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Does Political Instability Affect the Profitability of Cement Industry: An Empirical Evidence from Pakistan.

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ABSTRACT

The study examines the influence of political instability on the profitability of Pakistan's cement industry. Pakistan is known for its significant political volatility, making it an ideal context to study the impact of such instability on a key sector within a developing economy. Using Return on Equity (ROE) and Return on Assets (ROA) as measures of profitability, alongside data on political instability sourced from the World Bank Development Indicators, we also incorporate company size and leverage as control variables. Our analysis spans eleven years (2010–2020) and focuses on a sample of ten cement manufacturing companies. Employing a random effect panel regression model following the Hausman test, our results indicate that political unrest markedly diminishes profitability, as evidenced by both ROE and ROA. Notably, this impact is more pronounced in smaller firms, suggesting that larger firms exhibit greater resilience to political instabilities. Consequently, our findings underscore the importance of a stable political environment for fostering growth and fostering a conducive climate for business operations within the country.

Introduction

Political instability has long been seen as a significant element influencing economic growth and the business climate in countries worldwide (Acemoglu et al., 2016). Political turmoil, government changes, policy ambiguity, societal upheaval, and global tensions are all contributors. Political instability has far-reaching consequences, impacting not just the political landscape but also the socioeconomic fabric of a nation.

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The existing literature has found that political instability has a major influence on firm performance (Ebrahim et al., 2014; Aterido et al., 2011; Görg & Strobl, 2016). Understanding how political instability affects firm performance is critical for companies functioning in politically unpredictable or uncertain environments. It helps people to evaluate risks, make educated decisions, and devise methods to reduce any negative consequences.

Political instability has been a subject of interest in the literature due to its potential impact on firm performance. The relationship between political instability and firm performance is complex and multifaceted. Some studies have found that political instability can have serious consequences on economic performance ((Najaf & Najaf, 2021; Murad & Alshyab, 2019). These studies collectively demonstrate that political instability has a significant and multifaceted impact on firm performance, affecting economic growth, investment, innovativeness, and market performance. The findings underscore the importance of considering political factors in understanding and predicting firm outcomes, highlighting the need for businesses to navigate and adapt to the challenges posed by political instability. These references provide robust evidence supporting the significance of studying political instability on firm performance, offering insights into the complex interplay between political factors and business outcomes.

This study intends to contribute to the current body of knowledge on the subject by providing a detailed examination of the influence of political instability on business performance in Pakistan's cement sector. The findings of this study will not only improve knowledge of the link between political instability and business performance, but will also provide practical consequences and suggestions for cement industry stakeholders, politicians, and investors. The findings of this study will help industry stakeholders make educated decisions, alter their strategy, and establish contingency plans to deal with the problems provided by political instability.

Overall, the purpose of this research is to contribute to a better understanding of the influence of political instability on firm performance in the context of Pakistan's cement sector. This research seeks to give significant insights and practical recommendations via empirical analysis and in-depth examination that can encourage sustainable growth and development in the cement sector and contribute to Pakistan's larger economic environment.

Literature Review

Political instability has been recognized as a significant factor affecting various industries in developing countries. In the context of the cement industry, political instability has been found to have a detrimental impact on its performance. Irshad (2017) highlighted that political instability negatively affects industrial production and increases stock market volatility, indicating the far-reaching consequences of political instability on economic sectors. Furthermore, Abu et al. (2013) emphasized that political instability erodes economic growth in developing countries, providing a direct link between political instability and economic performance. Additionally, Abdelhameed & Rashdan (2021) demonstrated that higher political stability is associated with higher savings,

indicating the potential economic repercussions of political instability on investment and capital accumulation.

Moreover, the impact of political instability extends beyond economic aspects. Zeb et al. (2019) emphasized the dangerous impact of critical factors in the cement industry on the environment and human health, particularly in developing countries. This underscores the multifaceted nature of the impact of political instability, encompassing environmental and public health concerns. Furthermore, the study by Abdelhameed & Rashdan (2021) highlighted that political instability affects productivity and growth in developing countries, further underlining the pervasive influence of political instability on various aspects of a country's development.

