

Sex, Power and Money:
Market Reaction to a Sudden Change in Political Leadership

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1. Introduction

One of the most colorful episodes in American political history began with titillating rumors of a presidential sex scandal and culminated almost a year later in December 1988 with both the impeachment of President Clinton and the resignation of the Speaker-designate, Robert Livingston (R-LA), from the House of Representatives. The impeachment by the House and the subsequent failure to convict in the Senate were ponderous processes that dominated the national news, but the actual votes in each chamber of Congress were unsurprising. In contrast, the dramatic announcement by Representative Livingston stunned even his closest Republican lieutenants in the House. Consequently, this event — and the near simultaneous elevation of the relatively unknown Representative Dennis Hastert (R-IL) to the House Speakership, — provides a natural experiment for valuing firms' political activities.

A handful of similar event studies demonstrate that financial markets react to news of changes in the political connections of a specific firm or industry (Roberts 1990a, Hillman, et al. 1999, and Gely and Zardkjoohi 2001);¹ however, in contrast to these, we also test whether such changes in share prices are associated with the intensity of firms' contributions and lobbying activity. This makes our study most similar to Fisman (2001), who demonstrates that rumors

¹A larger and longer standing scholarly literature exploits the response of financial markets to characterize the substantive importance of economic regulations (e.g., Schwert 1981), national election results (e.g., Roberts 1990b and Herron 2000), Congressional procedures (Gilligan and Krehbiel 1988), and campaign finance reform (Ansolabehere, et al. 2004).

about the health of Indonesian president, Suharto, were not only associated with stock prices of politically connected Indonesian firms, but that the variation in these prices was in accord with the extent of political ties to the dictator. However, while we find that stock prices of client firms are affected in a predictable way by the changing fortunes of Hastert and Livingston, there is little evidence of differential effect associated with the amount of money devoted to contributions or lobbying.

Our results suggest that contributions and lobbying are more symptomatic of political ties and less the currency of the market for political favors in the U.S. Congress. This finding is consistent with a spate of recent empirical studies (Milyo et al. 2000, Ansolabehere et al. 2003), but nevertheless, it is also very much at odds with the conventional wisdom that interest group contributions and lobbying are the functional equivalent of bribery (e.g., Grossman and Helpmann 1994, Ackerman and Ayres 2002). Therefore, this study provides novel evidence on the limited efficacy of firms' political contributions and lobbying for generating economic rents by influencing policy-makers, which should be of great interest to policy-makers, opinion-makers and academics alike.

2. Money and Politics

In popular culture, politicians are often portrayed as “bought and paid for” by big business; indeed, the perennial and quixotic drive for “real” campaign finance reform takes its impetus from the widespread notion that legislators are captured by moneyed interests. There is likewise a well-established economic literature that assumes that political contributions and lobbying are important tools for rent-seeking (eg., Grossman and Helpmann 1994 and Ackerman and Ayres 2002). And while there surely exist polities for which such claims would be accurate,

the role of money in American politics, at the federal level at least, has long been highly constrained by both law and public opinion. In fact, scholars of American politics have long marveled at the disconnect between conventional wisdom and the lessons of academic research on campaign finance (Sorauf 1992, Levitt 1995, and Milyo 1997c and 1998). But do financial markets share the more cynical view of American politics? We exploit the recent occurrence of an unexpected change in the leadership of the U.S. House — the sudden resignation of Speaker-designate Robert Livingston (R-LA), and the arguably surprising choice for his replacement, Representative Dennis Hastert (R-IL) --- in order to test whether the stock prices of “client firms” react in accordance with the conventional understanding of American politics.

