

CAMPAIGN FINANCE REGULATIONS AND THE RETURN ON INVESTMENT FROM CAMPAIGN CONTRIBUTIONS

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Abstract

Being good liberal Democrats, we began this study with the belief that corporations use their campaign contributions to shape public policy and that donors substantially benefit from their campaign contributions. Stock markets should reflect the high returns that firms enjoy from their political strategies, and changes in campaign finance laws ought to alter the stock prices of firms that give heavily to politics. That, however, is not the assessment of investors – those who value firms and the environment in which they operate. We identified dates of key campaign finance regulatory decisions and measured changes in stock prices of firms affected by those decisions. These decisions immediately affected hundreds of millions of dollars of corporate giving, but they have no apparent effect on the markets valuation of the long-term profitability of firms. This conclusion suggests that the fundamental critique of campaign finance in America – that donations come with a quid pro quo and extract very high returns for donors – is almost surely wrong.

Campaign Finance Regulations and the Return on Investment from Contributions

The United States regulates campaign contributions from firms, individuals, and voluntary associations, such as labor unions, in order to prevent corruption of politicians by organized interests. Perhaps the clearest expression of this concern is found in the U.S. Supreme Court's decision *Buckley v. Valeo* 424 US 1 (1976). Justice Brennan, writing for the majority, argues that "contribution ceilings were a necessary legislative concomitant to deal with the reality or appearance of corruption." (424 *U.S.* 28). He continues:

To the extent that large contributions are given to secure a political quid pro quo from current and potential office holders, the integrity of our system of [424 *U.S.* 1, 27] representative democracy is undermined. Although the scope of such pernicious practices can never be reliably ascertained, the deeply disturbing examples surfacing after the 1972 election demonstrate that the problem is not an illusory one.¹

Economists and political scientists have long been puzzled about the influence of campaign contributions on public policy. An extensive literature examines the association between hard money contributions and public policy decision-making, especially roll call voting in the U.S. Congress. The large majority of studies find no significant effects of hard money contributions on public policy decisions reached by the legislature, and, in those studies that do find some association, the magnitude of the effects is typically very small, too small to make a difference in the outcome of the legislative decision.²

¹ 424 *U.S.* 28 (1976).

² See Ansolabehere, de Figueiredo, and Snyder (2003) for a summary of this literature.

More troubling still, the total amount of campaign contributing seems too small to produce much influence. Following the 1972 election, Gordon Tullock (1973) argued that although corruption is widely alleged, it is not plausibly large. Assuming a reasonable return on investment, the total value of all goods and services that firms buy with their campaign contributions cannot be more than a several hundred million dollars per year. Campaign spending has since grown from \$200 million in 1972 to \$3 billion in 2000. A very good return on investment in private markets might double the amount of money to, say, \$6 billion. That might sound like a lot, but it is rounding error on the national accounts, and likely does not amount to a significant societal problem. Nor is this a large amount of money in terms of public policy, suggesting that interest group influence through campaign contributions is small.

Nor would firms make much profit from such activities if the rate of return on investment were in the neighborhood of that gained on other financial markets. Consider a typical Fortune 100 company. Annual revenues for these companies are, on average, \$50 billion, roughly 10% of which is profit. The companies most active in making direct contributions gave approximately \$1 million each in 2002. (Six corporations are on the FEC's list of the Top 50 Contributors to Candidates in 2002. These are Federal Express (\$1.2 million), Ernst&Young (\$1 million), Lockheed Martin (\$1 million), Deloitte Touche (\$1 million), Bank One (\$930,000), and Verizon (\$910,000).) An excellent return on this investment compared to the market would double the amount invested – a 100 percent rate of return. One million dollars in direct contributions, then, would translate into two million in revenue, a net of one million. But, this amounts to just two one-hundredths of one percent of the company's profit – difficult to notice and not much to get excited about.

On the other hand, such calculations may be wrong. Under some assumptions about the nature of political bargaining, companies might command an extraordinarily high return on investment (*e.g.*, Persson and Tabellini, 2002, pp. 187-190; Dal Bo, 2002). If the interest group has high leverage vis-à-vis the politicians, the group can extract all of the “rents.” In these models, politicians are willing to give away valuable benefits in order to get some small amount of interest group support because competing politicians might undercut them and because there is no electoral consequence or personal cost to such deal making.

A few empirical studies do find evidence consistent with high returns for some industries. Stratmann (1991) concludes that a \$3000 donation to a member of Congress from a sugar producer would guarantee that member’s support for the sugar price supports. Using these estimates does imply a very high rate of return. The sugar industry gave members of Congress \$1.3 million in contributions in 2001 and 2002, and the agriculture bill contained \$1 billion in price supports for that industry. Excessively high rates of returns are also implied by studies by public interest groups such as Common Cause. Industries ranging from pharmaceutical licensing to energy production to agricultural commodities give millions of dollars to federal and state campaigns at the time that government policies regulating those industries are made more favorable to corporate economic interests of companies and individuals in those industries. See, for example, the publications of Common Cause (www.commoncause.org).³

High rates of return on investment would have noticeable effects on both the profitability of firms and public policy. Consider, again, the example of a Fortune 500 company with \$50 billion in revenue. Suppose that company gave \$1 million worth of contributions to guarantee \$1 billion worth of government contracts and services, and \$100 million in profits. This would represent a 10,000 percent return on investment, and would account for 2 percent of a company’s annual profit.

³ Also, see Hedrick Smith *The Power Game* and Clawson, Neustadt, and Scott *Money Talks*.

The total potential effect on public policy might be similarly large. In the 2000 election, total campaign spending for federal offices reached \$3 billion. If all of that money received policies worth 100 times the investment, then the potential economic value of campaign contributions might be as much as \$300 billion – approximately equal to all government consumption expenditures and to nearly 3 percent of our national income.

