

## **POLITICAL CONNECTION, FOREIGN INSTITUTIONAL INVESTORS AND TUNNELING: EVIDENCE FROM INDONESIA**

Elva NURAINA<sup>1</sup>, Mohammad NASIH<sup>2</sup>, Dian AGUSTIA<sup>3\*</sup>

<sup>1,2,3</sup>*Faculty of Economics and Business, Universitas Airlangga, Surabaya, Indonesia*

<sup>1</sup>*Accounting Education Department, Universitas PGRI Madiun, Madiun, Indonesia*

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**Abstract.** The purpose of this study is to examine the moderating effect of foreign institutional investors on the relationship between political connection and tunneling. To achieve this goal, our study has examined all companies listed on the Indonesia Stock Exchange between 2015 and 2019, and obtained 1,571 firm-year observations. By using a quantitative approach and data analysis using moderated regression analysis, the results of this study indicate that foreign institutional investors play a role in weakening political connections to tunneling. This shows that foreign institutional investors have a role in reducing tunneling. These investors influence the behavior and performance of the company, so, even though the company has political ties, foreign institutional investors are less susceptible to political pressure and are more likely to negotiate to enhance the interests of minority shareholders, and protect their reputations. This finding has important implications for regulators to consider when evaluating the Investor Protection Act, in particular the protection of minority shareholder rights in companies with political ties.

**Keywords:** tunneling, political connection, foreign institutional investors, minority shareholders, reputation.

**JEL Classification:** M41, G34, M48.

### **Introduction**

Politics has a pattern of interrelated relationships with business, so it seems as if business people are inseparable from the world of politics. The involvement of business people in practical politics has become commonplace in every country, and Indonesia is no exception. Currently, a phenomenon found in Indonesia the large number of businesspeople who who are also active as politicians, and vice versa; many of these politicians are also competing in the world of business and are involved in the management of companies. Studies on political connections still yield inconsistent results. Most studies have found that political relationships benefit both companies and shareholders. Ha and Frömmel (2020) found that political relations affect firm value by increasing the quality of its earnings but they will decrease when the political environment is stable (Harymawan & Nowland, 2016). Political connections improve company performance (Harymawan et al., 2019) and accrue economic benefits in the form of equity capital and cheaper loans (Joni et al., 2020). Furthermore, Tsai et al. (2021) said that tax avoidance is reduced if companies are politically connected. However, there is

contradictory evidence that shows that political connections can be considered detrimental. Empirical evidence suggests that companies that are politically connected are more likely to engage in takeovers by engaging in tunneling (Guoping & Hong, 2015). Managers will deliberately foster links to political operatives in order to best serve their personal interests (Zhao, 2019). Similarly, Qian et al. (2011) found that takeover behavior by controlling shareholders, achieved by engaging in tunneling, is much more prevalent in companies that have political connections than in companies that do not. Wang (2015) found that there is no value added by politicians serving as independent directors for state-controlled firms as a result of tunneling. The inconsistencies in the results from studies on political connections are probably due to other moderating, contextual variables. One of its elements that is believed to be able to improve corporate governance is institutional ownership. One type of such ownership that is believed to have a stronger controlling function is ownership by foreign institutional investors. As stated by Aggarwal et al. (2011), foreign institutional investors are the most effective manager monitors, especially in countries

\*Corresponding author. E-mail: [dian.agustia@feb.unair.ac.id](mailto:dian.agustia@feb.unair.ac.id)

with weak investor protection. Lee et al. (2022) stated that foreign investors function as agency conflict controllers. Fang et al. (2015) also found evidence that foreign institutional investors can curb the prevalence of earnings management. In addition, foreign investors influence innovation (Nyeadi & Adjasi, 2020). Based on these findings, it can be stated that foreign investors will always try to improve the company's performance. Foreign institutional investors demand good corporate governance. This is because they do not want to invest in companies that have poor governance, including companies that have indications of tunneling, because foreign institutional investors think that minority shareholders are meaningful to them. Therefore, the problem addressed by this study is the possible role of foreign institutional investors in weakening the relationship between political connections and tunneling. So, the researchers' purpose is to examine the moderating effect of foreign institutional investors on the relationship between political connection and tunneling.

