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Economic Policy Uncertainty and Corporate Investment Decisions: A Literature Review of Quantitative Approaches and Dynamic Models

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Abstract. Economic policy uncertainty (EPU) has become a significant subject in economics and corporate finance since policy uncertainty can affect the manner in which firms make plans, finance, and use time in making investment decisions. This review article looks at the conceptualization and measurement of EPU, the theories that have been primarily applied trying to explain the importance of uncertainty to investment and what the fundamental patterns of evidence have shown across nations and sectors. The paper is organized around three general ways of transmission: real-options delay in case investment is irreversible, financing and cost-of-capital frictions and information flows which weaken the transmission of signals within decision-making under conditions of uncertainty. It also asks the question why firms respond differently- focusing on the importance of liquidity, constraints, ownership structure, and institutional context- and what strategies seem to assist firms in maintaining quality of investment when under uncertainty. The review concludes with the identification of implications to research design and the presentation of priority directions to conduct future research in measurement comparability, causal inference, and corporate responses.

Keywords: Economic policy uncertainty, corporate investment, real options, financial frictions, cost of capital

1. Introduction

Economic policy uncertainty (EPU) is the uncertainty surrounding future economic policies of government such as taxation, regulation, government spending, and monetary or fiscal activity that can alter expected payoffs of firms and risk profile of long-run projects [1]. This question has received lasting interest due to the fact that EPU can be proxied relatively high-frequency with the help of textual signals, and due to the fact that it may seem that the policy environment in most countries is becoming more contentious, unstable, and unpredictable to firms [2,3]. The combination of these two makes EPU research patterns helpful in the provision of a measurable relationship between political economy and corporate strategy. It is worth reviewing this literature due to two reasons. To begin with, the productivity growth and innovation, as well as investment decisions, are highly vulnerable to uncertainty, particularly when projects are characterized by sunk costs or

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irreversible commitments [4]. Second, EPU influences not only capital expenditures: the research establishes a connection between it and innovation, entry and exit behavior, cash holdings, and massive capital redistribution in the form of mergers and acquisitions, suggesting that uncertainty redefines the growth of firms and market structure [5,6]. Put collectively, these results encourage synthesis incorporating mechanisms, heterogeneity, and institutional environment instead of viewing results as factual entities. This review deals with four research questions. What is measuring EPU and how it can be validated across settings, and what does measuring choice involve, in comparison to comparability [1,7]? What theories can be most helpful in explaining the relationship between EPU and investment, in particular, real options, financing frictions, and information/price-informativeness channels [8,9]? What are the empirical regularities of the magnitude, persistence, and heterogeneity of the EPU effects on investment, innovation, and firm dynamics [10-12]? Lastly, which firm-level moderators and mitigation strategies are most supported and which ones are mixed in evidence [13-15]? These are the questions that make the review sound in the form of an explanation of why, when, and to whom the issue of policy uncertainty is relevant. The paper is structured as follows in the following way: Section 2 provides theoretical framework, Section 3 provides a review of empirical data in a thematic way, Section 4 provides summaries of tensions and trends, and finally Section 5 points to implications and research directions. The following section defines the conceptual tools that are applied in interpreting the evidence.

