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Election Uncertainty and Capital Structure

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Abstract

Given different preference of political parties on macroeconomic issues, elections create a policy uncertainty. We hypothesize that election uncertainty increases cost of equity due to lower investor demand on equity issuances. Using U.S. elections from 1960 to 2010, we show that market leverage and probability to issue leverage are highest in the election year. On the other hand, when the election uncertainty resolves, firms experience a sharp decline in their leverage ratios. This finding suggests that firms rebalance and move their leverage ratios to target leverage. Our results are robust to definition of market and book leverage, S&P credit rating, marginal tax rates, and sub-period analysis.

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1. Introduction

Most existing theories of empirical analysis of capital structure pay limited, if any, attention to the impact of a firm's political environment on its financing decisions, thus leaving a notable gap in the literature. Some recent studies have made significant efforts to fill this gap (Bliss and Gul 2012; Claessens et al. 2008; Cull et al. 2015, Faccio 2010; Khwaja and Mian 2005). However, these studies focus heavily on firms' political connections and explore their impact on capital structure decisions and financial constraints while ignoring other potentially important political variables. Our research aims to address this limitation by identifying another political variable that remains understudied in the literature—electoral uncertainty—and confirming its significant impact on firms' financing decisions.

Our theoretical intuition is grounded in Hibbs' (1977) classical partisan theory of economic policy. This theory proposes that rather than being benign social planners concerned with maximizing social welfare, governments pursue economic policies broadly in accordance with the interests and preferences of their core partisan constituencies. Following Hibbs' work, Alesina and Sachs (1988) and Chappell and Keech (1986), among others, show that left-wing governments are more likely to achieve low unemployment and high growth, whereas the primary concern of right-wing governments is to sustain low inflation.

Based on the presumed differences in the policies of Republicans and Democrats and the significant role of ruling parties in macroeconomic outcomes, the possibility of a change in the ruling party during election years introduces uncertainty about future policies in the United States. In this paper, we examine the effect of election uncertainty on the capital structure of U.S. firms and show that election uncertainty leads to more leverage in firms' capital structure, as the higher cost of equity during election years forces firms to tap more into the debt market.

We suggest that investors' demand for stocks decreases, thereby increasing the cost of equity during election years for two reasons. First, stock return volatility increases during election years, causing investors to delay their participation in the stock market. Pastor and Veronesi (2012) show that stock returns become more volatile when policy uncertainty is higher. Using U.S. presidential elections as a source of political uncertainty, Li and Born (2006) find that return volatility increases when election results are hard to predict. Even though higher volatility may generate a positive return for short-term investors, risk-averse investors' demand for money increases when volatility increases (Tobin 1958). Therefore, higher volatility due to election uncertainty decreases investor demand in the stock market.

Second, information asymmetry between investors and firms increases during election years. Election uncertainty has a direct effect on firms' decision-making because the macroeconomic environment in which firms work changes in response to partisan-based policy changes. For instance, many firms distributed special dividends[1] before the elections in 2012 due to the possibility of a tax increase with a change of the political party in power. Similarly, Julio and Yook (2012) show that corporate investments decline during an election year. Under election uncertainty, firms change or postpone their corporate decisions, thereby increasing information asymmetry between investors and firms and forcing investors out of the stock market.

As presidential elections in the United States occur every four years, there is an option value for investors to postpone their investments in the stock market until election uncertainty resolves.

[1] Hanlon and Hoopes (2014) found that firms altered the timing of their regular dividend payments by shifting what would have normally been January 2011 regular dividend payments into December of 2010.

In this case, as Bernanke (1983) suggests, investors trade extra returns from earlier investments for lower volatility in stock returns and lower information asymmetry when the election uncertainty resolves. The only way investors are willing to trade lower volatility and information asymmetry would be to require a higher return on their investments during election years, which results in a higher cost of equity. We hypothesize that given the increased cost of equity, firms tend to tap into the debt market and as a result increase leverage in their capital structure during election years.

However, timing the market to increase leverage during election years may disrupt firms' optimal capital structures. Therefore, after the election uncertainty resolves, firms may need to rebalance their capital structure. Following this argument, we hypothesize that firms decrease their leverage ratios in the year following elections. Similarly, we expect to see that while deviation from the optimal capital structure increases in election years, it becomes expectedly smaller in the year following elections due to the rebalancing of firms, leading to a capital structure cycle within election terms.

