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Investor-legislators: Tax holiday for politically connected firms

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ABSTRACT

In this paper, we examine whether political connections in the U.S. Congress affect voting patterns with respect to the American Jobs Creation Act of 2004 (AJCA). Using the financial disclosure statements of members of the U.S. Congress, we define political connections as equity-based ties between lawmakers and business groups, which capture the deliberate decision of lawmakers to establish a relationship by investing personal wealth in firm equity. We first examine whether politicians are more likely to hold equity in firms receiving benefits under the AJCA (i.e., firms with high repatriation tax costs). Our results suggest that politicians are more likely to hold equity positions in firms with high repatriation tax benefits only when such firms donate to their political campaign. We further examine how equity-based connections affect the AJCA voting outcomes and find that members of the House, but not of the Senate, holding repatriating firm's equity are more likely to vote in favour of the AJCA when PAC donations support their election campaigns. Last, we investigate whether politicians with equity holdings in repatriating firms are more likely to receive larger donations from firm-affiliated PACs before the AJCA vote in Congress. We find that PACs have larger contributions to House members who purchase equity in repatriating firms immediately prior to the AJCA vote. The results suggest that PACs of repatriating firms strategically target House representatives to increase political support for the tax holiday.

1. Introduction

An extensive literature aims to identify the determinants of voting patterns and regulatory intervention. At one extreme of this literature is the position that legislative preferences are influenced by constituents, corporations, and other interest groups whose support is critical for re-election campaigns (e.g., Bronars & Lott, 1997). Empirical studies argue that firms perceive – and perhaps receive – benefits from currying favour and making connections with politicians. These benefits may include higher valuation (Cooper, Gulen, & Ovtchinnikov, 2010; Faccio & Parsley, 2009), reduced tax burdens (Alexander, Mazza, & Scholz, 2009; Faccio, 2006), beneficial government interventions and access to federal funds (Duchin & Sosyura, 2012; Tahoun & van Lent, 2010), lucrative government procurement contracts (Goldman, Rocholl, & So, 2013), looser scrutiny from regulatory bodies (Correia, 2014; Yu & Yu, 2011) and preferential access to finance (Claessens, Feijen, & Laeven, 2008). An alternative position argues that politicians primarily vote based on their ideological preferences and that individuals choose – but do not affect – government policy (e.g., Lee, Moretti, & Butler, 2004; Mian, Sufi, & Trebbi, 2010). Under

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this view, the vote-buying argument is weak because corporations do not shift assets out of other investments to enter the market for political favours.[1] According to the ideological sorting theory, interest groups allocate donations such that they increase the expected number of votes of a favoured party/candidate, thus effectively sorting politicians with similar ideological preferences into office (see, e.g., Brock & Magee, 1980; Hillman & Ursprung, 1988; Edelman, 1992; Bronars & Lott, 1997). Recent research suggests that wealth interests motivate legislators to establish connections with the corporate world. Equity stakes of politicians in connected stocks outperform non-connected investments (Eggers & Hainmueller, 2014), and legislators vote in favour of the bailout to protect their private wealth with government intervention (Tahoun & van Lent, 2010).

