

ABSTRACT

This research is the pioneer study to examine the political connections and overinvestment in Indonesia as a democratic developing country with mixed economy system. By using samples of 1,044 and 543 firm-year observations from listed firms on the Indonesian Stock Exchange from 2012 to 2017, this study also extends the literature on political connection by assessing the role of governance mechanisms. A two-stage model is used to address overinvestment which used two types of measurement at the first place, then continued to establish the main analysis on the second stage. There are two findings in this study. First, the relationship of political connections and overinvestment in Indonesia is significantly negative. Second, this negative relationship between political connections and overinvestment will increase in accordance with governance mechanism from both external and internal parties of the firm, resulting in lower overinvestment. Those results indicate that there are different benefits of political connections which can affect the incentives of firms with political connections in different ways. This study also enhances the effectiveness of governance mechanism in mitigating the detrimental effect of overinvestment.

Keywords Overinvestment, Political connections, Government mechanism