2. Sample and Summary Statistics

Our sample consists of U.S. firms listed in the Compustat Industrial Annual Files between 1960 and 2010. Return data are obtained from the Center for Research in Security Prices. We exclude financial firms with SIC codes between 6000 and 6999. We eliminate observations that have a book value of assets less than $1 million in 2010 dollars. Our sample consists of 159,231 observations.

Our dependent variable is market leverage.[2] To calculate it, we divide the sum of short-term and long-term debt by the sum of short-term debt, long-term debt, and market value of equity, which is the number of common shares outstanding times the stock price per share. Following Hovakimian et al. (2012), all ratio variables are trimmed at the top 1%, and the variables that take on negative values are trimmed at the bottom 1% of their values.

Our firm-level control variables include size, tangibility, profitability, and market-to-book ratio. Size is the log of sales. Tangibility is plant property and equipment, scaled by total assets. To measure profitability, we use operating income before depreciation and scale it by total assets. We follow Hovakimian et al. (2012) to calculate the market-to-book ratio, where the market value is calculated as total assets minus the sum of the book value of equity plus the market value of equity, and the book value of assets is the book value of stockholders' equity plus the balance sheet deferred tax and investment tax credit minus the book value of preferred stock. We also control for industry leverage, which is the median market leverage for firms with three-digit SICs.

Our macro-level control variables include contemporaneous measures of the tax rate and expected inflation. Following Huang and Ritter (2009), we use the statutory corporate tax rate, which has varied since 1960. We also check the robustness of our results using marginal tax rates provided by John Graham for a subsample ranging from 1985 to 2010. We calculate the expected inflation using the Livingston Survey, which asks economists for their 12-month Consumer Price Index (CPI) estimates. We divide the average of 12-month CPI estimates by the base CPI, raise it

[2] The literature is divided on whether the market or book leverage should be used to measure the capital structure. While Hovakimian et al. (2012), Welch (2004) and Leary and Roberts (2005), among others, use market leverage, Shyam-Sunder and Myers (1999) focuses on book leverage ratios. In our paper, we present our results using market leverage, but our results hold if we use book leverage instead.

to the power of .85 (12/14 months, as there are 14 months from the estimation date to the end of the estimation period), and subtract one.

Table 1 presents descriptive statistics. The average market leverage in our sample is 27.7%. Panel B of Table 1 shows that market leverage is significantly higher in an election year compared to an election +1 year.

TABLE 1: Descriptive Statistics

Notes: Panel A of this table presents simple statistics for the main variables. Our sample period is from 1960 to 2010. Market leverage is the ratio of long term debt (DLTT) plus short term debt (DLC) to sum of long term debt (DLTT) plus short term debt (DLC) plus market value of equity (CSHO*PRCC_F). Size is the logarithm of sales (SALE). Tangibility is net plant, property and equipment (PPENT) scaled by total assets. Profitability is operating income (OIBDP), scaled by total assets. Market to book is the ratio of market and book values. Industry leverage is the median leverage for firms with the same three-digit SIC. Expected Inflation is the expected change in the consumer price index over the coming year and it is calculated using data from the Livingston Survey available at Federal Reserve Bank of Philadelphia. Tax is statutory tax rate. Panel B of the table presents the difference in market leverage and deviation from target leverage between election and election +1 year.

Panel A

Variables	Number of Obs.	Mean	Std. Dev.	Min.	Max.
Market Leverage	159,231	0.277	0.254	0.000	1.000
Size	159,231	4.641	2.145	-4.343	13.035
Tangibility	159,231	0.311	0.222	0.000	0.938
Profitability	159,231	0.093	0.169	-1.378	0.433
Market-Book	159,231	1.728	1.374	0.063	13.695
Industry Leverage	159,231	0.228	0.159	0.000	0.978
Expected Inflation	51	0.035	0.021	0.007	0.103
Tax Rate	51	42.133	7.040	34.000	52.800
GDP Growth	51	0.031	0.022	-0.035	0.072

Panel B

	Election Year		Election +1 Year		
Variables	Number of Obs.	Mean	Number of Obs.	Mean	Difference in Means
Market Leverage	39,531	0.277	40,445	0.271	0.006***
Deviation from Target	39,531	0.022	40,445	0.013	0.009***

1. Empirical Results

To test our main hypothesis, we run an ordinary least squares (OLS) regression of market leverage on election variables, controlling for size, tangibility, profitability, market-to-book ratio, industry leverage, expected inflation, and tax rate. In all three of our models in Table 2, we also control for year and Fama-French 48 industries and report t-statistics, which are adjusted for firm-level clustering. In the first model, our main independent variable is the election year dummy, which is