Political scientists and economists alike have long attempted to discern the extent to which legislators are agents of their financial backers. Despite several decades of research, there is in fact a dearth of systematic evidence to support the popular wisdom that campaign contributions are the functional equivalent of bribes (Milyo, et al. 2000, and Ansolabehere et al 2003). Instead, campaign contributions are better understood as payments for access to legislators (Langbein 1986, Austin-Smith 1987, and Wright 1990), or support for the reelection of friendly legislators (Bronars and Lott 1998, and Levitt 1998). Even so, it is lobbying activities, not campaign contributions, that appear to be the most important source of political influence; corporate interests devote far more resources to lobbying members of Congress than they do to political contributions, even during the regime of unregulated “soft money” contributions to political parties (Milyo, et al. 2000 and Ansolabehere et al. 2002).

Legislation is the product of collective effort; this, as well as the absence of an explicit contracting mechanism, works to hinder the operation of a “market for political favors.” In addition, the legislative process in the U.S. House is governed by numerous procedural rules that

empower various gate-keepers and agenda setters; chief among these are the committee chairmen and the Speaker (Shepsle 1979, and Weingast and Marshall 1988). Consequently, most attempts to measure political influence examine the fund-raising prowess of key committee members (Grier and Munger 1991, Milyo 1997b, Ansolabehere and Snyder 1999 and 2000). And while it is true that legislators in positions of authority raise more campaign money than their peers, social scientists have had difficulty finding convincing evidence of the existence of any quid pro quo.

The primary reason for the ineffectiveness of campaign contributions as bribes is that the marginal value of contributions to federal candidates is quite low. There are three reasons for this: 1) there is a great deal of “uninterested” money that flows to candidates (Milyo 1998 and Ansolabehere, et al. 2003), 2) even large changes in candidates’ campaign spending have negligible effects on electoral outcomes (Levitt 1994, Milyo and Groseclose 1999, and Milyo 1997b, 1998 and 2001), and 3) federal law severely restricts the size and sources of campaign contributions.

It is a common misperception that corporations may contribute money directly to candidates, but corporate contributions have been illegal since the Tilman Act of 1907. Nevertheless, there are two conduits by which money associated with a corporate interest may flow to federal candidates. First, firms may sponsor political action committees. There are approximately 1,500 corporate PACs active at the federal level, although the top 100 of these account for over half of all corporate PAC contributions. Corporations may pay for the operating expenses of a “connected” PAC, but such PACs can then solicit funds only from individuals associated with the corporate sponsor; consequently, all corporate PAC contributions

to candidates originate from individual contributions.² During the time period under consideration, federal law prohibited individual contributions greater than \$5,000 to any single federal PAC, and limited PACs to contributions of no more than \$10,000 per election cycle to any single federal candidate.³ The second conduit for “interested money” is individual contributions by firm employees, although such contributions were limited to \$2,000 per electoral cycle.⁴ However, it is not uncommon in practice for several PAC or individual contributions to be bundled together and delivered in a manner (e.g., by a lobbyist) that makes it clear that there is a corporate interest behind them.

Of course, the late 1990's was also a period of increasing unregulated “soft money” contributions to political parties. Because parties could use such funds in ways which could be considered close substitutes for campaign contributions to candidates, soft money provided a means for special interest to circumvent limits on direct campaign contributions. In this sense, soft money contributions would seem the most likely vehicle for firms to buy influence. However, Ansolabeher and Snyder (200x) report that the McCain-Feingold reform which outlawed soft money contributions to political parties had no impact on the share prices of firms’ that had a history of making large soft money contributions. Consequently, even unregulated soft money was unlikely to have been an effective means of rent-seeking.

² Most corporate and union PACs are connected PACs; an unconnected PAC may solicit funds from any individual or other political committee, but must also pay for its own operating expenses.

³A PAC may contribute only \$5,000 per election (primary and general), but the candidate need not be opposed in either. Consequently, the federal limit is effectively doubled.

⁴Again, an individual may contribute only \$1,000 per election (primary and general).

