



The effect of political uncertainty on the cost of corporate debt[☆]



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ABSTRACT

In this paper we bring new empirical evidence that political uncertainty is associated with higher corporate debt financing costs. Controlling for all bond and firm characteristics that could affect a firm's cost of debt financing, the uncertainty associated with the outcome of U.S. presidential elections leads to a 34 basis point increase in corporate bond spreads, with closer campaign years associated with additional costs. Similar results hold when we use the continuous measure of the *Political Uncertainty Index* by Baker et al. (2012). The uncertainty associated with gubernatorial elections, on the other hand, has no effect on the pricing of corporate bonds.

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1. Introduction

Businesses often face a significant amount of uncertainty related to the timing and content of government policy changes, as well as the potential impact that these policies have on corporate investment decisions and firm profitability. Although the U.S. enjoys a stable legal environment (La Porta et al., 1997), political uncertainty is not lessened, mainly due to the partisan variations in taxes, regulations, and social benefits that affect business cycles (see, e.g., Alesina, 1987; Alesina and Roubini, 1992). Recent incidents such as Affordable Care Act, Dodd–Frank Act and the Tea Party Movement are notable examples.

While recent empirical evidence suggests that political uncertainty is associated with a significant reduction in corporate investment (Julio and Yook, 2011, 2012) and/or inefficient investment decisions that can lead to high cash flow volatility and

therefore a higher risk of default (Durnev, 2010; Pástor and Veronesi, 2013), surprisingly, we know very little about how such uncertainty can affect the cost of debt, a firm's major source of external financing. In this paper we use several measures of political uncertainty to address this question empirically and provide new evidence of a causal relation between political uncertainty and the pricing of corporate bonds.

Political uncertainty could affect the value of corporate bonds in two important ways. First, the volatility of cash flows associated with changes in investment driven by political uncertainty is expected to affect the risk of default and therefore result in higher bond spreads (Cremers and Yan, 2010). Second, recent evidence suggests that a firm's political connections can affect its performance (Faccio, 2006; Cooper et al., 2010), probability of receiving government funding (Duchin and Sosyura, 2012; Cohen et al., 2010; Goldman et al., 2009), the likelihood of government bailout (Faccio et al., 2006), and the likelihood of fraud detection (Yu and Yu, 2011). To the extent that political uncertainty can directly affect the relationship between governments and corporations, and therefore a firm's access to public funding sources and/or scrutiny, and therefore its performance, debt holders should assess the related change in political uncertainty in their pricing of corporate bonds and charge higher spreads in the face of higher uncertainty about political incidents.

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Using a sample of over 20,000 corporate bond issues over the years 1980–2012 and three different proxies for political uncertainty, we find that such uncertainty significantly increases the cost of corporate bonds. Specifically, using U.S. presidential election years as our first proxy for political uncertainty, we find that controlling for firm, bond, industry and business characteristics, election years are associated with an average corporate bond spread that is 34 basis points higher than that associated with non-election years. In addition, in line with the argument of Alesina (1987) and Fowler (2006) that closer campaigns generate higher levels of uncertainty, we find that the closer winning margins indeed generate a significantly higher level of average bond spreads. To examine whether the cross sectional variation in bond spreads is driven by partisan variations in policies, we further differentiate Democratic-won elections and Republican-won elections, and find that regardless of which party wins the White House, the bond spread remains significantly higher in the election years.

We next use a second proxy for political uncertainty and adopt the *Political Uncertainty Index* compiled by Baker et al. (2012). This measure is a monthly index that covers the years 1985–2012 and combines Google News search results for terms related to political uncertainty, the scheduled expiration of federal tax code provisions, and forecasting error of consumer price index (CPI) and federal purchases of goods and services. Using this index, we find consistent results that higher level of political risk impose additional costs to corporate bond issuing.

We next use a third measure of political uncertainty by examining U.S. gubernatorial election during 1980–2012. Gubernatorial elections provide greater variation in terms of election years and geographic location. Jens (2013) uses gubernatorial elections as a proxy for political uncertainty and finds that it is negatively and significantly associated with corporate investment. Gao and Qi (2012) also find that the political uncertainty associated with gubernatorial elections is negatively associated with municipal bond issuance. We find, however, that gubernatorial elections have no significant effect on the pricing of corporate bonds. This last result implies that political uncertainty at higher levels (e.g., presidential elections) and lower level (e.g., gubernatorial elections) affect security prices through different channels. This question is important and could be fruitful for future studies.