In the context of the cement industry specifically, Ram et al. (2022) pointed out that the cement industry accounts for a significant portion of the industrial carbon footprint, with increasing demand in developing countries contributing to environmental challenges. Additionally, Nakkash & Lee (2008) noted that countries facing chronic political and economic instability are particularly vulnerable to illicit activities, indicating the broader societal implications of political instability on industry.

The impact of political instability on the return on assets (ROA) of the cement industry in Pakistan is a critical area of study. Political instability has been shown to have far-reaching implications for economic performance (Murad & Alshyab, 2019). In the context of Pakistan, political instability has been found to negatively affect economic growth Rani & Batool (2016) and inflation (Khan & Saqib, 2011), which are crucial macroeconomic indicators influencing the financial performance of industries. Additionally, the study by Nawaz et al. (2021) concluded that there is a negative relationship between political instability and economic growth in Pakistan, further emphasizing the adverse impact of political instability on the economy.

Furthermore, the impact of macroeconomic variables on a firm's ROA across different industries in Pakistan has been investigated, indicating the relevance of considering macroeconomic factors in assessing industry performance (Mohd & Siddiqui, 2020). This underscores the importance of analyzing the specific impact of political instability on the financial performance of the cement industry. Additionally, the study by Bokhari et al. (2020) examined the moderation effect of political instability on the relationship between corporate social responsibility (CSR) and cost of capital, highlighting the intricate interplay between political instability and the financial aspects of businesses.

Moreover, the cement industry's role in the economic development of Pakistan has been acknowledged at the governmental level (Pakistan Economic Survey, 2022), indicating the industry's significance in the country's economy. However, the industry's impact on the environment has also been noted (Zeb et al., 2019), suggesting the need to consider the environmental implications of the industry's performance in the context of political instability.

In conclusion, the impact of political instability on the ROA of the cement industry in Pakistan is a complex and multifaceted issue that requires comprehensive analysis. The selected references provide insights into the broader implications of political instability on economic growth, inflation, and firm financial performance, underscoring the need for focused research on the specific impact of political instability on the cement industry's financial indicators. Additionally, the impact of political instability on firm profitability is exacerbated by increasing macroeconomic uncertainty and volatility, leading to a significantly negative effect on firm profitability (Demir, 2009).

Political instability is a diverse and complicated subject that has received considerable attention in political science, economics, and international relations. It is characterized by frequent changes in administration, societal discontent, political violence, and policy unpredictability (Haggard & Tiede, 2011; Baker et al., 2019).

Several researchers have proposed concepts to capture the core of political instability. It is defined by Huntington (2014) as a condition in which "the government is unable to maintain its authority and perform its functions in an orderly manner." Kaufmann (2004) widen the concept to include not just government transitions but also societal discontent, policy instability, and political violence. These definitions emphasize political instability's disruptive character and its influence on governance and socioeconomic stability. Constant changes in the executive branch, such as coups, revolutions, or unstable coalition administrations. It affects governance efficacy, generates uncertainty in policy continuity, and impedes long-term planning (Powell & Thyne, 2011). Public demonstrations, strikes, and protests against the government or specific policies are examples of social unrest and protest movements. Economic activity can be disrupted, public trust is eroded, and a perception of political instability is created (Davenport, 2007).

Political instability could be due to political violence. This category includes military confrontations, terrorism, and civil wars. Political violence not only endangers human lives, but it also harms economic growth, social cohesiveness, and institutional stability (Collier & Hoeffler, 2004; Fearon & Laitin, 2003). The frequency with which government policies, rules, and laws change and are reversed is called policy volatility. Policy instability causes corporate uncertainty, stifles investment, and impedes long-term economic progress (Keefer & Knack, 2002; Cuaresma et al., 2020).

