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Effect of political uncertainty and corporate investment cycles in Nepal

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ABSTRACT

The present study investigates the relationship between corporate governance profile of acquiring firms and operating performance changes associated with merger and acquisitions in political uncertainty in Nepal. The financial sector mergers and acquisitions have been selected as sample transactions for the period of 2008 to 2011 and two years pre- and post-merger analysis has been conducted by using OLS regression. The estimated results indicated that post-merger operating performance of acquiring firms is positively related to its pre-merger level. Moreover, board size and CEO duality are negatively while board independence, outside dominated boards, and presence of large independent block holder are positively related to change in post-merger operating performance of acquiring firms in Nepal. The results were also robust with an alternative dependent variable of change in market value of acquiring firms. The results from replaced dependent variable were found to be more strong and cohesive with corporate governance profile of acquiring firms. Aligned with the existing literature, the study concluded that effective corporate governance mechanism does play its role in aligning the interests of managers with shareholders and enhances value for firms, particularly in large scale transactions of mergers and acquisition.

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Introduction

The relationship between politics and economic outcomes has a long history in research and public debate. One important way in which politics is hypothesized to influence real decisions is through the channel of uncertainty and instability. In particular, the incentives and uncertainties associated with possible changes in government policy or national leadership have implications for the behavior of both politicians and firms [Alesina, Alberto, 1987]. The effects of policy uncertainty are especially relevant in light of the recent financial crisis and recession. There is a great deal of uncertainty as to how governments will shape policy to stimulate investment in the short run and formulate regulatory and economic policy in the long run. It has been argued that this uncertainty itself may be hindering a recovery by inducing firms to delay investment until the uncertainty related to future financial regulation and macroeconomic policy is resolved. In this paper, we examine the effects of political uncertainty on the investment behavior of firms in the context of national elections. Elections in which the national leader is determined provide an interesting setting to study the effects of political uncertainty on investment for two important reasons. First, while standard models of policy typically assume a single welfare-maximizing planner that makes policy choices over the entire life of the economy, the real world is characterized by leaders who face limited terms and may be replaced by other leaders with different policy preferences. Election outcomes are relevant to corporate decisions as they have implications for industry regulation, monetary and trade policy, taxation, and, in more extreme cases, the possible expropriation or nationalization of private firms. Second, investigating the impact of political uncertainty on investment is a challenging task due to the potential endogeneity between uncertainty and economic growth as the economic downturn itself has arguably generated a great deal of political

uncertainty. Elections around the world provide a natural experimental framework for studying political influences on corporate investment, allowing us to disentangle some of the endogeneity between economic growth and political uncertainty. If political uncertainty is higher when changes in national leadership are more probable, elections provide a recurring event that helps isolate the impact of policy uncertainty on investment from other confounding factors. The timing of elections is out of the control of any individual firm and indeed fixed in time by constitutional rules for a large proportion of observations in our sample. In addition, elections around the world take place at different points in time, allowing us to net out any global trends in corporate investment. Using national elections in 48 countries between 1980 and 2005, we examine changes in corporate investment as political uncertainty fluctuates by comparing corporate behavior in the year leading up to the national election outcomes with that in nonelection years [Alesina, Alberto, Gerald D. Cohen, and Nouriel Roubini, 1999]. The intuition underlying the relationship between electoral uncertainty and investment is simple: If an election can potentially result in a bad outcome from a firm's perspective, the option value of waiting to invest increases and the firm may rationally delay investment until some or all of the policy uncertainty is resolved. The relationship between uncertainty and real investment has been modeled by Bernanke (1983) and Bloom, Bond, and Van Reenen (2007), among others. In these models, firms become cautious and hold back on investment in the face of uncertainty. Others have modeled the effects of political uncertainty in a macroeconomic context. Rodrik (1991) and Pindyck and Solimano (1993) are prominent examples of this literature in which the uncertainty brought about by political factors leads firms to choose lower levels of investment expenditures. Chen and Funke (2003) model the private investment decision in emerging markets in the face of policy uncertainty. More

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recently, Bloom, Floetotto, and Jaimovich (2009) model business cycles as a function of variation in levels of macroeconomic uncertainty [Alesina, Alberto, and Roberto Perotti, 1996]. The idea that political instability can deter investment at the aggregate level find that measures of political instability and violence are correlated with cross-country differences in investment rates. The mass movement of April 2006 in Nepal sought to restore parliament for the democratic process to continue and to initiate a peace process for the end of a ten-year long armed conflict. This required the Communist Party of Nepal (Maoist) to join democratic competition which in turn necessitated the devising of a constitution to manage root causes of conflicts afflicting the nation. Hence, a Constituent Assembly (CA) election, that would pave the way for an inclusive state responsive of social diversity and sustainable peace, was seen as the compromise solution among all the political forces. A train of processes and events was thus set off resulting in the advent of current Nepalese politics. A Comprehensive Peace Agreement (CPA) was signed between an alliance of the seven political parties (six after the merger of Nepali Congress and Nepali Congress-Democratic) and the CPN (Maoist) on November 21, 2006. An Interim Constitution drafted and the restored parliament dissolved to pave the way for an interim legislature and interim government that included the CPN (Maoist) in 2007. The ruling seven-party alliance (SPA) announced substantive structural reforms, such as declaration of the country secular, federal and republican. Civilian control of Nepal Army (NA), nationalization of royal property, empowerment of the Premier as head of state, abolition of the national unification day and substitution of the national anthem were announced as time went by. There were also reform measures such as greater inclusiveness regarding marginalized people in the CA, the bureaucracy and police. However, all these measures have allowed a neo-patrimonial regime to incubate, sapping the political will necessary to alter the policy and strategic development vital to transform the "structural causes of conflicts". This has hindered efforts for cultural, social, economic and political transformation needed to establish a well-organized virtuous state capable of instituting sound democratic governance. The political transition has remained highly turbulent due to the open-ended nature of the conflict system. It is, therefore, hard to say whether Nepal has actually entered a post-conflict phase. The continuation of high political dynamics in the country now indicates a steady erosion of the writ of state and the low level of constitutional and government's stability. This has resulted in a new bargaining environment for armed non-state actors and movement-oriented ethno-regional forces thus further limiting the scope for complex reforms, both involving long-term institutional restructuring and short-term policy interventions. The weakness of state institutions has further spoiled efforts to promote relief to vulnerable sections of the population and address conflict residues. Social movements of marginalized groups-- women, Dalits (untouchable underclass), Janajatis (ethnic groups), Aadibasis (indigenous groups) and Madhesis (people living in the southern plains) -- for identity, proportional representation, federalism and self-determination and insurrectionary activities of two-dozen non-state armed actors have upset the coherence of state-society relations in an unprecedented manner. While the mainstream parties have interest in restructuring the state, the social forces favor restructuring political parties to expand the social base of politics. As a result, the SPA has missed three deadlines (June