Two diverging views, then, characterize the influence of corporate money in electoral politics. By one account the return on investment in politics is comparable to other investments, and corporate giving is not a substantial societal or economic problem because the amounts are just too small. By another account, firms are able to get a lot for a little. Although not all firms use campaign contributions to increase their profitability, those that do receive lucrative government contracts, tax breaks, and regulatory decisions.

Is there evidence that firms profit substantially and systematically from their campaign contributions to candidates and parties?

To address this question, we examine the stock market valuations of those large corporations that give campaign funds at the time of key legislative and legal decisions to regulate or deregulate campaign finance. We compare these “donor” firms with other large firms that give little or no money to political campaigns and with the overall market to assess whether contributing improves the overall profitability of firms. If firm’s political donations gain valuable government contracts, tax breaks, or favorable other policies, then changes in the rules restricting campaign contributions should alter the profitability of firms and their value on the stock market. In the field of finance, this methodology is generally referred to as an event study.

We focus on the immediate effects of crucial regulatory decisions. Tacitly, we assume that these events involve an element of surprise. Events include key committee decisions or dates of

roll call votes in Congress, dates on which the President announces he will sign a law, important regulatory decisions by the FEC, and Supreme Court decisions. Careful consideration of specific events suggests that the markets could not anticipate many of the key campaign finance decisions considered here. Before regulatory decisions are announced, the markets either had the opposite information or were uncertain about the rules. For example, the BiPartisan Campaign Reform Act eliminated soft party contributions, which totaled \$300 million in 2000, and the Supreme Court's decision in *McConnell v. FEC* to uphold the law was a surprise to many working on the case. It wasn't until the case was settled before it became clear that future soft money contributions were indeed prohibited by federal law. Once regulatory decisions are made, investors can revise their assessments of the future earnings of companies affected by changes in the rules.

Ultimately, then, the markets allow us to assess the consequences of firms' political investments on public policy. Campaign contributions affect government policies, which in turn affect firm profits. If the stock markets react little to campaign finance regulations, then it is an indicator that either campaign contributions have no effect on public policy or that public policies have little effect on firms' profits. However, if campaign finance regulations result in significant changes in the valuations of firms, then there is an indication that campaign finance practices affect public policy in substantial ways. And, the value of the change in the market valuation of the firms is an indicator of the value of public policies bought through campaign contributions.

In performing this analysis we have in mind two competing arguments about the influence of campaign funds. If the rate of return is very high, then we expect that significant changes in campaign finance regulations would increase the stock values of donor firms by several percent. However, if the return on investment is modest, in line with that of other investments, then we expect that the effect on prices will be less than a trace amount.

Event Study Methodology

In this paper, we focus on legal and legislative decisions affecting two sorts of campaign finance practices in the U.S.: (1) direct corporate contributions to candidates, and (2) corporations' unlimited soft money donations to parties. We examine the market's response to a series of critical legal and administrative decisions from the passages of the FECA in 1971 through the Supreme Courts decision to uphold the BCRA in 2002 that determined whether and how much firms could give to politics.

Direct corporate contributions to candidates and parties in federal elections were prohibited in the 1925 Corrupt Practices Act. Over the five years from 1971 to 1976, Congress, the Courts, and administrative agencies rewrote federal law allowing companies to make direct campaign contributions, allowing government contractors in particular to make donations, and allowing firms to raise money widely within their firms. This series of events created a new campaign finance system, one in which Political Action Committees wielded considerable power in Congress. While some of these events, like the writing of the federal laws, unfolded over several months, many of the key legal, legislative, and administrative decisions were immediate and surprising. For example, the Federal Election Commission ruled in November, 1975, that Sun Oil Company's Political Action Committee could raise funds broadly within the firm from managers and employees, a decision that is widely credited with leading to the explosion in the number and activity of corporate political action committees. Decisions like the FEC's SUNPAC ruling are ideal events for the event study methodology. They involve a sudden and surprising change in regulation of direct corporate contributions, and they can be dated precisely.

Regulation of party soft money contributions also involves several critical surprise events, especially decisions by the Supreme Court. Soft money evolved slowly throughout the 1980s, but

accelerated quickly in the 1990s, spurred along by the Court's 1996 ruling in *Colorado Republican Party v. FEC*. Congress and the Court shut the door on soft money in 2002. The passage of the BiPartisan Campaign Reform Act in 2002 shut to door on roughly \$300 million in corporate campaign contributions that were not subject to limits. And, perhaps the most surprising decision in all of the regulatory and legal decisions, the Court upheld the prohibition on soft money in *McConnell v. FEC*.

The legislative, legal, and administrative decisions provide a series of events, many completely unanticipated, that substantially altered the rules governing campaign contributions in the United States and that affected hundreds of millions of dollars worth of corporate contributions.

We can examine the effects of these decisions stock market data and standard event study methodology.⁴ Previous papers by Roberts (1990a, 1990b), Fisman (2001), Jayachandran (2002), and others have found that political events – such as the death of Senator Henry (Scoop) Jackson in 1983 and Senator James Jeffords' party switch in 2001 – can have a noticeable impact on stock prices. Also, event studies have found that legal decisions affecting regulation of industries, such as tobacco, strongly affect the stock returns of the industry in question (Lax and McCubbins, 2004).

The methodology of event studies begins with an assessment of the value of firms relative to the overall stock market using the Capital Asset Pricing Model. The daily rate of return on the investment in any firm is the daily percentage change in a firm's stock price. An ordinary least squares regression of a firm's rate of return on the overall market's rate of return yields of how a stock normally tracks with the market. A surprise event that affects the revenues and profits of a given firm will affect the price of that firm on the market. While an efficient market will quickly adjust to a change in a firm's long-term profitability, there will be a short-term affect on the stock's price, which will appear as a large deviation from the normal trajectory that the stock follows.

⁴ See Schwert (1981) for a description of the method and a survey of papers employing it.

