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How Political Connections Influence the Success of Small and Medium Enterprises

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Abstract

This study examines how political connections affect the performance of small and medium enterprises (SMEs) in Vietnam. Using a panel fixed effects approach, data was collected biennially from 2005 to 2015, focusing on Vietnamese SMEs in collaboration with the Central Institute for Economic Management (CIEM), the Development Economics Research Group (DERG), and the Institute of Labor Science and Social Affairs (ILSSA), at the University of Copenhagen. The results show that political connections have a significant negative impact on SME performance. While these connections provide benefits such as easier access to bank loans, tax breaks, and smoother regulatory processes, they also require firms to incur higher informal payments and labor costs, making inefficient resource allocation. Furthermore, the impact of political ties is more pronounced in regions with weaker institutional frameworks.

Keywords: SMEs, Political Connections, Credit Access, Firm Performance, Vietnam

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Introduction

The role of political connections in influencing the performance of private enterprises has become a key topic in recent academic literature. Several studies suggest that businesses with political ties can secure financial advantages. These advantages can include access to bank loans [1], improved firm valuation [2], and overall enhanced performance [3].

For small and medium-sized enterprises (SMEs) in transitional economies, the situation is more complex. In these environments, government control over resources and weaker regulatory systems create significant barriers for firms. Having political connections can be a critical factor in overcoming these barriers, allowing firms to access credit, receive favorable tax treatment, or enjoy regulatory exemptions [4-7]. However, some studies also argue that political connections can harm performance, particularly because they may reduce incentives for firm managers to focus on maximizing shareholder wealth [2, 8].

This study aims to assess the dual impact of political connections on SME performance, particularly in the context of Vietnam. More specifically, we focus on the following questions: What are the benefits and costs of having political ties for SMEs? How do these connections influence a firm's overall performance?

In this paper, we particularly examine the effects of communist party membership on firm performance. In an economy where SMEs often face systemic discrimination and distrust, political affiliation with the ruling party can be crucial. The communist party's dominant position means that membership can provide firms with access to government officials and offer a status that might help overcome regulatory and market challenges [6]. To analyze these dynamics, we utilize a unique panel dataset from 2005 to 2015, which includes SMEs operating in various sectors of Vietnam's economy. The data provides insights into enterprise background, financial structures, sales strategies, employment, and personal business characteristics.

Our analysis reveals that political connections have a mixed impact on SME performance. While politically connected firms tend to underperform compared to their non-connected counterparts, they enjoy certain advantages, such as easier access to financial resources, lower taxes, and less time spent on regulatory processes. We also identify that the underperformance of connected firms is often linked to higher informal fees and increased labor costs. Additionally, we find that political ties are especially valuable in less-developed regions where the institutional environment is weaker.

Contributions to the literature

This study makes several notable contributions to the existing body of research. First, it provides new insights into the dual impact of political connections on small and medium-sized enterprises (SMEs) by examining both the potential benefits and drawbacks. While prior studies have largely focused on the advantages of political connections, such as access to credit or favorable tax treatment [4, 6-8], our research goes a step further by investigating the associated costs, which include informal payments and inefficient resource allocation, particularly in the Vietnamese context. Second, the paper focuses on an emerging market where governmental influence over business operations is strong and corporate governance is often weaker. By doing so, it sheds light on how political connections affect firm performance in environments with less developed institutional frameworks. This aspect of the study reviews agency theory, particularly in understanding how political factors may drive risk-taking behaviors among SMEs. Lastly, our research adds to the existing literature by identifying the mechanisms through which political connections influence SME performance and the potential costs associated with these connections in transition economies.

This paper is structured as follows: Section 2 reviews the existing literature on political connections and firm performance, introducing the theoretical framework and hypotheses. Section 3 outlines the data collection process and econometric models used for analysis. Sections 4 and 5 present the empirical results and discuss the implications of the findings. The final section concludes the paper with a summary and recommendations for future research.

