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Politics and the Business Corporation

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Politics and the Business Corporation

Robert H. Sitkoff

Abstract

This essay explores the policy bases for, and the political economy of, the law's long-standing regulation of corporate political speech. The essay has three parts. First, it contends that the conventional justifications for regulating corporate interventions in politics - that corporate donations unnaturally skew the political discourse (bad politics) and that corporate political donations harm shareholders (agency costs) - assume irrational investors and substantial capital market inefficiency. Drawing on public choice theory, the essay also explores the aim of retarding rent-seeking as an alternative justification for regulating corporate interventions in politics. Second, the essay reexamines the history of the regulation of corporate political speech and suggests a political economy analysis whereby corporations favored limitations on corporate donations in order to obtain protection from rent extraction by politicians. Finally, the essay explores the implications of this analysis for the modern regulation of corporate political donations.

Do politicians want donations more than corporations want to give them?

Politics and the Business Corporation

BY ROBERT H. SITKOFF

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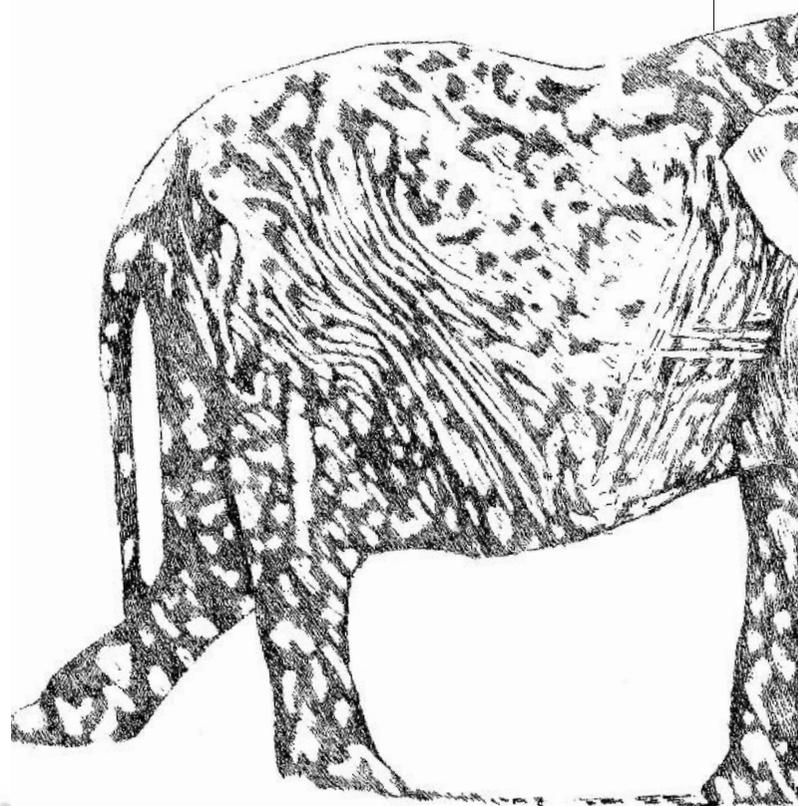
THE TILLMAN ACT OF 1907 MADE IT A crime for corporations to give financial “contributions” to federal political candidates. Today, the act bars not only direct “contributions” to a candidate’s campaign, but also “independent expenditures” that are spent on behalf of a candidate but are not coordinated with the candidate. Corporations, in short, are barred from making “hard money” donations in federal elections. Roughly 30 states have similar rules for candidates for state office.

The vintage of those rules distinguishes them from the bulk of modern campaign finance law, most of which was enacted in the Watergate reforms of the 1970s. They are also distinguished by their severity. Except for the Tillman Act and its state law counterparts, since the landmark 1976 case *Buckley v. Valeo*, the Supreme Court has regularly struck down outright bans on “independent expenditures” and “contributions.”

Despite a century’s worth of regulation, however, many believe that corporate political influence is still too great. Hence, one of the principal aims of the Bipartisan Campaign Reform Act of 2002 (BCRA) was to ban corporate “soft money” donations (i.e., heretofore unregulated donations to political parties). Sen. Russell Feingold (D-Wis.), one of the act’s sponsors, explained that this would close one of “the biggest loopholes in the system.”