TABLE 2: Leverage Regression

Notes: This table presents OLS regression results of market leverage on election variables. Our sample period is from 1960 to 2010. Election year is a dummy variable which is equal to one if presidential election is held in the fiscal year. Election +1, Election +2, Election +3 are dummy variables that equal to one if the fiscal year is one year, two years or three years after the election year respectively. First half dummy is equal to one if either election +1 or election +2 is equal to 1. Industry leverage is the median leverage for firms with the same three-digit SIC. Robust t-statistics are in parenthesis. ***, **, * refers to 1%, 5% and 10% significant levels.

	Model 1		Model 2		Model 3	
Intercept	0.705	***	0.615	***	0.791	***
	(10.123)		(9.31)		(11.75)	
$Size_{t-1}$	0.009	***	0.009	***	0.009	***
	(11.832)		(11.832)		(11.832)	
$Tangibility_{t-1}$	0.152	***	0.152	***	0.152	***
	(17.454)		(17.454)		(17.454)	
$Profitability_{t-1}$	-0.262	***	-0.262	***	-0.262	***
	(-37.413)		(-37.413)		(-37.413)	
$Market\text{-}Book_{t-1}$	-0.043	***	-0.043	***	-0.043	***
	(-51.362)		(-51.362)		(-51.362)	
$Industry\ Leverage_{t-1}$	0.506	***	0.506	***	0.506	***
	(43.803)		(43.803)		(43.803)	
Expected Inflation	-7.894	***	2.510	***	-7.894	***
	(-7.425)		(6.586)		(-7.425)	
Tax Rate	-0.013	***	-0.011	***	-0.013	***
	(-7.842)		(-6.605)		(-7.842)	
Election Year	0.086	***				
	(8.917)					
Election Year + 1			-0.183	***		
			(-33.175)			
Election Year + 2			-0.154	***		
			(-26.98)			
Election Year + 3			-0.131	***		
			(-21.915)			
First Half					-0.086	***
					(-8.917)	
Number of Obs.	159,231		159,231		159,231	
R-Square	0.297		0.297		0.297	
Industry Dummies	Yes		Yes		Yes	
Year Dummies	Yes		Yes		Yes	

equal to one if there is a presidential election in a given fiscal year. The positive coefficient suggests that firms, on average, hold more leverage in election years compared to non-election years. While the election year dummy is statistically significant with a t-value of 8.917, it is also economically significant. In election years, the leverage of U.S. firms is 8.6% higher than in non-election years.

While an election year dummy explains how leverage changes in an election year compared to non-election years, it does not explain how leverage changes within one election term. If firms increase their leverage in an election year due to the higher cost of equity, we should see a readjustment in the capital structures of firms. To examine the change in leverage within the election term, we create three dummy variables: election +1, election +2, and election +3, where election +1 is the following year after the election. In our second model, using the election year as the base year, we expect the election +1 dummy to have a negative coefficient. Our regression result shows that firms decrease their leverage by 18.3% immediately after the election year from their leverage ratios in the election year. This sharp decline in leverage ratios suggests that firms try to readjust their capital structure after election uncertainty resolves.

An increase in market leverage due to election uncertainty and the subsequent sharp decline in market leverage suggest that firms attempt to rebalance their capital structure and move toward their optimal leverage ratios. Following Kayhan and Titman (2007),[3] we estimate target leverage ratios and calculate the deviation from the target leverage. Panel B of Table 1 shows that deviation from the target leverage decreases by half in the election +1 year, confirming our rebalancing argument.

We also examine how leverage changes two years and three years after the election. Both coefficients are negative and significant, suggesting that leverage ratios decrease from their highest level in election years. Furthermore, the coefficients of election +1, election +2, and election +3 present an increasing pattern. While the coefficient of election +1 is -0.183, the coefficient of election +2 increases to -.154 and the coefficient of election +3 increases to -.131. Taken together, model 2 presents evidence that, as a presidential election approaches, leverage increases continuously from the election +1 year to the election year. While leverage reaches its highest point during the election year, it decreases sharply in the election +1 year and slightly increases in the second and third years after the election.