Literature review and hypothesis development

The relationship between firms and political connections has garnered significant attention in both developed and developing economies, particularly concerning how such ties influence access to resources, firm performance, and financial outcomes. A key finding in the literature is that politically connected firms often enjoy preferential treatment, such as improved access to credit or tax advantages [4, 7, 9, 10]. Faccio [8] provided evidence across 47 countries showing that firms with political ties were more likely to secure bank loans or benefit from favorable tax rates. The strength of the political connection often correlates with the level of benefits a firm can receive, with stronger connections translating to more substantial advantages. Furthermore, these benefits are more pronounced in countries with weaker legal frameworks or higher corruption levels, where businesses often rely on political connections for survival.

However, several studies also highlight the potential downsides of political ties, especially in terms of firm performance. Politically connected firms may perform poorly due to increased reliance on political support rather than sound business practices, often resulting in inefficiencies [7, 8]. Firms with political ties may also face higher operational costs, such as informal fees and political bribes, which can erode profitability. Additionally, Bliss and Gul [11] suggest that such firms are often burdened with higher leverage and default risks, which negatively impact their financial stability. Research by Wong and Hooy [12] indicates that only long-term, stable political connections, such as those with government officers or board members, have a positive impact on firm performance. Short-term relationships, like those with family members or business partners, do not yield the same results. In contrast, Amore and Bennedsen [13] observed that in some cases, political connections can boost firm performance, particularly when family members are involved in politics and help firms receive favorable treatment from local governments.

Despite these contrasting findings, the overall impact of political connections on firm performance remains unclear, particularly in developing countries with weaker institutional structures. This leads us to propose the following hypothesis:

Hypothesis 1: Political connections have a negative impact on firm performance.

In developing countries where political influence is pervasive and institutional frameworks are underdeveloped, firms may depend on political connections to gain access to resources. However, the costs associated with maintaining these connections, such as informal payments and inefficiencies, may outweigh the benefits, leading to poorer performance compared to firms without political ties. Thus, we hypothesize that political connections may harm the performance of SMEs in transition economies.

Hypothesis 2: Politically connected SMEs are more likely to experience inefficient resource allocation than non-connected firms

The resource dependence theory suggests that firms are often influenced by external resources, such as government support or financial access, which in turn impacts their operations [14]. This theory posits that politically connected firms have easier access to crucial resources like financing or government contracts. For instance, research by Leuz and Oberholzer [15] in Indonesia revealed that SMEs with political connections were more likely to seek and secure financial assistance from local

governments. Similarly, Li *et al.* [6] analyzed data from over 3,000 private enterprises in 2002 and found that firms with political ties were more likely to secure loans from banks, with these loans often coming with more favorable terms, such as lower interest rates and fewer collateral requirements [7, 16, 17].

While these findings highlight the advantages of political connections, they also raise concerns about inefficiency. Political ties may result in a misallocation of resources, as connected firms may prioritize political relationships over sound business practices. This could lead to inefficient use of capital, overstaffing, and other suboptimal decisions that hinder the firm's long-term performance. Therefore, it is reasonable to hypothesize that politically connected SMEs experience a higher level of inefficiency in resource allocation compared to their non-connected counterparts.

Hypothesis 3: Politically connected SMEs receive more preferential treatment than non-connected SMEs

The literature generally points to political connections offering firms a distinct advantage, particularly in terms of preferential treatment. Firms with political ties are more likely to receive favorable terms, such as easier access to credit or favorable government contracts. However, the benefits derived from these connections may not always translate into improved performance. While the advantages of political connections are clear, the associated costs—such as informal payments or a focus on maintaining political relationships—can lead to inefficiencies. Thus, we hypothesize that politically connected SMEs will enjoy more preferential treatment, but this may come at the cost of operational inefficiency and reduced overall performance.

The ambiguity of political connections in firm performance

Despite the considerable body of research on the role of political connections in business, the effect on firm performance remains ambiguous. This is particularly true for SMEs in developing economies like Vietnam, where political connections may play a more pronounced role in accessing resources. While some studies have explored the impact of political ties in specific financial years or small areas within Vietnam, there is a gap in understanding the broader, long-term effects of these connections on SMEs' financing and overall performance. Therefore, the influence of political links on SMEs in Vietnam is an important question that requires further investigation.