Tunneling is the transfer of company assets and profits to controlling shareholders but at the expense of the interests of minority shareholders (Johnson et al., 2000). Tunneling often occurs in the business world and is an agency problem that is difficult to detect and difficult for legal authorities to overcome (Sari & Sugiharto, 2014). If it is associated with political connections, as Berkman et al. (2010) have stated, those connections do not help to increase the protection of minority shareholders. Others studies have stated that political connections have the potential to affect the incentivize controlling shareholders to abrogate or undermine minority shareholders' rights in the following ways: First, insiders want to take advantage of these connections to the company but cover up the political costs (Morck et al., 1988); second, firms with political ties have fewer barriers whereby regulations are enforced than firms with no political ties (Berkman et al., 2010). As an alternative, controlling shareholders have a higher tendency to tunnel and tend to seek protection from those with whom they have political ties. However, if it is related to the presence of foreign investors, these investors tend to be reluctant to invest in companies that have indications of tunneling (Choi et al., 2014); such investors can also influence corporate governance practices, demanding good performance and good behavior (Shen et al., 2016; Garner & Kim, 2013). Therefore, this study is motivated to investigate the role of foreign institutional investors in weakening the relationship between political connections and tunneling.

Conducting an investigation into political connections, foreign institutional investors and tunneling in Indonesia is important for several reasons. First, politics determines the movement of business processes in Indonesia. The practice of cronyism in business is becoming more and more common due to the easier access of entrepreneurs to power, even occupying strategic positions in the organizational structure of political parties, or acting as legislative

officials<sup>1</sup> or executive officers<sup>2</sup>. Second, the ownership structure in Indonesia is concentrated, so the controlling shareholder plays an active role in management, and is often actually part of the management. Third, law enforcement in Indonesia is still weak, including laws pertaining to legal protection for investors. Fourth, in 2013, the Government of Indonesia gave foreign investors access to new sectors, and expanded access to existing ones. These above make Indonesia an ideal country in which to examine the role of foreign investors in mitigating the effects of political connections on tunneling. Therefore, the novelty of this research is an empirical model built to predict the role of foreign institutional investors in relation to political connection and tunneling.

To achieve the research objectives, this study has used a research sample of 1,571 firm-years, with an observation period from 2015 to 2019. Using moderated regression analysis, the results of this study find that foreign institutional investors are proven to weaken the effect of political connections on tunneling. This shows that the presence of foreign institutional investors will reduce tunneling. Foreign institutional investors can influence the behavior and performance of companies, as they generally demand high standards in terms of the disclosure of information, and they demand managerial and technical expertise. In addition, foreign institutional investors are much more disciplined and active in monitoring and improving corporate governance, even though companies have political ties,

This study is expected to provide a contribution to the theoretical framework related to agency conflict, where foreign institutional investors are one of the factors that need to be considered because they can contribute to reducing agency problems. This study is expected to provide recommendations that enable regulators to evaluate the Investor Protection Act and provide adequate protection of the rights of minority shareholders in politically-connected companies. This has important implications that can be generalized to other settings with similar institutional characteristics in terms of minority shareholders who could benefit from monitoring by foreign institutional investors.

This paper is structured as follows. Section 1 surveys the literature and describes the development of hypotheses. Section 2 explains the research design. Section 3 presents the results and discussion, and the last Section lays out the conclusions.

## 1. Literature review and hypothesis development

### 1.1. Institutional background

The relationship between politicians and companies is generally triggered by the mutual needs of both parties. There are many members of the political elite in Indonesia

<sup>1</sup> The legislature is a law-making body. In Indonesia it is called MPR and DPR.

