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# The partisan policy cycle and firm valuation

Isa Camyar [a,*], Bahar Ulupinar [b,1]

[a] University of Pennsylvania, International Relations, 652 Williams Hall, 255 S. 36th Street, Philadelphia, PA 19104-6305, United States
[b] West Chester University, Department of Economics and Finance, 304 Anderson Hall, West Chester, PA 19383, United States

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ABSTRACT

Our research probes the firm valuation impact of partisan-motivated policy cycles. We first identify the micro-channels of policy transmission that link partisan policy disturbances to firm value. Then, we draw on firm-level data from 21 industrial democracies for the period extending from 1989 to 2008 to examine whether government partisanship has any distinct impact on firm value. We identify a surprisingly large and consistent positive relationship of left-oriented governments with firm value. Additionally, our research finds that the partisan impact on firm value is appreciably conditioned by factors like economic openness.

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## 1. Introduction

Since Hibbs (1977) introduced the Classical Partisan Theory (henceforth the CPT) of economic policy, partisan policy cycles have been widely reported in the form of expansionary (contractionary) fiscal and monetary disturbances under left- (right-) oriented governments. However, despite decades of scholarship on the subject, the economic implications of these cycles are yet to be fully ascertained. Existing studies almost exclusively emphasize the implications of partisan policy cycles for *macroeconomic* outcomes like growth, inflation and unemployment. Our research differs markedly from prior research in its focus on the *microeconomic* implications of these cycles. More precisely, we investigate whether there are any cyclical patterns in firm valuation that can be attributed to partisan policy disturbances.

To the extent that partisan policy disturbances influence real and nominal variables in the market condition where firms make their operational and financial decisions, these disturbances may conceivably generate a partisan impact on firm valuation. The pertinent questions, then, are through which channel(s) and in what direction this impact materializes. To answer these questions, we turn to the economic policy analysis literature. In brief, our review of the literature highlights two points. First, it is possible to differentiate at least four channels of policy transmission that may turn partisan policy disturbances into value-boosting and/or value-depressing forces for firms: the product market, the capital market, the labor market and the public good channels. Second, policy disturbances by left- and right-oriented governments can set in motion multiple and conflicting, as well as reinforcing, forces for firm value via these four channels. This in turn creates some degree of theoretical ambiguity about the valuation impact of government partisanship. That is, the direction of the partisan impact on firm value is not theoretically unequivocal. Hence, it is appropriate to characterize it as an empirical matter.

* Corresponding author. Tel.: +1 215 898 0452; fax: +1 215 573 3207.
*E-mail addresses:* icamyar@sas.upenn.edu (I. Camyar), bulupinar@wcupa.edu (B. Ulupinar).
[1] Tel.: +1 610 436 3468.

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In our empirical analyses, we rely on firm-level data drawn from 21 industrial democracies for the period extending from 1989 to 2008. Using Tobin's Q as our measure of firm value, we explore whether the partisan orientation of the national government has any distinguishable impact on firm valuation. In our analyses, we consistently find that firm value differs significantly according to government partisanship. In particular, left-oriented governments have a surprisingly large, positive impact on firm valuation.

The surprising nature of the key finding makes it all the more necessary to conduct further tests to check its stability. The robustness of the finding is corroborated when (a) we use alternate measures of partisanship; (b) we consider the possibility of a lag in the partisan impact on firm value; (c) we run our models with different sub-periods and (d) we address issues such as overrepresentation of firms from some countries and firm heterogeneity in our data.

Subsequently, we inspect whether the partisan impact on firm value is conditioned by the context of policy-making. In particular, we interact government partisanship with institutional and structural factors like Central Bank Independence, Economic Openness and Exchange Rate Regimes that are shown to be likely to limit partisan differences in economic policy and, by extension, in firm valuation. Our results show that of these factors, only economic openness appreciably conditions the partisan impact on firm value, causing it to weaken. Additionally, we test whether the partisan impact is neutralized by economic actors' anticipation of partisan policy disturbances, as would be expected according to the Rational Partisan Theory (RPT) of economic policy (Alesina, 1987). Our results do not offer any support for the RPT. More specifically, we find that partisanship impacts firm value regardless of the expected level of economic actors' anticipation of policy disturbances.

