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A Cost-Benefit Analysis of Corporate Political Spending Disclosure

White Paper by
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EXECUTIVE SUMMARY

This report provides a generalized cost-benefit analysis of a potential rule promulgated by the Securities and Exchange Commission (SEC) that would require public corporations to disclose corporate political spending. Existing evidence on both the dynamics of corporate political spending and the costs and benefits of SEC mandatory disclosure in general, as well as the use of agency theory, an economic framework that highlights the asymmetric interests and knowledge between corporate managers and shareholders, indicate that the range of potential benefits of corporate political spending disclosure – to shareholders and the market – vastly outweigh the possible costs of compliance to public corporations.

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KEY FINDINGS

- Shareholders are becoming increasingly concerned with corporate spending for political purposes. The lack of information available to the public about such spending puts shareholders and the public at enormous economic risk.
- The costs of requiring the disclosure of corporate political spending would be nominal. For a politically active company to file accurate IRS returns, it must already keep track of its political spending. A new rule requiring disclosure would merely make this internal accounting of corporate political spending available for the investing public.
- Research also suggests that corporate political spending is not proprietary information and that requiring disclosure will not be a larger burden for smaller firms.
- The benefits of mandatory disclosure of corporate political spending would be substantial. It would diminish the monitoring costs for shareholders, create better economic incentives for corporate executives, and generate positive externalities for companies that are already in compliance, and provide potential investors with key information for making rational investment decisions.

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INTRODUCTION

In August of 2011, a group of high profile law professors filed a petition with the Securities and Exchange Commission (SEC), calling on the agency to require public companies to disclose what corporate resources they spend on political activities. The Committee on Disclosure of Corporate Political Spending argued that shareholders are increasingly concerned with corporate spending for political purposes. "Shareholders need to receive such information for markets and the procedures of corporate democracy to ensure that such spending is in shareholders' interest."[1] While some large public companies have begun to share this information, there is no existing rule that requires companies to disclose this information to investors. "Most political spending remains opaque to investors in most publicly traded companies."[2] The petition to the SEC addresses this lack of transparency and asks that the SEC add to its history of designing disclosure rules for information relevant to investors by adopting a rule to disclose corporate political spending. Two years later, File No. 4-637 is finally on the SEC's official agenda.

One of the processes that the agency is obligated to undergo in reviewing a proposed rule is cost-benefit analysis, in which the basic idea is to measure the impact of government regulation by imitating the workings of markets. In other words, if the total costs of a potential decision outweigh the benefits, then it is not a desirable decision (just as it would not be for a private business).

This paper describes the costs and benefits involved in the proposed rule to mandate the disclosure of corporate political spending. First, I describe the various forms of corporate political spending. Then, I define the use of agency theory as the economic framework best suited to identifying the costs and benefits of the proposed corporate political spending disclosure rule. I then map agency theory onto corporate political spending and illustrate the ways in which such activity generates monitoring costs, highlight the main tenets of the debate on the costs and benefits of SEC mandatory disclosure in general, and use the existing evidence from the above discussions to identify and compare the costs and benefits of political spending disclosure. I conclude that the range of economic benefits of this disclosure rule would vastly outweigh the nominal costs imposed on corporations for compliance.

CORPORATE POLITICAL SPENDING

Prior to the Supreme Court's Citizens United v. Federal Election Commission decision in 2010, corporate political activity (CPA) had included the following tactics: direct lobbying of lawmakers; donating soft-money to political parties, which was legal until the 2002 Bipartisan Campaign Reform Act (BCRA, commonly known as McCain-Feingold); spending through affiliated corporate political action committees (PACs); and grassroots lobbying to encourage the public to engage on a particular issue (Hillman et al. 2004).

Citizens United v. FEC added another tool into the corporate political chest. Companies were granted the ability to spend corporate treasury funds on two types of political ads: 1) independent expenditures that expressly advocate for the election or defeat of a candidate, and 2) electioneering communications as defined by BCRA, which are colloquially known as broadcast "sham issue ads."