To be fair, there is also a plethora of evidence that is consistent with the conventional wisdom on the role of money in American politics. For example, firms in highly regulated industries are more likely to form PACs (Grier, et al 1994), incumbents and legislative leaders raise a greater proportion of their campaign funds from PACs (Ansolabehere and Snyder 1999 and 2000), and the timing of contributions is coincident with important legislative events (Stratmann 1995 and 1998). In addition, there is substantial evidence that interest groups and legislators are engaged in long-term relationships; among the most important determinants of incumbent fund-raising prowess is the likelihood that a legislator will remain in office (Snyder 1990 and 1992, Romer and Snyder 1994, and Milyo 1997a and 2001) or the legislators' reputation for policy consistency (Kroszner and Stratman 2000). Consequently, repeated interaction between legislators and interest groups may result in the emergence of implicit contracts to for non-simultaneous exchanges contributions for legislative favors. To the extent this is true, evidence that contributions influence policy will not be manifest in traditional studies of the effects of campaign contributions on contemporaneous roll call votes. For this reason, perhaps the best evidence that there is a tangible return to firms' from PAC contributions is found in a study by Brian Roberts (1990a).

Roberts examined the stock market reaction to the unexpected death of Senator Scoop Jackson (D-WA), who was at the time the ranking minority member of the Senate Armed Services Committee. Roberts found a decrease of about 2% in the stock prices of firms based in Washington state and/or providing political action committee contributions to Jackson; firms similarly associated with Jackson's likely successor, Senator Sam Nunn (D-GA), realized an

increase of about 1% in their stock prices.⁵ While this study establishes some value to firms that is associate with PAC contributions, Roberts does not test whether firms whose PACs make larger contributions are disproportionately affected by this event. In contrast, Fisman (2001) relates the share prices of Indonesian firms to an index of firms' connectedness to the Suharto regime. However, because political connectedness is measured essentially by the extent of overlapping kinship relationships, Fisman's study is uninformative about the value of domestic political activities undertaken by American firms.

3. The Event

In the fall of 1998, House Republicans were pursuing the impeachment of President William Jefferson Clinton for lying under oath and obstruction of justice. That these charges stemmed from the president's misleading testimony in a controversial sexual discrimination complaint and his subsequent attempts to deny an "improper" relationship with a former White House intern, enraged both partisan defenders, who saw the process as little more than a Republican power grab, and social liberals, who argued that extramarital sex should be a private matter and that lying about sex did not rise to the level of an impeachable offense. For their part, social conservatives were likewise in high dudgeon at what they perceived to be the most egregious manifestation of Clinton's moral shortcomings, as well as the hypocritical posturing of

⁵Despite Scoop Jackson's moniker ("the Senator from Boeing"), there was a slight *increase* (albeit insignificant) in Boeing's stock price after Jackson's death. However, the interpretation of these estimates is complicated by the fact that just one trading day prior to the event under study, a Boeing plane operated by Korean Air was shot down by Soviet fighters over the Sea of Japan. For this reason, it is possible that the effects identified by Roberts understate the true impact of Scoop Jackson's passing on firms' share prices.

his political allies; compromise would not be in the offing.

The bitter political struggle that played out daily in the media alienated some voters, many of whom apparently attributed less blame to the telegenic Clinton than to his Republican inquisitors. In addition, First Lady Hilary Rodham Clinton's decision to stand by her man in opposition to what she had previously charged was a "vast right wing conspiracy" further swayed public opinion against the impeachment process. As a consequence, House Republicans suffered a disappointing performance in the midterm elections of 1998; this was followed in short order by the retirement of the much embattled Speaker, Newt Gingrich (R-GA), and the selection by the Republican caucus of Robert Livingston (R-LA) to be the next Speaker of the House.

