	-.0489891	.0951558	-0.51	0.607
Corruption*Size (COR.SIZE)	-.0042481	.1171907	-0.04	0.071
Constant	2.121947	.2062341	10.29	0.000
Observation		6,452		
Wald chi2(10)		169.44		0.0000

Source: STATA Output

The results show that corruption and political instability have a negative impact on the firm's performance which indicates that the likelihood of firms' investment in human capital declines as a result of corruption and political instability with and without interaction term. The firms that consider political instability as obstacles for their business, their human capital are inversely affected.

The results indicate increasing probability of firms' age on firm's performance, which expresses that by increase in firm's age the performance of the firm increase. The results of firm's size indicate a positive impact of firm's size on performance of the firm. The results further indicate that the performance of the firm is high for the large firms as compared to medium size firms. The results indicate increasing probability of manufacturing sector on firm's performance. The results of interaction terms of political instability and size of the firm express the decreasing probability of firm's performance. The results of interaction terms of corruption and size of the firm express the decreasing probability of firm's performance.

5. Conclusion and Policy Recommendation

The objective of the current study was to estimate the effect of corruption and political instability on firms' performance in low income economies. We have applied logistic regression on World Enterprise Survey dataset to find the probability of firms' performance. The study concluded that corruption and political instability decrease the likelihood of firm's performance.

The firms facing the corruption and political instability have high probability of investment in human capital. Firm-specific characteristics such as age of the firm, size of the firm increases the probability of firms' performance. The firms working in manufacturing sector have high probability of firm's performance. From the policy perspective it is pertinent to mention that manufacturing sector should be free from corruption.

Increase firm's performance. The financial sector should be developed for provision of easy access to finance for the firms so that firms can increase their level of human capital and increase their performance.

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