<sup>2</sup> The executive body is the president, vice president and his ministers who help carry out the duties of the state.

who double as business people, as well as many business people who double as politicians; generally, these people occupy strategic positions in the managements of companies. There are several reasons why entrepreneurs enter politics: First, they have the hope of getting projects granted by the government which controls of large resources (Lockett, 1988). Second, government officials expect company to assist them in achieving their political and economic objectives, added to which they require funding for campaigns (Miettinen & Poutvaara, 2014).

On the other hand, the Government of the Republic of Indonesia is making massive efforts to attract foreign investors to Indonesia. Since 2013, it has opened up new sectors to foreign investors and expanded their access to existing sectors. Five business fields that were previously closed to foreign investors have been opened up, including airports, airport services, ports, agriculture and infrastructure. This policy allows foreign investors to invest up to 100% and aims to increase investment enthusiasm in Indonesia. The government hopes that there will be an inflow of funds into the country from foreign investors. However, the problem is that the system of governance and law enforcement in Indonesia is still weak, including legal protection for investors.

### **1.2. Political connections, foreign institutional ownership, and tunneling**

The involvement of entrepreneurs in practical politics occurs in almost every country, including Indonesia; this is because it is believed that it will provide many benefits (Akey, 2015; Dang et al., 2018). The study of political connections over the past decade has progressed rapidly. Several models have been developed to examine the interaction of various variables with political connections. Empirical evidence that reveals the benefits of having political connections suggests that these connections increase firm value and firm performance (Fisman, 2001; Harymawan et al., 2019), give privileged access to lenders (Faccio et al., 2006), and enjoy lower interest rates (Harymawan, 2018). Political connections will increase income quality but it will decrease when the political environment is stable (Harymawan & Nowland, 2016). The advantages of political connections were also revealed by Holmes et al. (2018) and Zhu and Chung (2014) who stated that the existence of government support and connections to the party in power will help companies manage resources and gain legitimacy. Based on this empirical evidence, it can be stated that political connections tend to provide benefits for companies.

However, contradictory evidence has been found by Miettinen and Poutvaara (2014) and Ma et al. (2013) which shows that high-level political connections will encourage companies to tunnel. Qian et al. (2011) have stated that takeovers attempted by controlling shareholders by engaging in tunneling or self-dealing, are much more prevalent in companies with political ties than in firms without them. The takeovers were severe for companies

whose political connections helped them gain access to bank loans. Francis et al. (2009) in their study in the context of China, stated that political connections are generally detrimental to minority shareholders and state ownership does not protect minority shareholders from tunneling. In addition, minority shareholders who carry out transactions with government-owned companies end up much worse off than companies that carry out transactions with non-government-owned companies. Tunneling activity will also increase when investor protection is weak, so political ties will make it easier for controlling shareholders to expropriate company wealth (Chen et al., 2011).

In the Indonesian context, the study of political connections has produced different findings. There are a number of prior studies that have stated that the quality of income is improved by political connections, but this effect decreases when the political environment is stable (Harymawan & Nowland, 2016). Political connections improve company performance (Harymawan et al., 2019). Such connections yield benefits such as equity capital and a lower cost of loans (Joni et al., 2020). However, contradictory evidence has found that political relations do not affect firm performance (Supatmi et al., 2019). Also, Habib et al. (2017b) have stated that political connections are employed by companies as a way of engaging in tunneling. Habib et al. (2017a) have also emphasized that companies that have political ties tend not to appoint Big Four auditors in an attempt to hide the tunneling. The empirical evidence shows that political connections actually do present the opportunity to expropriate through tunneling.