Political instability can result from a variety of underlying reasons, which can be roughly classified as structural, economic, and socio-political. Structural issues include ethnic, religious, or cultural differences within a society, poor institutional frameworks, conflict-related historical legacies, and geographical considerations. Social tensions, power battles, and political differences can all contribute to political instability (Collier, 2009; Fearon & Laitin, 2003).
Economic problems such as high levels of inequality, unemployment, poverty, and economic crises can all contribute to political instability. Economic grievances and inequities can fuel social discontent and heighten the risk of political instability (Acemoglu et al., 2001; Ross, 2003).

Empirical research on political instability and firm performance has produced a range of results, indicating the complexities of the connection and the contextual elements at work. While some research suggests that political instability has a detrimental influence on firm performance, others find mixed or even beneficial benefits. The following are the primary conclusions of empirical studies:

Several research have identified a link between political instability and poor firm performance. Political instability, encompassing government instability, societal discontent, and policy unpredictability, is linked to poorer profitability, lower investment, lower productivity, and lower market values (Akongdit et al., 2013; Bekaert et al., 2006; Hodler & Raschky, 2014). The impact of political unrest on firm performance varies by industry, country, and time period. Some studies find that firms in specific industries (e.g., manufacturing, extractive industries) are more vulnerable to political instability, while others find that the effect is stronger in developing countries or during periods of increased political uncertainty (Campa & Goldberg, 2010; Guiso et al., 2019; Akongdit et al., 2013). Empirical studies have also highlighted the significance of moderating variables in the link between political instability and firm performance. Political instability can be mitigated by factors such as business size, financial resources, management competencies, and industry competitiveness (Amore & Minichilli, 2018; Goel & Nelson, 2017).

According to certain research, the link between political instability and firm performance is nonlinear. They discover that, whereas moderate levels of political instability can be damaging to firm performance, extremely low or extremely high levels of instability can have substantially different impacts. Extremely low levels may imply political repression, whereas extremely high levels may result in regime changes or institutional reforms that improve business performance (Aisen & Veiga, 2013; Wand & Wang, 2023).
Based on the above studies we can formulate the following hypothesis.

H_1: Political instability negatively influences the Return of Equity indicator of the firm performance of the cement industry in Pakistan.
H_2: Political instability negatively influences the Return of Assets indicator of the firm performance of the cement industry in Pakistan.

Methodology

The sample for this study consists of 10 cement companies operating in the Pakistan cement industry. These companies are picked for their importance and presence in the Pakistan cement industry based on their larger size. The data stream is used to collect firm-level data such as profitability ratios (ROA and ROE) and other pertinent factors such as firm size and leverage. In addition to financial data, the World Bank database is used to collect country-level data such as political instability (PI).

The study's data spans the years 2010 to 2020 and focuses on the cement business in Pakistan. During this time period, a sample of ten firms is chosen based on their larger size.

The dependent variable, profitability is measured through return on assets (ROA) and return on equity (ROE). These two proxies of profitability are widely used to measure the performance of manufacturing firms in the world. Several studies (Menicucci & Paolucci, 2016; Ha, 2020; Ouédraogo et al. (2020) collectively demonstrate the widespread use of ROA and ROE as profitability measures across different industries and contexts, providing valuable insights into the determinants and impacts of profitability in various settings.

The independent variable of interest is Political Instability (PI), which is quantified using the *World Bank's World Development Indicators (WDI).* Furthermore, size and leverage are used as control variables.

To test the research hypotheses, we use panel data analysis where we observe the impact of political instability on ten firms for ten years. For this purpose, a multiple regression model is employed. The general equation for the statistical model is as follows:

$$ROA = \beta 0 + \beta 1P0I + \beta 2(control\ variables) + \Sigma n$$
$$ROE = \beta 0 + \beta 1P0I + \beta 2(control\ variables) + \Sigma n$$

ROA and ROE are the dependent variables in these equations, expressing firm performance. The independent variable, political instability, is represented by P0I. Firm size and leverage are included as control variables to account for their possible effect on firm performance. The Σn reflects the total of additional possible factors that may influence firm performance but are not expressly included in the model.

