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STOCK MARKET REACTIONS TO POLITICAL EVENTS: What Can We Learn about the Efficacy of Political Connections?

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ABSTRACT

The value of some firms is strongly affected by which party controls political power. Stock market reactions to political events demonstrate this. However, contrary to common perception, event studies do not indicate that the ability to make unlimited campaign contributions enhances a firm's value. Geographic and personal connections to political actors matter more, although there is some evidence that personal connections may be rented via professional lobbying.

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1. Background

It is no secret that many Americans are concerned about the existence and extent of political corruption. For example, in a national opinion survey taken in the fall of 2008, 50 percent of respondents agreed that corruption in the federal government is an "extremely serious concern," while 30 percent called it a "serious concern." Only 4 percent were "unconcerned" about corruption.[1] At the same time, 52 percent of respondents indicated that they thought political corruption was "widespread" throughout the federal government, and 42 percent stated that corruption was limited to certain individuals and offices in the federal government. Only 6 percent of respondents considered corruption rare or nonexistent. However, Americans are not sanguine about quick fixes for the problem of political corruption. Only 30 percent of respondents agreed (including only 7 percent that strongly agreed) that some package of political reforms exists that would greatly reduce their concern about corruption in the federal government. Many Americans view politics as an inherently corrupt activity.

The timing of this survey, in the immediate aftermath of a financial panic, probably served to inflate popular concern about corruption, but evidence from other surveys indicates persistent concerns about corruption in Congress.[2] Moreover, subsequent events likely have not had much of a salutary effect on public opinion. The last four years have witnessed government bailouts of private industry, unprecedented increases in stimulus spending, large loan guarantees to private firms, and unsavory machinations undertaken to round up votes in Congress to pass the recent health care reform. The current election cycle has also seen the rise of so-called super PACs (political action committees) and total campaign spending is expected to far eclipse previous records.

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[1] D. Konisky, J. Milyo, and L. Richardson, "Cooperative Congressional Election Study: Missouri Content 2008," 2008, http://hdl.handle.net/1902.1/14121, Polimetrix (version 1).
[2] For example, see Jeffrey M. Jones, "Record 64% Rate Honesty, Ethics of Members of Congress Low," *Gallup Politics*, December 11, 2011, http://www.gallup.com/poll/151460/Record-Rate-Honesty-Ethics-Members-Congress-Low.aspx; and Joseph Carroll, "Americans Increasingly View Most Members of Congress as Corrupt," *Gallup News Service*, May 17, 2006, http://www.gallup.com/poll/22837/Americans-Increasingly-View-Most-Members-Congress-Corrupt.aspx.
[3] J. Milyo, "Do State Campaign Finance Reforms Increase Trust and Confidence in State Government?" (working paper, University of Missouri, Columbia, MO, 2012).
[4] G. Grossman and E. Helpman, "Protection for Sale," *American Economic Review* 84 (1994): 833–50.
[2] For example, see Jeffrey M. Jones, "Record 64% Rate Honesty, Ethics of Members of Congress Low," *Gallup Politics*, December 11, 2011, http://www.gallup.com/poll/151460/Record-Rate-Honesty-Ethics-Members-Congress-Low.aspx; and Joseph Carroll, "Americans Increasingly View Most Members of Congress as Corrupt," *Gallup News Service*, May 17, 2006, http://www.gallup.com/poll/22837/Americans-Increasingly-View-Most-Members-Congress-Corrupt.aspx.

What exactly is political corruption? Surely, illicit activities such as bribery and influence-peddling are corrupt. These quid pro quo arrangements are what the courts are most concerned about when deciding whether there is a compelling government interest to justify regulating political activities (for example, contribution limits, mandatory disclosure requirements, and so forth). But public opinion about "political corruption" likely extends beyond this legal concept and instead reflects popular concern with practices that may be legal but are nonetheless disturbing. These may include favoritism in the awarding of government contracts and hiring, or the passage of regulations and legislation to benefit certain groups or individuals. In some instances, favoritism toward friends, family, and political associates may cross the line into illicit activity, but often such cronyism is "politics as usual."

In common parlance "corruption" also takes on meanings outside of quid pro quo relationships or cronyism. For example, legal activities, especially campaign contributions and lobbying, are often characterized as corrupt or corrupting. Beyond this, partisanship and ideology also play an important role in whether people perceive corruption; events and actions are always more suspicious when they involve members of an opposing faction.[3] Consequently, in reviewing and analyzing the social scientific evidence on political corruption, it is important to distinguish between quid pro quo corruption and cronyism, and between actual corruption and legal activities (for example, campaign contributions) that may facilitate corruption.