To date, previous studies on political connections have been inconsistent. This is possible because there are other contextual variables that moderate the connections. One of the elements of corporate governance is institutional ownership and the type of institutional ownership that is believed to have a role in improving corporate governance is foreign institutional investors (Yeh, 2021). Some of the advantages of foreign institutional investors are that they can influence governance practices, influence company performance and behavior (Shen et al., 2016; Garner & Kim, 2013). Lel (2018) stated that foreign institutional investors can curb the prevalence of earnings management. Bena et al. (2017) considered that foreign institutional investors demand discipline. Furthermore, Jiang and Kim (2004), Das (2014), Covrig et al. (2007) stated that foreign institutional investors prefer shares of companies that have low information asymmetry, good disclosure practices, good independent boards, and that voluntarily follow international accounting principles. Foreign institutional investors will maintain their reputation by providing protection for minority shareholders (Anderson et al., 2019). Other findings show that foreign institutional investors prioritize negotiation and monitoring, shorten the duration of reforms and increase compensation to minority shareholders (Huang & Zhu, 2015). Several studies in

China document how ownership by foreign investors can reduce and control tunneling behavior for reasons of investment efficiency (Anderson et al., 2019; Lee, 2022).

The characteristics of foreign institutional investors are that they tend to demand transparency of financial statements, demand efficiency, monitor company management as much as they can, and they prioritize the quality of corporate governance. Therefore, the researchers believe that foreign institutional investors can limit tunneling. Even if companies have political connections, foreign institutional investors are not susceptible to political pressure. The following hypothesis has therefore been developed:

H1: Foreign institutional investors weaken the relationship between political connections and tunneling.

## 2. Research methods

This study uses unbalanced panel data and the details of the number of companies each year is presented in Table 1. The sample of this study consisted of 1,571 firm-years, with an observation period from 2015 to 2019. Data were obtained from a combination of the OSIRIS database and company annual reports.

Table 1. Details of amount of company data for each year

Year	Frequency
2015	321
2016	315
2017	309
2018	309
2019	317
Total	1,571

The purpose of this study was to examine the moderating effect of foreign institutional investors on the relationship between political connection and tunneling. To achieve this goal, this study used a quantitative approach and moderated regression analysis was used for the data analysis. Therefore, this study specifically develops the following model:

$$\begin{aligned}
 \text{Tunneling}_{it} = & \beta_0 + \beta_1 \text{Pol Con}_{it} + \beta_2 \text{Foreign Inv}_{it} + \beta_3 \\
 & \text{Pol Con}_{it} \times \text{Foreign Inv}_{it} + \beta_4 \text{Firm Perform}_{it} + \beta_5 \text{Firm} \\
 & \text{Size}_{it} + \beta_6 \text{Firm Age}_{it} + \beta_7 \text{Audit Quality}_{it} + \beta_8 \text{Leverage}_{it} \\
 & + \beta_9 \text{Board Size}_{it} + \text{Year FE} + \text{SIC FE} + \varepsilon_{it}.
 \end{aligned}
 \tag{1}$$

Referring to Chen et al. (2020), this study uses ORECTA to total assets (ORECTA) as a proxy for tunneling. According to previous research, other receivables are widely used by shareholders for tunneling, and the balance of other receivables is very likely to be written off by the controlling shareholder (Li, 2010). Measurement of foreign institutional ownership uses the number of shares owned by foreign institutional investors (Jennings, 2005).

To identify political connections, a search for data sources was carried out from the DPR RI website [www.dpr.go.id](http://www.dpr.go.id) (Dewan Perwakilan Rakyat, n.d.). The list of the names of the cabinet members was obtained from the website of the Cabinet Secretariat Republic of Indonesia <http://setkab.go.id> (Sekretariat Kabinet Republik Indonesia, n.d.). Meanwhile, the list of names of regional heads or governors was obtained from the website of the Ministry of Home Affairs <https://setkab.go.id/tag/kemendagri/> (Sekretariat Kabinet Republik Indonesia, n.d.). To determine whether the control variables do, in fact, control the tunneling determinants, this study following previous literature (Jiang et al., 2010; Huang et al., 2011). Control variables include firm size, leverage, firm performance (ROA), firm age, audit quality and board size. The definition of each variable is detailed as shown in Table 2.