These excess returns measure the effect of the regulatory change on the profitability of the firm, and thus the economic value of the public policy change.

Following the event study literature, we estimate the following equation, a modification of the Capital Asset Pricing Model:

$$R_{it} = \mathbf{a}_i + \mathbf{b}_i M_t + \sum_{j=1}^J \sum_{s=1}^5 \mathbf{g}_{js} D_{ij} I_{st} + \mathbf{e}_{it}$$

where i indexes firms, t indexes dates, j indexes donor status (*e.g.*, large donor, non-donor), R_{it} is the return on firm i 's stock for date t , M_t is the market return for date t , $D_{ij} = 1$ if firm i is a type- j donor and 0 otherwise, and $I_{st} = 1$ if $s = t$ and 0 otherwise. If events 1, 2, 3 and 5 produced “bad news” for a donor, then the corresponding \mathbf{g}_j 's should all be negative and statistically significant; and if event 4 produced “good news”, for large soft money donors, then the corresponding \mathbf{g}_4 should be positive and statistically significant. (Note, $R_{it} = (P_{it} - P_{i,t-1}) / P_{i,t-1}$, where P_{it} is the closing price of firm i 's stock on date t .)

We assembled data on daily stock prices for all Fortune 500 companies from January 1, 1970 through December 12, 2003.⁵ Some of these companies are not publicly traded and others were involved in complicated mergers during the period under study – dropping these cases leaves approximately 450 firms.⁶ To measure the market return we used the CSRP value-weighted return.

We identified a series of key event dates using the Congressional Quarterly Weekly Report and the New York Times. For each legal and administrative decision, we identified the date on which the official decision was issued by the agency or court; we also identified any dates on which the press indicated that a decision was imminent and the likely outcome of that decision. In some cases, the official date of a decision, like the FEC's SunPAC decision, comes weeks after the

⁵ The first date is exactly one year prior to the first of our five events.

⁶ The total number of observations is therefore nearly 325,000.

decision was released to the press. For each legislative decision, we identified the dates of final passage in the House and Senate and the date the president signed the law. We also identified the dates on which the press reported key committee decisions or political agreements were struck.

Finally, we use data from government agencies and from public interest groups, such as Common Cause and the Center for Responsive Politics, to identify which firms were likely affected by the decisions. Before the FEC was created, Common Cause issued a series of reports that extracted the contributions of each firm and individual from the reports filed with the Clerk of the House and Secretary of the Senate. The Federal Election Commission took over this responsibility following the passage of the FECA in 1974. We use these reports to determine which firms had Political Action Committees and which formed them following the Sun PAC decision. We also use the amounts reported to determine which firms were large campaign donors, and which gave only modest or small amounts. The Center for Responsive Politics created a database of soft money donors in the 1990s. We use this to identify firms that gave large amounts of soft money and were therefore most affected by the decisions in 2002 that resulted in the closure of this loophole.⁷

FECA and the Return on PAC Donations

In 1971, Congress repealed a fifty-year old ban on corporate political giving. The Corrupt Practices Acts of 1911 and 1925 prohibited corporations from giving to candidates for federal office and provided that candidates report their donations and expenditures to the Clerk of the House and the Secretary of the Senate. The Federal Election Campaign Act of 1971 allowed corporations and unions to donate directly to candidates for federal office through a separate and

⁷ Firm stock market price data and market data are from CRSP (Center for Research in Security Prices, at the University of Chicago) and Factiva. Soft money donations are from the web site of the Center for Responsive Politics (<http://www.opensecrets.org/softmoney/index.asp>) and the Federal Election Commission.

segregated fund, commonly called a political action committee or PAC. Over the subsequent 5 years, Congress, the Courts, and the administrative agencies of the United States clarified what corporations could and could not do in the realm of campaign finance. While it is debatable as to whether the Progressive-era prohibition on direct corporate giving had much teeth, the system that emerged at the end of 1976 allowed companies to make contributions legally, it provided a comprehensive system for disclosure of campaign contributions, and it limited the amounts that firms could give directly to politicians.

A large number of corporations formed Political Action Committees soon after the laws allowed them to. In 1974 only 89 corporations had political action committees. Their numbers grew to 550 by 1977 and approximately 1500 by 1982. The number of corporate PACs has since ranged from 1600 to 1800. Much of the commentary on the campaign finance system created by the Federal Election Campaign Act has criticized Congress and the Courts for opening the door to corporate political power. Brooks Jackson, for example, describes the system created by the FECA as one of *Honest Graft*.

To measure the value of having a PAC, we examine the effects of the key dates associated with the FECA on the market returns of firms that had a PAC by 1978 or that were engaged in corporate contributing in 1974. We use the list of Fortune 500 firms with PACs in 1978 as a list of firms likely to use or benefit from the new campaign finance system. Because many of these PACs formed after the key legislative and legal decisions, we also considered the list of Fortune 500 firms with PACs as of 1974. Our results are similar with both lists, so we use the 1978 list as it captures, to some degree, the extent to which the firms likely to use this means of political influence can be predicted. Of particular interest are government contractors. These firms are highly dependent on

federal grants and programs, and federal election law deals explicitly with their rights to give. In many ways, these are the cleanest cases to assess the return on investment.