Contributions, Lobbying, and Corruption

For many political observers, the source of political corruption is obvious: privately financed political campaigns facilitate a market for political favors.[4] Advocates of campaign finance reform have long asserted that campaign contributions are bribes and that only full public financing of political campaigns can address the problem of political corruption. I argue that while there is some superficial evidence consistent with the view that campaign contributions are the

[3] J. Milyo, "Do State Campaign Finance Reforms Increase Trust and Confidence in State Government?" (working paper, University of Missouri, Columbia, MO, 2012).
[4] G. Grossman and E. Helpman, "Protection for Sale," *American Economic Review* 84 (1994): 833–50.

functional equivalent of bribes, upon closer inspection that hypothesis is not well supported by the scholarly literature.[5]

The best example of this is found in analysis of corporate PAC campaign contributions and roll-call votes on issues of interest to those same corporations. Firms in industries that are more highly regulated or dependent on government contracts are more likely to form PACs.[6] These PACs make contributions to party leaders and members that sit on committees with relevant policy jurisdictions.[7] More to the point, PAC contributions are also highly correlated with the likelihood that a firm will benefit from government investment and with roll-call votes on legislation favored by the sponsors of corporate PACs.[8] Even the timing of contributions—coincident with major steps in the legislative process—suggests a market for favors.[9] All this is consistent with the notion that campaign contributions are like bribes, but it is also consistent with the phenomenon that PACs support the politicians who hold the beliefs most beneficial to the employees and investors in the associated firms.[10]

In fact, both theory and evidence favor the latter interpretation.[11] First, bribery and influence-peddling are illegal, so it is not possible to make legally enforceable promises regarding exchanges of money for favors. Second, contributions made directly to federal candidates are limited by law, so the amounts of money being contributed from any one source may not justify the opportunity cost of illicit behavior. Third, contributions to candidates must be disclosed; the activities of politicians are closely monitored by competing candidates and watchdog groups eager to make accusations of impropriety. Fourth, several studies show that marginal campaign expenditures have negligible effects on federal election contests;[12] this implies that political

[5] Students of American politics have long noted the disconnect between conventional wisdom on the role of money in politics and scholarly research. For example, see F. Sorauf, *Inside Campaign Finance: Myths and Realities* (New Haven, CT: Yale University Press, 1992).
[6] K. Grier, M. Munger, and B. Roberts, "The Determinants of Industry Political Activity, 1978–1986," *American Political Science Review* 88, no. 4 (1994): 911–26.
[7] K. Grier and M. Munger, "Committee Assignments, Constituent Preferences, and Campaign Contributions," *Economic Inquiry* 29 (1991): 24–43.
[8] R. Duchin and D. Sosyura, "The Politics of Government Investment" (working paper, University of Michigan, Ann Arbor, MI, 2011).
[9] Thomas Stratmann, "The Market for Congressional Votes: Is Timing of Contributions Everything?," *Journal of Law and Economics* 41, no. 1 (1998): 85–114.
[10] For example, see S. Levitt, "Are PACs Trying to Influence Politicians or Voters?," *Economics and Politics* 10, no. 1 (1998): 19–35; and S. Bronars and J. Lott, "Do Campaign Contributions Alter How a Politician Votes? Or, Do Donors Support Candidates Who Value the Same Things That They Do?," *Journal of Law and Economics* 40 (1998): 317–50.
[11] J. Milyo, D. Primo, and T. Groseclose, "Corporate PAC Contributions in Perspective," *Business and Politics* 2, no. 1 (2000): 75–88.
[12] For example, see S. Levitt, "Using Repeat Challengers to Estimate the Effects of Campaign Spending on Election Outcomes in the U.S. House," *Journal of Political Economy* 102 (1994): 777–98; A. Gerber, "Campaign Spending and Election Outcomes: Re-estimating the Effects of Campaign Spending," *American Political Science Review* 92, no. 2 (1998):

contributions to high-spending incumbents are particularly inefficient in-kind gifts and unlikely to curry much favor. Fifth, the amounts of money transferred to politicians in the form of contributions are typically dwarfed by corporate lobbying expenditures, which suggests that contributions are less effective at influencing policy than lobbying is. In turn, corporations devote far more resources to charity than to political activities, which again suggests that both contributions and lobbying have limited impact. Given all this, it is not surprising that most carefully researched studies find no causal impact between campaign contributions and legislators' roll-call votes.[13]

This evidence has led many political scientists to suggest that contributions may simply buy access to politicians;[14] however, there is also little evidence that access and lobbying influence roll-call votes in any systematic manner.[15] Of course, roll-call votes are a very blunt measure of influence. It is possible that the purpose of campaign contributions and lobbying is to influence legislators to alter their behavior in committee markups of legislation.[16] Alternatively, firms and interest groups may employ lobbying and political advertising as a legislative subsidy to aid political allies in government via the provision of political intelligence and coordinated marketing campaigns on specific policy issues.[17] Consequently, lobbying and political contributions may have effects that are difficult for researchers to observe and may provide large payoffs to firms that engage in such activities. This is the motivation for using stock market event studies to decipher the value of political connections that might otherwise go undetected.