This transition was not entirely unexpected; indeed, press reports noted that Gingrich had suggested that Livingston might become the next Speaker as early as a year prior (Seeyle 1998). However, no one could have foreseen what was to occur just a few weeks later. In mid-December, the notorious pornographer, Larry Flynt, who was offering \$1 million to anyone with compromising information on Republican party leaders, was set to expose what he termed "Republican hypocrisy." On the evening of Thursday December 17th, in a pre-emptive move, Speaker-designate Livingston told the House Republican caucus that he had been unfaithful to his wife "on occasion." After this admission, Livingston became defiant and, to the cheers of his colleagues, promised not to let anyone deter him from his duty as the next Speaker of the House. (Alpert and Walsh 1998, and Alpert 1998) However, on that Saturday morning, December 19th, Livingston took to the House floor and in a quavering voice, announced his resignation from the House. Members of both parties were shocked by the news; even the second-ranking Republican in the House, Tom Delay (R-TX), a.k.a. "The Hammer," held his head in his hands

and wept (Kaiser 1998).

The Republican party was in disarray, and only one day away from an historic impeachment vote. But within hours of Livingston's resignation, Dennis Hastert (R-IL) had secured his party's support for the Speakership (Walsh 1998). The New York Times described Hastert as being propelled "in a flash from obscurity..." (Stevenson 1998); however, the six-term congressman was the fourth ranking Republican in the House, and in November had been urged by many in his party to challenge Representative Dick Armey (R-TX) for the position of majority leader. But Hastert had previously promised Armey that he would not compete and he stayed loyal to his vow (Connolly 1998). Hastert's reputation for integrity and party loyalty served him well in December, as he was the clear and immediate favorite among Republicans to take over the Speakership.

On Sunday, December 20th, as was expected, the President was impeached on two counts pertaining to lying under oath. Consequently, the transition of power in the House is inextricably linked to the impeachment of President Clinton. However, most observers expected the House to vote to impeach, but they agreed that Clinton would not be convicted in the Senate (cite), so there was no strong expectation that there would be an additional transfer of power. Further, there is no reason to believe that the set of client firms associated with Livingston and Hastert would be affected greatly by the remote chance of a future transfer of power to Vice-President Gore.

For these reasons, the events occurring on the weekend of December 19-20, 1998 provide a natural experiment for testing the importance of firms ties to legislative power brokers. Contemporaneous new reports (cited above) confirm that Livingston's resignation was not anticipated before it occurred that Saturday morning, and Hastert's promotion was a foregone

conclusion by Sunday. Consequently, we compare the changes in client firms' share prices from that Friday to the following Monday. However, because news reports of Livingston's marital infidelity broke Friday morning, we also conduct our event study for the period starting Thursday and ending the next Tuesday.

4. Sources of Data and Definitions

All campaign contribution and lobbying data are from the Center for Responsive Politics (CRP). Data on stock returns are from the Center for Research on Security Prices (CRSP). We define "client firms" of Livingston and Hastert as those firms with headquarters in either Louisiana or Illinois, respectively, or with associated PAC or employee contributions (HARD MONEY) to either legislator during the 1998 election cycle. These definitions produce 134 Livingston client firms and 271 Hastert client firms.

CRP examines the federal disclosure information on individual contributions and assigns these contributions to a corporate interest whenever possible. CRP also counts contributions from all other individuals at the same address, so this variable is subject to some double counting in the case of working couples. Because our HARD MONEY variable is the sum of contributions to either Livingston or Hastert from a corporate PAC or individuals associated with a corporation, this variable should be considered an upper bound estimate of the flow of money from corporate interests to either politician. SOFT MONEY is the sum of all unregulated contributions to parties made by a corporation or individuals associated with a corporation (including co-resident family members or employers or managers). These contributions cannot be tied to either Livingston or Hastert, but they are a good indication of which firms are politically active.

As noted above, several studies suggest that the most important tool of political influence is lobbying. The Federal Lobbying Disclose Act of 1996 requires firms that spend more than \$20,000 in any quarter on lobbying activity to disclose their total lobbying expenses. Firms are required to count the value of in-house lobbying, but it is doubtful whether every communication by an executive to government officials is actually counted as lobbying. Therefore, our LOBBY variable represent an underestimate of the lobbying activities of firms.