The legal status of Political Action Committees emerged over a five-year span. Congress created this particular mechanism as a way that firms could give legally. But it took further amendments by Congress and legal and administrative rulings to fully establish this mechanism for corporate political giving. We consider the following key events and dates:

- The Federal Election Campaign Act of 1971. This act legalized corporate and union contributions through a separate and segregated fund, and it imposed limits on the size of group and individual donations. Importantly, government contractors were not permitted to contribute to candidates or parties. The Senate passed the Act on August 5, 1971, and the House, on November 30, 1971. President Nixon indicated that he would sign the House version on December 1, 1971 and signed the Act into law on February 7, 1972.
- 1974 Amendments to the Federal Election Campaign Act. The Amendments established the Federal Election Commission to implement the FECA and permitted government contractors to make direct contributions. These amendments appeared to have been stymied in conference, but a deal was announced on October 1, 1974. The House passed the law on October 8, 1974, and the Senate on October 10, 1974. President Ford signed the bill into law on October 15, 1974. These amendments had conflicting affects on contributors. By creating an enforcement agency, the act was clearly aimed at preventing abuse of the new laws; however, the act also allowed government contractors to give money. We view the act as against most corporate donor's interests, except for contractors. Below, we provide a separate analysis of contractors.

- SUNPAC. Sun Oil Corporation asked the Federal Election Commission for an administrative decision concerning whom the corporation could solicit for contributions to its PAC and how overhead could be paid for. The FEC ruling allowed corporations to solicit widely and to share some of the costs of operations. Experts on campaign finance law widely attribute this ruling with the emergence of PACs and the explosion in corporate political giving. The FEC issued its ruling (dated November 24, 1975) on November 18, 1975. The New York Times reports on October 14, 1975 that the Justice Department had made a ruling favoring corporate political giving.
- Buckley v. Valeo. On January 30, 1976, the Supreme Court held unconstitutional involuntary limits on spending and independent expenditures but upheld limits on direct contributions, citing the government's interests in combating "corruption or the appearance of corruption." The decision also struck down the provisions of the FECA creating the Federal Election Commission as a violation of separation of powers. We view Buckley as favorable to corporate donors. By eliminating spending limits, the decision increased demand for campaign contributions. By vacating the Federal Election Commission, the decision shut down the agency for enforcing the new laws.
- 1976 Amendments to the Federal Election Campaign Act. In these amendments, Congress reestablishes the provisions of the FECA not struck by the Courts and reconstitutes the Federal Election Commission. The Senate passed the bill on March 24, 1976. In the House, the main obstacle to passage lay in the Rules committee, which passed a rule favorable to the bill by an 8-7 vote on March 19, 1976, and the floor passed the bill on April 1, 1976. The House-Senate conference was approved April 28, 1976. The House approved the report on May 3, 1976, and President Ford signed the bill into law on May 11, 1976.

Because it reverses the decision in *Buckley*, we view these amendments as unfavorable to business.

These are the key decisions and dates that created the system of Political Action Committees under the Federal Election Campaign Act. How did the markets assess firms most clearly affected by these decisions?

Table 1 presents the excess returns of Fortune 500 firms relative to the market on the days surrounding these key decisions. The table reports the excess average returns for two types of firms – Donors and Non-Donors. Non-donors are those that had no PAC by 1978; Donors are those with a PAC by 1978.⁸ The analysis estimates the change in valuation of the firm over a three-day period – one day before the event to one day after the event.⁹ In the statistical model above, excess returns are estimated by the coefficients measuring the change in the intercept for a firm on the days around a given event, i.e., the β_j 's.¹⁰ We suppress the other coefficients estimated in the model. A coefficient of 1 means that firms experienced a 1 percent increase in their stock prices above what one would expect from their long-run market performance. The final column of the table shows the difference between Donors and Non-Donors excess returns. We performed an F-test to test whether the pair of coefficients for Donors and Non-Donors on a given date were equal. Those coefficients found to be significantly different at the $p = .10$ level are denoted with

⁸ The analysis using firms with PACs in 1974 leads to similar inferences.

⁹ We also estimated the equations for five-day and seven-day windows. The results were the same.

¹⁰ We ran four regressions, one each for the events surrounding the passage of the 1971 law, the passage of the 1974 law, the Sun PAC decision, and Buckley and the passage of the 1976 law. We pooled all of the firms for each event and estimated separate alpha's and beta's for each. We included dummy variables for each event.

an asterisk (*). In no case were the excess returns of Donors and Non-Donors different at the p = .05 level.

| Table 1. Excess Stock Returns of Fortune 500 Firms At Time of Campaign Finance Regulatory Decisions in the 1970s | | | |
|---|--------------------------|-----------------------------------|-------------------|
| EVENT | DONORS ? (SE) | NON- DONORS ? (SE) | DIFFERENCE |
| FECA (1971) | | | |
| House Passes | -0.11 (.11) | 0.06 (.07) | -0.17 |
| Senate Passes | 0.40 (.15)** | 0.41 (.09)** | -0.02 |
| President Signs | -0.24 (.15)* | -0.12 (.09) | -0.12 |
| 1974 Amendments | | | |
| House Passes | 0.17 (.13) | 0.10 (.08) | 0.07 |
| President Signs | -0.16 (.13) | 0.03 (.08) | -0.19 |
| Sun PAC (1975) | | | |
| October 14 | -0.20 (.12)* | -0.12 (.07) | -0.08 |
| November 7 | -0.40 (.13)** | -0.23 (.07)** | -0.18 |
| November 18 | -0.07 (.13) | -0.01 (.07) | -0.06 |
| Buckley v. Valeo (1976) | | | |
| January 19 | -0.04 (.10) | 0.17 (.06)* | - 0.21* |
| 1976 Amendments | | | |
| Senate Passes | -0.15 (.10) | -0.16 (.06)* | -0.01 |
| House Rules Committee | -0.10 (.10) | -0.10 (.06) | 0.00 |
| House Passes | -0.15 (.10) | -0.10 (.06) | -0.05 |
| President Signs | 0.30 (.10)** | 0.10 (.06) | 0.20* |

The results in Table 1 show no evidence of large excess returns accruing to Donors as a result of the legalization of corporate campaign contributions and the creation of the PACs. First, we expect Donor firms to post substantial gains in the stock prices in response to these decisions if

campaign contributions receive excessively high returns on investment. None of the coefficients is in the neighborhood of 1 or 2 percent increases in prices. Typically, the coefficients are in the neighborhood of .1 percent changes. The small magnitude of the excess returns indicates that allowing corporations to set up PACs and make political donations has at best a trace effect on the value of these firms. In fact, the market responded to ten of the thirteen key decisions with *decreases* in the prices of donor firms. The three events that showed increases in the prices of donor firms were the Senate's passage of the 1971 FECA, the House's passage of the 1974 Amendments and the President's announcement of support for the 1976 Amendments. In the first two cases, Non-Donors posted similar gains, suggesting that all Fortune 500 companies did relatively well that day. The declines posted on some dates, such as the Justice Department decision on Sun PAC, exceeded the magnitudes of the coefficients on the two dates showing gains. Overall, Donor firms did slightly worse in the market following key decisions.