401–11; and J. Milyo, "What Do Candidates Maximize (and Why Should Anyone Care)?," *Public Choice* 109, no. 1/2 (2001): 119–39.

[13] S. Ansolabehere, J.de Figueiredo, and J. Snyder, "Why Is There So Little Money in U.S. Politics?," *Journal of Economic Perspectives* 17, no. 1 (2003): 105–30.

[14] For example, see J. Wright, "PAC Contributions, Lobbying and Representation," *Journal of Politics* 51 (1989): 713–29.

[15] See S. Ansolabehere, J. Snyder, and M. Tripathi, "Are PAC Contributions and Lobbying Linked? New Evidence from the 1995 Lobby Disclosure Act," *Business and Politics* 4, no. 2 (2002): 131–55; and J. Milyo, "Bribes and Fruitbaskets: What Does the Link between PAC Contributions and Lobbying Mean?," *Business and Politics* 4, no. 2 (1995): 157–59.

[16] For example, see R. Hall and F. Wayman, "Buying Time: Moneyed Interests and the Mobilization of Bias in Congressional Committees," *American Political Science Review* 84 (1990): 797–820. For a different perspective, see G. Wawro, *Legislative Entrepreneurship in the United States House of Representatives* (Ann Arbor, MI: University of Michigan Press, 2000).

[17] R. Hall and A. Deardorff, "Lobbying as Legislative Subsidy," *American Political Science Review* 100, no. 1 (2006): 69–84.

2. Political Event Studies

The logic of stock market event studies is straightforward.[18] Under the efficient market hypothesis, share prices of publicly traded firms reflect current information about the profitability of those firms. It follows that any new information that affects a firm's bottom line will quickly be capitalized into its share price. Therefore, any surprising event that affects some industry or group of firms will produce a coincident response in the stock prices of those firms. This allows researchers to test hypotheses about what matters for firms' profitability.

The first key step in an event study is identifying an event that contains surprising information. The sudden and untimely death of a powerful politician would be one example. Even somewhat anticipated events may contain an element of surprise. For example, the outcome of a close election resolves uncertainty, even if the result was not wholly unanticipated. The event's degree of surprise will affect the magnitude of the response in the share prices of affected firms. This is because anticipated events are already capitalized into share prices. Thus, some caution must be exercised in interpreting findings from events that are not complete surprises.[19]

The second key step in an event study is choosing a baseline for comparing stock prices before and after the event. Consider the change in actual share prices immediately before and after an event: This change captures the market valuation of the informational shock associated with the event, but it also captures the value of anything else that is simultaneously occurring. For that reason, most event studies examine "abnormal returns" by comparing the change in the actual stock price of an affected firm to a prediction of what would have occurred otherwise. These predictions are usually based on the recent historical correlation between changes in a firm's share price and changes in the overall market.

Bush versus Gore

Several political event studies examine the effect of elections on the share values of firms expected to fare better under one administration than another.[20] While every election cycle holds

[18] S. Brown and J. Warner, "Measuring Security Price Performance," *Journal of Financial Economics* 8, no. 3 (1980): 205–58; and W. Wells, "A Beginner's Guide to Event Studies," *Journal of Insurance Regulation* 23, no. 4 (2004): 61–70.
[19] S. Snowberg, J. Wolfers, and E. Zitzewitz, "How Prediction Markets Can Save Event Studies" (working paper, California Institute of Technology, Pasadena, CA, 2011).
[20] For example, see B. Roberts, "Political Institutions, Policy Expectations and the 1980 Election: A Financial Market Perspective," *American Journal of Political Science* 34, no. 2 (1990): 289–310.

some uncertainty, the hotly contested presidential race in 2000 was an outlier in this regard. Brian Knight at Brown University exploits the uncertainty in the lead-up to the 2000 election to demonstrate that a portfolio of firms expected to fare well under either a Bush or Gore presidency is sensitive to changing expectations about the election outcome.[21]

