Title: Policy Risk and Investment: Examining the Impact of Ruling Party Duration and Political Institutions

Investors find democracies more attractive than non-democracies (Jensen, 2003, 2006) and avoid states involved in wars (Schneider and Troger 2006). Clearly, investors are attracted to low policy risk environments. While there are a large number of studies on the link between investment and political stability, there appears to be less attention to its effects within democracies. One of the exceptions is Fuss and Bechtel's (2008) work on the impact of changes in coalitions in Germany. However, these studies typically focus on market valuations and volatility within a particular country. To account for variation across democracies, we focus broadly on capital formation and extend the argument that policy risk influences investment. We contend that variation in behavioral aspects, specifically ruling party duration, and institutional features of democracies shape the real economy through investment decisions. These factors shape perceptions of policy risk and, in turn, gross capital formation. Investment is depressed when new ruling parties come in power, since policy outcomes become less predictable, but increases as they stay in power longer. We also argue that policy risk is mitigated by institutional features that restrict ruling parties' policy autonomy. In particular, we argue that veto players mitigate the negative impact on investment caused by the alternation of ruling parties. Similarly, first-past-the-post (FPTP) electoral rules, which tend to reduce veto players, magnify the impact of the alternation of parties. e test the effects of changes in ruling parties measured as the lengths of time that the chief executives' parties stay in power, as well as the effects of institutional variables, namely veto players and electoral rules. Testing these hypotheses is complicated by a number of econometric challenges, leading us to employ several strategies to establish confidence in our results. First, because the relationship between ruling party duration and investment has not yet been explored, we use locally weighted scatterplot smoothing (LOWESS) to identify functional forms suitable for the analysis. Second, panel models are used to test the impact of ruling party duration and institutional variables. Third, we address the possibility that the relationship between ruling party duration and economic performance could be endogenous. If longer ruling party duration attracts more investment and the resulting in positive economic performance that elongates ruling party duration, simultaneity bias, caused by the correlation between the residual terms in the duration equation and investment, becomes a concern. We utilize a multiple equation approach to account for this problem. In particular, we use an instrumental variables approach with duration models to estimate the equation for ruling party duration. Finally, we use generalized method of moments (GMM) to check for the robustness of the results, as GMM is more efficient than the instrumental variable approach in the presence of heteroskedasticity and serial correlation. Our analysis uses time series cross-section data covering forty-six democracies between 1981 and 2007. The results show that ruling party duration has positive impact on investment. The hypotheses that political institutions with more veto players increase investment and that the FPTP systems discourage investment are also supported.