In addition, we examine whether political uncertainty affects bond contract characteristics and find limited evidence that it is negatively associated with bond maturity and issuance amount. While self-selection driven by differences in firm characteristics between firms issuing bonds in the high uncertainty periods and those issuing in low political uncertainty periods may bias our results, such potential self-selection should work against us, because firms that choose not to issue bonds in the election years may face even higher bond spread if they do issue. To address the concern of self-selection, we adopt the Heckman (1979) self-selection model and find an even stronger effect of political uncertainty on the cost of bonds. This is consistent with the argument in Cao et al. (2013) that firms may postpone external financing in the presence of political uncertainty.

Next, we examine whether political connections affect corporate bond spreads. As we previously argued, a firm's political connections could be a key determinant of exposure to political risk and thus affect bond pricing. However, it is almost impossible to collect full information on each firm's political connections over the time. We therefore proxy for a firm's political preference with a measure of firm level political contribution information collected from the *Federal Election Commission*. While not an ideal proxy for political connections, this measure does imply a firm's political preference for campaign candidates. Controlling for bond

and firm characteristics, we find that firms that mostly contribute to Republican candidates suffer from a higher cost of bond when a Democrat candidate wins the election, but not vice versa. This finding however needs to be interpreted with caution, because it is possible that the political contribution is not an accurate measure for political preference, and/or that a firm's political preference does not accurately reflect its exposure to political risk.

Finally, we perform placebo test and subsample test. For our placebo test, we use years *other than* presidential election years as a robustness check. We do not find any evidence that during these hypothetical years firms experience a higher cost of debt compared to election years. In the subsample test, we separate the entire sample into sub samples of high versus low political uncertainty periods by the level of monthly *Political Uncertainty Index*. We find that political uncertainty only has a significant impact on bond pricing during high uncertainty periods, confirming the previous results that political uncertainty matters only when the level of uncertainty is prominent. Both tests further support our argument that political uncertainty imposes a higher cost of bond financing.

This paper makes a number of important contributions to the literature about political uncertainty. First, this is the first paper that finds that political uncertainty matters in the pricing of corporate bonds. Second, this paper is the first work to examine the effect of political uncertainty with several proxies. Our results show that country level political incidents are more likely to impact the bond market, whereas state-level uncertainty has an insignificant impact on bond pricing. Our study invites further investigation on how gubernatorial elections affect firm-level investment, given that the cost of debt capital may not be a valid channel. Third, using political uncertainty as an exogenous shock, this paper provides strong evidence that uncertainty has a causal effect on bond pricing.

Our work is related to several papers in the area of political uncertainty. Francis et al. (2014) investigate the impact of political exposure on firm's private borrowing. Our paper differs in both the variable of interest and measure of political uncertainty. Gao and Qi (2012) look into the impact of gubernatorial elections on the municipal bonds, while we look at the corporate bond market. Qi et al. (2010) look at how cross-country variation in political rights affects the cost of corporate bonds, while we examine a similar question from the perspective of political uncertainty. Bradley et al. (2014) examine the cost of debt in the context of firm's political strategy and contribution. Our paper looks at the impact of more general nationwide political environment. In our robustness check, however, we do not find that political contribution plays a big role in the pricing of corporate bond. Cao et al. (2013) examine a firm's capital structure decisions during political uncertainty periods, and show that firms take precautions to prevent issuing public bonds during political uncertainty period. We provide evidence that a higher cost of debt capital is indeed a concern for bond issuing firms during high political uncertainty periods.

The rest of the paper is organized as following. Section 2 describes corporate bond data, proxies of political uncertainty, and main sample. We conduct our main empirical tests in Section 3. Section 4 provides robustness checks. We discuss the implications of results and conclude in Section 5.

2. Data, sample and measurement

2.1. Corporate bond and firm characteristics

We collect U.S. corporate bond issuance information from Merger's Fixed Investment Securities Database (FISD). We keep all bonds from U.S. domiciled industrial issuers and require complete information on bond terms, current or historical ratings from

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