Knight constructs portfolios of "Bush-firms" (n=41) and "Gore-firms" (n=29) based on public pronouncements made by several financial analysts offering advice about which firms and industries would be most affected by the election. Knight then uses betting odds from the Iowa Electronic Market as a kind of daily tracking poll. The key insight is that these betting odds will react to information shocks that portend the electoral fate of Bush or Gore. Knight demonstrates that fluctuations in the betting odds are significantly related to fluctuations in share prices over the course of the 2000 general election campaign. Overall, the Bush portfolio of firms was worth 3 percent more after the election and the Gore portfolio about 6 percent less; the implied value of Bush's victory was equivalent to a transfer of over $100 billion in market capitalization from the firms in the Gore portfolio to those in the Bush portfolio.

Knight also examines the total political contributions by firms in each portfolio, and how these are correlated with share price movements. In 2000, corporations were permitted to make unlimited "soft money" donations to political parties. Knight finds that the excess returns to firms are positively correlated with political contributions; however, he notes, this does not establish a causal link between contributions and market valuations of firms. Politically active firms choose to support candidates and parties based on the policy preferences of those actors, and the firms that are most sensitive to political outcomes are also most likely to be politically active.[22] For this reason, the observed correlation between contributions and excess returns also reflects this reverse causality. Ignoring this fact can produce a highly exaggerated estimate of the efficacy of corporate contributions.

To underscore this point, if the link Knight observed between soft money contributions and changes in the market capitalization of firms is causal, it indicates a return of about 2,000 percent on soft money contributions to political parties. This implies that investors are extremely irrational

[21] Brian Knight, "Are Policy Platforms Capitalized into Equity Prices? Evidence from the Bush/Gore 2000 Presidential Election," *Journal of Public Economics* 91 (2007): 389–409. Also see A. Mattozzi, "Can We Insure against Political Uncertainty? Evidence from the U.S. Stock Market," *Public Choice* 137 (2008): 43–55.
[22] Ansolabehere, de Figueiredo, and Snyder, "Why Is There So Little Money in U.S. Politics?"

for persistently ignoring the availability of such astronomical returns, or that the returns to political contributions are extremely speculative so that the risk-adjusted return is closer to the normal rates of return. However, this latter explanation would mean that the evidence of such realized returns on contributions should be quite rare. Instead, as will be shown, researchers repeatedly find that contributions (and lobbying) are associated with high-excess returns. Consequently, Knight's study is best viewed as identifying the treatment effect of the 2000 election outcome on the share prices of different firms and demonstrating that this effect varies across firms in a manner correlated with soft money political contributions. His study fails to identify the treatment effect of corporate contributions on share prices.

John Shon has also examined the Bush-Gore election. Unlike Knight, he focuses on the postelection legal dispute over recounts as the event of interest.[23] Shon demonstrates that the net share of industry contributions to Republicans is correlated with excess returns in the industry. This finding is consistent with Knight's results, but similarly fails to identify the treatment effect of contributions.

The Jeffords Effect

In the spring of 2001, Senator James Jeffords of Vermont switched parties and flipped majority control of the U.S. Senate to the Democrats. Contemporaneous news reports described the defection as a surprise, which makes this change in political control of the Senate a potential natural experiment. Seema Jayachandran examines the abnormal returns from this event to firms making large soft money contributions to either party in the 2000 election cycle.[24] According to this study, firms that chose to make soft money contributions to Republicans lost about 0.8 percent of their market capitalization when Jeffords switched parties. This finding confirms that party control of political institutions matters to politically active firms.[25]

Jayachandran also demonstrates that the amounts of soft money contributions are correlated with excess returns. If misinterpreted as a causal effect, her findings imply a rate of return of over 700 percent on soft money contributions. Once again, this study does not identify

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[23] John Shon, "Do Stock Returns Vary with Campaign Contributions? Bush vs. Gore: The Florida Recount," *Economics and Politics* 22, no. 3 (2010): 257–81.
[24] Seema Jayachandran, "The Jeffords Effect," *Journal of Law and Economics* 49, no. 2 (2006): 397–425.
[25] See C. Hartog and N. Monroe, "The Value of Majority Status: The Effect of Jeffords's Switch on Asset Prices of Republican and Democratic Firms," *Legislative Studies Quarterly* 33, no. 1 (2008): 63–84.

the treatment effect of corporate contributions on abnormal returns because it ignores reverse causality.