The regular four-year election cycle in the United States allows us to create two subperiods within an election term. The first half dummy is set to one if the fiscal year is one or two years following the election year. Confirming our results in the previous models, model 3 shows that U.S. firms hold 8.6% more leverage in the second half, which includes the third year and election year, compared to the first half.

Most of the control variables have expected signs. Larger firms and firms with more tangible assets carry more leverage. Conversely, we find that more profitable firms and firms with higher market-to-book ratios have lower leverage ratios. This finding is in line with the argument that firms with more growth opportunities are less willing to increase their leverage due to a potential need for debt to finance growth opportunities in the future. Leverage ratios increase with industry leverage. The coefficient of expected inflation is mixed in the three models, where a positive coefficient in the second model confirms Frank and Goyal's (2009) suggestion that higher expected inflation decreases the value of future payments to creditors and therefore increases leverage. However, the statutory tax rate in all three models is negative and significant, challenging the premise of the trade-off theory, which suggests that higher tax rates should increase leverage.

[3] Our Tobit regression to estimate target leverage is available upon request.

Nevertheless, a negative tax rate coefficient is not unusual in the literature (Hovakimian et al. 2012).

While leverage regression shows a cross-sectional relationship between election and leverage, it does not provide insight into the incremental change in leverage for individual firms. Our results in Table 2 may reflect some firms increasing their leverage during an election year and keeping it at that level in the following year after the election, while other firms do not change their leverage in an election year and decrease their leverage in the year following an election. Therefore, we run an OLS regression of change in leverage, which is the difference in the leverage of a company in the current and previous years. Table 3 presents our regression results on election variables, where the base year is the election year. The negative coefficients of the election +1, election +2, and election +3 variables suggest that the biggest change in leverage occurs in the election year. Compared to the change in leverage in an election year from the previous year, the change in leverage in election +1 from the election year is 18.5% lower. The negative and significant coefficients on election variables confirm our finding that, on average, individual firms increase their leverage in election years.

TABLE 3: Incremental Change in Leverage Regression

Notes: This table presents OLS regression results of change in market leverage on election variables. Our sample period is from 1960 to 2010. Robust t-statistics are in parenthesis. ***, **, * refers to 1%, 5% and 10% significant levels.

	Coefficient	T-stat	
Intercept	0.615	9.310	***
Market Leverage $_{t-1}$	-0.150	-67.525	***
Size $_{t-1}$	0.000	0.679	
Tangibility $_{t-1}$	0.025	10.546	***
Profitability $_{t-1}$	-0.037	-13.452	***
Market-Book $_{t-1}$	-0.001	-5.008	***
Industry Leverage $_{t-1}$	0.024	6.662	***
Expected Inflation	2.063	8.210	***
Tax Rate	-0.009	-7.184	***
Election Year + 1	-0.185	-39.599	***
Election Year + 2	-0.148	-32.915	***
Election Year + 3	-0.122	-23.865	***
Number of Obs.		159,052	
R-Square		0.138	
Industry Dummies		Yes	
Year Dummies		Yes	

Next, we examine whether the probability of debt issuance changes in an election year. We run a probit regression of debt issuance on the control variables that we use for change in the leverage regressions. Additionally, following Hovakimian (2006), we control for selling expense, research and development (R&D) dummy and net operating loss carry forward, one-year cumulative return, and the market-to-book (MB) > 1 indicator. Our dependent variable is the debt issuance dummy, which takes a value of one if the net debt issued constitutes more than 5% of total assets and zero

TABLE 4: Debt vs Equity Choice Regression

Notes: This paper presents probit regression results of a dummy variable, which is set to one if a firm issues debt and to zero if a firms issues equity in a given year, on election variables. Our sample period is from 1960 to 2010. NOLC is net operating carryforwards scaled by total assets. MB>1 is a dummy variable which is equal to one if the market to book ratio is greater than 1. Cumulative one-year return is stock return of the previous fiscal year. T-statistics are in parenthesis. ***, **, * refers to 1%, 5% and 10% significant levels.