Second, comparison of the estimated Excess Returns of Donor firms and Non-Donor firms reveals that the stock values of Donor firms did not improve compared with Non-Donor firms. On eleven of the 13 dates, Non-Donors did better than Donors. When the House Passed the 1974 Amendments the Donors excess returns were seven-hundredths of a percent higher than the returns of Non-Donors, and when the President signed the 1976 Amendments, the Donors returns were two-tenths of a percent higher than non-donors. This last date is by far the best event in the analysis in terms of Donors' excess returns. However, on three other dates – the House's passage of the 1971 law, which opened the door to legalization of corporate giving, the signing of the 1974 Amendments, and the second date of the Sun PAC decision – their losses nearly matched their gains following the signing of the 1976 Amendments.

Donors also did relatively badly following the Buckley decision. It is unclear whether Buckley should be judged as favorable to donors or unfavorable. On the one hand, the decision did hold contribution limits to be constitutional. On the other hand, the Court struck down the FEC, effectively killing the enforcement mechanism of the law, and it set aside spending limits, thereby increasing demand for contributions. The Court could have also vacated the 1971 law, putting corporations back under the 1925 Corrupt Practices Act, which prohibited direct political donations.

To get a better read on how people at the time assessed the case, we read through the New York Times and Wall Street Journal's coverage of this case. We are struck by the lack of coverage and interest in this case. Although much has been written since about the decision, we found only two stories in the Journal and three in the Times. Neither were overly concerned about contribution limits. Rather, the Journal's articles focused on the constitutionality of the FEC and the performance of the FEC enforcing the law, and the Times articles focused on candidates' expenditure limits. The primary papers, then, viewed the Buckley decision as ultimately favorable to corporations, because it struck down restrictions on demand for money and because it eliminated (for the time being) the enforcement agency. After Buckley, Donors' stock prices fell two-tenths of a percent compared to the prices of Non-Donors.

One concern with these estimates is that we may not have identified sufficiently precisely the firms affected by the campaign finance rules. Specifically, it may have been difficult for the markets to anticipate which firms were going to form PACs or hoped to expand their fundraising activities.

Two aspects of these decisions allow us to zero in on particular sorts of firms. First, the administrative decision that is widely credited with spurring the growth of political action

committees concerned one firm in particular – Sun Oil Company. Sunoco sought the FEC’s interpretation of the new law on matters that would affect the amount of money that could be contributed. The FEC’s ruling directly affected Sunoco’s political activity and, thus, the profitability of that firm.

Information about the FEC’s decision was revealed in the press on three key dates. On October 14, 1975, the New York Times reported that a decision was forthcoming and likely favorable to SunPAC. On November 6, 1975, the Department of Justice issued a ruling granting some of Sunoco’s request. And, on November 18, 1975, the FEC issued its ruling. Sunoco’s stock price relative to the market dropped nine-tenths of one percent from October 13 to October 15; it dropped two-tenths of one percent relative to the market from November 5 to November 7, and it rose three tenths of one percent from November 17 to November 19. None of these changes were statistically distinct from the prediction of no effect, and the movement following the first two announcements was decidedly in the wrong direction. As important as the SunPAC decision was in the development of corporate political action, the markets evidently did not see the decision as one likely to affect appreciably the long-term value of the firm.

Second, the 1974 amendments reversed the long-standing prohibition on government contractors giving directly to political campaigns, a prohibition maintained under the 1971 law. The profitability of government contractors depends strongly on federal appropriations and regulations, probably as much as any firms. The potential effects of campaign finance regulations are greatest for these firms.

We estimated the excess returns of government contractors, compared with non-contractors, around the two key dates in the passage of the FECA. We found that the average stock price of government contracts rose three-tenths of a percent more than the average stock price of non-

contractors from the day before the House passed the 1974 amendments to the day after the House approved the legislation. However, the average stock prices of contractors fell two-tenths of one percent after President Ford signed the measure.

The market's response to the SunPAC decision and to the legalization of contributions from government contractors in 1974 was at best uneven. Sun Oil Company's price went up slightly after the FEC issued its SunPAC opinion, but its price fell by as much on reports that the FEC would make a decision favorable to the company. The average price of government contractors fell slightly after the 1974 amendments were signed into law. And for neither event did any decision stimulate a noticeable increase in the stock prices of the firms immediately affected.

These two cases bear out the more general pattern: Investors did not perceive that Political Action Committees would raise the value of firms seeking political influence. One interpretation of this result is that PAC donations do not carry a high rate of return on investment. This might be because contributions do not exact a quid pro quo. Alternatively, these results may reflect the effectiveness of the law. FECA limits a PAC's contribution to a candidate to no more than \$10,000 in a two-year period. That limit may be sufficiently low that firms cannot capitalize on their political donations.

A second possible interpretation of our findings is that the markets may not have foreseen the true value of PACs. Investors may not have appreciated the extent to which corporations would embrace campaign giving, nor may have investors had sufficient knowledge to predict which firms would choose to set up PACs. The passage of FECA moved the US from a situation in which the law forbid corporate donations, making it difficult to accurately identify which firms would be affected directly by these historic decisions and events. The case of Sun Oil Company casts doubt on this explanation, but this interpretation is worth further consideration.