14 and 20 and November 22) for the CA elections to draft a new constitution. It was forced to amend the Interim Constitution three times in eight months--(May 9, June 14 and December 18) to give in to rising demands that the political process was exacting and to give in to the voice of various agitating groups. Among the provisions included in the amendments the more significant ones empower the parliament to abolish the monarchy, if found plotting against the CA elections, and declare the country a federal democratic republic, subject to ratification by the elected CA, or even before that by a two-thirds legislators if the King poses a threat to the elections. Despite voices emerging for a space for monarchy and efforts of CPN (Maoist), NC and CPN-UML to woo its supporters, King Gynendra remains aloof from the power struggle. All this has not changed the political dynamics for the better. The Madhesi People's Rights Forum (MPRF), a group which organized violent protests in the Tarai where scores of people were killed last year, is demanding a fourth revision of the constitution to address the grievances of the Madhesis. The peace process kept in limbo by the political events appears to have been finally taken up with the 23-point accord reached among the SPA constituents on 23 December. It finally decided that it would establish a high level Peace Council and the six basic pillars of peace within a month. Accordingly, the National Human Rights Commission of Nepal has been assigned to probe into rights violations during past emergency rule, managing cantonments and providing remuneration to Maoist combatants, return of illegally seized public property, end to forced donation by Maoists, etc. It vows to hold the CA elections by April 10, 2008, has increased the number of seats for CA from 497 to 601 and began a common process of electoral socialization through joint mass meetings. The process is marred by mutual accusations. On January 16, Minister for Peace and Reconstruction R. C. Paudel, made a public call on all the agitating groups for dialogue and facilitate CA elections. He has to be more strategic with the ability to strike a balance between achieving the human rights protection objective and responding to changing narratives of discourse, contexts, actors, issues, rules and political priorities. Political uncertainty is not the only mechanism through which real outcomes can be affected around the timing of elections. Two alternative explanations in the literature suggest election-induced cycles in investment. The first is the political business cycles hypothesis. Starting with the Nordhaus (1975) model of political business cycles, there has been much debate over whether incumbents manipulate fiscal and monetary policy instruments to influence the level of economic activity prior to an election in order to maximize the probability of re-election. Thus, one alternative explanation for our results is that corporate investment is reacting to changing macroeconomic fundamentals. While the political business cycles hypothesis predicts that average economic activity should be higher just before the election, the actions used to stimulate the economy could have a crowding-out effect on private investment. The second alternative explanation is related to the value of political connections. Some firms may have incentives to change their investment behavior to help ensure that their political connections remain in office through the election cycle. Bertrand et al. (2006) investigate the behavior of politically connected firms around municipal elections in France, and find that the firms managed by connected CEOs boost their investment during election years, particularly in politically contested areas, likely in an attempt to help their connection get re-elected. We

conduct formal tests of these alternative hypotheses and find no evidence that they are operating in our sample of firms. We therefore view the political uncertainty hypothesis to be the explanation among existing theories that best fits the patterns in the data. The findings in this paper have two important contributions. The first document a new stylized fact regarding corporate investment around the world, namely, a tendency for firms to reduce investment in election years. This result demonstrates an important link between the political process and real outcomes. Second, we provide evidence suggesting that political uncertainty matters for a firm's real investment and savings decisions. This result is an interesting illustration of how uncertainty in general can influence investment dynamics. As far as we know, we are the first to examine the effects of national elections on firm-level investment behavior around the world