Materials and Methods

Data collection and processing

This study utilizes panel data gathered from the Small and Medium Scale Manufacturing Enterprises (SMEs) survey in Vietnam, which was conducted biennially from 2005 to 2015. The survey was a joint effort between the Central Institute for Economic Management (CIEM), the Institute of Labor Science and Social Affairs (ILSSA), and the Development Economics Research Group (DERG) at the University of Copenhagen (Denmark). The data includes SMEs from nine provinces in Vietnam: Hanoi, Ha Tay, Phu Tho, Hai Phong, Nghe An, Ho Chi Minh, Khanh Hoa, Quang NamLam Dong, and Long An. These regions were selected to represent both urban and rural settings, providing a balanced cross-section of Vietnam's business landscape.

The study is focused on SMEs with fewer than 300 employees. To improve data quality and reduce bias, firms that were surveyed irregularly or only once during the study period were excluded. This allowed for more consistent and reliable longitudinal data analysis.

In terms of political connections, over 15% of firm owners or managers in the sample were members of the Communist Party, with most joining the party before they started their businesses. This minimizes the concern of reverse causality, as membership was not driven by post-business success. Furthermore, around 50% of the firm owners or managers had prior experience working in public sectors before transitioning to private enterprise. The typical SME in the sample had about 16 employees, which is in line with the national average for SMEs in Vietnam. However, many firms were household operations with fewer than ten employees. **Table 1** provides more detailed breakdowns of the dataset.

Key statistics overview

In **Table 1**, we summarize the statistics of different variables, focusing on both the entrepreneur and firm characteristics. The data covers over 14,000 observations, reflecting a wide array of variables including party affiliation, educational background, and firm performance. Entrepreneurs are typically aged around 46, with many having prior experience in public employment. Their firms vary in size and asset value, and there's a notable presence of informal payments in business dealings.

Table 1. The statistics of different variables.

Variable	Observations	Mean	Standard deviation	Min value	Max value
Entrepreneur characteristics					
Party membership	14,351	0.1332	0.3398	0	1

Professional education	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 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	0.3787	-9.5102	6.9077
ROE	14,132	0.16868	0.39519	-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 spent on bureaucracy	9,473	2.1812	3.1376	0	50
PCI	14,043	58.1368	4.7297	38.8	67.12

Comparing party and non-party member entrepreneurs

Table 2 compares the characteristics of entrepreneurs who are party members versus non-members. Significant differences are observed across various factors such as age, education, and prior government experience. Party members tend to have larger firms with more assets and tend to be older with more education. However, they also show lower firm profitability compared to their non-Party counterparts.

Table 2. The characteristics of entrepreneurs who are party members versus non-members

Variable	Party member	Non-party member	Difference
Entrepreneur characteristics			
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 (0.0044)	0.4426*** (0.0116)
Former cadre	0.3692 (0.0110)	0.0840 (0.0025)	0.2852*** (0.0077)
Firm characteristics			
Employees (log)	2.003 (0.0357)	1.8326 (0.0121)	0.1705*** (0.0344)
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 spent on bureaucracy	13.0948 (0.2113)	15.4495 (0.0732)	-2.3547*** (0.1993)

Correlation and multicollinearity assessment

Table 3 outlines the correlations between key variables in the study. The low correlation coefficients suggest no major issues with multicollinearity, which is further supported by the variance inflation factor (VIF) values that remain below 2. Significant correlations are mostly observed between education, age, and firm size, reflecting trends in the data.

Table 3. The correlations between key variables in the study.