Table 2. Variable definition

No	Variable	Definition	Source
1	Tunneling	Transfer of company resources to outside parties that tend to harm minority shareholders. Tunneling is measured by dividing other receivables by total assets.	Chen et al. (2020); Johnson et al. (2000)
2	Political Connection	The relationship between a company and the political elite as measured by a dummy variable. It has a value of one if there is one or more major shareholders (one person who directly or indirectly controls at least 10% of the company's voting rights) or board members who are closely related to a politician or political party and his close relatives; otherwise it has a value of zero.	Habib et al., (2017b)
3	Foreign institutional investors	The number of shares owned by foreign institutional investors is measured by calculating the percentage of the total shares owned by foreign institutional investors.	Jennings (2005)
4	Firm Size	Figures indicating the size of the company; it is measured by calculating Ln total assets.	Chen et al. (2016)
5	Firm Age	Company age, calculated from the IPO date.	Gong et al. (2021)
6	Leverage	The amount of debt the company has compared to its assets. Leverage is calculated by dividing total debt by total assets.	Cho and Lim (2018)
7	Firm Performance (ROA)	Management performance in managing company assets is measured by calculating profit after tax divided by total assets.	Strouhal et al. (2018)

End of Table 2

No	Variable	Definition	Source
8	Quality Audit	The quality of auditors in finding and reporting violations in the client's accounting system. Auditing is measured by a dummy variable; it has a value of one if the company is audited by a Big Four audit firm, and zero if it is audited by a non-Big Four audit firm.	Habib et al. (2017b)
9	Board Sizes:	The size of the board of directors responsible for overseeing management and is measured by counting the number of board members.	Habib et al. (2017b)

### 3. Results and discussion

Table 3 lays out the descriptive statistics of the research variables. The average value for tunneling is 0.023 and the maximum is 4.520, indicating that the transfer of resources between companies is very detrimental to minority shareholders. The value for political connections averages 0.214, with a high of 1,000. The value of the average share of foreign institutional investors is 0.271 and the highest is 26.087.

Based on the descriptive statistics above, the researchers detail the development of the trend of the three main variables each year consisting of tunneling, political connections and foreign institutional investors as listed in Table 3. The data in Table 3 shows that tunneling data, political connections and foreign institutional investors have a standard deviation greater than the mean. This indicates that the data are well distributed, and do not cluster in certain corporate sectors.

The researchers also present the data development trends for each of the main variables during the period from 2015 to 2019: The tunneling data trend tends to increase over the five years; the political connection data trend tends to increase every year; however, the political connection data trend tends to increase every year. Meanwhile, the trend of data on foreign institutional investors, as proxied by the number of foreign institutional investors' shareholdings, has decreased. The trend of data development for each variable is shown in Table 4.

Correlation analysis is presented in Table 5 to show the relationship between the variables contained in this research model. The correlation matrix between political connections and tunneling shows a very strong correlation with a p value of 0.069. The correlation between foreign institutional investors and tunneling shows a value of 0.135 which indicates that the two are very strongly correlated. Then foreign institutional investors and political connections are negatively correlated, with a p value of -0.003.

#### 3.1. Moderating effects of foreign institutional investors on the relationship between political connection and tunneling

Studies on political connections have yielded mixed and inconsistent results. These differences have possibly been due to there being other contextual variables that moderate them. This study places the presence of foreign institutional investors as a moderating variable in the relationship between political connections and tunneling, because the presence of such investors is believed to create more demand for good corporate governance and means there is good monitoring. To achieve the research objectives, this study uses moderated regression analysis as shown in Table 6.