Tarai's Geopolitics

Twenty-two districts in Nepal's southern plains bordering India constitute the Terai or Madhesh. It is fertile area and is linked to Nepal's major supply routes to hills. After the declaration of secular state and talk about redistributive land reforms, the glue that bind hill and Tarai communities got lost. The Madhesi movement spearheaded by the MPRF wants the declaration of the Madhesh as an autonomous region, talks with armed Madhesi groups, balanced distribution of state revenue and income to Madhesh, proportional representation in all the governance institutions including the NA, appointment of chief administrators in Madhesh from the Madhesi communities, return weapons captured by Maoists to the concerned people and declaration of those killed during the Madhesh movement as martyrs including compensation for their families. The TMLP has expressed its desire to have its own state organs for the plains. The two radical components of Janatantrik Tarai Mukti Morcha (JTMM) demand international mediators like the UN to resolve their issues and a separate independent state. India's assertion that "Tarai's demands should be addressed," has provoked a prickly reaction from various political forces. Premier Koirala who had earlier assertion that the "Tarai problem can be resolved within a minute with India's cooperation" has led to suspicions about an 'Indian hand' in the unrest. India's main opposition, Bharatiya Janata Party (BJP), however, criticizes the Indian government for remaining silent on the collusion of Indian and Nepali communists for creating turmoil in both countries and quashing of the symbols of Nepal's stability and unity-Hindu state and monarchy. An open border with India, existence of co-ethnics across the border and affiliation of each group and political party with like-minded ones in India create a context in which resolution of conflict requires confidence-building measures from both sides. The violent conflict in the Tarai has forced the hill people to migrate to safe places and create their own mechanisms in the area, like the Chure Bhavar Unity Society (CBUS) that positions itself in the foothills bordering the Terai and the mountains, for autonomy and self-defense. The autonomy movement in the Madhesh has snowballed into ethnic Tharus, Rais, Limbus, Tamangs, Gurungs, Magars, Dalits and Newars also demanding autonomous federal states based on the right to self-determination. But, there is no unity among Madhesi groups due to their multiple caste, language, religious and ethnic identities. For example, TMLP leadership is dominated by high caste groups, MPRF by intermediary caste groups and JTMM by lower caste groups. The government's Special Task Force (STF), deployed in Kathmandu and eight Terai districts, has failed to

penetrate, divide and destroy criminal networks and create public security for local governance to operate. Nepal's problems cannot be tackled without taking this regionalism into account and identifying ways to address it. No matter how one looks at this problem, it seems obvious that there is no military solution. The political package must create a situation favorable to all groups where they see they have more to gain through peace than violence. An election in a security and authority vacuum will neither have legitimacy nor ability to institutionalize democratic polity.

Law and Order

The Nepalese army has expressed its commitment to democracy and a nationally-owned security sector reforms. But, Chief of Army Staff, Gen. R. Katawal clearly said "No" to integrate the CPN (Maoist) combatants. The UN has verified 19,602 politically indoctrinated People's Liberation Army (PLA) out of its total force of over 32,000. Premier G. P Koirala agrees with the army's viewpoint and has given options to Maoists- to integrate the PLA into industrial security groups or give them priority in foreign employment. Nepal's total strength of security forces stands at 165,000-- NA (92,000), the civilian police (48,000) and Armed Police Force (25,000). The NA is holed up inside barracks as per the peace accord. The existence of these two adversarial structures does not provide any incentive for confidence building and to pursue a viable peace process for the future. Similarly, without disarming all autonomous armed groups and improving civil-military relations, the chances of free and fair elections remain fragile. Erosion of state monopoly on power, taxation and loyalty of citizens, growth of competitive violence and failure of statehood in governance have confiscated the state's capacity to provide security in the country. As a result the ability of the political system to maintain balance of power between different governance organs is severely undermined which is telling on its capacity to enforce rule of law, provide service delivery and resolve the multi-layered conflict [Brown, LD and ML Caylor (2006)]. SPA's control over the legislature, the executive control over the judiciary and a lack of legitimate opposition have established monopoly rule. There is an absence of institutions protecting property rights and promotion of collective goods. Nepal has a very weak middle class and poor mediating agencies to protect the rights and welfare of the poor. Tax contributes 12 percent to GDP and the contribution of public sector output to GDP is only about 7 percent. Foreign aid constitutes 70 percent of development outlays. Domestic revenue raising capacity is very poor. Easy borrowing from international institutions has established the government's autonomy from their tax paying citizens. As a result, the government is less concerned with institutional capacity of the state to deliver governance goals. The substantial contribution of remittance to GDP (17 percent) too has detrimental effect on the accountability of government. GDP growth rate of 2.3 percent hardly balances out the population growth of 2.2 percent. The daily per capita income of \$ 1 puts Nepal's human security condition at the bottom of world development statistics. Feudalism, caste hierarchy and patriarchy have suppressed social mobility of the underclass. This lack of social and economic security has made Nepal's politics highly inflammable amidst radical appeals and growing frustration. Nepal's bureaucracy, police and public institutions are highly politicized along partisan lines, de-motivated, show poor esprit de corps and weak to enforce rule of law and deliver essential public services. "The rulers have no trust in the constitution, leading to its

failure," Chairman of the Constitution Drafting Committee, Laxman Aryal said on January 15. To him, the constitution emerged as a compromise among SPA constituents for the transition politics until the CA election is conducted. It, therefore, does not hold the principles of constitutionalism. He added, "We saw nothing during its first year, but chaos and deterioration of law and order." This condition has made national integrity system ineffective in controlling crime, corruption and impunity. Public institutions and enterprises are still monopolized by ruling parties. Sense of public trust in the authority, assuming that the government is trustworthy and acting in the public interest, is sharply declining. Lack of a boundary between leaders' personal and institutional interests has given birth to a political culture of clientalism although new social movements of women, youth, Dalits, indigenous people and ethnic groups are increasingly challenging the position of authority fixed at birth, lineage and patronage. They are seeking to remold the pre-modern political culture of mutual distrust, betrayal and revenge and into post-conflict modern culture of a shared future based on social justice, democracy and peace.