Variable	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*	-0.1289*	0.1132*	1.0000		1.06
Informal fee rate	0.0869*	0.0495*	0.1338*	0.0045	-0.0444	-0.0362*	0.0824*	0.1128*	1.0000	1.16

Econometric models

Vietnam is governed by a single political party: the communist party. This party is organized based on democratic centralism, with the National Congress being the highest authority. The Congress meets every five years to elect the central executive committee, which selects the general secretary and the political bureau. The party sets the policy agenda, which is then carried out by the government through various levels of administration. At the local level, the People's Council and the People's Committee are the primary legislative and executive bodies in provinces, districts, and communes. To participate in these bodies, individuals must be members of the communist party. Furthermore, only party members have the right to vote for the people's committee members, with approval from higher-level Party committees. As a result, joining the communist party is often seen as a key step for entrepreneurs who want to build strong connections with local government institutions.

The relationship between political connections and firm performance has been debated, with mixed results. Some research has shown that firms with political ties tend to perform better than those without [5-7, 18-20]. In contrast, other studies have indicated that political connections can have a negative impact on firm performance [7, 8, 21].

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

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

The dependent variable, profit, will be measured using return on assets (ROA) and return on equity (ROE). Additionally, Pit represents a dummy variable for party membership, where Pit equals 1 if the owner/manager of firm i is a party member at time t, and 0 otherwise. The control variables, Xit, consist of both owner/manager and firm characteristics that impact the credit accessibility of firm i at time t.

To assess the efficiency of resource allocation within a firm, we adopt the approach used by Hsieh and Klenow (2009), which compares the marginal productivity of factors of production across firms. Firms that use more resources but produce less output are considered to exhibit inefficient resource allocation. The following model is used to test hypothesis 2:

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

The variables Δlit and Δkit represent the changes in labor and capital allocation, respectively. These are calculated by taking the logarithmic difference of the firm's share of total employment (or fixed assets) in year t compared to year t-1. A firm's share is determined by dividing its total employment (or fixed assets) by the total employment (or fixed assets) across all firms in the relevant industry and province. MPLit (marginal productivity of labor) and MPKit (marginal productivity of capital) are calculated by taking the logarithm of sales divided by total employment (or total fixed assets). The INFit variable represents the informal fee rate, which is calculated by dividing the total informal fees incurred by the firm by its total sales in the same year. Xit includes control variables that consist of characteristics of both the owner/manager and the firm.

Despite SMEs comprising the majority of enterprises in the market, they often face significant barriers to accessing formal credit, primarily due to a lack of proper collateral or verified financial records. As a result, these businesses tend to rely heavily on self-financing or informal lending options, which come with higher costs. However, SMEs with strong relationships with local government or positions within the Communist Party's Executive Committee can navigate these challenges more effectively.

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

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

Dependent variables for hypothesis testing

To test the hypothesis, we use several dependent variables. First, we measure the loan ratio, which is the total bank loans divided by the total assets, to see if political affiliation helps SMEs access formal credit. Next, the tax rate is defined as the total tax payments divided by total sales, to understand the influence of political connections on taxation. Lastly, we consider the percentage of time spent on government regulations as a measure of bureaucratic inefficiency. The variable pit is a dummy variable where it equals 1 if the owner or manager of firm i is a party member at time t, and 0 if they are not. Control variables (Xit) consist of characteristics of both the owner/manager and the firm that impact access to credit at time t.

Results and Discussion

Party membership and firm performance

To begin, we explore the impact of political connections on firm performance using two key indicators: return on assets (ROA) and return on equity (ROE). **Table 4** displays the results supporting Hypothesis 1. Initially, we run a regression with

the party membership dummy variable and relevant control variables related to the entrepreneur and firm. The findings reveal a negative relationship between political affiliation and firm performance, echoing the work of Faccio (2010), which showed that connected firms typically underperform. In particular, party membership leads to a reduction in ROA by six percentage points, which is significant at the 5% level. Among the control variables, firm size (based on employee count) and informal fee rate have a negative effect on ROA, while leverage is positively correlated with better profit outcomes. Notably, the age of the owner/manager is significantly associated with a lower ROA.

Next, we explore whether party membership affects ROA through additional factors, such as work experience in the public sector and prior care experience. The regression results in column 2 of **Table 4** continue to show a significant negative relationship between firm performance and party membership. Despite adding more variables, the impact of party affiliation remains largely unchanged. Interestingly, neither of the new political connection variables significantly affects ROA.