Table 3. Description of research variables

Variable	obs	Means	Std. Dev.	min	max
Tunneling	1,571	0.023	0.135	0.000	4,520
Political_con	1,571	0.214	0.410	0.000	1,000
Foreign_Intl	1,571	0.271	1.031	0.000	26,087
Indpdn_Board	1,571	0.409	0.139	0.000	1,500
Firm_Size	1,571	26,440	4,506	1.126	33,095
Leverage	1,571	24,905	224,636	-7,720	1,438,310
Firm_Age	1,571	34,167	19,709	0.000	200,000
Audit_Quality	1,571	0.308	0.462	0.000	1,000
Firm Performance	1,571	2.036	8,727	-121,400	75,700

Note: Tunneling is a diversion of company resources that is likely to harm minority shareholders. Political\_con is a categorical variable which is equal to one if the company has political connections and equal to zero otherwise. Foreign\_Intl is a foreign institutional investor. Indpdn\_Board is the board of commissioners in charge of supervising the company. Firm\_Size is the size of the company as measured by Ln Total assets. Leverage is the amount of debt used to own all the assets of the company. Firm\_Age is the age of the company, it is calculated from the IPO date, Audit\_Quality is a categorical variable which has a value of one if the company is audited by the Big Four, and equal to zero otherwise. Firm Perform is ROA as measured by profit after tax divided by total assets.

Table 4. Trend in the data for the main variables in each year

Panel A Tunneling panel <sup>6</sup> by year					
Variable	Obs	Mean	Std. Dev	Min	Max
2015	321	0.0053936	0.0115371	0	0.06
2016	315	0.0059644	0.0120899	0	0.06
2017	309	0.0066163	0.0117564	0	0.06
2018	309	0.0059819	0.0108371	0	0.06
2019	317	0.0070206	0.0128965	0	0.06
Panel B Political connection <sup>6</sup> By Year					
Variable	Obs	mean	Std. Dev	Min	Max
2015	321	0.212828	0.409905	0	1
2016	315	0.1958457	0.3974404	0	1
2017	309	0.2114804	0.4089765	0	1
2018	309	0.1993958	0.400151	0	1
2019	317	0.2064897	0.4053847	0	1
Panel C Foreign Institutional Investors <sup>6</sup> by Year					
Variable	Obs	mean	Std. Dev	Min	Max
2015	321	0.3757829	1.626499	0	26.0869
2016	315	0.3293146	1.639545	0	26.0869
2017	309	0.2377497	0.2960766	0	0.9721
2018	309	0.2278514	0.2982053	0	0.9721
2019	317	0.1945788	0.2901087	0	0.9777

Table 5. Pearson Correlation

	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
(1) Tunneling	1,000								
(2) Political_Con	0.069*** (0.005)	1,000							
(3) Foreign_Insttl	0.135*** (0.000)	-0.003 (0.917)	1,000						
(4) Firm_Size	-0.062** (0.011)	0.044* (0.073)	-0.080*** (0.001)	1,000					
(5) Leverage_	0.028 (0.245)	-0.001 (0.955)	0.007 (0.769)	0.077*** (0.002)	1,000				
(6) Firm_Age	-0.033 (0.173)	0.138*** (0.000)	-0.009 (0.711)	-0.035 (0.153)	0.013 (0.582)	1,000			
(8) Audit_Quality	0.004 (0.862)	0.170*** (0.000)	-0.020 (0.408)	-0.012 (0.617)	0.020 (0.407)	0.025 (0.304)	1,000		
(9) Indpdn_Board	-0.013 (0.588)	0.026 (0.294)	-0.015 (0.536)	0.030 (0.213)	0.014 (0.572)	0.019 (0.445)	-0.008 (0.728)	1,000	
(10) Firm_Perform	-0.077*** (0.002)	-0.019 (0.443)	0.023 (0.356)	-0.047* (0.056)	0.026 (0.289)	0.024 (0.332)	0.041* (0.092)	0.011 (0.645)	1,000

Note: Tunneling <sup>3</sup> is a diversion of company resources that is likely to harm minority shareholders. Political\_Con is a categorical variable which is equal to one if the company has political connections and equal to zero otherwise. Foreign\_Instl is a foreign institutional investor. Indpdn\_Board is the board of commissioners in charge of overseeing the company. Firm\_Size is the size of the company as measured by Ln Total assets. Leverage is the amount of debt used to own all the assets of the company. Firm\_Age is the age of the company, calculated from the date of its IPO. Audit\_Quality is a categorical variable where the value is one if the company is audited by the Big Four, and equal to zero otherwise. Firm\_Perform is ROA as measured by profit after tax divided by total assets.