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But if corporate political power is potentially so dangerous, how did corporations come to be subject to all of this regulation in the first place? Why were they unable to lobby successfully against the rules? And while we are on the subject, is corporate political activity really so dangerous?

WHY REGULATE CORPORATE POLITICAL ACTIVITY?

Critics usually offer two explanations for why corporate political activity needs to be regulated: Corporate donations unnaturally skew the political discourse, and corporate donations harm shareholders. Let us look at the merits of both of those explanations.

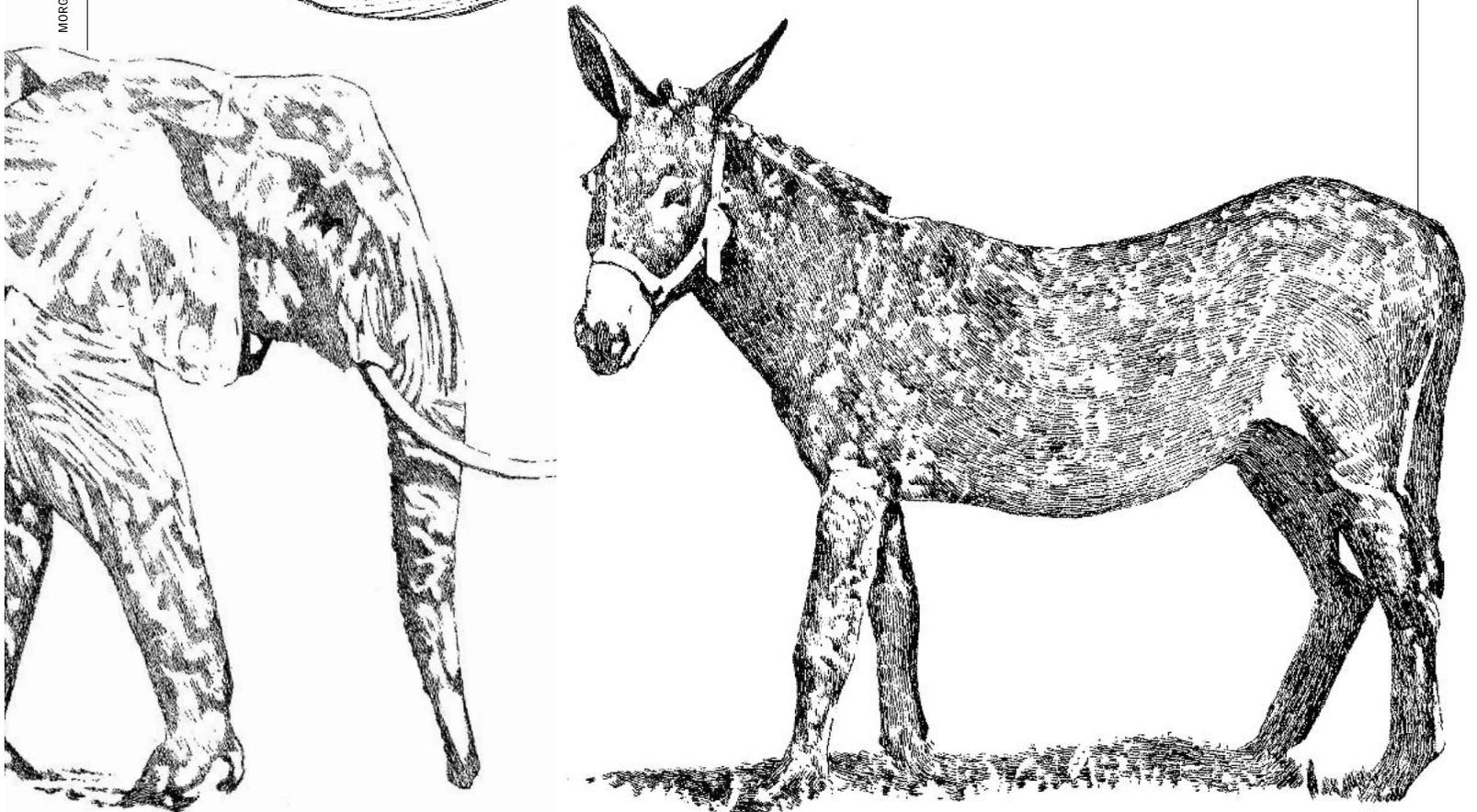


MORGAN BALLARD

Special advantages The Supreme Court provided the leading articulation of the view that corporate political activity will skew the political discourse in the 1990 case *Austin v. Michigan Chamber of Commerce*. In *Austin*, the Court observed that the state grants corporations “special advantages” such as “limited liability, perpetual life, and favorable treatment of the accumulation and distribution of assets.” Those “special advantages,” in the Court’s view, allow corporations to amass “immense aggregations of wealth... that have little or no correlation to the public’s support for the corporation’s political ideas.” Thus, the Court held that restrictions on corporate political activity are permissible to offset the “unique state-conferred corporate structure that facilitates the amassing of large treasuries.”