2. Theoretical background

Since the policy uncertainty cannot be directly observed, measurement forms the basis of theory testing. The most common approach measures EPU indices by the frequency of newspaper articles containing a combination of terms that relate to the economy, policy, and uncertainty, and validation exercises can be performed by human audits of sample articles of large size [1]. This measurement plan is important since it lets researchers establish policy uncertainty as a time-varying shock, and research how firms react to policy uncertainty when it increases in areas beyond their control. It also provides an opportunity to work across countries, and increases the comparability issues in the case of different media systems and political institutions. The first significant conduit between EPU and investing is real options theory. In the case of partial irreversibility of investment projects and sunk costs, uncertainty drives a value of waiting, and firms postpone investment until additional information comes or a policy risk can be eliminated [12]. According to this logic of waiting and seeing, the contemporaneous investment will be lower when there is more uncertainty and more powerful in environments with a high irreversibility, e.g., in capital-intensive industries or another deal that is very difficult to reverse [5]. It also suggests heterogeneous impacts due to the variation of option value of delay by the redeployability of the asset, the competitive pressure and the viability of the delay postponement. The second channel is concentrated at financing frictions and the cost of capital. EPU can increase the perceived risk and risk premia, limit access to credit, leading to an increase in the cost of financing and a decrease in investment, especially by financially constrained firms that depend on external finance [9]. In this perspective, uncertainty is not merely over the postponement of irreversible projects, but the price and availability of funds, particularly on innovation and other long-term investments. According to the mechanism, liquidity and balance-sheet strength is predicted to moderate the response to investment. A third channel underlines information and price informativeness. When there is strong uncertainty, the information contained in the market prices can be less informative about the fundamentals, the information that managers can use to assess the investment opportunities, and the sensitivity of the investment to changes in the discount-rate is decreased [8]. This channel switches the focus of the levels to the sensitivities

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meaning that policy easing may not be more effectively translated into investment when the periods are uncertain. These three channels inform the organization followed of the empirical review.

3. Literature review

3.1. Measurement and political drivers

Baker et al. [1] offer the impactful centre of reference to EPU measurement, demonstrating that a news-driven index may be created and supported to indicate policy-associated uncertainty, as opposed to generic macro volatility. They relate EPU spikes to large events and demonstrate that uncertainty innovations are linked to falling investment, output and employment, which inspires firm-level studies that treat EPU as an economic phenomenon. This breakthrough of measurement also promotes extensions that look into political drivers of uncertainty. Political cycles seem to create uncertainty patterns that are predictable. Baker et al. [3] review 23 countries and announce that EPU generally rises during the election month and the month before and that the US peaks are greater when there is a close and polarized election. This fact places EPU as a matter of half-a political contestation and polarization, which can be applied in identifying strategies, which utilize electoral timing or political circumstances as quasi-exogenous variation. It also indicates that EPU shocks could be concentrated around institutional events as opposed to their arrival in a pure random manner. The opportunity and the limit of comparability are brought to light in measurement extensions to various institutional environments. Dav.is et al. [7] create a China EPU index on based on mainland newspapers and document that it responds to major developments, such as a sharp increase during the spike of trade policy tensions in 2017-2018 and a spike of trade policy uncertainty in 2018. They further state that unexpected changes in China EPU project disappointments in economic performance in VAR models estimated using post 1992 data. These findings support country-specific indices and suggest at the same time that media organization and state-market relationships can influence what is reflected in the term policy uncertainty.

3.2. Corporate investment and irreversibility

One common theme is that increased EPU correlates with reduced corporate investment, as expected by real-options predictions. Gulen and Ion [5] are reported to have concluded that high policy uncertainty lowers the rate of investment over a number of quarters and starts recovering partially, which is expected of delayed investment timing in, at least, some environments [8]. This non-linear trend is significant since it implies that uncertainty can influence how often investment waves occur, rather than capital levels in the long-run. Sector and setting become hence necessary to the understanding of magnitude. The irreversibility mechanism is honed through industry-oriented studies. EPU in US hospitality is observed to have a negative impact on corporate investment, and the effects are especially applicable to the firms that fall in the lower quantiles of capital expenditures intensity, which indicates heterogeneity within the sector [10]. The fixed-asset intensity of hospitality makes the sector an ideal setting in which irreversible investments and uncertain demand conditions are combined. This industry experience develops a sense that can be established in other industries that require a lot of capital. The studies conducted on emerging markets indicate that uncertainty may reduce the quality of investment besides the quantity. The higher EPU relates to lower investment efficiency in Pakistan and that political instability enhances the negative relationship, which means that uncertain policy environment can increase misallocation as well as decrease spending [11]. These findings add to the research agenda by outlining the problem of

