THE RELATIONSHIP BETWEEN ELECTORAL UNCERTAINTY AND CROSS-BORDER INVESTMENT DECISIONS

Extended Abstract

MOTIVATION

Traditionally, international business (IB) research has often associated political risk with country governance quality (Slangen, van Tulder 2009), corruption and freedom (Jiménez 2010), expropriation (Hajzler 2012), overall country risk ratings (López-Duarte, Vidal-Suárez 2010; Osabutey, Okoro 2015; Buckley et al. 2007; Quer et al. 2012) and political constraints (Laufs et al. 2016; Delios, Henisz 2003; Henisz, Delios 2001). These definitions have in common an exclusive focus on a country’s static and historical institutional framework, while largely ignoring dynamic events. However, certain dynamic events, namely elections, lead to a redistribution of political power within a country, which, in turn, can lead to changes in institutional conditions (Mei, Guo 2004; Gulen, Ion 2015). Hence, IB research is at risk of an incomplete and possibly biased understanding of political risk when ignoring elections. With this paper, we aim to extend current knowledge by investigating the relationship between risk related to elections and firms’ cross-border investment decisions.

THEORETICAL BACKGROUND AND HYPOTHESES

Researchers have found that timing and predictability of democratic elections represent significant sources of political uncertainty and are associated with increased stock market volatility (Boutchkova et al. 2012; Goodell, Vähämaa 2013; Li, Born 2006), reduced corporate investment rates (Julio, Yook 2012), reduced aggregated FDI flows (Julio, Yook 2016) and increased bond yield volatility (Bernhard, Leblang 2006). Based on these literatures, we expect electoral uncertainty to be generally negatively associated with investment decisions. Hence, we formulate H1:

Hypothesis 1 (H1): The probability for a firm to invest in a given country will be lower in quarters leading up to an uncertain election than in quarters leading up to a relatively certain election or during non-election periods.

Governmental discretion has the potential to harm foreign businesses in many ways, such as unexpected regulatory changes (Henisz, Williamson 1999) and even expropriation (Hajzler 2012). Consequently, numerous scholars found that strong governmental discretion translates into increased political hazard, which deters market entry (Delios, Henisz 2003; Duanmu 2012; Guler, Guillén 2010b; Henisz, Delios 2001; Henisz, Zelner 2001). Similarly, Julio, Yook (2012) find that domestic corporate investment cycles in countries with stronger checks and balances are less sensitive to election uncertainty. Other scholarship, however, is more cautious about the negative relationship between political constraints and firm behavior. García-Canal, Guillén (2008) find that firms prefer weak institutional constraints when entering a foreign market, because high governmental discretion enables them to negotiate favorable entry conditions. Particularly in periods preceding elections with uncertain outcome, such lack of political constraints creates incentives for the ruling incumbent to engage in opportunistic, business-friendly behavior, hence improving the bargaining position of firms (Nordhaus 1975; Drazen 2000; Rogoff 1987). These opportunistic strategies of political agents are particularly pronounced in cases where incumbent governments face potentially close elections, hence creating urgency to increase voters’ goodwill (Vaaler 2008). Hence, we formulate H2:
Hypothesis 2 (H2): Firms will be more likely to invest a given market prior to close elections if political constraints in that country are weak

Research provides ample evidence that firms develop capabilities, which help them deal with political uncertainty. These are derived in several ways. For one, countries from home countries with a high degree of political uncertainty are more tolerant to political risk in their target markets (Holburn, Zelner 2010; Jiménez 2011; Fernández-Méndez et al. 2015). Secondly, the same is true for firms, which have gained experience through internationalizing into politically instable markets (Jiménez et al. 2014; Jiménez 2010). In an analogue reasoning, we deduct H3:

Hypothesis 3 (H3): Firms will be more likely to invest in a given market prior to close elections if they possess experience in dealing with such challenges

METHODS

We analyze election and cross-border investment data from a global sample of 55 host countries between 2003 and 2015. We compile an unbalanced panel of publicly traded firms by downloading constituent lists for all major stock indices from the Standard & Poor’s COMPUSTAT database.

To operationalize the dependent variable, we obtain cross-border M&A and greenfield data from Thomson Reuter’s SDC PLATINUM and Financial Times FDI MARKETS. The variable is a binary measure that takes a value of 1 if a firm conducts either a greenfield or a M&A transaction in a host-country in a given quarter, and 0 otherwise. To operationalize electoral uncertainty, we manually gather data on outcomes and participants for 181 national elections across our set of 55 countries from several different sources, including the World Bank’s Database of Political Institutions (DPI). In line with previous research (Julio, Yook 2012), we categorize an election as close if the margin of victory of the election winner over the runner-up is smaller than the first quartile of the distribution of margins across the entire sample of countries. To account for government discretion in host countries, we complement the dataset with Henisz’s (2017) most current version of the political constraints index for each host country. We define a measure for experience with close elections by assigning a dummy variable with the value of one in case a company has invested in at least one country with electoral uncertainty over the preceding 4 quarters, and zero otherwise. In addition, we include numerous control variables. Following previous market entry studies (e.g., Henisz, Delios 2001; Delios, Henisz 2003), we control for host market economic conditions using data from The World Bank World Development Indicators (WDI). We furthermore control for geographical and cultural distance between home country and host country by including the number of kilometers between the two countries’ capitals as well as historical colonial ties (Mayer, Zignago 2011). We also control for freedom of elections by including the Freedomhouse (Freedomhouse 2017) measure on electoral processes. Lastly, we control for differences in firm size by using the log of total assets, the financial data for which is derived from S&P and Thomson Reuters.

In line with previous panel studies on market selection (Delios, Henisz 2003; Guler, Guillén 2010a; Henisz, Delios 2001), we assume that each firm is at risk of entering any country during any given quarter. Hence, we expand the gathered data into a three-dimensional panel structure, consisting of all possible firm - host country - quarter observations, and yielding over 2.5 million observations. We use a binomial probit regression due to the dichotomous nature of our dependent variable and include fixed effects for years and firms in order to account for unobserved heterogeneity and temporal shocks across these variables (Holburn, Zelner 2010).

PRELIMINARY FINDINGS
We find empirical support for all three hypotheses. The coefficients are highly significant, correctly signed and interaction plots look as expected. Furthermore, the coefficients for all control variables are signed as expected.

**Publication bibliography**


Fernández-Méndez, Laura; García-Canal, Esteban; Guillén, Mauro F. (2015): Legal Family and Infrastructure Voids as Drivers of Regulated Physical Infrastructure Firms’ Exposure to Governmental Discretion. In *Journal of International Management* 21 (2), pp. 135–149. DOI: 10.1016/j.intman.2015.03.003.