Voice and Participation of Marginalized

The struggle for human rights in Nepal for liberation, entitlements and social opportunities still remains unfinished. Chairman of the National Human Rights Commission of Nepal (NHRC) K. N. Upadhaya stresses the need for joint efforts among the human rights organizations and individuals to mitigate human rights violations in an effective manner. The government's presence is felt to some extent only in Kathmandu and some urban nodes. Killing, kidnapping, extortion, strikes, food shortages, rocketing prices, shrinking job opportunities and growing fear have deteriorated human rights conditions in the periphery. Last year, 130 civilians got killed by various forces. Seventy-two political parties have applied in the EC for registration. This number represents asymmetry and diversity in Nepalese social life. A number of social groups are struggling for social, gender and inter-generational justice in the party structure of mainstream parties. Internal party democracy is essential to make political power proportional to its representativeness and end the fissiparous tendencies that have sapped their social integration potential. The country has 102 ethnic groups and more than 82 languages. No single group claims more than 18 percent of the population. This means it is a country of minorities and there is no institutional mechanism to prevent the minority from becoming a majority. Civil society groups are columnized along partisan lines. This condition has marred the possibilities for cooperative action for public service. Despite the legislation of the Right to Information Act, the media is unevenly distributed just like the per capita income and, therefore, people of backward and remote areas have no access to the public sphere in shaping the agenda. In contrast, the apex body of media persons, Nepal Federation of Journalists, revealed the condition of media freedom this way: Between April 24, 2006 to December 1, 2007 one journalist was killed, one disappeared, 74 detained and 128 threatened. There were 203 attacks on media houses, 129 journalists lost their jobs and 55 media houses were shut down.

Engagement of the International Community

For an international community caught in a fluid political climate, it will be hard to enlarge the development space as agreed in the Basic Operating Guidelines (BOG), other than relief and humanitarian supplies. The presence of the international community in Nepal acts as a deterrence against

excessive use of violence and abuse of human rights. Japan has put Nepal in the category of a "fragile state." By definition, a fragile state creates a situation for humanitarian intervention owing to anarchy of free wills, poor governance and failure to enforce rule of law. India has often insisted that elections to the CA must take place on time at any cost, but remained silent when the SPA failed to create a favorable security and law and order situation. The European Union and the US are insisting that the security situation in Nepal must improve for a credible, free and fair election. On January 18, the US Ambassador to Nepal, Nancy J. Powell suggesting the government and political parties to fulfill earlier commitments made in the peace accord said, "The CA polls will not guarantee sustainable peace in Nepal. What is necessary for the sustainable peace is loyalty to the nation." On January 11, UN Secretary-General Ban Ki-Moon submitted his report to the UN Security Council proposing a six-month extension of UNMIN's mandate to support Nepal's peace process through CA elections. He has advised against downscaling the UN's presence, emphasizing that it could imperil prospects for a successful election, except in the cases of technical assistance which has already been provided. The UN too favors a credible CA election with improved security, government's engagement in a dialogue with disgruntled groups and abolition of the culture of impunity. Unlike the EU, however, India, the US and China have geopolitical priorities. India's role in bringing the SPA together against the 'monarchy' in November 2005 and their joint struggle forced King Gyanendra to hand over power to the political parties. As the SPA established their monopoly over power and resources but failed to maintain security and rule of law, it evoked the security concern of neighbors. China has voiced against "any foreign intervention in Nepal," showed interest to actively involve itself in Nepal's peace process, expressed anxiety about the events taking place in the Tarai and asked the Nepalese leaders to take independent decisions depending less on outside forces. Aid coordination and coordination of government-donor practices have become particularly important in Nepal, especially to engage both sides in abolishing the historical practice of clientalism and paternalism, building trust on each other's role and engaging in multi-dimensional aspects of the peace-process, such as state-building, support to constitution-making, transport, communication, energy development, education, agriculture, rural development, water supply, finance, health and sanitation and sustainable development. Conflict mitigation projects should involve rehabilitation of the damaged infrastructure and internally displaced people, rural reconstruction and eradication of the root causes of mal-development which, in the first place, triggered the cycle of conflict.

Expectation of People at the Grassroots Level

The media and the political leaders have generated unrealistic expectations among the population that the CA is the panacea that will fulfill all their needs and desires. It was important to cast the message that CA is meant to frame a draft of the constitution and the necessary laws for governance. People at the grassroots level are expecting informed and reason-based knowledge about the constitution-making process, the suitability of the election system, improvement in security and are concerned about political stability, cooperation from outside, avoidance of unnecessary foreign intervention, knowledge about the modern state, functions of political systems, government, political parties and leadership, enfranchisement of citizens and their stake-holding in public

institutions, social cohesion, support in education, health and economic activities and social justice. Minorities are increasingly questioning about their human rights in a majority dominated federal state. They want to know about their role in the multi-staged negotiation with the CA, suitability of federalism, concept of a republic and the vision of a New Nepal [Core, J., Holthusen, R., Larcker, D. 1999]. Ordinary people also ask about the mixed election system that has been adopted and which presents a new challenge- what with the twin-ballot paper for voters and administration. FES training series on civic education has created a synergy as demands for such activities from various quarters have increased, advocacy documents have been utilized by all sides, resource persons interviewed by the media and published in the local papers. They were even involved in non-partners' activities with the same advocacy resources. In general, our programs have strengthened the civic competence of citizens as they can debate on equal terms with their leaders and contest their view points. In many conflict-hit places, our activities provided space for dialogue among heterogeneous participants and directly contributed to building public opinion, democratic will-formation and reconciliation. We also tried to encourage participants to speak up and share their views rather than just receiving top-down dissemination of knowledge and information. In many places, they suggested to us to provide training to central level leadership and demanded more seminars in the districts and villages so that dialogues across diverse communities can build trust between conflict-torn societal groups and improve their relations with the state.