[1] http://blogs.law.harvard.edu/corpgov/files/2011/08/SEC-Petition.pdf p.10
[2] http://blogs.law.harvard.edu/corpgov/files/2011/08/SEC-Petition.pdf p.10

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Before Citizens United, corporations had been barred from making these expenditures in federal elections, but after Citizens United they were freed to spend an unlimited amount on both categories of political ads. Citizens United also changed the law in 22 states that had similar corporate expenditure bans. Because of pre-existing disclosure loopholes, companies can hide this new political spending from the investing public (Torres-Spelliscy 2011 and Aprill 2011).[3]

Why do corporations engage in political spending activity? Is CPA effective? Which parties does it benefit and what are the broader impacts? The following sections present the basic structure of the principal-agency framework and draw from existing research to unpack some of CPA's properties and its impacts on corporate players.

AGENCY THEORY

Agency theory is the most commonly used economic framework for understanding the dynamics of corporate governance in general. It describes conflicts of interest between managers (agents) and shareholders (principals) based on the fact that a) their goals are not perfectly aligned and b) problems of asymmetric information exist between them (see Jensen and Meckling 1976, Fama 1980, and Eisenhardt 1989).[4] In regard to the former, rather than maximizing corporate profits, manager-agents seek to maximize an objective utility function that would include salary and benefits as well as qualitative factors like power and prestige, all subject to a given profit constraint. In terms of the latter, asymmetric information – a kind of market failure – arises when the agent has more information or expertise than the principal. These two factors, combined with the fact that, in some situations, managers are more insulated from risk, constitute a problem called moral hazard. Because of the moral hazard inherent in a situation with conflicting objectives, asymmetric information, and insulation from risk, principal-shareholders must be able to monitor the actions of firms' agent-managers, which imposes direct costs (hiring an external auditor) and/or indirect costs (shareholders' opportunity costs) (Eisenhardt 1989 and Johnson and Greening 1999).

The literature supporting the moral hazard problems that arise out of the principal-agent framework is convincing. Bebchuk and Fried (2004) link weaker shareholder rights with higher CEO pay and Yermack (2006) finds a negative relationship between perquisites of major company CEOs and average shareholder returns. According to Coates (2010), "observable corporate governance provisions consistently predict the degree to which faithless managers divert shareholder wealth for their own ends, destroy corporate wealth, and reduce public welfare" (2). Coffee (1984) states that managers "have strong incentives to withhold adverse information and to undertake preemptive buyouts of their own firm, which are facilitated by withholding positive information" (752). Of course, in light of cases like the Enron Corporation accounting scandal, one does not have to delve deeply into academic research to comprehend the moral hazard problems prevalent in corporate governance. The following section highlights some of the ways CPA conforms to the principal-agent scenario, which thereby produces serious moral hazard problems for companies that engage in political spending and for their investors.

CPA AGENCY PROBLEMS

The economic literature suggests that there are two primary reasons why corporations engage in CPA. One ready explanation is they do it to maximize profit for the company. As a "political investment" (Hadani 2011), corporations are expecting a "return," particularly in the following forms: reduced trade barriers, earmarks, government contracts, reduced or easier regulatory inspections, favorable rate regulation, and lower tax rates (Coates 2010).

[3] Corporations often combine CPA tactics. For example, Ansolabehere et al. (2004) finds that 86% of all contributions come from firms that have both lobbyists and political action committees. Schuler et al. (2002) show evidence that firms tend to mix contributions and lobbying (contributions are what purchase the lobbying access).

[4] Controlling shareholders, who have the ability to divert corporate resources, are also sometimes characterized as agents (Ferrell 2007-2008).

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There is a tremendous amount of literature that evaluates whether CPA actually achieves the aforementioned firm-level outcomes, and the results are not consistent. For example, Cooper et al. (2010), Bonardi et al. (2006), and Dean et al. (1998) all find evidence of a positive impact of CPA on firm-level outcomes while Aggarwal et al. (2011), Coates (2010), Ansolabehere et al. (2004), Igan et al (2009), Milyo (1999), and Banker et al. (1997) have all found negative outcomes. These conflicting results suggest that CPA creates uncertainties and risks for shareholders well beyond those that typically accompany economic investment activities.

The second explanation, which is gaining ground in the economics literature, is that corporate managers spend in politics for their own self-aggrandizement, at the expense of the company. In the CPA context, there is considerable potential for personal advantages to corporate executives, particularly prestige, a future political career, and star power (Hart 2004) or to help political allies (Aggarwal et al. 2011).