Taking Stock

The event studies described to this point examine how major changes in party control of political institutions affect the share prices of politically connected firms in the United States.[26] Similarly, several political event studies demonstrate that legislative or regulatory policy shocks also affect corporate share prices in a predictable manner.[27] Taken together, these studies establish the potential for corruption (since political and policy outcomes significantly affect the profitability of firms), but little else. Similarly, several recent studies identify a persistent positive correlation between corporate lobbying or contributions from corporate PACs and share values, but these are not informative about the causal impact of lobbying or contributions on the value of a firm.[28]

The next set of event studies reviewed will investigate the possible presence of quid pro quo relationships with specific members of Congress; these will be more informative about the importance of different types of political connections for firm performance.

Dead Senators

Brian Roberts conducts one of the more creative political event studies by examining the impact of Senator Henry "Scoop" Jackson's sudden death on "client firms" in the defense industry.[29] Senator Jackson (D-WA), the ranking minority member of the Senate Armed Services Committee, died from a ruptured coronary artery on September 1, 1983. The next highest ranking

[26] Event studies of electoral outcomes in other countries reveal similar findings. For example, see M. Herron, "Estimating the Economic Impact of Political Party Competition in the 1992 British Election," *American Journal of Political Science* 44, no. 2 (2000): 320–31; M. Bechtel and R. Fuss, "Capitalizing on Partisan Politics? The Political Economy of Sector-Specific Redistribution in Germany," *Journal of Money, Credit and Banking* 42, no. 2–3 (2010): 203–35; and P. Castella and F. Trillas, "The Effects of Surprise Political Events on Quoted Firms: The March 2004 Election in Spain," *Journal of the Spanish Economic Association* (2011, forthcoming).

[27] For example, see G. Schwert, "Using Financial Data to Measure Effects of Regulations," *Journal of Law and Economics* 27 (1981): 121–58; and T. Gilligan and K. Krehbiel, "Complex Rules and Congressional Outcomes: An Event Study of Energy Tax Legislation," *Journal of Politics* 50, no. 3 (1988): 625–54.

[28] For example, see M. Cooper, H. Gulen, and A. Ovtchinnikov, "Corporate Political Contributions and Stock Returns," Journal of Finance 65, no. 2 (2010): 687–724; J. Huber and M. Kirchler, "Corporate Campaign Contributions and Abnormal Stock Returns after Presidential Elections," Public Choice (2011, forthcoming); and H. Chen, D. Parsley, and Y. Yang, "Corporate Lobbying and Financial Performance" (working paper, University of Colorado, Boulder, CO, 2010); For a competing view, see R. Aggarawal,F. Meschke, and T. Wang, "Corporate Political Contributions: Investment or Agency?" (working paper, University of Kansas, Lawrence, KS, 2012).

[29] Brian E. Roberts, "A Dead Senator Tells No Lies: Seniority and the Distribution of Federal Benefits," *American Journal of Political Science*, 34(1) (1990): 31–58.

Democrat on the committee was Senator Sam Nunn of Georgia. This event transferred the power to influence committee legislation from Jackson to Nunn. To the extent firms buy influence via PAC contributions, evidence of this transfer of power should have been reflected in the share prices of these financial client firms. Politicians seek pork and other benefits for their constituents, so this event may also have been expected to affect firms located in either Washington or Georgia.

Roberts examines the effect of Senator Jackson's death on both financial and geographic client firms. He finds no abnormal returns for firms whose only connection to either senator was through PAC contributions, but he does observe that firms located in Washington and Georgia did realize abnormal returns of about −2 percent and +1 percent, respectively. Because this event was not coincident with any other change in party control of institutions, it demonstrates a treatment effect on a firm's bottom line due to having an influential representative in Congress. However, Roberts does not explore whether the amount of PAC contributions related to excess returns, so some caution is in order regarding the importance of financial client relationships.

Sex, Power, and Money

In December 1998, Republicans in the U.S. House of Representatives impeached President Bill Clinton. The impeachment vote itself was essentially down party lines and unsurprising. A few weeks later, as expected, the Senate refused to remove President Clinton from office. Immediately before the impeachment vote, Representative Robert Livingston (R-LA), the chairman of the House Appropriations Committee and Speaker-designate of the U.S. House, announced that he had been unfaithful to his wife. To the stunned protests of Republicans, Livingston announced that he would resign from office. Within 24 hours, Republicans had rallied around Dennis Hastert (R-IL) as the next Speaker of the House. This event is similar to the passing of Scoop Jackson in that partisan control did not change, but it resulted in a rather dramatic change in the influence of particular members of Congress.