In this paper, we examine whether political connections in Congress affect voting patterns with respect to the American Jobs Creation Act of 2004 (hereafter, AJCA or 'the Act'). Using the financial disclosure statements of members of Congress, we define political connections as equity-based ties between active legislators and business groups that are created when politicians directly invest their own personal wealth in firm equity. In contrast to other measures of political connections, such as campaign donations (e.g., Ansolabehere, de Figueiredo, & Snyder, 2003; Brown, Drake, & Wellman, 2015), connected board members (e.g., Kim & Zhang, 2015) or lobbying activities (e.g., Alexander et al., 2009; Brown et al., 2015; Chen, Gunny, & Ramanna, 2014; Kim & Zhang, 2015), the equity-based measure captures the deliberate decisions of politicians to establish a relationship with a specific firm by buying and holding its equity.[2] We focus on equity-based connections in the settings of AJCA voting for several reasons. First, under the AJCA, U.S. firms receive a one-time tax break of up to 29.75% on accumulated foreign income that is repatriated to the U.S., resulting in $312 billion in repatriated funds and tax savings of approximately $3.3 billion. The AJCA is one of the most important regulations in the field of corporate taxation, generating significant tax savings for beneficiary firms while failing to achieve its policy objectives in terms of economic growth and job creation.[3] Second, the AJCA has primarily benefited firms with high tax repatriation costs, which allows us to clearly identify the main beneficiaries of this regulation. To the extent that most bills affect a variety of constituents and interest groups simultaneously, the AJCA presents a unique setting in which to associate voting patterns with affected business groups. Third, the context of the AJCA is such that reverse causality is not a concern in the empirical analysis. The dividend eligible for deduction under the Act is estimated using audited financial statements certified on or before March 31, 2003. This date predates the introduction of the bill to Congress, and it is thus unlikely that firms can adjust unremitted foreign earnings to meet the requirements of the repatriation holiday (Chen et al., 2014).

Our analysis is structured as follows. First, we examine the composition of a politician's equity portfolio and focus on the tax-specific characteristics of its constituents (firms). We conjecture that politicians directly invest personal wealth in firm equity to increase their chances for re-election and that the level of political support and the amount of campaign contributions made by interest groups is likely to affect such chances. Consistent with the prior literature, we expect that politicians' equity holdings facilitate their interactions with interest groups. Our results suggest that politicians are more likely to make equity investments in firms with high repatriation tax costs only when such firms donate to their political campaigns, all other factors constant. Therefore, we propose that politicians' portfolios are likely to be biased towards legislative solutions that favour donating firms with high repatriation tax benefits.

Second, we examine how equity-based connections affect voting outcomes with respect to the AJCA. On one hand, politicians may hold equity to reduce a firm's uncertainty about the intentions of the politicians' actions towards the firm, thus enhancing the firm's incentive to extend support during both current and future elections. On the other hand, politicians may hold equity in firms that they find ideological kinship with and/or that they believe will benefit from the politicians' predetermined policy positions. We explain the probability of casting a Yea vote on the AJCA with the equity-ownership stakes in beneficiary firms. The empirical findings suggest that members of House were more likely to give support to the tax cut when they held equity in repatriating sponsor-firms. By contrast, the equity–donation links are not found to have influenced the vote in the Senate.

Wealth interests may also motivate legislators to establish connections with the corporate world (Eggers & Hainmueller, 2014; Tahoun & van Lent, 2010; Ziobrowski, Cheng, Boyd, & Ziobrowski, 2004). To relate personal wealth considerations to voting patterns, we further examine the investment behaviour of Congress members around the AJCA passage. Using equity transactions executed during the period 2004–2005, we find that Congress members were more likely to purchase equity in repatriating firms prior to casting a Yea vote on the AJCA. Additionally, empirical findings suggest that the probability of buying equity in repatriating firms was higher for politicians who supported the AJCA and received lower political contributions from repatriating-firm PACs.

[1] Opponents of the vote-buying theory also suggest that there are thousands of private interests bidding for benefits and thousands of candidates vying for funds, which should drive the rate of return on an investment in politics to levels that are similar to other investments (e.g., Ansolabehere et al., 2003; Tullock, 1972).

[2] Vote-buying models assume that political donations represent transactions in the market for political favors. However, it is plausible that political candidates are not fully aware of contributors' identities and contribution amounts. In contrast to PAC donations, which are made by a large number of firms, politicians are rather selective in assembling their equity portfolios and have equity positions on average in six firms. Moreover, politicians may decide not to have direct equity holdings but delegate their wealth management to third parties, such as blind trusts. Thus, the decision to tie personal wealth to a firm's equity is likely deliberate and well-considered by politicians.

[3] Senate Permanent Subcommittee on Investigations, Majority Staff (2011).

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