Austin rests on the assumption that, without regulation, corporations would in fact deploy their “large treasuries” in politics in such force as to become a “corrosive and distorting” influence. But managers who divert corporate resources from profit-making activities to politics on such a grand level as to warrant the characterization “corrosive and distorting” will find their firm’s “large treasur[y]” vanishing as the firm becomes less competitive in product and capital markets. And perpetual life cuts in precisely the opposite direction than the Court supposed — it solves the “last period” problem. As a class, managers must always consider tomorrow’s product and capital market competition. Managers have numerous incentives not to trade their firm’s future profitability for an election victory.

The logic behind the Court’s limited liability analysis is likewise obscure. Limited liability does not shield the corporation



itself from liability for its debts. It merely caps the shareholders' personal liability for corporate debts at the amount of their investment. To suppose that limited liability will help an incorporated firm amass a huge treasury for use in electoral campaigns is therefore to suppose investor irrationality. Who would invest in a company that, rather than promising handsome returns, merely hands over the corporate treasury to political candidates? The answer is, only those investors who prefer the corporation's political activity over larger dividends or stock price appreciation. The only exceptions to this, as discussed below, are if the political activity represents narrowly targeted rent seeking that increases the firm's profits, or if the market is uninformed about campaign donations and so cannot police managers.

Disclosure Putting aside the rent-seeking motive for now, the concern about the market's ability to police managers does not damage the thesis. At best, it argues for disclosure so that the

other use. Rather than reckless corporate political spending, efficient markets should prompt what is, from the corporation's perspective, efficient rent seeking.

Of course, from the perspective of society, rent seeking is undesirable. Obtaining rents through redistributive regulation merely reallocates, rather than increases, social wealth. And in this context, reallocation often does nothing more than shift wealth from one company in a diversified shareholder's portfolio to another. Worse still, the reallocation comes at the cost of deadweight lobbying expenses. So, this rationale for limiting corporate campaign expenditures has some purchase.

There is, moreover, a plausible argument that the corporate form affords a comparative advantage in lobbying. The idea is that the main obstacles to effective lobbying — the collective action and free rider problems that have been well known since James Buchanan and Gordon Tullock's 1962 book *The Calculus of Consent* and Mancur Olson's 1965 book *The Logic of Col-*

Who would invest in a company that, rather than promising handsome returns, merely hands over the corporate treasury to political candidates?

fact of the corporation's political donations would be impounded into its stock price. In other words, disclosure is all that is required to ensure that the amount of the corporation's treasury that goes to political activity lines up with its investors' support for that activity.

This is not to say that the corporation's financial strength will match the numerical strength of its views within the general population. But the same is true for any person, or unincorporated association of persons, of means. Indeed, there is something odd about worrying only about corporate wealth. Individuals like Ross Perot (who spent at least \$63.5 million of his own money in his unsuccessful 1992 presidential campaign), Steve Forbes (who spent at least \$38.7 million of his own money in his unsuccessful 2000 presidential campaign), Jon Corzine (who spent at least \$63 million of his own money in 2000 to win one of New Jersey's Senate seats), and Michael Bloomberg (who spent at least \$68.9 million of his own money in 2001 to become mayor of New York) are not subject to the disciplining force of capital markets, but public corporations are.

Rent seeking A better variation on the worry that corporations will skew the political discourse is the problem of corporate lobbying for private-interest legislation. This argument is at least plausible in that it does not require investor irrationality. Indeed, rational investors might happily tolerate managers' making campaign donations when the marginal return on those payments — the "rents" that come from the private-interest governmental action that the spending purchases — exceeds the marginal return on directing that money to any

lective Action — might be alleviated by the corporate form. If you do not own stock, then you do not benefit from the larger dividends or appreciation in the stock price caused by the passage of private-interest legislation. Perhaps that justifies singling out corporations for special treatment.