Legislative and legal decisions to prohibit contributions address many of the concerns with the analysis of the events surrounding FECA. In situations where regulations force corporations to give much less or to cease giving it is clear which firms are directly and immediately affected. Here we consider two prominent cases. Congress and the Court to close the soft money loophole in 2002, and California imposed limits on campaign contributions in the late 1980s and early 1990s.

BCRA and the Return on Soft Money Donations

The BiPartisan Campaign Reform Act is the mirror image of the Federal Election Campaign Act in one important respect. The FECA legalized corporate political contributions; the BCRA ended an important form of giving. Throughout the 1980s and 1990s, the Federal Election Commission and the courts permitted corporations to give unlimited amounts of money directly from their treasuries (not through a PAC) to the parties for “state party building activities,” so-called soft party money. Although little used before the 1992 campaigns, soft party money had ballooned to over \$300 million in 2000. Congress responded in 2001 with the BiPartisan Campaign Reform Act, which prohibits soft money donations.

As with political action committees, corporate America did not universally embrace soft money as a business strategy. The Fortune 500 companies include many of the largest soft money donors, as well as a large number of companies that had no PAC or gave little or no soft money. Consider the distribution of soft money. The ten largest soft money donors over the 4-year period 1999-2002 were AT&T (\$6.8 million), Freddie Mac (\$6.4 million), Philip Morris (\$5.3 million), Microsoft (\$4.2 million), SBC Communications (\$3.3 million), Verizon (\$3.1 million), Fannie Mae (\$3.0 million), Pfizer (\$2.9 million), Bristol-Myers Squibb (\$2.8 million), and Anheuser-Busch

(\$2.7 million). On the other side, an impressive list of firms gave no soft money at all, including IBM, American Electric Power, Intel, ALCOA, Whirlpool, and Consolidated Edison.

We distinguish four clusters of firms based on their total soft money donations. *Non-Donors* are those who gave \$10,000 or less from 1997 to 2000, *Modest Donors* those who gave between \$10,000 and \$250,000; and *Large Donors* those who gave at least \$250,000. A handful of firms gave at least \$1 million over the four years from 1997 to 2000. The first group contains 216 firms; the second group contains 142 firms, with an average contribution of about \$90,000; and the third group contains 142 firms, with an average contribution of \$1,080,000. There are 50 *Million Dollar Donors*.

Contrasting the stock prices of large soft money donors and non-donors reveals the extent to which unregulated corporate donations affect a firm's bottom line. BCRA eliminated soft money contributions and the stream of profit that those donations underwrote. If the returns on investment are more modest, the effect on a company's stock price would be negligible – in the range of one one-hundredth of one percent. If the returns are exceptionally large and the cost of soft money to government and society might be substantial, the effect of banning soft money would be to lower the stock value of these firms by about 1 to 5 percent.

One important prerequisite for conducting an event study is the ability to determine the date of an event that releases new information into the market. We are especially fortunate in this regard because we know *precisely* the date of the Supreme Court's decision on BCRA: December 10, 2003. Moreover, because the outcome was uncertain until the very moment the court revealed its decision, new information was clearly released to the market that day. While it is difficult to know exactly how much of a "surprise" the decision was, the fact that almost no observers were willing to make predictions suggests that they believed the court was about as likely to strike down

the BCRA as it was to uphold it.¹¹ An example of the tentative commentary offered by campaign finance law experts is the following, by Professor Michael C. Dorf of the Columbia University Law School: “The four-hour oral argument in *McConnell* indicated, above all, that the Justices remain deeply divided over how to approach campaign finance regulation... It was not clear from the lengthy oral argument which of these views will prevail. Indeed, it was not even clear what legal standard would be used to judge the challenged provisions of BCRA.”¹² The day after the decision, campaign finance expert Thomas Mann said: “Yesterday, [the Supreme Court reached] another 5:4 decision that surprised many, although, certainly, not all members of this panel, in the reach and clarity of its findings on the Bipartisan Campaign Reform Act.”¹³ Other pieces of evidence support this view. The final vote on BCRA’s soft money provisions was as close as possible, 5 to 4. At the oral arguments in September, Justice Rehnquist, thought to be pivotal on this matter, subjected the defense to hostile lines of questioning, which signaled his likely vote against upholding key provisions of the Act.¹⁴ And many observers find that Justice O’Connor, another pivotal justice, is “even more inscrutable than usual” on campaign finance questions.^{15,16}

¹¹ As consultants on this case (Snyder on the side opposed to the BCRA and Ansolabehere on the side in support of it), two of the authors had detailed knowledge of the proceedings and followed the litigation closely. Both thought the plaintiffs were more likely to prevail.

¹² Quoted from an article on the CNN web site, September 19, 2003, “The Supreme Court’s campaign finance reform argument.” The article was found at <http://images.cnn.com/2003/LAW/09/19/findlaw.analysis.dorf.campaign.finance/>.

¹³ Brookings Briefing, “Supreme Court Rules on Campaign Finance Case: The Legal and Political Impact of *McConnell v. FEC*,” December 11, 2003.

¹⁴ See, for example, the *Washington Post* article on Aug 31, 2003 by Charles Lane, “Rehnquist May Be Key for Campaign Finance Chief Justice’s Past Votes Leave Outcome of Challenges to McCain-Feingold Law Uncertain.”

¹⁵ Quote by Professor Roy Schotland of the Georgetown University Law Center, from *Washington Post* article on Aug 31, 2003 by Charles Lane, “Rehnquist May Be Key for Campaign Finance Chief Justice’s Past Votes Leave Outcome of Challenges to McCain-Feingold Law Uncertain.”