To complicate matters, in CPA settings, asymmetric information between managers and shareholders is ubiquitous. Corporate executives know precisely how much money is being spent on politics while neither CPA's process nor strategic outcomes are at all transparent to shareholders or the investing public (Fisch 2006 and Butler and Ribstein 1995). Unlike economic production, the market does not signal the "production" of CPA. In other words, if a closed-door meeting between a corporate lobbyist and a policymaker goes badly, that failure will not be broadcast nor will it be reflected in the company's stock price. This lack of transparency makes it extraordinarily difficult, maybe impossible, for millions of dispersed shareholders to monitor – and hold accountable – the actions of managers who might not have the skills to be effective at achieving their strategic goals (Hart 2004) or are motivated by their personal gain, at the expense of shareholders.

All three of these factors – the considerable ambiguity about CPA outcomes, the potential personal rewards to managers of political spending, and the lack of transparency (asymmetric information) in both CPA processes and goals – renders CPA a moral hazard situation that is extremely risky for shareholders.[5]

Recent evidence strongly supports this conclusion. For example, Coates (2010) finds that when shareholder rights are weak and, thus, there is little transparency, corporations engage in more CPA. Hadani (2011) also found that when there is no monitoring, firms were more likely to engage in political spending. Aggarwal et al. (2011) report that worse corporate governance is correlated with larger donation sums and that a lack of transparency allows for CPA to serve as a form of private benefits for corporate managers. A recent study by Schepers and Gardberg (2011) also found that, on average, the corporations that spend the most on CPA tend to disclose less than companies with more moderate CPA.

Furthermore, shareholders are well aware of, and concerned with, the agency problems of CPA. Hadani (2011) finds that institutional investors (large ones in particular) tend to oppose CPA and also cites a Mason-Dixon shareholder poll that 85% of respondents felt that a lack of CPA monitoring had allowed for management to act in ways that were in conflict with shareholder preferences.

THE COSTS AND BENEFITS OF SEC MANDATORY DISCLOSURE REGULATION

In order to effectively highlight the potential costs and benefits of the SEC File No. 4-637 petition to develop rules to require public companies to disclose to shareholders the use of corporate resources for political

[5] A theoretical argument against the moral hazard problems of CPA is the "Wall Street Rule," which states that if the shareholder is in conflict with corporate management, it is more efficient (less costly) to sell corporate shares than demand behavioral change (Joo 2001). However, there are two factors that invalidate the Wall Street Rule: 1) institutional investors or controlling investors are not able to easily sell all their shares (Han et al. 1999) and 2) the transparency that the Rule presumes does not, in fact, exist in the CPA context.

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activities, it is useful to discuss some of the economic research and debates on the costs and benefits of SEC mandated corporate disclosure in general.

The economic impacts of SEC disclosure regulation are intensely debated in the literature. Arguments against mandatory disclosure claim that requiring corporate disclosure is unnecessary, as the market will compel firms to disclose information (Grossman and Hart 1980 and Easterbrook and Fischel 1984). However, that conclusion is based on perfect symmetry of interests and information between managers and shareholders, which, as is well-established in the economics literature, is a fairly weak assumption.

Researchers also argue that mandatory disclosure rules impose competitive costs, i.e. they would be forced to share proprietary information with their competitors (Ferrell 2007-2008). Finally, there is evidence that disclosure rules can sometimes be costlier for smaller companies (Bushee and Leuz 2005).

Arguments supporting mandatory disclosure point to several factors that would foster market efficiency. For example, it would lower the cost of capital (Ferrell 2007-2008). In terms of principal-agent problems, mandatory disclosure can also compel managers to focus more narrowly on the maximization of shareholder value (rather than their own utility maximization) (Greenstone et al. 2005). Finally, firms previously filing with the SEC experience positive stock returns and permanent increases in liquidity, suggesting positive externalities from disclosure regulation (Bushee and Leuz 2005).

THE COSTS AND BENEFITS OF CORPORATE POLITICAL SPENDING DISCLOSURE

How do these economic arguments apply to SEC disclosure in the CPA context? In terms of costs, there are a few commonly identified categories to consider.