This justification, however, points to something of a puzzle: If the corporation is such an effective vehicle for lobbying, how did the Tillman Act and its state law analogues get passed in the first place? We shall return to this question shortly.

Shareholder protection It is often suggested that limits on corporate political activity are necessary to protect shareholders from managerial opportunism. President Theodore Roosevelt, for example, urged that "directors should not be permitted to use stockholders' money" for political purposes, and in the early 20th century some members of Congress used words like "embezzle" to characterize such activity.

An initial response to this charge is simply to rehash the earlier discussion. The various markets within which managers operate — capital, product, and corporate control — should sufficiently align managers' interests with that of shareholders. Still, there is likely to be enough slack in those markets for managers to get away with some political spending.

Yet this criticism proves too much, for it is similarly applicable to any seemingly non-profit-maximizing activity undertaken by managers. It fails to explain why this particular form of managerial discretion requires special legislation and indeed criminalization. The crucial question is whether there is any reason to suppose that ordinary corporate governance checks

on the shareholder/manager agency problem will be unusually ineffective in the context of political donations. There are several related points to be made here.

First, capital markets must be aware of the slack, so stock prices should be discounted accordingly. Relatedly, in the absence of a mandatory proscription, investors could have demanded a “no politics” charter provision. This is not a fanciful notion; before the passage of the BCRA, a number of large corporations — including General Motors, Ford Motors, Monsanto, Time Warner, Dell, Cisco, and IBM — announced a policy against giving soft money donations.

Second, an absolute proscription is serious business. No matter how sophisticated the shareholders and how much they might want to permit political spending by managers, the prohibitions are mandatory. A less drastic alternative would have been to ban corporate political donations in the absence of a specific charter provision authorizing them.

Third, there are good reasons why shareholders might want managers to make political donations. For example, given the possibility that the corporation will be the victim of redistributive legislation sought by others, it might be more efficient (owing to collective action and free rider problems) to have the corporation’s managers engage in political activity rather than for shareholders to do so themselves. Managers are more likely than shareholders to be aware of what legislation will benefit or harm the corporation. Thus, for all the same reasons that shareholders delegate decision-making authority regarding ordinary business judgments to managers, they might also want to delegate authority to make political interventions. A nice case study for this point, detailed in a work-in-progress by Fordham University law professor Jill Fisch, is Federal Express’s long-standing program of careful and coordinated political interventions.

Another possible basis for shareholder support of corporate political activity is that spending on politics is sometimes a more profitable alternative to spending on, say, research and development. Shareholders want managers to invest in whatever has the highest rate of return. On this view, as with corporate charitable giving (which no one seems eager to proscribe despite the existence of the very same shareholder/manager agency problem), there might well be a corporate profit-maximizing and therefore pro-shareholder rationale for corporate political activity.

Of course, unlike most (but not all) charitable spending, corporate efforts to obtain redistributive legislation or regulation reduce social welfare. Thus, if the corporate form affords competitive advantages in the “market for legislation,” then that might be a reason to limit corporate political activity. But the basis for the ban would be to protect society from the lobbying of corporations (and so, by extension, their shareholders), not to protect shareholders from managers.

Finally, there is some irony in the contrast between the law’s treatment of charitable and political donations. Although the common law imposed some limits on managerial freedom to make charitable donations, several states have freed managers from even those restraints. Those states have therefore aggravated the very same agency problem that has been suggested as a justification for proscribing corporate political donations.

The minority shareholder An interesting variant on the shareholder protection rationale is the plight of minority shareholders. The idea here is that, even if a majority of the shareholders approves of the corporate political intervention, the minority should not be compelled to fund political activity with which its members disagree.

This analysis, however, assumes that shareholders are locked into their investment; that in the absence of regulation, all corporations will engage in corporate political activity; that there is a paucity of fungible investment vehicles; and that securities markets are opaque. Those assumptions, which are necessary to establish compulsion, are dubious.

If there are resources held by prospective investors who are skittish about funding political speech but otherwise would be happy to invest in stock, then some managers would insert “no politics” clauses into their corporate charters, or mutual fund companies would create a “no politics” fund, to tap into this potential source of cheaper capital. Consider by analogy the proliferation of “social responsibility” funds. Perhaps even more apposite, consider that a number of high-profile, publicly traded corporations pledged to forbear from soft money donations long before the BCRA.