In columns 3 and 4 of **Table 4**, we analyze ROE as the dependent variable. The results align with those for ROA, showing a consistent negative relationship between ROE and party membership. With all estimates being significant at the 5% level.

Table 4. Effect of political ties on business performance

Variables	ROA (1)	ROA (2)	ROE (3)	ROE (4)
Party membership	-0.0634**	-0.0639**	-0.0644**	-0.0649**
	(0.0276)	(0.0277)	(0.0288)	(0.0288)
Firm characteristics				
Log of employment	-0.0153***	-0.0156***	-0.0161***	-0.0165***
	(0.00369)	(0.00369)	(0.00384)	(0.00385)
Log of total assets	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 characteristics				
Age of owner/manager	-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)
Previous public-sector work		-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				

Significance levels: ***P < 0.01, **P < 0.05, *P < 0.1

Although Vietnam and China share similar political frameworks and economic structures, our findings differ from those in Li's study. Li *et al.* [6] used data from 2002 focusing on privately owned businesses and found a positive correlation between party affiliation and profitability in China. However, their analysis only covered a single year, whereas our study benefits from a broader panel dataset spanning from 2005 to 2015. The results from our regression analysis suggest that politically connected firms in Vietnam may incur higher informal fees to establish political connections, which could contribute to lower overall performance. Additionally, the underperformance of connected SMEs in Vietnam may be attributed to the costs associated with forging these political ties.

Party membership and resource allocation

We analyze whether informal fees contribute to inefficient resource allocation to understand why political connections may negatively affect firm performance. To do this, we assess capital reallocation, which is measured by the change in the firm's share of industry fixed assets from one year to the next, and labor reallocation, measured similarly by changes in the firm's share of industry employment. The marginal productivity of capital and labor is calculated by the logarithms of sales divided

by fixed assets or the number of employees. Firm-fixed effects are included to account for the higher productivity or growth of SMEs that specialize in certain industries. The results of this regression are presented 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

In columns 1 and 2, we observe that businesses operating in sectors with higher labor productivity tend to hire more workers. However, the increasing cost of informal fees results in inefficient labor allocation. On the other hand, columns 3 and 4 do not provide enough evidence to suggest that informal fees lead to better capital allocation. Wu *et al*. (2012) pointed out that state-owned firms with political ties often struggle to meet policy goals, leading to underperformance and lower value. This explains why politically connected SMEs may increase labor hiring to fulfill political objectives. Overall, while political connections can help SMEs access benefits like bank loans and tax reductions, they contribute to labor allocation inefficiencies that can diminish firm performance and hurt the economy as a whole.

Additional testing: the importance of political ties

We argue that businesses establish connections with politicians and government officials to navigate market obstacles. This section highlights the benefits of political connections for firms that are connected.

We first use a fixed-effect regression model to explore how political ties affect access to bank loans. The dependent variable in this case is the loan-to-asset ratio, and the results are shown in the first column of **Table 6**. Our findings are consistent with previous research indicating that firms with political connections have greater success in securing bank loans compared to those without such ties (as seen in Sapienza [9]; Claessens *et al.* [10]; Faccio [8], and others). Specifically, firms with party members in their leadership can increase their loan amounts by 11.8%. Additionally, individuals with prior public-sector work experience can boost their loan ratio by 3.56%. These findings are statistically significant at the 1% level. Notably, about half of the sample firms had previous public sector experience before launching their businesses, which helped them form valuable networks within local government and related 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

We next investigate whether political party membership offers any benefits to SMEs in terms of tax rates, fees, and time spent on government-related processes. To analyze this, we perform a fixed-effects regression, using tax rates and the proportion of time entrepreneurs allocate to managing government regulations as dependent variables. The estimation results are presented in columns 2 and 3 of **Table 6**. Our findings align with past studies, such as Mian and Khwaja [4], Li *et al*. [6], and Li and Zhou (2015). Specifically, SMEs where the owner or manager is a Communist Party member benefit from a tax rate reduction of 1.58% compared to those with no political affiliation. Moreover, these connected firms can save 1.31% of their monthly time dealing with government regulations. While political ties do come with their costs, they yield significant benefits in terms of reduced operational burdens.