I investigate this episode in a working paper coauthored with Scott Smart.[30] We follow Roberts in defining financial and geographic client firms, based on PAC contributions and the physical presence of firms in Louisiana or Illinois, respectively. Like Roberts, we find large and significant effects for geographic clients; firms located in Illinois realized a 4 percent abnormal

[30] J. Milyo and S. Smart, "Sex, Power and Money: Market Reaction to a Sudden Change in Political Leadership" (working paper, University of Missouri, Columbia, MO, 2012).

return compared with those in Louisiana in the immediate aftermath of Livingston's resignation. However, firms for which the only connection was via PAC contributions realized no abnormal returns. The amount of money contributed by PACs did not matter, nor did the presence or amount of soft money contributions or lobbying expenditures.

The preceding two event studies both find that powerful incumbents benefit firms in their home states, but PAC contributions to these same incumbents have no independent effect on abnormal returns. We also find that neither soft money contributions to parties nor lobbying activity confer any benefit to firms tied to a particular powerful member of Congress. These results contrast with those of several of the other studies reviewed, which find a correlation between corporate political activity and abnormal returns.

Campaign Finance Law

Two recent event studies examine major changes in campaign finance laws. The Bipartisan Campaign Finance Reform Act of 2002 (BCRA, also known as McCain-Feingold) ended the practice of unlimited soft money contributions to parties, and the Supreme Court's 2010 decision in Citizens United opened the door to unlimited corporate independent expenditures. If campaign contributions buy political favors, these events should have enormous ramifications for firms. Legislation is a collective effort, so the prospect of buying off multiple legislators via limited PAC contributions (one by one and with no explicit contracting) should be relatively inefficient compared to making unlimited contributions directly to party leaders via soft money or with a possible "wink and a nod" via independent expenditures.

Ansolabehere, Snyder, and Ueda consider several events related to BCRA: House passage, Senate passage, the president's signature, the U.S. Supreme Court argument, and the Supreme Court decision.[31] They compare excess returns around each event for large soft money donors, moderate donors, and nondonors; without exception they find no support for the hypothesis that losing the ability to make unlimited soft money contributions harmed firms that had previously engaged in that activity.

[31] S. Ansolabehere, J. Snyder, and M. Ueda, "Did Firms Profit from Soft Money?," *Election Law Journal* 5, no. 2 (2004): 193–98.

More recently, the Supreme Court's split decision in Citizens United has unleashed a torrent of criticism from reform advocates. Several prominent politicians, including President Barack Obama and Senator John McCain (R-AZ), have bemoaned the decision to allow corporations to make unlimited independent expenditures and warn that it will lead to massive corruption. If so, Citizens United should be an immense boon to politically sensitive firms.

Timothy Werner collected stock market data for the Fortune 500 firms and tracked their share prices around three events connected to the court's consideration of Citizens United: the initial decision for a rehearing, the second round of oral arguments, and the ultimate decision.[32] Werner found no overall effect on the share prices of large firms associated with any of these events. Werner also compared abnormal returns for politically sensitive firms based on lobbying expenditures; once again there were no effects across the board.

Taking Stock, Again

The reviewed studies strongly imply that there is no cash on the barrel head market for political favors in which corporations buy favorable legislation with contributions. Nor does it appear that lobbying activity confers any treatment effect on firms' profitability. Instead, contributions and lobbying appear to be symptomatic of underlying relationships and political sensitivity. That is, contributions and lobbying activity are not the source of political connections, but they are caused by the existence of some more meaningful connection between firms and their political allies (for example, geographic location, constituent preferences, party platforms, and so forth). In particular, the constituent relationship with powerful political benefactors seems to generate abnormal returns. This is consistent with studies of political ties in authoritarian countries and may indicate political corruption and cronyism.[33] However, politicians are expected to seek favors for constituents in a representative democracy. The remaining event studies take a closer look at other sources of connections among firms, lobbyists, and politicians.

[32] Timothy Werner, "The Sound, the Fury, and the Nonevent: Business Power and Market Reactions to the Citizens United Decision," *American Politics Research* 39, no. 1 (2010): 118–41.
[33] For example, see T. Ferguson and H. Voth, "Betting on Hitler—The Value of Political Connections in Nazi Germany," *Quarterly Journal of Economics* 123, no. 1 (2008): 101–37; R. Fisman, "Estimating the Value of Political Connections," *American Economic Review* 91, no. 4 (2001): 1095–102; and H. Li, L. Meng, Q. Wang, and L. Zhou, "Political Connections, Financing and Firm Performance: Evidence from Chinese Private Firms," *Journal of Development* 87 (2008): 283–89.

Is It Who You Know?