5. Empirical Methods and Results

Our main empirical test examines how the market prices of Livingston and Hastert client firms reacted to the change in House leadership. In addition, we run some cross-sectional tests to see if the type or amount of money that a firm contributes has an impact on the stock market's response to the leadership change. In addition to hard money contributions, we examine soft money contributions firms made to the Republican (and Democratic) party as well as the money firms spend on lobbying efforts.

Table 1 provides some descriptive statistics for our sample. Perhaps the most important observation to make about these numbers is that the money firms spend on lobbying efforts dwarfs the amount that they donate to candidates through hard money or to parties in the form of soft money.

	Livingston Clients	Hastert Clients
No. of firms	134	271
% of firms		
Hard money	31.7%	76.9%
Soft money	29.5%	47.8%
Republican soft money	29.2%	47.0%
Lobbying spending	36.9%	66.4%
Any type	41.0%	78.4%
Mean Contributions (dollars)		
PAC	3,349	3,707
Soft	305,381	419,524
Republican soft money	220,553	291,742
Lobbying spending	3,323,553	4,304,549

Because soft money and lobbying spending cannot be traced directly to a particular political figure, we do not use these figures in identifying a firm as being a client of either Hastert or Livingston. Rather, we use this type of spending as an indicator of a firm’s political activity. Later, we run cross-sectional regressions to determine whether the level or type of political spending by a client firm is associated with the firm’s stock price reaction to the change in leadership.

We use an event study methodology to assess the impact of the leadership change on client-firm stock prices. This approach is widely used in the economics and finance literature to examine the impact on stock prices of a wide variety of “events” ranging from corporate

decisions such as changes in dividend payments or major acquisitions, to external events such as natural disasters or changes in the opinions of professional security analysts.

In event studies, it is important that the “event” being studied has a well-defined beginning and end and is largely unanticipated by the stock market. This requirement often makes it difficult to study the impact of political events on the values of publicly traded firms because election outcomes and legislative outcomes occur over an extended period of time and because at the time of a final vote, the outcome is not usually in doubt. In the present context, press reports suggest that Livingston’s resignation and Hastert’s subsequent election as Speaker were both unexpected events. Because the leadership change took place over a single weekend, we measure the price change of client firms from the market’s close on Friday, December 18 to the closing price on Monday, December 21. In event time, Monday is day zero. However, given that Livingston disclosed his extramarital affair to House colleagues on the previous Thursday, we also look at the stock market reaction over a slightly longer event window, from event day -2 to event day +2.

To measure the leadership change’s impact on client firm stock prices we calculate an abnormal return for each client firm and average the abnormal returns across firms. Our data source is the Center for Research on Security Prices (CRSP). The abnormal return for a firm equals the actual return on a particular day minus the expected return that day. For event windows longer than one day, the cumulative abnormal return equals the sum of the abnormal returns on each event day. Calculating an abnormal return clearly requires a model for estimating expected returns, and the finance literature offers several candidate models. In most cases, when the event window is very short, the choice of a model for expected returns has a small effect on the final results.

We estimate abnormal returns using two different approaches. The first approach simply subtracts the “market return” from the actual return earned by a given stock on a particular day:

$$AR_{it} = R_{it} - R_{mt} \quad \text{Equation 1}$$

In Equation 1, AR_{it} is the abnormal return for firm i on day t , R_{it} is the actual return for firm i on day t , and R_{mt} is the actual return for a market index on day t . We use the change in the CRSP value-weighted index to calculate the return on the overall market. A disadvantage of using Equation 1 is that it assumes that all stocks are equally sensitive to market movements, or stated another way, that all stocks are equally risky. Therefore, as an alternative, we measure abnormal returns as follows:

$$AR_{it} = R_{it} - \beta_i R_{mt} \quad \text{Equation 2}$$

The coefficient β_i is the firm’s beta coefficient which indicates the stock’s sensitivity to market movements. To calculate an abnormal return using Equation 2, we must first estimate the beta coefficient for each client firm. We estimate firm betas by estimating an OLS regression with the firm’s stock return as the dependent variable and the market index return as the independent variable. We estimate this regression over a pre-event period from day -200 to -50.

