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The politics of government investment ☆

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ABSTRACT

This paper investigates the relation between corporate political connections and government investment. We study various forms of political influence, ranging from passive connections between firms and politicians, such as those based on politicians' voting districts, to active forms, such as lobbying, campaign contributions, and employment of connected directors. Using hand-collected data on firm applications for capital under the Troubled Asset Relief Program (TARP), we find that politically connected firms are more likely to be funded, controlling for other characteristics. Yet investments in politically connected firms underperform those in unconnected firms. Overall, we show that connections between firms and regulators are associated with distortions in investment efficiency.
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1. Introduction

The fabric of corporate political connections is at the heart of research on political economy. A number of studies show that political connections increase firm value (Fisman, 2001; Faccio, 2006) and that firms actively establish political connections via hiring politically connected directors and financing election campaigns (Goldman, Rocholl, and So, 2009; Cooper, Gulen, and Ovtchinnikov, 2010). Although the link between political connections and firm value is reasonably well established, we know less about the mechanisms through which such connections create firm value and affect real economic outcomes. This article investigates one such mechanism: the access of politically connected firms to government investment funds.

Our study focuses on the financial crisis of 2008–2009, thus exploiting an economywide shock, which simultaneously affected a large cross-section of firms and resulted in the largest federal investment program in US history. We study a broad array of political connections, ranging from

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the relatively passive ties between firms and politicians, such as those based on politicians' voting districts, to the more active forms of influence, such as lobbying, political contributions, and recruitment of politically connected directors. Using a novel, hand-collected data set on firms' applications for federal investment under the Troubled Asset Relief Program (TARP), we test the role of political influence across three dimensions: (1) firm decisions to apply for government investment; (2) government decisions to allocate investment funds; and (3) expost performance of investments in politically connected firms.

We motivate our analysis with several hypotheses. One hypothesis is that firms with political connections receive favorable treatment in the allocation of government funds. This view would be consistent with theories of the politics of government ownership and investment (e.g., Shleifer and Vishny, 1994), which suggest that federal capital is used to accommodate private interests of politicians, such as securing electorate votes, funding election campaigns, and extracting personal benefits from corporate lobbying. Under this scenario, firms' incentives to use their political influence to obtain government investment are likely to be stronger for underperforming firms, where government funds are more critical for their survival. For example, the financial press reports cases when politicians went as far as changing the text of the legislation to save ailing firms in their home state in response to petitions by firms that were too weak to qualify for government investments (Paletta and Enrich, 2009). The external audits of government investments in 2008–2009 disclose *documented* outside inquiries on investment applications from 56 firms, whose identities are not disclosed.[1] The alleged attempts of external influence on regulators were sufficiently significant that on January 27, 2009, the Treasury established a formal restriction on contacts with lobbyists regarding applications for federal investment to "limit lobbyist influence in federal investment decisions."[2] This hypothesis predicts that politically connected firms are more likely to receive government funds and that subsequent returns on these investments are likely to trail those on their unconnected peers, as predicted in Stigler (1971), Shleifer and Vishny (1994), and Banerjee (1997).

An alternative hypothesis posits that firms were capital rationed during the financial crisis because of the spike in the cost of financing and the information asymmetries between firms and investors (e.g., Myers and Majluf, 1984; Greenwald, Stiglitz, and Weiss, 1984). In this case, firms may use their lobbying efforts and connections to politicians and regulators to provide government officials with valuable information about firms' financial condition and future outlook. Under this hypothesis, first modeled in the seminal work by Downs (1957), political connections can mitigate the information asymmetry between government officials and the firm and result in more informed federal investment decisions. This hypothesis predicts that politically connected firms are more likely to receive government investment funds and that these investments are likely to outperform those in unconnected firms.

A third possibility is that firms' political connections do not play a significant role in the allocation of government investments. For example, public scrutiny of political influence via campaign contributions, lobbying efforts, and directorship ties to regulators (all publicly observable in the United States), as well as the audit of federal investment programs, may negate attempts to influence government decisions. In particular, career concerns of federal officials under close monitoring (Fama, 1980) represent one mechanism limiting the efficacy of corporate political connections. In fact, government officials may treat investments in connected firms with extra caution to defend themselves against future accusations. This hypothesis predicts no difference in government capital allocation and investment returns between politically connected and unconnected firms.

Our empirical analysis focuses on the Capital Purchase Program (CPP), the first and largest TARP initiative. Initiated in October 2008 and closed in December 2009, CPP invested \$205 billion in government funds. To determine the application status of firms eligible for CPP (application submissions are not disclosed by regulators), we hand-collect these data from press releases, annual and quarterly reports, proxy statements, and other filings. We are able to ascertain the application status of 537 public firms eligible to participate in the program (89.5% of all eligible public firms), which account for 92.7% of the program's investment funds.

We introduce four variables of political influence. Our first measure captures firm ties to the main decision makers in the CPP investment process: banking regulators and the Treasury. We consider a firm to be connected via this measure if it employed a director in 2008–2009 with simultaneous or former work experience at either a banking regulator or the Treasury. Our second proxy is a firm's connection to a member of the House Financial Services Committee, which played a key role in the development of federal investment programs. We consider a firm to be connected to a Congress representative if it is headquartered in his or her district. Our third measure of political influence is a firm's size-adjusted amount of expenditures on lobbying Congress and banking regulators on the issues of banking, finance, or bankruptcy in 2008–2009. Our fourth measure is a firm's size-adjusted amount of campaign contributions to the House Financial Services Committee in the 2008 election cycle. Overall, these variables proxy for the various mechanisms of a firm's influence on government officials involved in developing and implementing CPP.

Our first set of empirical results concerns the determinants of a firm's decision to apply for CPP. We find that the overwhelming majority (80.2%) of public firms eligible to participate in CPP submitted applications for investment, a finding consistent with the attractive financial conditions of the program, a simple application procedure, and an option to refuse CPP funds after application approval. As expected, the firms that chose not to apply for CPP were the best-capitalized financial institutions, which had a lower need for additional capital. We do not find reliable evidence that a firm's political connections

[1] Quarterly report to Congress by the special inspector general of the Troubled Asset Relief Program, October 21, 2009.

[2] US Department of Treasury, 2009. Treasury secretary opens term with new rules to bolster transparency, limit lobbyist influence in federal investment decisions. Press release, January 27.

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