Several recent studies examine event studies to reveal the importance of personal ties between corporations and governments. For example, Faccio and Parsley examine the impact of the sudden deaths of politicians around the world on the value of geographic client firms.[34] Consistently with the studies previously reviewed, they find that severing firms' links to politicians produces significant and negative abnormal returns. But do personal connections matter in the United States?

Goldman, Rocholl, and So suggest that they do.[35] They check all S&P 500 firms for the presence of board members who previously held elective office, and classify firms as connected to Democrats or Republicans. Not surprisingly, they find that Republican-connected firms realized positive abnormal returns after the 2000 election while Democrat-connected firms realized negative abnormal returns; however, these findings may reflect only the fact that party platforms tend to favor or disfavor particular firms. More intriguingly, they observe positive abnormal returns upon the announcement of a new politically connected board member. This suggests that investors value firms with politically experienced and connected boards.[36]

Geithner versus Cheney

Then-President-Elect Barack Obama's announced intention in November 2008 to nominate Timothy Geithner to be the U.S. secretary of the treasury provides a unique opportunity to test the efficacy of personal connections in American politics. Acemoglu, Johnson, Kermani, Kwak and Mitton use public information regarding Geithner's personal friendships and the frequency of meetings with executives in various industries to show that these sources of connections are associated with significant and large abnormal returns to firms.[37] Considering the announcement of Geithner as an event, connected firms realized a 15 percent abnormal return.

[34] M. Faccio and D. Parsley, "Sudden Death, Taking Stock of Geographic Ties" (working paper, Vanderbilt University, Nashville, TN, 2007). See also related work in M. Faccio, "Politically Connected Firms," *American Economic Review* 96, no. 1 (2006): 369–86; and M. Faccio, R. Masulis, and J. McConnell, "Political Connections and Corporate Bailouts," *Journal of Finance* 66, no. 6 (2006): 2597–635.
[35] E. Goldman, J. Rocholl, and J. So, "Do Politically Connected Boards Affect Firm Value?," *Review of Financial Studies* 22, no. 6 (2008): 2331–60.
[36] See also Q. Do, B. Nguyen, Y. Lee, and K. Nguyen, "Out of Sight, Out of Mind: The Value of Political Connections in Social Networks" (working paper, Singapore Management University, Singapore, 2011).
[37] D. Acemoglu, S. Johnson, A. Kermani, J. Kwak, and T. Mitton, "The Value of Political Connections in the United States" (working paper, Harvard University, Cambridge, MA, 2010).

Moreover, when unfavorable news broke about Geithner's tax "issues," these same firms realized abnormal negative returns.

Not all personal connections matter, however. Fisman, Fisman, Galef, and Khurana conduct a similar study of firms connected to Vice President Dick Cheney.[38] The authors define political connections based on overlapping board membership during Cheney's tenure as the CEO of Halliburton; the events examined include Cheney's selection as a vice-presidential running mate, the 2000 election, and news reports on Cheney's health. However, across several events there are no abnormal returns to firms connected to Cheney. This null finding may reflect the relative unimportance of the office of the vice president, at least compared with the office of secretary of the treasury during a financial crisis; or it may suggest that not all political connections can be exploited for advantage.

Lobbying Connections

The evidence that personal connections can be valuable to firms raises the question of whether such connections can be purchased or rented. Professional lobbyists like Jack Abramoff ply such a trade. Borisov, Goldman, and Gupta examine stock market reactions to Abramoff's 2006 guilty pleas related to bribery of public officials and overbilling clients.[39] The authors find that S&P 500 firms that spent more on lobbying in the three years before the Abramoff scandal realized negative abnormal returns after news of Abramoff's plea agreement. In addition, lobbying firms also realized negative returns from the introduction and passage of the Lobbying Accounting and Transparency Act of 2006. However, both the observed abnormal returns and the passage of lobbying reform could be driven by unfavorable publicity for all firms engaged in lobbying after the Abramoff scandal. To untangle the causal effect of lobbying from other confounding factors, it is necessary to examine some external change in the ability of firms to lobby.

Just such an experiment occurred in 1993, when President Clinton issued an executive order restricting the lobbying activities of former senior executive branch officials. Gely and Zardkoohi compare the abnormal returns of lobbying firms that employed covered former officials

[38] D. Fisman, R. Fisman, J. Galef, and R. Khurana, "Estimating the Value of Connections to Vice President Cheney" (working paper, Princeton University, Princeton, NJ, 2006).
[39] A. Borisov, E. Goldman, and N. Gupta, "The Value of (Corrupt) Lobbying" (working paper, Indiana University, Bloomington, IN, 2011).

before and after the executive order was issued.[40] They find that abnormal returns to lobbying firms fell after the executive order; however, the authors do not explore whether clients of these lobbying firms also realized some negative impact.