Theoretical Background

The researchers in corporate finance have investigated the outcome of mergers from different perspectives. During the last few decades a number of studies on M&A have been conducted and several theories have been proposed and tested empirically. The studies include validating the economic impact of mergers on industry consolidation, shareholders value addition and post merger performance of companies. A critical question addressed by these studies is whether a merging partner has achieved the expected performance or not. Several measures have been used to analyze the outcomes of a merger including short and long term impact of merger announcements, effect on shareholders' value etc. (Mantravadi and Reddy, 2008). A number of studies have been conducted in developed economies on post-merger financial performance evaluation. Lubtakin (1983) surveyed the literature on the topic and concluded that acquiring firms might get benefits from merging because of synergy effect. Healy et al. (1992) used a sample of 50 large US mergers between 1979 to 1984 to examine the post-merger operating performance and found that operating performance has been significantly improved for acquiring firms following mergers. The literature has witnessed numerous researches on the managers' interests, corporate governance mechanism and merger performance. Morck et al. (1990) tested for managerial self-interest indirectly by arguing that managers with such behavior will either diversify or buy growth firms. Since this type of acquisition strategy is associated with reduced shareholders wealth, these M&A were driven by manager's self-interest. Kroll et al. (1990) found that compensation of CEO and executives was enhanced after the mergers due to increased size of new firm. Travlos and Waeglein (1992) reported that CEO shareholdings and incentive plans to be positively associated with cumulative abnormal returns (CARs) of acquiring firms. Ueng (1998) and

Datta et al. (2001) found that shareholding and equity based compensation of managers induce them to announce M&A and lead to higher CARs. All of these studies concluded that, in a merger and acquisition decision, managers safeguard their own interest instead of shareholder wealth maximization. The modern corporation structure is based upon separation of ownership theory due to which a costly agency phenomenon is more prevalent in the firms. The potential for agency conflicts inherent in this theory makes it imperative for publicly traded firms to have an effective corporate governance system. The most direct mechanism of corporate governance is the board of directors. The power to hire, compensate and fire top executives gives well functioning boards the ability to greatly reduce the conflicts of interest between shareholders and managers. Board size has been suggested by Lipton and Lorsch (1992) and Jensen (1993) as a possible factor to have an impact on monitoring quality in the firm. Yermack (1996) posit a negative relationship between board size and Tobin's q. Core et al. (1999) found that larger boards are more sympathetic to CEOs and they are able to extract higher compensation from larger boards. However, larger boards may do a better job as well and this notion is supported by Grinstein and Hribar (2004) who found that larger boards tend to pay smaller M&A bonuses to its executives.

Results and Discussions

The relationship between politics and economic outcomes has a long history in research and public debate. One important way in which politics is hypothesized to influence real decisions is through the channel of uncertainty and instability. In particular, the incentives and uncertainties associated with possible changes in government policy or national leadership have implications for the behavior of both politicians and firms. The effects of policy uncertainty are especially relevant in light of the recent financial crisis and recession. There is a great deal of uncertainty as to how governments will shape policy to stimulate investment in the short run and formulate regulatory and economic policy in the long run. It has been argued that this uncertainty itself may be hindering a recovery by inducing firms to delay investment until the uncertainty related to future financial regulation and macroeconomic policy is resolved. In this paper, we examine the effects of political uncertainty on the investment behavior of firms in the context of national elections. Elections in which the national leader is determined provide an interesting setting to study the effects of political uncertainty on investment for two important reasons. First, while standard models of policy typically assume a single welfare-maximizing planner that makes policy choices over the entire life of the economy, the real world is characterized by leaders who face limited terms and may be replaced by other leaders with different policy preferences. Election outcomes are relevant to corporate decisions as they have implications for industry regulation, monetary and trade policy, taxation, and, in more extreme cases, the possible expropriation or nationalization of private firms. Second, investigating the impact of political uncertainty on investment is a challenging task due to the potential endogeneity between uncertainty and economic growth as the economic downturn itself has arguably generated a great deal of political uncertainty. Elections around the world provide a natural experimental framework for studying political influences on corporate investment, allowing us to disentangle some of the endogeneity between economic growth and political uncertainty. If political uncertainty is higher when changes in national leadership are more probable, elections provide a

