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# The value of the revolving door: Political appointees and the stock market[☆]

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ABSTRACT

We analyze stock market reactions to announcements of political appointments from the private sector and corporate appointments of former government officials. Using unique data on corporate affiliations and announcements of all Senate-confirmed U.S. Defense Department appointees of six administrations, we find positive abnormal returns for political appointments. These estimates are not driven by important observations, volatile stocks, industry-wide developments or the omission of further commonly used return predictors. Placebo events for close competitors and alternative dates yield no effects. Effects are larger for top government positions and less anticipated announcements. We also find positive abnormal returns for corporate appointments and positive effects of political connections on procurement volume. Our results suggest that concerns over conflicts of interest created by the revolving door seem justified, even in a country with strong institutions.



## 1. Introduction

When President Obama took office in 2009, he faced the challenge of filling top positions in the federal administration with political appointees. Like former Presidents, he also tapped the reservoir of private sector experts. For example, he nominated William J. Lynn III, a former Raytheon executive, as Deputy Secretary of Defense. But the revolving door spins both ways: Legions of leaving Bush appointees joined the industry.

The literature on political appointees focuses on the trade-off between a decrease in competence and an increase in political control (e.g., Lewis, 2008; Huber and McCarty, 2004). In contrast, the public debate often revolves around the value of industry expertise for regulation or procurement and concerns about potential conflicts of interest. Commenting on Lynn's nomination, a defense analyst said, “On the one hand, if you don't have defense-industry experience, then you're lacking critical insight. On the other hand, if you do, it's inevitable that in some way it's going to impact on your judgment.”[1] Lynn's nomination also met resistance over conflicts of interest in Senate hearings: “[T]he revolving door is an important issue for us to talk about […] You went directly from the Pentagon to a defense contractor. You are coming back directly from a defense contractor […] into the Department of Defense. […] This is troubling to a lot of people […] and it's an incestuous business what's going on in terms of the defense contractors and the Pentagon […].”[2]

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[1] Loren Thompson cited in Defense Daily, “Lynn confirmation vote expected today,” Feb. 11, 2009.

[2] Sen. Claire McCaskill cited in Federal News Service, “Hearing of the Senate Armed Services Committee confirmation hearing on expected nominations by President-elect Barack Obama,” Jan. 15, 2009.

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Concerns over conflicts of interest seem justified. Political appointees can directly favor their former employers in procurement, regulation and merger and acquisition decisions as well as indirectly in strategic planning and preferential access to decision makers and information. Incentives for such preferential treatment may exist either because appointees expect to rejoin the companies or because they want to return favors. Similarly, former appointees bring valuable connections and information about the Pentagon and competitors to firms hiring them. But institutional safeguards embodied in ethic rules counter such concerns. Moreover, the United States is often considered to have a favorable institutional environment with checks and balances and a free press. Whether firms benefit from potential conflicts of interest is ultimately an empirical question.

Do firms profit from the political appointment of one of its members? Do firms profit from hiring a former political appointee? These two questions lie at the heart of this paper. We address these questions by estimating stock price reactions to announcements of appointments and hirings. Given that stock prices reflect expected future profits and news affecting these expectations is immediately priced in, these stock price reactions reflect the value of political connections associated with the revolving door. Thus, positive stock market reactions are consistent with the view that conflicts of interest indeed matter.

Event studies have several advantages over alternative approaches. Compared to effects on realized firm performance or the volume of procurement contracts, effects on stock prices are immediate. Thus, it is easier to relate cause and effect and abstract from confounding factors. Further, unlike effects on the volume of procurement contracts, stock price reactions are a comprehensive measure for the value of political connections.

In our empirical analysis, we concentrate on political appointees in the U.S. Department of Defense. This department has the largest budget (over USD 700 billions in recent years), procurement volume (Gansler, 2011) and number of appointees (excluding attorneys, marshals and ambassadors; Lewis, 2008). The Department of Defense assures a large and homogenous sample. Our sample covers appointees nominated by or serving under Presidents Bush Sr. to Obama, encompassing six administrations over 20 years. We consider the universe of Senate confirmed positions at the Department of Defense, totaling 527 person–position combinations or 383 individuals. For these observations we reconstruct the employment and affiliation history within two years of government service and gather the exact date of political and corporate appointments through a full-text search using LexisNexis and SEC-filings. We consider an appointee to be connected to a firm, if she has served as a member of board of directors or advisory board, an executive officer or an employee of that firm. We then link the information on political and corporate announcements to daily stock market data of these connected firms. This yields a sample of 85 observations (72 firms and 59 persons) related to political appointments and 85 observations (76 firms and 58 persons) for corporate hirings of former government officials. We use these data and both classical and panel event study approaches to estimate abnormal returns for announcements.

