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Policy Uncertainty and Firm Characteristics Jointly Impact Corporate Leverage

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Introduction

What determine firms financing decisions has attracted extensive attention of researchers. Studies in the capital-structure literature have endeavoured to uncover which firm characteristics are reliably important factors for capital structure, based on the trade-off, market-timing and pecking-order theories [1].

One crucial omission from previous studies is that government Economic Policy Uncertainty (EPU) is assumed away, as if firms would only look at their size, market-to-book assets ratio, tangibility, profits and so on, when deciding on their leverage ratios. This assumption is neither realistic nor supported by empirical evidence. To redress the omission, recently Li and Qiu investigate two main questions: Is EPU indeed important for capital structure decisions? If so, how might EPU work jointly, not independently, with firm characteristics in shaping corporate debt-financing decisions [2].

How do the authors tackle this issue?

To make their results comparable with those of prior work on the US, Li and Qiu include US firms in the sample under investigation. They have done several things as outlined below. First, the authors use two measures of EPU available. One is the overall EPU index and the other is the news-based EPU index. The former is the most comprehensive while the latter is the most widely-used. Second, the authors conceive a research framework by allowing EPU to interact with firm characteristics in dynamic panel regression models. Inspired by Fama and French, Li and Qiu examine how the responses of the leverage target and ultimately, of actual leverage to EPU vary across firms as a linear function of firm characteristics. Third and also importantly, the authors control for non-policy economic uncertainties and financial crises. Fourth, the authors consider either the ratio of debt to book assets or the ratio of debt to market assets as the measure of leverage, to serve the purpose of robustness checks. Finally, they conduct graphical analyses of the estimation results to draw the implications of EPU for corporate leverage [3].

Description

Li and Qiu show strong evidence that EPU and firm characteristics are jointly important in shaping companies debt-financing decisions. Specifically, over time, the marginal effects of a firm's characteristics on its debt ratios are not constant but changes with EPU and so can be positive or negative. Meanwhile, across firms at a given year, the marginal effects of EPU on their debt ratios are not the same but differ due to different firms having different characteristics and can be positive or negative too. However, on average, a rise in EPU would cause economically significant declines in the debt ratios of firms. These results are not seen in the empirical evidence provided by the existing capital-structure studies. These results can be viewed as the main contributions of Li and Qiu [4].

Government economic policy uncertainty can have detrimental effects on the economy. Previous research suggests that uncertainty related to government spending, tax and regulatory and monetary policies exacerbated the 2007-2009 great recession and slowed the economic recovery. The level of policy uncertainty in the United States increased significantly during the period 1985-2012, peaking around the government's failure in raising federal debt-ceiling in August 2011 and the fiscal cliff crisis at the end of 2012 whereby several previously enacted laws would come into effect simultaneously, potentially leading to an increase in taxes and a decrease in spending. Economic policy uncertainty was suggested to have caused more than one-%-point decrease in the US real Gross Domestic Product (GDP) and the loss of over one million jobs during the period 2011-2012. Given the profound impact of policy uncertainty on the economy, academic researchers have shown increasing interest in investigating the effects of policy uncertainty on corporate policies.

The authors also demonstrate that non-policy economic uncertainty does not subsume EPU in terms of their impacts on corporate leverage, nor vice versa. It has been found that business cycles and implied stock market volatility have a negative, while realized stock market volatility has a positive effect, on book and market leverages, for the overall EPU index and the news-based EPU index. Therefore, the effects of non-policy economic uncertainty on leverage are independent of those of EPU detected.

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These results are not seen either in the existing capital structure studies which consider overall macroeconomic conditions without isolating EPU.

Conclusion

The results reported by Li and Qiu have several implications for corporate leverage. For instance, in tranquil years, it is firm characteristics and their coefficients that determine the responsiveness of corporate leverage to EPU innovations. Such responsiveness can be viewed as reflecting firms conservativeness or aggressiveness in their capital structure choices. In addition, Brogaard and Detzel note that government policy makers can contribute to uncertainty regarding fiscal,t regulatory or monetary policy, referred to as EPU. This implies that changing the transparency and stability of implementing economic policies (*i.e.*, changing EPU) may move the cross-economy average debt ratio up or down, given firms negative responsiveness of corporate leverage to EPU at the aggregate level.

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