recurring event that helps isolate the impact of policy uncertainty on investment from other confounding factors. The timing of elections is out of the control of any individual firm and indeed fixed in time by constitutional rules for a large proportion of observations in our sample. In addition, elections around the world take place at different points in time, allowing us to net out any global trends in corporate investment. Using national elections in 48 countries between 1980 and 2005, we examine changes in corporate investment as political uncertainty fluctuates by comparing corporate behavior in the year leading up to the national election outcomes with that in nonelection years. The intuition underlying the relationship between electoral uncertainty and investment is simple: If an election can potentially result in a bad outcome from a firm's perspective, the option value of waiting to invest increases and the firm may rationally delay investment until some or all of the policy uncertainty is resolved. The relationship between uncertainty and real investment has been modeled by Bernanke (1983) and Bloom, Bond, and Van Reenen (2007), among others. In these models, firms become cautious and hold back on investment in the face of uncertainty. Others have modeled the effects of political uncertainty in a macroeconomic context. Rodrik (1991) and Pindyck and Solimano (1993) are prominent examples of this literature in which the uncertainty brought about by political factors leads firms to choose lower levels of investment expenditures. Chen and Funke (2003) model the private investment decision in emerging markets in the face of policy uncertainty. More recently, Bloom, Floetotto, and Jaimovich (2009) model business cycles as a function of variation in levels of macroeconomic uncertainty. The idea that political instability can deter investment at the aggregate level is supported by empirical evidence. Barro (1991) and Alesina and Perotti (1996) find that measures of political instability and violence are correlated with cross-country differences in investment rates. Pindyck and Solimano (1993) and Mauro (1995) find evidence that political uncertainty and an index measuring bribery and corruption are negatively related to investment spending at the aggregate level. However, some difficulties arise in interpreting the aggregate evidence. First, it is not clear whether the various measures of political instability are exogenous to economic conditions and aggregate investment. Second, as discussed in Pindyck and Solimano (1993), the models of investment under uncertainty are less clear about how uncertainty affects long-run equilibrium investment rates, defined as the ratio of investment to capital stock, as uncertainty affects both the optimal capital stock and investment in the long run. The predictions of the models are less ambiguous when there are temporary shocks to the level of uncertainty as the uncertainty mainly works through investment rather than capital stock in the short run. Indeed, Bernanke (1983) shows that events whose long-run implications are uncertain can generate investment cycles by increasing the returns to waiting for new information, particularly when the source of uncertainty periodically renews itself over time. A temporary increase in uncertainty surrounding national elections creates incentives that may induce immediate declines in investment expenditures. Our empirical investigation provides results consistent with the political uncertainty hypothesis. We document novel and robust evidence that political uncertainty around national elections induces cycles in corporate investment. In the period leading up to the election, investment expenditures decline by show that the election-year drop in investment is followed by a small temporary increase in

investment in the year immediately following the election as the uncertainty over election outcomes subsides. However, the overall magnitude of the post-election increase in investment is smaller than that of the earlier decline. We also measure changes in cash holdings and find temporary increases in cash balances in the year prior to the election in the amount of 4.3% of the average cash to assets ratio, controlling for firm characteristics and economic conditions. The increase in cash holdings is similar in magnitude to the election-year decline in investment, suggesting that the funds that would have been used as investment are temporarily held as cash until the election uncertainty is resolved. Political uncertainty is not the only mechanism through which real outcomes can be affected around the timing of elections. Two alternative explanations in the literature suggest election-induced cycles in investment. The first is the political business cycles hypothesis. Starting with the Nordhaus (1975) model of political business cycles, there has been much debate over whether incumbents manipulate fiscal and monetary policy instruments to influence the level of economic activity prior to an election in order to maximize the probability of re-election. Thus, one alternative explanation for our results is that corporate investment is reacting to changing macroeconomic fundamentals. While the political business cycles hypothesis predicts that average economic activity should be higher just before the election, the actions used to stimulate the economy could have a crowding-out effect on private investment. The second alternative explanation is related to the value of political connections. Some firms may have incentives to change their investment behavior to help ensure that their political connections remain in office through the election cycle. Bertrand et al. (2006) investigate the behavior of politically connected firms around municipal elections in France, and find that the firms managed by connected CEOs boost their investment during election years, particularly in politically contested areas, likely in an attempt to help their connection get re-elected. We conduct formal tests of these alternative hypotheses and find no evidence that they are operating in our sample of firms. We therefore view the political uncertainty hypothesis to be the explanation among existing theories that best fits the patterns in the data. The findings in this paper have two important contributions. First, we document a new stylized fact regarding corporate investment around the world, namely, a tendency for firms to reduce investment in election years. This result demonstrates an important link between the political process and real outcomes. Second, we provide evidence suggesting that political uncertainty matters for a firm's real investment and savings decisions. The researchers in corporate finance have long recognized that the separation of ownership and control in firms has created the potential for agency phenomenon which may be costly. The managers have substantial freedom to pursue their personal benefits at the expense of shareholders wealth due to limited incentive for shareholders to monitor the behavior and performance of agents. The wealth maximization of shareholders will not motivate corporate decision making in the absence of effective corporate governance mechanism. This result is an interesting illustration of how uncertainty in general can influence investment dynamics. As far as we know, we are the first to examine the effects of national elections on firm-level investment behavior around the world. This article aims to contribute to the literature on the developmental role of foreign direct investment (FDI) through an examination of the Nepalese experience. Despite

significant liberalization of the foreign investment regime and the introduction of attractive investment incentives, Nepal's achievements.