To anticipate our main findings: For political appointments ("ex ante"), we find positive one- and two-day average abnormal returns of 0.77% and 0.78% and of 0.77% and 0.77% with the classical and panel approach, respectively. Abnormal returns are larger for (former) board members, top pay-grades in the Department of Defense, appointees nominated by a Democratic administration (for the one-day window) and for those events, where the announcement was at least partly unanticipated. For corporate appointments ("ex post"), the corresponding figures are 0.72% and 1.03% and 0.68% and 0.95%, though these results are statistically less strong. The baseline results are robust to the exclusion of extreme abnormal returns, scaling of abnormal returns, the adjustment of returns by industry returns and the inclusion of further commonly used return predictors. Placebo events for close competitors or alternative dates yield no effects. In a complementary analysis with procurement data, we find positive effects of the revolving door. The size of these realized effects is broadly consistent with the size of expected effects reflected in stock price reactions.

Our paper contributes to the literature on the importance of political connections. Event studies document large effects of policy platforms (Knight, 2007; Coulomb and Sangnier, 2014) and even secrete policy decisions (Dube et al., 2011) on the fortune of affected firms. Political connections may be important for firms in this respect and allow them to influence policies in their favor — at least in countries with weak institutions. Stock price reactions of connected firms to news about the fate of leaders reflect the value of political connections in these countries (e.g., Fisman, 2001; Faccio, 2006). For countries with presumably strong institutions, there is less conclusive evidence regarding the importance of political connections in general and conflicts of interest created by the revolving door phenomenon in particular. For the U.S., Goldman et al. (2009) find positive stock market reactions to appointments of former politicians and officials to corporate boards and Goldman et al. (2013) observe changes in procurement volumes of connected firms around a change of control of Congress. While these results are suggestive of the value of political connections in the U.S., they may also be due to the ability and knowledge of the new board members and changes in policy platforms, respectively. Direct evidence on the importance of political connections comes from Blanes i Vidal et al. (2012), who show that former congressional staff members are particularly valuable to lobbying firms hiring them while the Congress member to whom they are connected is still in office.

Although we also look at corporate appointments of former appointees, our focus is on political appointments of persons coming from the private sector. Positive stock market reactions to these appointments are indicative of conflicts of interest and are less fraught with problems of interpretation. Further, conflicts of interest are arguably more worrisome if appointees can directly influence important decisions. Related in this regard are two papers on the value of political connections to one prominent politician and political appointee, respectively. Fisman et al. (2012) find no stock market reactions to news about Vice President Cheney for Haliburton where he was CEO, other firms on whose board he served or firms with Haliburton directors on their board. In contrast, Acemoglu et al. (2013) report large stock price reactions to the nomination of Treasury Secretary Geithner for firms whose executives he met as head of the New York Federal Reserve Bank, financial firms based in New York or firms whose directors have personal ties to Geithner.

Our paper contributes to this literature by providing direct evidence on conflicts of interest in a country with allegedly strong institutions that emerge when industry members pass through the revolving door to become government officials. Only a few of the connections in Fisman et al. (2012) and none of the ones in Acemoglu et al. (2013) are related to the revolving door phenomenon. Thus, these papers are not primarily concerned with conflicts of interest stemming from political appointments of individuals from the private sector. Instead of focusing on one prominent top ranking politician, we look at a large number of political appointments over more than two decades of former industry employees, executives, directors or advisors to positions at different levels in the hierarchy of one large government department. The clear and salient classification of political connections through former employment and the focus on one department guarantees a homogenous sample. At the same time, the large number of appointments over a long time period not only increases statistical power and reduces the importance of confounders but also allows us to look at the heterogeneity of effects. For example, the prevalence of conflicts of interest may differ across the government hierarchy. Cabinet members are powerful but also closely watched by legislators and the media. Lower level appointees also have opportunities for favoring former employers and often avoid the scrutiny by the media and politicians. This was demonstrated by the tanker-leasing scandal. Darleen A. Druyun, acting Assistant Secretary of the Air Force (Acquisition), increased the price