First, compliance costs of CPA disclosure should be nominal. Lobbying and other political contributions are not tax deductible as regular business expenses for tax reporting purposes under Internal Revenue Code § 162(e). Thus, in order for a politically active company to file accurate IRS returns it must already keep track of its CPA. The new rule envisioned by SEC File No. 4-637 would merely make this internal accounting of CPA available for the investing public. So long as the reporting categories chosen by the SEC in the new disclosure rule mirror the categories that the IRS lists as non-deductible political expenditures under § 162(e), the cost of compliance may be as little as the hours it would require an employee to copy and paste data from an internal file into a public one. Furthermore if the new SEC rule adds to an existing reporting requirement such as filings currently made by companies on Form 10-K or Form 10-Q, then there would be minimal additional production or mailing costs for reporting companies. Rather, companies would merely add a few lines of text to disclosures that they are already legally required to give to their investors.

The second issue is the aforementioned problem of firm size. Bushee and Leuz (2005) document that disclosure requirements result in higher costs for smaller companies. This can be explained by lower production costs of information for bigger companies, i.e. economies of scale (Jensen and Meckling 1976). However, considering that the accounting process for CPA disclosure to the SEC would be as simple as making internal accounting records public, there is no reason to expect that smaller companies would bear a larger burden from a disclosure requirement than larger companies. In other words, neither type of firm is expected to experience a noticeable increase in accounting costs.

The third issue to consider is the potential competitive costs to corporations, which should not be problematic. Companies already often match competitors' political contributions and CPA tends to concentrate by industry (Grier et al. 1994), which suggests that corporate political spending is not proprietary information that could potentially be threatened by mandatory disclosure.[6]

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The expected benefits of mandatory disclosure of corporate political spending would be substantial. Disclosure would help to mitigate the moral hazard problems inherent in CPA by diminishing the monitoring costs for shareholders, allowing them to make more informed investment decisions. It would also create incentives for managers to focus on the kinds of CPA that would maximize shareholder wealth rather than their own self-interest. Finally, it would offer the same kinds of positive externalities that corporations, which already share required information, enjoy from mandatory disclosure. All of these impacts would have significant benefits for market competition and economic efficiency.

In summary, it is indisputable that an SEC rule requiring companies to disclose their corporate political spending would result in only a nominal set of compliance costs to corporations engaged in political activities while creating a wide range of benefits to the economy, particularly by: generating positive externalities for corporations that are already in compliance, offsetting the large monitoring costs from a lack of transparency in corporate political spending borne by existing shareholders, providing potential investors with key information with which to make rational investment decisions, and creating incentives for self-interested corporate managers to more effectively maximize shareholder wealth.

CONCLUSION

This report draws from robust economic methodology and the existing body of empirical research evidence to highlight the relative costs and benefits derived from a mandatory disclosure of corporate political spending.

Corporate political spending includes a range of tactics – direct lobbying of lawmakers, soft-money, PAC activity, and grassroots lobbying. Since the Supreme Court's Citizens United v. Federal Election Commission decision in 2010, corporations have also had the ability to spend corporate treasury funds on two kinds of political ads: 1) those advocating for election or defeat of a candidate, and 2) "sham issue ads."

Deciphering the CPA context using agency theory demonstrates that CPA generates significant moral hazard problems. Agency self-interest, asymmetric information (i.e. lack of transparency), and ambiguous evidence on the strategic impacts of CPA result in moral hazard problems that render CPA extraordinarily risky for shareholders and the investing public.

When I consider, based on the evidence in the economic literature, what the impacts of a potential SEC rule requiring CPA disclosure would be, I conclude that the benefits would vastly outweigh the costs. By observing current patterns of CPA, I predict that compliance costs to corporations would be nominal. For example, the accounting costs would be marginal as CPA is already recorded for tax purposes; small and large companies alike would face minimal compliance costs; and CPA is not proprietary information and, thus, no competitive costs are expected.

Furthermore, the benefits of CPA disclosure would be substantial. This rule would help to correct the market failures that currently exist in CPA by creating incentives for managers to focus less on their personal gains and more on maximizing shareholder wealth, providing shareholders with key information with which to make rational investment decisions, and generating positive externalities for corporations that already disclose their CPA to shareholders. In other words, requiring corporations to disclose their political donations would substantially improve the efficiency of capital markets, which is why I urge the SEC to promulgate a rule requiring corporate political disclosure for publicly traded companies.

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[6] One might wonder how competitors could discover information about CPA when shareholders cannot. One possible channel is through politicians, who both know whether a given corporation has spent money supporting or lobbying them and have an incentive to use that information strategically to extract support from that corporations' competitors. Another possible channel is politically active trade groups, whose representatives have information about corporate contributions to the groups as well as political spending more broadly.

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