¹⁶ Another interesting piece of evidence is the BCRA “market” run for an undergraduate course on the Supreme Court at the University of North Carolina at Chapel Hill. About 130 students in the class traded in the market, rewarded with grades. The betting was on whether or not the electioneering communication provisions would be upheld. The last prices at which trades took place, posted on December 8, were \$.55 for the position that the provisions would be upheld and \$.55 for the position that the provisions would be struck down, on bets that paid \$1.00 – this implies beliefs very close to 50-50. See <http://www.unc.edu/courses/2003fall/poli/079/001/market/>.

In addition to the Supreme Court's final decision, there were four other events surrounding BCRA that might have surprised the market. Thus, we have five events in all.

- The U.S. House passed the bill on February 14, 2002.
- The Senate passed it on March 20, 2002.
- The president signed the bill into law on March 27, 2002.
- The Supreme Court heard oral argument on September 8, 2003 (at which, Justice Rehnquist's questioning was viewed as a signal that he would side with plaintiffs)
- The Supreme Court issued its ruling on December 10, 2003.¹⁷

Were soft money donors hurt by the Supreme Court's decision to uphold BCRA? The short answer is: Evidently not.

At the end of the trading day on December 10, the firms that gave soft money had had a better day on Wall Street than firms that gave no soft money. The value of the broad market index dropped by about .5% on December 10th. The stock prices of *Large Donors* dropped by .3% that day, the prices of *Moderate Donors* dropped by .6%, and the prices of the *Non-Donors* lost .8% of their value that day. The *Million Dollar Donors* – such as AT&T, Microsoft, and Philip Morris – saw their stocks drop only by .1%. This is exactly the *reverse* of our expectations.

The event study analysis confirms this conclusion. Table 2 shows the estimated effect of the events on firms' stock market valuations (i.e., the β 's) for the three types of donor firms. A value of 1 means that a firm's price rose 1 percent more than one would expect given the performance of the market that day. The events marking the passage of BCRA and the Court's

¹⁷ Hertzell, Martin, and Meschke (2002) studied the impact of the first three of these events on the stock returns of 40 major soft-money donors, and found no significant effects. These were probably less surprising than the last event. The vote on final passage in the House was 240-189, and the vote in the Senate was 60-40; moreover, other events that occurred during consideration of the bill may have been equally important, such as the approval of a rule by the Rules Committee on February 8, the adoption of the rule by the full House on February 13, and the approval of the Shays-Meehan substitute amendment over two competitors on February 13. We analyze all five events for completeness.

decision to uphold the law had no statistically discernable effect on the valuation of firms that gave large amounts of soft money; i.e., their β 's are statistically indistinguishable from 0. What is more, the effects of the events on firms that gave no soft money and firms that gave modest amounts of soft money were not statistically different from firms that gave large amounts of soft money. Specifically, the F-statistics at the foot of the table reveal, in the first case, that the β 's for the different types of firms are not significantly different from each other and, in the second case, that we cannot reject the hypothesis that the β 's are 0. That is, the data are consistent with the hypothesis that all of the events had zero effect on the valuations of all types of firms. If anything, the court's decision appears to have *helped* the *Large Donors*, and hurt the *Non-Donors* – again, completely contrary to expectations.

| Table 2: Excess Stock Returns of Fortune 500 Firms Around the Time of Key BCRA Decisions | | | | | |
|--|-----------------|------------------|--------------------|---------------------------|---------------------------|
| | House Passes | Senate Passes | President Signs | Supreme Court Argument | Supreme Court Decision |
| Large Donors | -.19 (.23) | .32 (.23) | .07 (.23) | -.11 (.23) | .13 (.23) |
| Moderate Donors | -.08 (.23) | .31 (.23) | .46* (.23) | -.17 (.24) | -.18 (.24) |
| Non-Donors | -.21 (.19) | .24 (.19) | .19 (.19) | -.31 (.20) | -.42* (.20) |
| F-statistic 1 | 0.11 | 0.05 | 0.81 | 0.24 | 1.69 |
| F-statistic 2 | 0.69 | 1.84 | 1.78 | 1.14 | 1.89 |
| Standard errors in parentheses * = significant at the .05 level F-statistic 1 is for testing $H_0: \beta_{1s} = \beta_{2s} = \beta_{3s}$ (i.e., the effect of event s is the same for all 3 types of firms) F-statistic 2 is for testing $H_0: \beta_{1s} = \beta_{2s} = \beta_{3s} = 0$ (i.e., the effect of event s is zero for all 3 types of firms) | | | | | |

In short, the Bipartisan Campaign Reform Act did not affect the stock prices of corporations that gave considerable amounts of soft money.

There are two possible interpretations to these findings. One possibility is that BCRA will have little effect on behavior. Investors might have expected that firms will find a way around the new law. Indeed, the FEC now faces new challenges in dealing with committees known as 527's and 501(c)4's.¹⁸ We believe, however, that the soft money ban has teeth and will eliminate the sizable corporate donations that were the hallmark of soft money in the 1990s. Indeed, many companies announced shortly after the Court's decision in *McConnell v. FEC* that they would not set up 527 accounts.

A second, more profound possibility is that the premise of most of the discourse over campaign finance is simply wrong. Firms may not care much about soft money because they do not profit much from soft money donations. As noted in the calculations above, even if firms treated their soft-money donations as investments, and these investments produced a fairly decent rate of return, the total effect on profits would be minuscule and virtually undetectable in stock market prices.

Moreover, very few firms gave large amounts of soft money. Anyone who has followed this issue over the past decade can probably name some of the large soft money donors – such as R.J. Reynolds, Philip Morris, and AT&T. But they are the exceptions. Only one in 25 Fortune 500 companies gave in excess of \$1 million of soft money in the 2000 election, while 40% gave no soft money at all, and half gave \$10,000 or less.