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governance, capability, and institutional embedding as a part of the uncertainty response. The findings broaden the research agenda by bringing out the concern of governance, capability and institutional embedding as part of uncertainty response. Additional evidence on heterogeneity based on the ownership and reversibility of assets comes in form of quasi-experimental evidence seen in China. Based on the 2015 supply-side structural reform in China as a quasi-natural experiment, Liu and Zhang [12] find that EPU has a strong impact on hindering real investment and the net debt issuance of the private firms but no significant impact on the state-owned firms. They also indicate that there is no major connection between EPU and cash holdings in their environment compared to the American evidence, and they refer to the difference in institutions regarding the way firms adapt. These oppositions encourage further consideration of the resources of financing and channels of information.

3.3. Cost of capital, innovation, and sensitivity effects

In addition to the levels of investment, the literature indicates that EPU is able to modify the response of investment to financial conditions. A policy uncertainty is observed in a 21-country environment to complicate the negative correlation between investment and the cost of capital, meaning that companies will be less sensitive to discount-rate changes during periods of high uncertainty [8]. This trend is in line with an information mechanism where price information is less informative and less market information is used by managers as uncertainty increases. It also assumes that the transmission of policies can be undermined by uncertainty levels when the extent of uncertainty is high. The channel of financing-frictions is enhanced by the evidence of innovation. Xu [9] concludes that EPU raises the cost of capital in firms and is linked to reduced innovation, but with stronger implications on financially constrained firms and those that rely on external finance in competitive markets. Crossover industry evidence suggests that EPU is associated with reduced patent-based innovation indicators, and that transparency, financial liberalization and robust property and patent protections all moderate negative impacts [16]. Coupled with these studies, it suggests that uncertainty can be particularly harmful to long-horizon investments whose sources of funding rely on investor confidence and access to credit.

3.4. Financial policies and capital reallocation

One of the key mitigation questions is whether the firms cushion uncertainty with the help of the liquidity management. In the United States, companies expand amounts of cash in reaction to an expansion in EPU, and buffers of cash are related to smaller adverse impacts of uncertainty on the outcomes of investment and innovation, particularly in limited firms [13]. This implies that precautionary liquidity is capable of maintaining the option value and mitigating the necessity to trim off valuable projects. Simultaneously, cross country variations imply that liquidity cannot always be the adjustment margin. More recent research goes to combine uncertainty with financial frictions at scale. Evidence to support this is presented by Alfaro et al. [17], and models indicate that uncertainty shocks cause a decline in investment and hiring and cash increases and a decline in debt and dividends and financial frictions increase and extend these effects. This point of view of the uncertainty multiplier can explain why uncertainty can be particularly contractionary in tight credit periods and why measures of cross-sectional constraint are relevant. These concepts relate well with decisions involving reallocation like M&A and export entry. Mergers and acquisitions are also large, discrete investment decisions that are influenced by EPU. Policy uncertainty is linked to reduced M&A transactions at macro and firm levels, and it is found out that implication of uncertainty

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increment is followed by an aggregate value of deals and a number of deal decreases, with no observable future recovery [5]. According to channel tests, less reversible deals and firms more susceptible to policy-related demand risk are associated with stronger effects, which is also in line with a real-options delay mechanism [5]. Trade-policy uncertainty also lowers investment and entry to the export market since the cost of sunk entry would escalate the worth of waiting and preferential trade agreements might elevate trade partially by diminishing uncertainty on future choices [18]. These strands show that uncertainty affected internal capital formation and cross-firm reallocation of resources to put in place the subsequent synthesis.