Then, we conduct a correlational analysis to probe what may be driving our results. This analysis indicates that while left-oriented governments, with their expectedly expansionary policy disturbances, seem to generate value-boosting forces via the product market, labor market and public good channels in our sample, they may generate value-depressing forces via the capital market channel. Further consideration of our overall results suggests that the public good channel may indeed be what drives the surprisingly large, consistent positive relationship of left-oriented governments with firm value.

Although our robust finding is surprising for a variety of reasons, it is not all that unexpected in view of empirical patterns identified in diverse bodies of research. First, our finding starkly contrasts with the common notion that firms typically benefit more from and hence are more supportive of right-oriented governments compared to left-oriented governments, due to the former's supposedly more business-friendly policies. However, various studies have already cast doubt on this common notion. For example, Hibbs (1977) reports some ambiguity in how firm profitability is affected by government partisanship in his discussion of the distributional consequence of inflation. Gertler and Gilchrist (1994) and Thorbecke and Coppock (1996) provide evidence that contractionary monetary policies, more likely to occur under a right-oriented government according to the CPT, considerably hurt firm performance. In their analysis of sector-specific consequences of expectations for government partisanship, Bechtel and Füss (2010) show that firms located in different industries are differentially impacted by the electoral prospects of a right-/left-leaning coalition in Germany, calling into question the idea that firms *uniformly* benefit from right-oriented governments. Additionally, studies challenge the view that firms consistently throw their electoral support behind right-oriented parties. For example, studies like Clawson et al. (1992), Grier and Munger (1991, 1993) and Rudolph (1999) in particular report that firms in the US are not strictly ideological and are in some cases highly pragmatic in their campaign contributions, much more so than other political actors like labor unions. A similar pattern, though at the industry level, is identified in Germany by Bechtel and Füss (2010). Collectively, these studies highlight an ambiguity in the interest of firms as social agents (Thompson, 1982: 233). Our result lends further support to this ambiguity.

Second, the pattern of a persistent partisan impact on firm valuation goes against the rational view of stock markets. If rational, forward-looking investors capitalize the effect of political factors into stock prices (Fama, 1970), how could predictable partisan differences make any appreciable difference in firm valuation over such long periods? Evidence for the rational view of stock markets is mixed. Some studies provide confirming evidence that the electoral prospects of specific parties are capitalized into the stocks of those firms and industries whose future profitability is expected to be positive due to their campaign contributions (Knight, 2006; Mattozzi, 2008; Bechtel and Füss, 2010) and the sector implications of parties' policy platforms (Herron et al., 1999). However, other studies point to disconfirming evidence. The most compelling of such evidence comes from the presidential puzzle literature. Santa-Clara and Valkanov (2003) identify that excess return is consistently higher under Democratic presidents compared to their Republican counterparts over decades. The same pattern is confirmed in more recent works like Sy and Al Zaman (2011). Our finding represents another addition to this body of disconfirming evidence.

Third, a large and consistent partisan impact at the *micro-level* may seem contrary to a relatively more mixed impact at the *macro-level*. Studies like Franzese (2002), Clark (2003) and Potrafke (2009) raise questions about the magnitude and stability of the partisan impact on macroeconomic outcomes and policies. However, a relatively mixed pattern at the macro-level does not mean that we should see the same pattern at the micro-level. The multiple channels of policy transmission may magnify the impact of a relatively weak macroeconomic policy or outcome pattern on firms. Our research testifies to the need to pay more attention to the micro-level to fully appreciate the economic consequences of partisan politics.

## 2. Channels of policy transmission

We begin with a concise specification of the value of the representative firm. Following Modigliani and Miller (1961), the representative firm's value V can be decomposed into two components: an earnings stream from assets already in place V(A) and an earnings stream from investment opportunities V(I).

$$V = V(A) + V(I).$$

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