The lack of apparent financial losses associated with the end of soft money indicates at the very least that the campaign contributions do not exact exceedingly large returns on investment. Thousand-fold returns, as suggested by Senate hearings into the abuse of soft money and other anecdotes, are not borne out in the behavior of investors.

¹⁸ These are the tax code designations for political advocacy groups.

Regulation and Deregulation in California

The state of California swung from an unregulated campaign finance system to one with fairly low contribution limits and back to an unregulated system not once but twice over the last fifteen years. Beginning in 1974, California provided for public disclosure of campaign contributions, but imposed no limit on the amounts donated. In the 1980s and 1990s, the people of California twice approved initiatives that limited campaign donations, and, twice, the Courts struck down contribution limits. California, then, seesawed between unregulated and regulated donations throughout this period.

The key dates behind these decisions were as follows:

- June 8, 1988. The voters of California approve two measures regulating campaign finances – Propositions 68 and 73. Both propositions pass, but Proposition 73, which imposes contribution limits on PACs of \$2,500 per election to a candidate, receives more of the vote and becomes law.
- September 25, 1990. Federal District Judge Lawrence K. Karlton rules Proposition 73's contribution limits unconstitutional. The decision "spur[s] a frenzy of fund-raising in the closing days of the 1990 governor's race." The U.S. Court of Appeals in San Francisco upholds the District Court's ruling in February, 1992.
- November 5, 1996. Voters approve Proposition 208, which imposes \$250 contribution limits.
- January 6, 1998. Federal District Judge Karlton invalidates Proposition 208. The U.S. Court of Appeals later upheld this decision and refused to enforce Proposition 208.

The most active firms in state elections in the late 1980s and early 1990s were California's banks, insurance companies, utilities, and agricultural corporations. Because of the structure of the financial and energy industries these firms, such as Wells Fargo and Pacific Gas and Electric, operated almost entirely within the state. While none of California's agricultural interests were publicly traded Fortune 500 companies in 1988, several of the financial and utility firms were. How did the changes in state laws affect the stock market's assessment of the value of these firms?

We found more movement in the stock prices of the California companies associated with the seesaw of campaign contribution limits, but the effects were not uniformly in the expected direction. When Proposition 73 passed, the stock values of California utilities and banks rose nine-hundredths of one percent; other Fortune 500 companies in these industries rose by the same amount. When the District Court struck down Proposition 73, the stock prices of California utilities and banks *fell* by 1 percent, a significant different from non-California firms in these industries. But, one would expect their prices to rise if unlimited contributions benefited the firms. When the voters passed Proposition 208, the stock prices of California's utilities and banks fell by one-half of one percent compared to similar firms, a statistically significant change. However, when the District Court vacated that law, the stock prices of California's utilities and banks *fell*, this time by four-tenths of one percent.

Overall, the observed changes in prices were at best inconsistent. Only one of the observed changes was noticeable and in the expected direction. On one date there was absolutely no difference between the California firms and non-California firms, and on two dates the movement was in the wrong direction.

Conclusions

Throughout the 20th Century, campaign finance laws have been revised frequently to deal with the emergence of new ways of raising and spending campaign money and to address concerns about the political influence of donors. We have examined two significant changes in the laws governing the legality of corporate political contributions to federal candidates – FECA and BCRA – as well as the imposition and elimination of contribution limits in California. These rulings appear to have had no noticeable effect on the stock prices of firms that were directly affected.

This conclusion raises a problem with a basic premise behind much campaign finance regulation in the United States. Is there a high social cost to corporate political giving? Probably not. Corporate political donations would amount to a series problem of corruption if either (1) they gave a large amount of money and received a reasonable return, or (2) they gave a modest amount of money and received an excessively large return. Corporations, in fact, give relatively little to campaigns, compared to their other investment and production activities. Corporate federal PAC contributions came to only \$92 million in 1999 and 2000, and corporate soft money amounted to about \$350 million in the 2000 election cycle. In order for corporations' PAC contributions and soft money donations to extract highly valuable public policies, the return must be worth many thousands of times the initial investment. Our analysis of stock prices suggests that the return on investment is not excessively high. In one fell swoop the Congress and the Court declared the lion's share of corporate political giving illegal. The stock prices of the firms that gave such money were unchanged. The total value of the public policies bought with such donations, then, is quite small.

This is not to say that the government has no interest in preventing a quid pro quo between donors and politicians. There is a governmental concern in regulating corruption. Racketeering and

bribery laws seek to limit such undue influence. The Federal Election Campaign Act, we believe, should be viewed in a similar light. FECA, BCRA, and the Court's rulings in *Buckley v. Valeo* and *McConnell v. FEC* protect the principle-agency relationship between voters and their representative. Current laws create a further barrier against organized interest groups interference in that relationship. That concern may be most appropriately handled through stricter enforcement of laws that prohibit bribery (Lowenstein, forthcoming), but, as Brennan argued in *Buckley*, campaign finance deserves a somewhat higher hurdle than more traditional bribery rules. If we are to rely on private financing of political campaigns, then the opportunity for inappropriate contributions is somewhat greater, and there needs to be stronger protection against interest group influence. But, when we step back from the ties between specific donors and specific representatives and look at the cumulative affect of such relationships, it appears that corporate campaign contributions do not affect the profitability of those firms that give.

This conclusion, of course, raises all manner of questions about corporate political behavior. Why do any corporations bother to set up PACs and give to campaigns at all? Why is there the perception that corporate money is very powerful? Why do firms oppose efforts to regulate campaign finance? These questions deserve careful further consideration. At the very least, our analysis suggests that there is little empirical foundation for the common assumption that firms give in order to obtain highly valuable tax benefits, sizable subsidies and contracts, or favorable regulatory treatment. The total value of such benefits appears to be quite small, so small that the stock markets registered no response to the political reforms embodied in FECA and BCRA. If we are right, then we must rethink the legal and public philosophy behind the regulation of corporate campaign contributions.

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