	Model 1		Model 2		Model 3	
Intercept	0.827	***	1.507	***	1.507	***
	(4.532)		(8.112)		(8.112)	
Size	0.079	***	0.079	***	0.079	***
	(13.670)		(13.670)		(13.670)	
Tangibility	0.005		0.005		0.005	
	(0.089)		(0.089)		(0.089)	
Profitability	1.025	***	1.025	***	1.025	***
	(15.643)		(15.643)		(15.643)	
Market-Book	-0.137	***	-0.137	***	-0.137	***
	(-18.248)		(-18.248)		(-18.248)	
Industry Leverage	0.238	**	0.238	**	0.238	**
	(2.534)		(2.534)		(2.534)	
Selling Expense	-0.019		-0.019		-0.019	
	(-0.721)		(-0.721)		(-0.721)	
NOLC	0.000		0.000		0.000	
	(0.833)		(0.833)		(0.833)	
MB > 1 dummy	-0.313	***	-0.313	***	-0.313	***
	(-11.337)		(-11.337)		(-11.337)	
Cumulative one-year Return	-0.054	***	-0.054	***	-0.054	***
	(-5.091)		(-5.091)		(-5.091)	
Election Year	0.680	***				
	(5.910)					
Election Year + 1			-1.384	***		
			(-12.190)			
Election Year + 2			-0.680	***		
			(-5.910)			
Election Year + 3			-0.315	***		
			(-2.964)			
First Period Dummy					-0.680	***
					(-5.910)	
Number of Obs.	28,236		28,236		28,236	
R-Square	0.178		0.178		0.178	
Industry Dummies	Yes		Yes		Yes	
Year Dummies	Yes		Yes		Yes	

if the net equity issued exceeds 5% of total assets. Following Chang et al. (2006), only issue years in which the firm-issued net debt or equity exceeds 5% of the book value of assets are included in the sample; years in which both are issued or neither are above the 5% cutoff are not included in our sample. Consequently, there are 28,236 observations in this sample.

We have three models with different election variables, and our results are presented in Table 4. In the first model, we only use the election year, which is positive and significant. The untabulated marginal effect of this variable is 15.7%, suggesting that firms are 15.7% more likely to issue debt in an election year than in non-election years. In the second model, using the election year as a base year, we examine the probability of debt issuance in non-election years. The untabulated marginal effect of election year +1 suggests that the probability of debt issuance decreases by 32.3% following an election year compared to the election year.

The marginal effects of election +2 and election +3 show that firms are 15.7% and 7.5% less likely to issue debt in election +2 and election +3 years, respectively, compared to an election year. Overall, our debt/equity choice regression shows that firms' probability of issuing debt is highest in the election year, and this probability sharply declines in the year following the election. Similarly, model 3 presents evidence that firms are less likely to issue debt in the first half compared to the second half of the election term.

To examine the robustness of our results, we run our main regression with different model specifications. First, we use book leverage instead of market leverage in our main regression. Myers (1977) suggests that debt is supported by assets in place instead of growth opportunities; therefore, it is better to use book leverage. Furthermore, market leverage numbers change quickly, and managers are less likely to adjust their capital structure following changes in market leverage. Following Welch (2011), our book leverage is measured as the ratio of long-term debt (DLTT) plus short-term debt (DLC) to the sum of long-term debt (DLTT) plus short-term debt (DLC) plus the book value of equity. Model 1 in Table 5 shows that our results are robust to the definition of leverage. Furthermore, the coefficient of election +1 in this model is more than three times the coefficient of election +1 in the market leverage regression (8.6% in Table 2 vs. 26.3% in Table 5), suggesting that there is a sharper decline in book leverage following an election. In the untabulated results, we also show that our results are robust to a different measure of book leverage, which is calculated as the sum of long- and short-term debt, scaled by total assets.

Our second robustness check is related to marginal tax rates. Based on trade-off theory, the higher the tax rate, the more benefit there is in issuing debt. Therefore, in the original regressions, we controlled for the statutory tax rate, which is available for our sample period. However, the statutory tax rate is a systematic tax rate, and not all firms are taxed at the given statutory tax rate. Therefore, we use marginal tax rates, provided by John Graham, to check whether our results remain robust to the definition of the tax rate. Our only constraint on marginal tax rates is that this tax rate was created for the period after 1985. Model 2 presents evidence that substituting the marginal tax rate for the statutory tax rate does not affect our results. In the untabulated results, we also show that our results remain robust to marginal tax rates as generated by Blouin et al. (2010).