Table 2 shows our results for Livingston client firms. On event day 0, Livingston client firms experience an abnormal return of slightly less than -1.0% which is statistically significant. The results are essentially the same whether we estimate abnormal returns using Equation 1 or 2.

Over the slightly longer event window, the results confirm a drop in value for Livingston client firm. These firms lose roughly 3% of their values in the five trading days surrounding Livingston’s resignation, suggesting that their connections to Livingston were valuable to shareholders.

Table 2 – Abnormal Returns for Livingston Client Firms				
Event Window	Equation (1)	t-stat	Equation 2	t-stat
Day 0	-0.009	-4.06	-0.007	-3.11
Day -2 to +2	-0.036	-7.28	-0.027	-5.64

Table 3 report findings for Hastert client firms. We might expect that Hastert’s unexpected election as House Speaker would increase the values of his client firms, but Table 3 indicates that we find no such evidence. On event day 0, Equations 1 and 2 both indicate that Hastert client firms earned abnormal returns that were statistically indistinguishable from zero. Over the five-day event window, there is some evidence of a counterintuitive negative abnormal return. However, this result is significant only when we use Equation 1 to estimate abnormal returns. For reasons stated above, Equation 2 allows risk to vary across firms, and over time the importance of this risk adjustment will increase. Equation 2 results for the five-day window suggest no significant abnormal returns for Hastert client firms.

Table 3 – Abnormal Returns for Hastert Client Firms				
Event Window	Equation (1)	t-stat	Equation 2	t-stat
Day 0	-0.001	-0.45	0.000	0.06
Day -2 to +2	-0.011	-2.16	-0.006	-1.18

There are several possible explanations for our finding that Hastert client firms do not benefit from his election as House Speaker. First, Hastert was presumably an influential figure

in Congress even prior to this event. Rising to the position of Speaker increased his power, but perhaps not so much so that we can detect it in the stock prices of client firms. Second, our process for identifying the firms that stood to gain most from Hastert's increased influence may be flawed in some way. Below we conduct cross-sectional tests to see if firms that gave more money, gave a particular type of money, or spent more on lobbying have unusually high or low abnormal returns. Third, it is possible that client firms of Hastert simply do not benefit from his rise in power.

To try to gain additional insights regarding the value of political influence, we estimated cross-sectional regressions which attempt to explain variation in client-firm abnormal returns as a function of the characteristics of those firms and their political activities. In all of these regressions the dependent variable is the abnormal return for the client firm as measured by Equation 2 (we estimated regressions for both event windows). On the right hand side we included several measures of political spending including the amount of hard money donations, soft money donations, and lobbying expenditures. We also estimated regressions using dummy variables for each spending category rather than the amount spent. As an additional control variable we included the natural logarithm of the firm's market capitalization, and in the Livingston client firms we added a dummy variable for firms in the oil and gas industry. We added this last dummy because Livingston client firms were more heavily concentrated in oil and gas than in any other industry (one in five firms with headquarters in Louisiana is from this industry). In addition, numerous press accounts described Livingston as being friendly to the oil industry. Upon Livingston's election as speaker, the Sierra Club sent an alert to its members warning them of increased risk of oil and gas drilling in environmentally sensitive areas (cite).

In general, the results of our cross-sectional regressions are as follows. Variables that

capture political spending, whether measured on a continuous or binary basis, are not reliably linked to abnormal returns experienced during this event by either Livingston or Hastert client firms. The most robust finding that we have is that Livingston client firms in the oil and gas industry experienced large negative abnormal returns (on the order of -3% to -6%) upon Livingston's resignation. Finally, there is also a fairly robust finding that larger firms have higher abnormal returns, both for Livingston and Hastert client groups. However, on the event day, the S&P500 was up a bit more than the Russell 2000 (large cap vs. small cap indexes), so large firms doing well relative to smaller ones was a market-wide phenomenon.

6. Discussion

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