Alternatively, take the distinction between incorporated nonprofit political associations and for-profit business corporations that the Supreme Court has seized upon to justify exempting the former from limits on corporate donations. According to the Court, shareholders or members of incorporated nonprofit political associations can easily dissociate themselves from the organization should they disagree with its political activity. In contrast, because shareholders of business corporations are “dependent” on the enterprise for income, there is an “economic disincentive” to dissociating.

This is backwards. The minority shareholder who invests in stock for income, which is the precondition to having an “economic disincentive” to dissociating, is by hypothesis indifferent between companies with comparable rates of return. He has no reason not to sell his stock in the politically active company and then invest the proceeds in another company that is not politically active. In contrast, the minority shareholder or the member of an incorporated nonprofit political association often faces a shortage of alternatives. There is a thick market for corporate securities; the menu of political associations is less extensive.

Election codes A final objection to the shareholder protection rationale is that all state law corporation-specific campaign finance limitations are located in state election codes, not in their corporate codes.

By operation of the choice-of-law rule known as the “internal affairs doctrine,” this creates an odd asymmetry. Shareholders of all corporations, wherever incorporated, are “protected” against managers making corporate donations within a state that has enacted a proscription on corporate donations. But shareholders of firms incorporated in such a state are not necessarily protected against managers’ political spending outside that state. Had the rules been included in the states’ corporate codes, however, the statutes would have barred political spending by managers everywhere, not just within

jurisdictions that have such a ban in their election codes. Accordingly, the failure to include the provisions in state corporate codes strongly suggests that they were not motivated by a worry about shareholder rights.

THE POLITICAL ECONOMY OF REGULATING CORPORATE POLITICAL ACTIVITY

Earlier, it was suggested that the corporate form might provide an effective vehicle for overcoming the collective action and free rider problems that are the principal barriers to effective lobbying. The idea was that incorporation captures, in the form of stock, the group's (shareholders') stake in the leaders' (managers') lobbying efforts. Moreover, in contrast to the costs of organizing a new group, the fixed costs of organization are sunk for an already existing corporation.

The argument in favor of more heavily regulating corporate political activity is that it offsets those advantages. But if that is right, why were corporations not successful in lobbying against the rules in the first place? Perhaps the reason is that tighter regulation of corporate political activity is, in fact, advantageous for corporations.

Collective action One pro-corporation view of proscribing corporate political activity is that doing so helps solve a collective action problem faced by corporate managers. If we suppose that corporate political activity represents both offensive and defensive lobbying, then corporations as a class might do better with a flat ban on corporate campaign contributions. The problem is that the managers of few corporations could risk adopting such a policy unilaterally. Viewed in this manner, the statutes solve the collective action problem because they enforce concerted action. And from the perspective of diversified shareholders, legislated wealth transfers between incorporated firms represent nothing more than a deadweight loss in the amount of the transfer costs.

This collective action dynamic may explain why, on the state level, corporate political donations are regulated by election rather than corporate codes. As noted above, had those rules been included in state corporate codes, then they would regulate donations made anywhere by corporations incorporated in that state. Instead, because they are located in state election codes, the laws govern the donations of all corporations, regardless of their state of incorporation, with regard only to elections in the state that enacted the given statute. This is responsive to the collective action problems in and out of state. With respect to in-state elections, they disarm all corporations regardless of their state of incorporation. But with respect to out-of-state elections, corporations incorporated in-state are not unilaterally disarmed, so they are not placed at a disadvantage out-of-state when competing in jurisdictions without a comparable statute.

The "new" economic theory of regulation Traditional public choice theory assumes that demand and supply exist for regulation in the same way they do for any other commodity. Recent scholarship, however, has expanded the traditional theory by developing a more sophisticated account of the role of

individual legislators. Most closely associated with Northwestern's Fred McChesney, this "new" economic theory of regulation replaces the traditional view of lawmakers as passive suppliers with a model in which lawmakers actively seek out opportunities to extract donations and other forms of support. In the words of McChesney, "The model extends the [traditional] economic theory of regulation to include the gains available to politician-maximizers from alleviating costs threatened or actually imposed on private actors by legislators themselves and by specialized bureaucratic agencies."