Next, we check whether the Standard and Poors (S&P) rating affects our results. A higher credit rating should increase firms' probability of having more leverage, as higher credit ratings alleviate the information asymmetry problem for creditors. If higher rated firms happen to increase their leverage during the election year, our election year variables may capture this effect when the S&P rating is not controlled for. Therefore, in model 3 we add S&P ratings taken from Compustat. We convert categorical S&P ratings to numerical values, where the highest rating,

TABLE 5: Robustness Checks

Notes: This table presents robustness checks for the second model in Table 2. Our sample period is from 1960 to 2010. Model 1 uses book leverage as the dependent variable. Book leverage is the ratio of long term debt (DLTT) plus short term debt (DLC) to the sum of long term debt (DLTT) plus short term debt (DLC) plus book value of equity. Model 2 uses marginal tax rates, provided by John Graham, instead of statutory tax rates. Model 3 controls for S&P ratings, taken from Compustat. Model 4 is for the first half of our sample period, from 1960 to 1895, and model 5 is for the second half of our sample period, from 1986 to 2010. Robust t-statistics are in parenthesis. ***, **, * refers to 1%, 5% and 10% significant levels.

	Model 1		Model 2		Model 3		Model 4		Model 5	
Intercept	0.464	***	0.278	***	-0.559	***	0.636	***	0.222	***
	(4.132)		(5.791)		(-6.833)		(3.843)		(5.089)	
Size	0.016	***	0.009	***	0.024	***	0.010	***	0.008	***
	(4.056)		(8.133)		(10.678)		(7.521)		(9.582)	
Tangibility	0.236	***	0.156	***	0.072	***	0.138	***	0.165	***
	(3.333)		(12.356)		(4.622)		(9.934)		(16.401)	
Profitability	0.411	***	-0.186	***	-0.106	***	-0.600	***	-0.189	***
	(2.972)		(-18.260)		(-3.442)		(-31.790)		(-27.041)	
Market-Book	-0.056	***	-0.046	***	-0.058	***	-0.053	***	-0.040	***
	(-5.236)		(-30.341)		(-18.889)		(-32.441)		(-42.831)	
Industry Leverage	0.068		0.490	***	0.300	***	0.452	***	0.512	***
	(1.386)		(29.903)		(14.182)		(26.943)		(35.160)	
Expected Inflation	6.601	*	-0.209	**	0.428		1.692	***	2.247	***
	(1.927)		(-2.282)		(0.764)		(12.226)		(5.910)	
Tax Rate	-0.008	***			0.011	***	-0.010	***	0.001	
	(-3.623)				(8.862)		(-2.919)		(0.831)	
Marginal Tax Rate			-0.249	***						
			(-18.071)							
S&P Rating					0.038	***				
					(36.160)					
Election Year + 1	-0.263	***	-0.129	***	-0.170	***	-0.027	***	-0.179	***
	(-2.667)		(-28.010)		(-19.022)		(-8.960)		(-31.811)	
Election Year + 2	-0.142	***	-0.119	***	-0.155	***	-0.017	***	-0.150	***
	(-2.656)		(-21.810)		(-18.001)		(-4.378)		(-26.360)	
Election Year + 3	-0.116	**	-0.073	***	-0.125	***	-0.087	***	-0.127	***
	(-2.090)		(-17.591)		(-13.432)		(-26.763)		(-21.341)	
Number of Obs.	154,114		70,148		19,748		53,910		105,321	
R-Square	0.002		0.285		0.539		0.356		0.269	
Industry Dummies	Yes		Yes		Yes		Yes		Yes	
Year Dummies	Yes		Yes		Yes		Yes		Yes	

"AAA," is coded as 1, and the worst rating, "B-," is coded as 16.[4] While the S&P rating is positive and significant, as expected, it does not affect our main results.

Finally, we examine whether our results are driven by specific periods or elections. We divide our sample into two subperiods. Using 50-year data, we test whether our results hold for the first and second periods separately. Models 4 and 5 show that in both subperiods, election +1, election +2, and election +3 have negative and significant coefficients, while the magnitude of these coefficients follows the same pattern in Table 2. In the untabulated results, we also show that our results remain the same when we exclude the year 1974, when the market leverage ratio jumps to 47.5%.

2. Conclusion

This paper provides an important contribution to the recent stream of research that explores the political economy of capital structure. Existing studies do not devote enough attention to electoral uncertainty and its implications for firms' capital structure decision. We present theoretical discussion and empirical evidence showing that election uncertainty causes firms to have more leverage in an election year, as investors face higher information asymmetry, and higher volatility increases the cost of equity. We find that after election uncertainty resolves in the post-election year, firms rebalance their capital structure. By decreasing their leverage in their capital structure, firms move toward their target leverage ratios.

[4] Following Hovakimian et al. (2012), we exclude firms with ratings lower than B-.

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