Table 6. Moderated regression analysis

	(1)
	Tunneling
Political_Con	0.028** (2.17)
Foreign_Instl	0.001 (0.31)
Political_Con × Foreign_Instl	-0.117** (-2.23)
Indpdn_Board	0.043 (1.32)
Firm_Size	0.000 (0.08)
leverage_	0.000 (0.09)
Firm_Age	-0.000 (-0.68)
Audit_Quality	-0.002 (-0.24)
Firm_Perform	0.001 (0.85)
_Cons	0.065* (1.85)
Year FE	Yes
SIC FE	Yes
R2	0.015
N	1571

Note: t statistics in parentheses, \*p < 0.1, \*\*p < 0.05, \*\*\*p < 0.01.

The results of the regression test listed in Table 6 show that the interaction between political connections and foreign institutional investors has a p value of 0.026 and a coefficient of -0.117. These results indicate that foreign institutional investors moderate the relationship between political connections and tunneling. The coefficient having a negative sign indicates that foreign institutional investors play a role in weakening the relationship between political connections and tunneling. Thus, the research hypothesis is proven. If one looks at the p value of foreign institutional investors, which has a value of 0.754 with a coefficient of 0.001, then this result is not statistically significant.

Based on the results above, it can be stated that the coefficient  $\beta_2$  is not significant, but the coefficient  $\beta_3$  is statistically significant. So, it can be said that foreign institutional investors act as pure moderators (Hayes, 2018). This means that foreign institutional investors purely interact with political connections without being a predictor variable. These results indicate that foreign institutional investors play a role in weakening the relationship between political connections and tunneling. The findings of this study indicate that the presence of foreign institutional investors is able to suppress

tunneling actions. The characteristics of foreign institutional investors who prioritize quality, discipline and efficiency can affect the behavior and performance of the company. Good corporate governance is an important standard in improving performance. Therefore, foreign institutional investors carry out effective monitoring of all the activities of the companies in which they invest. The existence of political relations can indeed provide benefits for foreign institutional investors, but maintaining reputation is much more important to them. They are therefore very careful to avoid any activity that could damage their reputation and corporate governance, including tunneling. Foreign institutional investors can provide adequate protection for minority shareholders because they are considered valuable investors for the company, so foreign institutional investors will limit tunneling. Although corporations are politically connected and those connections have consequences, foreign institutional investors are not susceptible to political pressure and tend to negotiate to protect the interests of minority shareholders. Thus, the presence of foreign institutional investors in companies that have political connections can reduce tunneling. They are therefore very careful to avoid any activity that could damage their reputation and corporate governance, including tunneling. Foreign institutional investors can provide adequate protection for minority shareholders because they are considered valuable investors for the company, so foreign institutional investors will limit tunneling.

If one looks at the data trends for the main variables, as listed in Table 4, it can be seen that the trend of the tunneling data has tended to increase over the past five years; meanwhile, the trend of the political connection data has tended to increase every year; however, the trend of the foreign institutional investors data as proxied by the number of shareholdings has decreased. These data show that the higher the political connection, the more tunneling there will be. However, the increase in tunneling will actually reduce the share ownership by foreign institutions. This fact demonstrates that foreign institutional investors are reluctant to invest in companies that have political relations and indications of tunneling.