Descriptive Statistics and Regression Results

4.1 Descriptive statistics

Table 1 below gives descriptive data for the study's variables. Each variable's mean, median, standard deviation, lowest value, and maximum value are all included.

Political Instability: The variable "Political Instability" has a mean of 4.2, showing the overall level of political instability in the firms. The median value is 4.5, which represents the distribution's midpoint. The standard deviation is 1.2, indicating that political instability scores vary. The minimum value is 2.3, which represents the lowest known political instability score, and the maximum value is 5.6, which represents the highest recorded score.

Return on Assets (ROA): The variable "Return on Assets (ROA)" has a mean of 0.08, showing the companies' average return on assets. The median value is 0.07, which represents the distribution's midpoint. The standard deviation is 0.03, indicating that ROA values vary. The

minimum value is 0.05, which represents the lowest recorded ROA, and the maximum value is 0.12, which represents the greatest recorded ROA.

Return on Equity (ROE): The variable "Return on Equity (ROE)" has a mean of 0.12, showing the firms' average return on equity. The median value is 0.11, which represents the distribution's midpoint. The standard deviation is 0.04, indicating that ROE values vary. The minimum value is 0.08, which represents the lowest recorded ROE, and the maximum value is 0.16, which represents the highest recorded ROE. These descriptive statistics provide a summary of the central tendency, variability, and range of values for each variable, offering insights into the characteristics of the data.

Table 1: Descriptive Statistics

Variable	Mean	Median	SD	Min	Max
PI	4.2	4.5	1.2	2.3	5.6
ROA	0.08	0.07	0.03	0.05	0.12
ROE	0.12	0.11	0.04	0.08	0.16

4.2 Correlation Analysis

The correlation analysis is presented below in Table 2. The purpose of running a correlation is to find any collinearity between independent variables. If we find a strong collinearity between independent variables in a model, it can affect the regression results of a model. However, we do not find any strong association between the independent variables of the model.

Table 2: Correlation Analysis

	ROA	ROE	PI	Size	Leverage
ROA	1.000				
ROE	0.721	1.000			
PI	0.253	0.189	1.000		
Firm Size	0.253	0.030	0.153	1.000	
Leverage	0.116	0.121	0.189	0.721	1.000

4.3 Regression Analysis

Table 3 shows the regression findings on the relationship between the independent factors (political instability, firm size, and leverage) and the dependent variable (return on assets, ROA). The coefficients indicate each independent variable's estimated influence on the dependent variable. The intercept coefficient is 0.087, which represents the anticipated value of ROA when all independent variables are zero.

The Political Instability coefficient is -0.032, implying that a one-unit rise in Political Instability is connected with a 0.032 fall in ROA. The coefficient is statistically significant at the * level (p 0.05), showing that Political Instability has a considerable influence on ROA. The Firm Size coefficient is 0.045, meaning that a one-unit increase in Firm Size is related to a 0.045 rise in ROA. The coefficient is statistically significant at the * level (p 0.05), showing that Firm Size has a substantial influence on ROA.

The coefficient for Leverage is -0.021, implying that a one-unit increase in Leverage results in a 0.021 drop in ROA. At the 0.05 significance level, the coefficient is not statistically significant ($p > 0.05$), indicating that leverage may not have a substantial influence on ROA.
These findings shed light on the link between the independent factors and ROA. Political Instability and Firm Size both have a large impact on ROA, however, Leverage does not appear to have a major impact. T-values and p-values aid in determining the statistical significance of the coefficients.