Hypothesis Development and Empirical Strategy

When a particular investment project is characterized by some degree of irreversibility and uncertainty over future cash flows or discount rates, the value of the investment project will be affected by the same factors that influence the pricing of financial options, in particular, the volatility or uncertainty of the value of the underlying asset. The application of option pricing to capital budgeting has generated many empirical predictions and insights on how investment dynamics change in the face of uncertainty. Some classic examples include McDonald and Siegel (1986), who examine the valuation of operating options and the value of waiting to invest. They demonstrate that even moderate amounts of uncertainty can more than double the required rate of return for investment projects. Ingersoll and Ross (1992) model the timing decision in the face of interest rate uncertainty. They argue that, under the assumptions of irreversibility and uncertainty, the simple net present value (NPV) rule is not optimal from a value-maximizing perspective. Uncertainty increases the value of waiting to invest through what Bernanke (1983) terms the "bad news" principle. That is, an increase in uncertainty causes reductions in current investment only if there is some probability of a bad outcome. In the context of national elections, this suggests that firms will delay investment in anticipation of possible negative changes in the country's macroeconomic, taxation, or monetary policies, or in the regulatory environment in general. However, in some cases the outcome of an election could be construed as good news, regardless of who wins in the end. For example, if the current government is corrupt or incompetent, firms could view a likely change in power as good news and hence may not reduce investment prior to the realization of the election outcome since any different outcome may be better than the current state of affairs. The bad news principle is more subtle in this case. For example, suppose a firm is choosing among several mutually exclusive investment projects, each with a positive expected return. Also suppose that the outcome of an upcoming election will increase the expected return of each of the investment projects, regardless of the outcome. The firm still has an incentive to delay investment if the outcome would reorder the rankings of the individual projects in terms of expected returns. Thus, the bad news principle does not require the possibility of extreme policies such as nationalization of private assets to induce changes in investment. Even positive changes in policy may induce an incentive for firms to wait to invest as the outcome will still have implications for how firms allocate investment spending across various investment opportunities. If political uncertainty matters for firms, then the recurring nature of the political uncertainty around elections can generate cycles in investment spending. This is an application of Bernanke's bad news principal, with the possibility of a bad election outcome inducing firms to hold off on investment projects. This leads to our primary hypothesis that investment expenditures are expected to decline in the year leading up to the election. That is, we expect the average effect of electoral uncertainty to be a temporary decline in the conditional mean investment rate for all firms in the sample. The bad news principle also suggests that the value of waiting to invest will vary from firm to firm and across countries. Within countries, the magnitude of the investment cycle may vary across

elections, depending on the degree of uncertainty regarding election outcomes. The spread between potential outcomes as well as the likelihood of each outcome will generate heterogeneity in the size of observed investment cycles. Across countries, we hypothesize that investment cycles will be more pronounced in countries with a higher probability of policy changes or larger variation in possible policy outcomes after the election. Since we are investigating national elections, we expect the effect of elections to be larger for countries with more centralized governments. Political institutions may matter as well. Countries in which political decisions are more constrained by various checks and balances are less likely to experience large policy swings following a change in power. For example, presidential systems are typically considered to have greater checks and balances but less flexibility in policy making relative to parliamentary systems, suggesting that perhaps large policy swings are more common in parliamentary systems. We also expect that countries with less stable governments in general will experience larger changes in investment around elections. Within countries, we hypothesize that the drop in investment expenditures will be larger when the election outcome is more uncertain. In particular, we expect cycles to be more pronounced for elections with close outcomes relative to those with large margins of victory. While the amount of uncertainty regarding the impending election outcome is unobservable, we do observe the election results and vote counts for each candidate. Using the size of the margin of victory as a proxy for the degree of outcome uncertainty in any given election, we examine whether investment cycles vary with the degree of uncertainty across elections within countries. We also investigate the political platform of the incumbent leader during the election year. The political platform of an incumbent with respect to economic policy may have asymmetric effects on investment cycles. Firms are likely to view a possible shift in leadership from a market-friendly leader to a socialist leader as worse news than a possible shift in the other direction. Our empirical strategy employs the timing of national elections around the world to test the political uncertainty hypothesis. It is important to note that the timing of elections is not a direct measure of political uncertainty. Hence, an important identification assumption is that political uncertainty is indeed higher on average in the period leading up to an election compared to other time periods. Evidence from financial markets suggests that the uncertainty related to elections and political changes is reflected in asset prices. Bialkowski, Gottschalk, and Wisniewski (2008) and Boutchkova et al. (2011) examine stock market volatility around national elections and find that volatility is significantly higher than normal during the election period. Boutchkova et al. (2011) further find that return volatility is higher around elections for firms operating in politically sensitive industries, suggesting that the increased volatility reflects higher political risk. Bernhard and Leblang (2006) document changes in bond yields, exchange rates, and equity volatility around elections and other political changes and show that these changes are larger during elections with less predictable outcomes. This evidence provides support for our identification assumption that political uncertainty is higher than normal during elections. Our empirical analysis produces two broad sets of results. In our first set of results, we employ the variation across elections, countries, and firms to help us identify the uncertainty channel to explain the reduction in corporate investment. Our basic approach here is to examine variation in corporate investment around the timing of national