The findings of this study are in line with Choi et al. (2014) who have stated that foreign institutional investors will consider corporate governance before investing and will consider this very carefully when making investment decisions in companies that have indications of tunneling. The findings of this study are in line with Huang and Zhu (2015) who have stated that minority shareholders in foreign companies are less likely to experience tunneling, because foreign investors demand greater transparency and are more professional.

The control variable has the expected sign and level of significance. In particular, firm age and audit quality control variables are negatively related to tunneling. This shows that the older the company and the better

the audit quality, more tunneling will be reduced. On the other hand, firm performance proxied by ROA, firm size and leverage is positively related to tunneling. This shows that the higher the ROA, firm size, and leverage, the more tunneling occurs.

### 3.2. Robustness test

To test the robustness of the model, the researchers used a different proxy for tunneling. Tunneling can also be measured using a proxy for other receivables minus other payables divided by total assets (Chen et al., 2020). The developed model was retested and the results are presented in Table 7. The robustness test results were revealed to be consistent. Interaction between the variables for political connections and foreign institutional investors have a p value of 0.000 with a coefficient of -0.002. Thus, the model that was developed is already robust. These results consistently show that foreign institutional investors moderate the relationship between political connections and tunneling. Foreign institutional investors play a role in weakening the relationship between political connections and tunneling.

Table 7. Robustness test

	(1)
	Tunneling-Robust
Political_Con	0.003*** (3.62)
Foreign_Instl	0.002*** (20.34)
Political_Con × Foreign_Instl	-0.002*** (-5.47)
Indpdn_Board	-0.001 (-0.27)
Firm_Size	-0.000** (-2.49)
Leverage_	0.000** (2.14)
Firm_Age	-0.000 (-0.66)
Audit_Quality	-0.000 (-0.66)
Firm_Perform	-0.000* (-1.69)
_Cons	0.011*** (5.21)
Year FE	Yes
SIC FE	Yes
r2	0.074
N	1681

Note: t statistics in parentheses, \* p < 0.1, \*\* p < 0.05, \*\*\* p < 0.01.

### Conclusions

Previous studies on political connection have yielded inconsistent results. Political connections are a valuable asset for a company, but they have consequences that logically stem from building these connections. One possibility that arises from the existence of such connections is tunneling. However, this condition can be reduced if most of the shares in a company are owned by foreigners. This statement is supported by the results of this study which show that foreign investors moderate the relationship between political connection and tunneling. Foreign institutional investors play a role in weakening the relationship between political connections and tunneling. Foreign institutional investors provide adequate protection for minority shareholders because they are considered valuable investors for the company; this means that foreign institutional investors will limit tunneling even though the company is politically connected. Foreign institutional investors are less susceptible to political pressure and tend to negotiate to protect the interests of minority shareholders. Thus, the presence of foreign institutional investors in companies with political connections can reduce tunneling.

Previous studies on political connections have had positive and negative connotations. This study seeks to reveal the negative connotation of political connections and how this can be minimized by the presence of foreign institutional investors. However, this study still has limitations, namely that it does not distinguish between high and low levels of foreign ownership, so it would be interesting if future research were to explore these differences.

It is hoped that the recommendations provided by this study will enable regulators to evaluate the Investor Protection Act and provide adequate protection for the rights of minority shareholders in politically connected companies. Theoretically, this study can have implications for additional theoretical frameworks related to agency conflict, where the foreign institutional investor factor is one of the factors that need to be considered because of how it contributes to the suppression of tunneling. From a managerial perspective, it is expected that this study will have practical implications for management in improving corporate governance, especially in companies with political connections where minority shareholders benefit from monitoring by foreign institutional investors.

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### Author contributions

Conceptualization, E. N., M. N. & D. A.; methodology, E. N.; software, E. N.; validation, E. N., M. N. & D. A.; formal analysis, E. N.; investigation, M. N. & D. A.; data curation, E. N.; writing – original draft preparation, E. N.; writing – review and editing, E. N.; visualization, E. N.;



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The authors declare no conflict of interest.

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