The costs of controversial political connections: Evidence from political scandals

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Having "friends in high places" can bring many benefits. But what happens if these "friends" are involved in shady business dealings, use taxpayer funds to finance lavish offices or vacations, are subject to sexual harassment lawsuits, or express homophobic or xenophobic views?

In a recent working paper, we study whether connections to controversial politicians exposes firms to reputational risks. We hand-collected a sample of 218 high profile political scandals involving members of the U.S. Congress that took place between 2000 and 2019, identified firms that contributed to these politicians' election campaigns, and estimated changes in these firms' share prices around the date a scandal was first announced in the news.

Our results reveal substantial costs of connections to disgraced politicians: firms that contributed to scandalous politicians' experience value losses of approximately 1%. They also experience an increase in shareholder proposals related to political spending disclosures, which means that in the aftermath of scandals, investors demand more transparency about the firms' political expenditures. These effects are limited to cases that reveal corrupt behaviour of politicians, implying that shareholders are mostly, or exclusively, concerned about the financial integrity of the contributing firms.

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Political donations

In many countries, firms and their managers lend financial support to politicians. For instance, Dutch entrepreneur, Steven Schuurman, recently made international headlines by donating €1.25 million to the German Green party. In the U.S., firms commonly donate funds to politicians through political action committees (PACs). These PACs are established in the firm's name and raise money among shareholders and employees. While firms cannot directly use corporate funds as donations, they can cover the PAC's administrative expenses, including expenses made to organize fundraising events. The executive team then decides how these raised funds are spent. Consider the 2020 presidential election to get an idea of how common PAC contributions are: companies from the S&P 500 alone transferred a combined sum of approximately $103 million to congressional candidates.[1]

Costs and benefits of political connections

Even though studies link firms' political connections to various benefits, such as access to government procurement contracts or bailouts (e.g., Faccio et al. 2006; Goldman et al. 2013), many shareholders are against, and even actively protest, firms' political spending (Baloria 2019). They may fear that political connections incentivize managers to pursue political goals rather than to maximize shareholder value (e.g., Coates 2012; Bertrand et al. 2018). They may also fear penalties through other stakeholders, as some political ties have stirred customer boycotts in the past. In 2010, retail giant Target experienced a highly publicized boycottafter backing the campaign of a conservative gubernatorial candidate. Likewise, Blue Bunny and Land O'Lakes were confronted with public outrage because of their contributions to former Representative Steve King.

Empirical strategy and results

Political scandals as exogeneous shocks to corporate reputation

Political scandals are an ideal setting to examine consequences of controversial political ties for several reasons: they are exogenous to the firm (i.e., our sample firms are not directly involved in the scandals); they take place isolated from wider changes in the political landscape, such as elections; and they affect one politician at a time. Moreover, even if some politicians are more likely to be involved in scandals, the actual materialization of that risk, i.e., the occurrence of the scandal and the media picking up on it, is unexpected.

Reputational losses versus expected loss in political benefits

Reputational losses via anticipated boycotts, litigation, or adverse media coverage on the firm's side may not be the only reason why scandals of politicians affect connected firms. Scandals frequently lead to resignations or lost reelection campaigns and thus, may also reduce the supply of political benefits to connected firms. Consequently, an alternative explanation for our findings is that investors discount the value of lost access to political benefits around scandal revelations.

We run several tests to disentangle the effect of losses in political benefits from losses in corporate reputation. First, we compare changes in connected firms' stock prices around scandals and around deaths of politicians. Deaths may reveal losses in benefits but are unrelated to connected firms' reputation. Second, we explore differences in politician-specific or firm-specific contextual factors that influence investors' reaction to scandals. The results of these additional tests suggest that investors' reaction is primarily driven by reputational concerns. We detect neither a significant reaction around deaths, nor higher losses for scandals that involve politicians who are more influential (and thus, better able to provide firms with political benefits). In addition, we find that the negative effect of corruption scandal revelations is greater for firms that have a higher risk of being involved in unethical behaviour, suggesting that the loss in value has to do with concerns about firms' (financial) integrity. Finally, we find that connections to politicians involved in corruption scandals, but not connections to deceased politicians, increase the likelihood of shareholder activism.

Contribution

Our study provides more insight into the costs and benefits of corporate political connections for shareholders and demonstrates the relevance of transparency. Firms do not have to disclose their political activities in the U.S., or in the E.U. While PAC contributions are published by the Federal Election Commission, there are several unobservable "dark money" channels through which firms can lend support to politicians. In 2012, the U.S. Securities and Exchange Commission Commissioner, Louis Aguilar, emphasized that investors should "not [be] left in the dark while their money is used without their knowledge or consent."[2]However, opponents of mandated political spending disclosures claim that such disclosures would harm firms by revealing proprietary information and by discouraging otherwise profitable political investments (Goh et al. 2020; Prabhat & Primo 2019). Our study adds to this debate by documenting that information on corporate political connections is useful for investors in their assessment of corporate risks.

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This blog post is based on their paper "*Friends in low places: The impact of political scandals on connected firms' stock prices*" available on SSRN.

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[1] This value is based on the data provided by the Federal Election Commission.

[2] The full speech can be found at https://www.sec.gov/news/speech/2012-spch022412laahtm.

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