3. Discussion

Much of the scholarly literature that investigates the potential corruption in American politics suffers from a preoccupation with campaign contributions. The research reviewed here strongly suggests that this is an exercise in looking under the lamppost. Well-designed political event studies do not support the hypothesis that campaign contributions buy political favors; this also accords with the lessons from more traditional research about money in politics. Evidence on the efficacy of lobbying is more mixed, in part owing to the limited number of event studies appropriate for identifying the treatment effects of lobbying.

In contrast, there is consistent evidence from event studies that firms located in the districts of powerful incumbents benefit from political favoritism. Likewise, firms with strong personal connections to politicians via family, friendship, and past-employment networks also realize positive abnormal returns. These findings imply that trust relationships are necessary to support potential corrupt practices and that cronyism is a more prevalent practice than quid pro quo exchanges of money for political favors.

The absence of a formal contracting mechanism makes it difficult to buy influence or access with campaign contributions. But politicians repeatedly interact with geographic constituents and personal connections; this repeated interaction facilitates mutual trust and permits the realization of gains from corrupt practices. Further, favoritism to geographic constituents is not likely to be considered as suspect as other forms of cronyism, so an exchange of favors between representatives and geographic client firms may be the easiest form of corruption to support.

It is easy to understand how politicians benefit from trading favors for campaign contributions or gifts from lobbyists. But if these pathways are not the source of political corruption, what do politicians gain by giving preferences to personal and geographic cronies?

[40] R. Gely and A. Zardkoohi, "Measuring the Effects of Post-Government-Employment Restrictions," *American Law and Economics Review* 3, no. 2 (2001): 288–301.

Geographic client firms employ potential voters and campaign volunteers, so again, the gains from trade are easier to imagine between politicians and geographic clients. Similarly, favors directed at influential interest groups may result in larger "legislative subsidies" in the form of issue advocacy that may help politicians realize specific policy goals. But none of the studies reviewed here explain how politicians gain from favoring personal cronies.

Two recent studies find that the stock portfolios of members of Congress consistently outperform the market.[41] The popular interpretation of this phenomenon is that politicians are profiting from market-relevant inside information about public policy. This makes personal connections a more efficacious pathway for quid pro quo corruption: Politicians confer policy favors on personal cronies in exchange for inside information and preferential business deals for themselves, their families, and their friends.

This form of corruption based on personal connections is difficult to identify and more difficult to prevent. This may explain why popular opinion sees corruption as pervasive and inherent in politics and not amenable to a quick fix via campaign finance reform or lobbying reform. The public and media attention currently focused on campaign contributions and lobbying might be better devoted to exposing and monitoring personal connections between politicians and firms. But if cronyism is inherent in politics, then perhaps the only way to mitigate the effects of corruption is through limited and smaller government.

One direction for future research is to identify politicians who have experienced extraordinary increases in wealth, trace back personal connections from those politicians to firms, and investigate whether such connections also yield abnormal returns. Such a coincidence might indicate the presence of quid pro quo corruption. In addition, the question of whether lobbyists can effectively manipulate personal connections deserves more attention. Lobbying and ethics regulations vary across states and over time; this variation may provide a natural experiment to

[41] A. Ziobrowski, P. Cheng, J. Boyd, and B. Ziobrowski, "Abnormal Returns from the Common Stock Investments of the U.S. Senate," *Journal of Financial and Quantitative Analysis* 39, no. 4 (2004): 661–76; and A. Ziobrowski, J. Boyd, P. Cheng, and B. Ziobrowski, "Abnormal Returns from the Common Stock Investments of Members of the U.S. House of Representatives," *Business and Politics*, 13, no. 1 (2011): article; however, for a competing view, see: A. Eggers and J. Hainmueller, "Capitol Losses: The Mediocre Performance of Congressional Stock Portfolios" (working paper, London School of Economics, London, 2011); and Eggers and Hainmueller, "Political Capital: Corporate Connections and Stock Investments in the U.S. Congress, 2004–2008" (working paper, London School of Economics, London, 2011). See also P. Schweizer, *Throw Them All Out: How Politicians and Their Friends Get Rich Off Insider Stock Tips, Land Deals, and Cronyism that Would Send the Rest of Us to Prison* (New York: Houghton Mifflin Harcourt, 2011).

better understand the efficacy of professional lobbying. Finally, future research should examine how the size and scope of government relates to the presence of political corruption.