elections and to demonstrate that these changes are larger for events in which the uncertainty related to election outcomes is higher. We recognize, however, that other mechanisms may be at play during election periods that can lead to changes in investment behavior. Therefore, in our second set of results we attempt to distinguish the political uncertainty channel from other existing hypotheses, namely, the political business cycles hypothesis and the possible effects of political connections. The researchers in corporate finance have long recognized that the separation of ownership and control in firms has created the potential for agency phenomenon which may be costly. The managers have substantial freedom to pursue their personal benefits at the expense of shareholders wealth due to limited incentive for shareholders to monitor the behavior and performance of agents. The wealth maximization of shareholders will not motivate corporate decision making in the absence of effective corporate governance mechanism (Nazir et al. 2009). Since the publication of "The Modern Corporation and Private Property" by Berle and Means (1932), a rich body of literature has focused on the ownership separation theory of principal and agent. Since then, researchers in finance have tried to explore the potential adverse effects of absence of effective control mechanism and misalignment of shareholders and managers interest. A considerable debate has been generated on the issue of whether managers maximize shareholder wealth or instead they focus on their personal objectives (Hubbard and Palia, 1995), or perquisites (Jensen and Meckling, 1976). Across countries, we find that the temporary decline in investment expenditures is larger in countries with civil law origin, fewer checks and balances, a less stable government, and a higher ratio of central government spending to GDP. Within countries, the cycles are more pronounced for firms in industries considered more sensitive to political outcomes. Elections in which the outcome is "close," as measured by voting results, lead to deeper investment cycles than elections in which the victor wins by a large margin. We also find that investment rates drop more in election years in which the incumbent national leader is classified as "market-friendly" by the World Bank. We also show that the election-year drop in investment is followed by a small temporary increase in investment in the year immediately following the election as the uncertainty over election outcomes subsides. However, the overall magnitude of the post-election increase in investment is smaller than that of the earlier decline. We also measure changes in cash holdings and find temporary increases in cash balances in the year prior to the election in the amount of 4.3% of the average cash to assets ratio, controlling for firm characteristics and economic conditions. The increase in cash holdings is similar in magnitude to the election-year decline in investment, suggesting that the funds that would have been used as investment are temporarily held as cash until the election uncertainty is resolved. Political uncertainty is not the only mechanism through which real outcomes can be affected around the timing of elections. Two alternative explanations in the literature suggest election-induced cycles in investment. The first is the political business cycles hypothesis. Starting with the Nordhaus (1975) model of political business cycles, there has been much debate over whether incumbents manipulate fiscal and monetary policy instruments to influence the level of economic activity prior to an election in order to maximize the probability of re-election. Thus, one alternative explanation for our results is that corporate investment is reacting to changing macroeconomic fundamentals. While the political business

cycles hypothesis predicts that average economic activity should be higher just before the election, the actions used to stimulate the economy could have a crowding-out effect on private investment. The second alternative explanation is related to the value of political connections. Some firms may have incentives to change their investment behavior to help ensure that their political connections remain in office through the election cycle. Bertrand et al. (2006) investigate the behavior of politically connected firms around municipal elections in France, and find that the firms managed by connected CEOs boost their investment during election years, particularly in politically contested areas, likely in an attempt to help their connection get re-elected. We conduct formal tests of these alternative hypotheses and find no evidence that they are operating in our sample of firms. We therefore view the political uncertainty hypothesis to be the explanation among existing theories that best fits the patterns in the data. The findings in this paper have two important contributions. First, we document a new stylized fact regarding corporate investment around the world, namely, a tendency for firms to reduce investment in election years. This result demonstrates an important link between the political process and real outcomes. Second, we provide evidence suggesting that political uncertainty matters for a firm's real investment and savings decisions. This result is an interesting illustration of how uncertainty in general can influence investment dynamics. As far as we know, we are the first to examine the effects of national elections on firm-level investment behavior around the world.

Investment Rates and Cash Holdings

Our final empirical analysis considers the cash holdings behavior of firms around national elections. Firms may hold cash on their balance sheet for various reasons, including a precautionary motive and a transactions motive. Opler et al. (1999) find evidence among U.S. firms that the precautionary motive for holding cash is very strong. In this section, we ask what happens to the cash that would have been invested in the absence of an election. Since investment declines during election years given cash flows and growth opportunities, we expect that firms have more cash than usual on a precautionary basis until the election is resolved. Estimating changes in cash holdings in light of our previous results is complicated by the fact that investment decisions and cash holding choices are made jointly. To understand the joint investment and cash holdings decisions around elections, we estimate the following system of equations:

$$I_{ijkt} = \beta_0 + \beta_1 \text{Election Dummy}_{jt} + \beta_2 Q_{ik,t-1} + \beta_3 CF_{ijk,t-1} + \beta_4 \%_GDP_{j,t-1} + \varepsilon_{ijkt}$$

$$\text{Cash}_{ijkt} = \beta_0 + \beta_1 \text{Election Dummy}_{jt} + \beta_2 Q_{ik,t-1} + \beta_3 CF_{ijk,t-1} + \beta_4 \text{Size}_{ijk,t-1} + \beta_5 LEV_{ijk,t-1} + \beta_6 I_{ijkt} + \beta_7 \sigma(CF)_{kt} + \beta_8 DIV_{ijkt} + a_j + \eta_{ijkt}$$

where the right-hand-side variables in the investment equation are defined previously. The cash regression incorporates control variables common in the cash holdings literature, including firm size (log of real total assets), leverage (book value of debt scaled by total assets), cash flow volatility, and dividend policy. Cash flow volatility ($\sigma(CF)_{kt}$) is calculated as the time-series standard deviation of three-digit SIC cash flows over the previous 4 years, DIV_{ijkt} is a dummy variable set equal to one if the firm pays a dividend in year t and zero otherwise, and a_j captures country fixed effects. The cash regression depends directly on investment, but the investment regression can be estimated independently as it does not explicitly depend on cash holdings.

Once the estimates are obtained, we compare the magnitudes of the coefficients on the election dummy across the two equations.

Conclusions

The present study provides some practical implications for corporate investors during political uncertainty in Nepal. In the financial sector of Nepal, the effective corporate governance profile of acquiring firms is causing positive changes in merger related operating cash flow performance due to political interference. Firms with smaller board size, separate positions for CEO and chairman of board, greater independence of the board, and having at least one large external block holders can achieve positive operating returns as an outcome of merger transaction.

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