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The election effect

Election years can have a significant impact on the business sector and business investment, writes Professor Paul Kerin.

Australia will experience a federal election campaign – and probably an election – in 2016. Election years have significant effects on business and it is useful for businesses to consider these effects in their decision-making.

While 7 September 2016 is the third anniversary of the last election, the Federal House of Representatives doesn't expire until 11 November and the latest possible election date is 14 January 2017. However, most expect an early election. The bad news is that research around the world shows that election years negatively affect the business sector and, in particular, business investment. Economists have studied the impacts of election years ever since Franklin Parsons, writing in the Journal of Farm Economics in 1934, showed that US hog prices were decidedly lower in presidential election years.

The impact of electoral uncertainty on business investment was first examined by a young Stanford academic in 1983. Many years later, that academic – Ben Bernanke – became chairman of the US Federal Reserve. The evidence shows that, on average, investment is about 5 per cent lower in the year leading up to an election than in other years. Firms' cash balances also rise, by roughly the same amount as investment falls.

This is because elections generate uncertainty about policy change. Heightened uncertainty raises the value of taking options. By deferring investment go/no-go decisions, firms buy "wait-and-see" options: they gain the benefit of making investment decisions after the uncertainty is resolved post-election.

The actual impact on investment in a particular election year depends on three factors: how predictable the election result and election date is, whether the incumbent party is favoured to win and whether the likely winner is more "market friendly" than the likely loser.

Investment drops by almost 11 per cent when the election result is least predictable (neck-and-neck). Investment starts to tail off earlier if governments call early elections than if they must run fixed terms. If the incumbent party is almost certain to win, investment hardly changes at all. If the incumbent party is almost certain to lose, investment is cut moderately. This is because businesses know the policies of an incumbent government better than those of an opposition; therefore, the perceived risk of policy change increases when the polls favour the opposition.

Investment deferral increases as election day draws near; it is less costly to defer investment a couple of months out from an election than a year out.

Electoral uncertainty also affects financial markets. Volatility in both equity and bond markets rises in the lead-up to elections, for largely the same reasons that investment falls. For example, volatility is higher when the result is less predictable or when the incumbent party is more likely to lose. Once election uncertainty is resolved, investment bounces back and sharemarket volatility drops.

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Ironically, while the recent narrowing of the Australian polls has raised the probability that our incumbent government will be returned, it will probably result in more investment deferrals because the election result is now harder to predict. At this stage, if the polls remain close, I'd predict somewhat more than a 5 per cent investment impact. As business investment accounts for about 15 per cent of GDP, a typical election year investment impact could slow GDP growth by 0.5 per cent or more – a significant hit to the Reserve Bank's current forecast of 2 – 3 per cent for 2016.

However, I certainly wouldn't recommend that firms slash investment plans for 2016. Deferral of an investment should only be considered if the election result could really turn the investment's net present value from positive to negative and if the option value of waiting exceeds the cost. This is likely to be the case for a small minority of investments that are highly sensitive to potential policy changes.

Nevertheless, on balance, it is useful for firms to err on the conservative side in forecasting demand for their products in 2016, for two reasons. First, many of your customers may consider deferring investments. Second, the impact of the election year on GDP growth could be significant. Erring on the conservative side will be most valuable if the polls remain close in the last few months prior to election day. ■