This political affiliation likely helps SMEs secure preferential treatment, which provides insights into the motivation behind joining the party. Party members in leadership roles within firms are more likely to attend specialized party training programs and engage in legislative activities. Furthermore, many party members in the private sector fall under the oversight of the centrally-run business sector, which enhances their ability to build more political connections. Thus, joining the party can be seen as the first step toward better access to local government structures and networks with other influential party members. As a result of their political ties, these firms benefit from lower operational costs and have a better chance of obtaining bank loans than their non-connected counterparts [22, 23].

Impact of the institutional environment

This part of the analysis examines the influence of political connections on SME performance within varying business environments. We rely on the Provincial Competitiveness Index (PCI), a tool designed to assess the performance, willingness, and capacity of local governments to improve the business climate. The PCI is surveyed annually by the Vietnam Chamber of Commerce and Industry (VCCI) with support from the U.S. Agency for International Development (US-AID). This index offers a more comprehensive view than previous studies, capturing the regional business environment and the development level of local institutions. The findings from this analysis are displayed 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

The findings indicate that political connections are more crucial for SMEs in areas where the market environment is less developed. Columns 1 and 2 in **Table 7** show the impact of party membership on firm performance across various business environments. The interaction between party membership and the provincial competitiveness index (PCI) positively influences return on assets (ROA) and return on equity (ROE) at a 5% significance level. These results suggest that political ties become less important in regions where local governments are more proactive in fostering a business-friendly environment, or in other words, where the market is more efficient. Column 3 demonstrates that as the business environment improves, firm characteristics like human capital and financial status play a more significant role in securing bank loans, while political connections remain more valuable in less developed regions [24].

Conclusion

This study investigates the effect of political connections on firm performance by analyzing a unique panel dataset of SMEs in Vietnam. Our results challenge most previous studies by revealing a negative impact of political ties on profitability. This can be attributed to the higher informal fees that politically connected SMEs must pay to establish these links. Furthermore, these firms may pursue political objectives that lead to inefficient resource allocation, ultimately causing underperformance. Our findings also highlight that one of the key ways connected firms gain advantages is through ties with the ruling Communist Party. This connection enables these firms to access bank loans, enjoy lower tax rates, and reduce time spent on government regulations. However, as the institutional environment improves, the importance of political connections diminishes. In the context of Vietnam's transition economy, where the institutional system is still evolving, political connections remain a crucial tool for SMEs to navigate market constraints.

Tables overview

Table 1 summarizes the main variables, covering 14,351 firm-year observations from 2005 to 2015. It categorizes variables into two groups: owner's attributes (party membership, former public sector employment, education level, age) and firm's attributes (total employment, total assets, ROA, ROE, firm age, total loans, value-added, informal fees, time spent on bureaucratic processes).

Table 2 compares the characteristics of entrepreneurs and firms for party members and non-party members, including t-tests for differences between the two groups. Statistical significance levels are indicated by asterisks.

Table 3 presents the correlation matrix of the explanatory variables, showing Pearson's correlation coefficients, with significance indicated at the 5% level.

Table 4 displays panel regression fixed effects results, analyzing political connections' impact on ROA and ROE. It includes both party membership and other political connection variables (e.g., public sector work experience).

Table 5 examines the effect of informal fees on resource allocation efficiency, with variables such as employment share and asset share over time. Control variables are included but not reported.

Table 6 reports panel regression fixed effects results on how political ties help SMEs access formal credit and other benefits, such as reduced taxes and time spent on regulations.

Table 7 investigates the effect of political connections on firm performance in different business environments. The interaction of party membership and the PCI is analyzed across multiple firm performance metrics, such as ROA, ROE, and access to loans.

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