4. Discussion & synthesis

The strongest conclusion that can be made throughout the reviewed studies is that EPU is typically related to the poorer investment performance, and the mechanisms and margins of response depend on the situation. The strong support of real-options delay takes place where the irreversibility of investment is salient, i.e. in fixed-asset-intensive industries, and in hard-to-backtrack strategic decisions such as acquisitions or entering an export market [5,10,18]. This process can explain the fact that uncertainty has been found to generate investment slowdowns when expected returns are positive, since firms may rationally favor flexibility. The implication is that, in addition to the volume of investment, the timing should be the main focus of investment models. The channel of financing frictions and cost-of-capital seem to be of particular significance in cases when it is necessary to provide external funding to the project or when the payback period of the project is long. The association of EPU with an increase in financing costs and reduced innovation is a factor that confirms that uncertainty raises discount rates or constrains the supply of capital, particularly by constrained firms [9]. The cross-country evidence indicates that by increasing transparency and legal protections, it is possible to mitigate the negative effect of policy uncertainty on innovation, implying that the effect of uncertainty varies across markets and legal institutions depending on how they are regulated [16]. This leads to a conditional statement; uncertainty is most destructive when it combines with weak institutions or binding financial restrainers, and not as a single entity. The information/sensitivity perspective provides an important added dimension. When high EPU undermines the investment-cost-of-capital relationship, then those policy instruments which act by responding to financial prices will be less effective when they are most required [8]. This assists in resolving the problem of why investment can be inert even when the cost of borrowing is low since companies might not take the cheaper capital as a good indicator in a policy environment where there is instability. It further indicates that credibility, clarity and progressive direction might also be important as the rate of rates. One of the biggest unanswered tensions is the cash holdings as a mitigation channel. There is US evidence that cash buffers increase in uncertainty and offset adverse effects on investment and innovation [13], whereas there is no significant cash-holding response even during a fall in investment and debt issuance in private firms [12]. These opposite outcomes suggest that the institutional differences, i.e. ownership structure, banking relationships, soft-budget constraints, and capital market depth, can be a determinant of the feasibility, optimality, or observability of cash accumulation. It is not a small deviation since it influences what the firms and policymakers may consider as feasible resilience strategies. Methodologically, the literature is increasingly conscious of the fact that EPU rises when the economy is going through a recession, which presents a hazard of endogeneity when uncertainty is simply a proxy of bad fundamentals. Quasi-natural experiments (e.g., major reforms), exposure-based identification and political-event designs can assist in isolating uncertainty shocks due to first moment declines [12,17]. Even better designs do not provide comparability of measurement on a country-to-country basis, as media

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systems and relations between states and the markets define policy uncertainty [1,7]. These shortcomings drive a research agenda that attempts to test mechanisms and moderators more directly as opposed to generalizability.

5. Conclusion

This review has considered the role of economic policy uncertainty in corporate investment decisions and their consequences with a focus on measurement, theoretical mechanisms, empirical regularities and cross-sectional heterogeneity. In general, the literature defines uncertainty as a factor that affects when investment takes place and what is invested, including capital expenditures, as well as, innovation activity, entry and exit patterns, and major strategic reallocations like mergers and acquisitions. Three general explanations are found across the research: delay incentives in cases where investment cannot be reversed, financing and cost-of-capital pressures that limits financing of long horizon projects and decreased informational clarity that undermines the responsiveness of investment in response to financial incentives. One implication is the fact that uncertainty is hardly ever a homogeneous shock. Strong balance sheets, liquidity positions, ownership structure and sensitivity to policy sensitive demand conditions determine the extent to which uncertainty is converted into actual decisions. The differences between institutions are also important, where like uncertainty increments may result in varied financial-policy alterations in different countries and complicate shoe-sized-fits-all management guidelines. There are three directions that future research should focus on. To begin with, it needs to enhance cross-country comparability of the measurement of uncertainty and explain what aspects of indices of policy uncertainty are captured by different media and political regimes. Second, it ought to increase the number of causal identification plans, particularly in new markets, in order to decouple uncertainty shocks and simultaneous business-cycle worsening. Third, it must pay greater system to mitigation strategies- it has to specifically tie corporate governance, transparency and innovation capabilities to quantifiable resilience in investment quality during high-uncertainty events. These measures would place the field beyond the description of associations and into an explanation as to which activities decrease the actual economic cost of uncertainty.

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