In this light, a richer understanding of the Tillman Act's political economy emerges. A fresh look at the historical record, both the legislative history and contemporaneous news accounts, reveals a story of systematic shakedowns of corporations followed by the enactment of the Tillman Act.

Political entrepreneurship The Tillman Act is usually explained as a product of political entrepreneurship by opportunistic politicians who capitalized on the Progressive Era's distrust of large corporations generally and a few salient corporate campaign finance scandals in particular.

The historical record supports this view. The presidential election of 1904 in particular was marked by numerous appeals to voters in which the candidates spoke of the evils stemming from the "corruptive" influence of large corporations. Following the 1904 election, charges of improper fundraising abounded.

Those criticisms prompted President Theodore Roosevelt to call for election reform in his 1905 message to Congress. That message, in turn, set in motion the enactment of the 1907 Tillman Act. Sen. William E. Chandler (R-N.H.) had introduced a similar measure in 1901, but it was only when the issue achieved popular salience after the 1904 election scandals that the proposal got anywhere. Two months after Roosevelt's speech, Sen. Benjamin R. "Pitchfork Ben" Tillman (D-S.C.) seized on Chandler's initiative and assumed sponsorship of the legislation. Tillman did so because it would attract public attention and give him a measure of control over the new Congress's legislative agenda.

When one adds the supposition that labor probably supported the Tillman Act in order to lessen the influence of management, the act's lineage seems to come together. But this simple account is unsatisfying. At the time of its passage, labor was not well organized, and the Tillman Act was later amended to apply with equal force to unions. There must be more to the story.

Political extortion The Tillman Act should be placed in the context of the evolution of modern campaign finance. The public controversy over the role of corporate money in the 1904 election represented the natural escalation of a process begun years earlier. Most notably, the national parties began shouldering a larger share of the burden in the elections of the late 19th century. Hence, the national parties began deploying systematic procedures for demanding contributions for their candidates — and corporations were a frequent target. Not coincidentally, this occurred soon after the Pendleton Act of 1883 banned contributions from civil servants.

In the 1896 election (the first of two in which William McKinley defeated William Jennings Bryan), the dominant

issue was monetary policy. So Mark Hanna, McKinley's chief fundraiser, focused his efforts on New York financiers and large corporations. Standard Oil was assessed \$250,000 and, under Hanna's stewardship, the Republican National Committee assessed banks at one-quarter of one percent of their capital. As Herbert Croly put it, Hanna "did his best to convert the practice from a matter of political begging on the one side and donating on the other into a matter of systematic assessment according to the means of the individual and institution."

To take advantage of the collective action problem facing those being leaned on, solicitation letters often included information on competitors' pledges. By the time McKinley's 1900 reelection campaign rolled around, Hanna had so systematized his collection efforts that, in the words of George Thayer, with "his customary efficiency, Hanna shook down the business world for \$2.5 million." Party affiliation did not matter; members of both parties were simply assessed their shares by Hanna and his staff. Contributions above and below those assessments were returned.

statute, which was reported in a *Times* editorial entitled "Happy Corporations": "[We] welcome... this legislation with very much the same emotions with which a serf would his liberation from a tyrannous autocrat."

Limited scope In this light, not only do the reported responses of corporate leaders make sense, but so does the legislation's limited scope. For example, the act did not touch donations funneled through managers in the form of increased compensation. This porousness was not an oversight; Congress rejected more restrictive proposals even though the holes in the Tillman Act's proscriptions were widely known at the time of its enactment. Thus, despite the Tillman Act, corporations could still "purchase" legislation through various indirect means, albeit at a higher "price." But the public outcry for regulation was mollified. And the cumbersomeness and increased costs of the remaining methods of corporate political intervention — consider the tax consequences and time delay of

“[We] welcome... this legislation with very much the same emotions with which a serf would his liberation from a tyrannous autocrat.”

With this history in mind, let us return to the 1904 election controversy. Many of the complaints charged in particular that it was improper for Roosevelt to have appointed George Cortelyou, former secretary of commerce and labor, to head the Republican National Committee. Though there was no proof of any actual wrongdoing, the problem was that the department's Bureau of Corporations had the authority to investigate corporations doing interstate business. As the *New York Times* editorialized, the objection was that "the chief of the Department which has become the custodian of corporation secrets [was] put at the head of the partisan committee whose principal function [was] to collect campaign contributions which come chiefly from great corporations."