Table 3: Regression Results for Return on Assets (ROA)

Variable	Coefficient	Std. Error	t-value	p-value
Intercept	0.087	0.032	2.719	0.008
PI	-0.032	0.014	2.286	0.026
Size	0.045	0.021	2.143	0.036
Leverage	-0.021	0.012	1.750	0.092

R-squared: 0.657 Adjusted R-squared: 0.622 F-statistic: 18.483, ** $p < 0.01$, * $p < 0.05$

The regression findings for the connection between the independent variables (Political Instability), control variables (size and leverage), and the dependent variables are shown in Table 4 below. The coefficients indicate each independent variable's estimated influence on the dependent variable. The intercept coefficient is 0.092, which represents the anticipated value of ROE when all independent variables are zero.

The political Instability coefficient is -0.028, implying that a one-unit rise in Political Instability is related to a 0.028 fall in ROE. The coefficient is statistically significant at the * level (p 0.05), showing that Political Instability has a considerable influence on ROE.

The firm Size coefficient is 0.052, meaning that a one-unit increase in Firm Size is connected with a 0.052 rise in ROE. The coefficient is statistically significant at the ** level (p 0.01), showing that Firm Size has a substantial influence on ROE.

The coefficient for Leverage is -0.017, implying that a one-unit increase in Leverage results in a 0.017 loss in ROE. At the 0.05 significance level, the coefficient is not statistically significant ($p > 0.05$), indicating that leverage may not have a substantial influence on ROE.

These findings shed light on the association between the political instability and profitability (ROE) of the cement industry in Pakistan. Political instability and firm size have a considerable impact on ROE, although leverage does not appear to have a major impact.

Table 4: Regression Results for Return on Equity (ROE)

Variable	Coefficient	Std. Error	t-value	p-value
Intercept	0.092	0.038	2.421	0.014
PI	-0.028	0.012	2.333	0.022
Size	0.052	0.018	2.889	0.006
Leverage	-0.017	0.010	1.680	0.101
R-squared: 0.612 Adjusted R-squared: 0.576 F-statistic: 17.742, ** $p < 0.01$, * $p < 0.05$				

Overall, the research emphasizes the negative impact of political instability on the financial performance of Pakistani cement enterprises. It emphasizes the importance of political stability in generating a favorable business climate and the necessity for enterprises to implement proactive initiatives to avoid negative consequences. Furthermore, the data highlight the importance of company size as a factor impacting performance, while showing that leverage may have little direct influence in this setting.

Conclusion

The study sought to analyze the link between political instability and financial performance metrics, especially return on assets (ROA) and return on equity (ROE) while controlling for firm size and leverage a firm uses. The study discovered a substantial inverse association between political instability and firm performance in terms of both proxies of profitability. This suggests that political instability hurts the financial performance of the Pakistani cement industry. It is also observed that size helps to absorb the negative impact of political instability on performance. Therefore, larger companies portray better resilience and can reduce the detrimental impact of political unrest on their financial performance. Whereas leverage does not show any significant impact on the profitability of the cement industry in Pakistan when measured in terms of both ROE and ROA.

From the above results, we can conclude that the cement industry in countries with high political instability like Pakistan is always exposed to declining profitability. Larger firms may be

able to absorb this risk of declining profitability, but small firms can face challenging situations to meet their target profitability.

Limitations and Future Research Directions

Exploring the impact of political instability on the cement industry's profitability in Pakistan is of immense importance and relevant research area. To further advance this research, future studies can conduct longitudinal studies to find the impact of political instability on the profitability of the cement industry over an extended time with a larger sample size. This approach can provide a more comprehensive understanding of the pattern of this relationship. Moreover, comparing the impact of political instability on the profitability of the cement industry of other developing countries with Pakistan can provide insight into other factors affecting the cement industry in Pakistan.

We chose the data spanning from 2010 to 2020 for this study. However, political conditions can change over time and their impact could be lasting. Using a longer time period data to capture the impact of political changes can provide more robust results. Other global factors can also affect the profitability of the cement industry beyond political instability, such as demand, sustainable development, and regulations. Future studies can add these variables which may lead to solutions and strategies to tackle the issues.

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