This is not to say that, in the late 1800s and early 1900s, corporations were not engaged in socially undesirable rent seeking. Rather, the point is that legislators are as active in the "market for legislation" as potential "buyers" such as corporations. To the extent that legislators actively raise funds through threats and other means, acquiescing in a ban on direct corporate contributions would be a rational corporate response.

Not surprisingly, corporate leaders embraced the Tillman Act for precisely that reason. One Republican State Committee member observed that corporate leaders were "entranced with happiness.... [T]hey are now in a position to toe us unceremoniously out of the door if we ask them for a penny.... They mean to take advantage of the laws forbidding them to give money for political purposes." Indeed, consider this reaction of a "great financial authority" to the Senate's passage of the

funneling a donation through managers as increased compensation — would provide an excuse for the inability to respond swiftly to an extortive ultimatum.

True, "soft money" donations are relatively easy to make and were not covered by the act. But the soft money donation was largely unknown until 1988. Indeed, as noted below, a similar confluence of factors may be found in the debate over the BCRA's ban on soft money donations.

Returning to 1907, the limited scope of the statute did not go unnoticed by contemporary observers. Upon the act's passage in the Senate, for example, the *Times* editorialized:

[The act] will lessen a very mean and sordid practice of blackmail. The beneficiaries of [regulation] will still find methods of furnishing the sinews of war to the party that controls their favors, but the great number of corporations that have suffered extortion through weakness and cowardice will have their backbones stiffened, and parties will be put to it to fill their coffers by really voluntary contributions.

THE TILLMAN ACT AND THE BCRA

There are strong parallels between the enactments of the Tillman Act and the BCRA. The former was enacted in a burst of political entrepreneurship in the wake of publicly salient and rampant corporate interventions in the presidential election of 1904. Those interventions represented an exaggerated application of a fundraising technique developed less than 20 years

earlier. Likewise, the BCRA owes its passage in large part to political entrepreneurship in the wake of publicly salient and rampant corporate soft money donations. Those donations represent an exaggerated application of a fundraising technique more or less invented in 1988. For the 2000 election, soft money contributions to the national parties amounted to roughly \$500 million.

Both the collective action and the extortion dynamics identified above are discernible in the rhetoric of the BCRA debate. Evidence of the former includes a statement by one manager that most “business today would prefer not to give. But there’s not going to be unilateral disarmament.” Regarding the latter, consider this excerpt from an editorial by Edward Kangas, then the global chairman of Deloitte Touche Tohmatsu:

What has been called legalized bribery looks like extortion to us.... I know from personal experience and from other executives that it’s not easy saying no to appeals for cash from powerful members of Congress or their operatives. Congress can have a major impact on businesses.... The threat may be veiled, but the message is clear: failing to donate could hurt your company.

Indeed, as recounted in the opinion of Judge Colleen Kollar-Kotelly, there was evidence presented in the lower court challenge to the BCRA (*McConnell v. FEC*, now on appeal before the Supreme Court) that corporate leaders feel “pressured” to make donations and fear “retribution” if they do not. As former senator David Boren (D-Okla.) testified, “Donors . . . feel victimized. Now that I’ve left office, I sometimes hear from large donors that they feel ‘shaken down.’”

CONCLUSION

In evaluating campaign finance reform, the proposal’s predicted effects on both rent seeking in the classic public choice sense and on political rent extraction in the McChesney sense are relevant considerations.

More broadly, additional insight is available from drawing on both traditional and modern learning on public choice. Putting aside the effect of banning soft money on rent seeking by interest groups, and further putting aside First Amendment considerations, the history of the Tillman Act perhaps furnishes an additional argument in favor of a corporate soft money ban. Such a ban might enhance shareholder welfare by making more difficult the extraction by legislators of large corporate soft money donations.

This argument, of course, is hardly a show-stopper. The market will eventually find a way to clear, and the substituted approach may be even less desirable. Consider that the use of corporate political action committees to evade the Tillman Act means that many corporate donations today are subject to fewer corporate governance checks than they would have been without the act. And if the BCRA is upheld, it will likely further channel corporate political spending into PACs. What is more, there is something to be said for encouraging more, rather than less, participation in politics.

Still, there are important lessons in the history of the Tillman Act for the modern debate over the proper role of business corporations in political life. R

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