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Political rights, taxation, and firm valuation – Evidence from

Saxony around 1900¹

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Abstract:

The extension of the franchise to social groups with less property and income is associated with greater income redistribution from the rich to the poor and extension in the provision of public goods, which leads to the growth of government expenditure. All of these expected changes are costly and therefore a higher taxation of citizens and industrial firms can be expected, which might have negative effects on investors behavior.

The present paper studies the effects of changes in the suffrage in the Kingdom of Saxony at the end of the 19th Century on stock market prices of Saxon firms listed on the Berlin stock exchange: Here the electoral law was changed twice: In 1896 a very restrictive franchise was introduced, which was abolished in 1909 and replaced by a more democratic electoral law. By applying standard event study methodology, we can provide evidence that the restriction of the electoral law had positive effects on Saxon firms on the stock market, whereby the extension in 1909 had negative effects on the stock market.

Keywords: Financial History, Taxation, Stock Markets, Event Study, Investors, Suffrage, Elections

JEL Classification: G11, G14, G18, D72, N23, N43

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Introduction

Nowadays, most rich countries are democracies and most poor countries are dictatorships. Democratic societies provide institutions that ensure economic and political freedom, protect property rights and improve opportunities for the population to run economic business. These institutions form frameworks of functioning markets and ensure liberty and contentment and are generally believed to encourage economic growth. This causality could be found in many empirical analyses.¹

On the other hand democratic institutions may also have growth retarding features. The argument goes as follows: more participation of the working poor may lead to more redistribution of income from the rich to the poor, extension of the provision of public goods and thus a rise in government expenditure which will then be financed with higher taxation of the richer population. Higher taxation reduces income of capital owners, who might then withdraw or reduce investment - which reduces the ability of firms to overcome liquidity constraint which has negative effects on industrial growth and thus economic development.²

The Kingdom of Saxony is the perfect case to study these effects on investment behavior and firm valuation for four reasons:³ First, the electoral law was changed twice within a very short period. The law introduced in 1896 reduced the possibility of participation of the working poor and the law from 1909 extended it again. That way it is possible to study both, the effect

¹ See for instance Lipset (1959), Olson (1993), Przeworski and Limongi (1993), Leblang (1996, 1997)

² See for instance Husted and Kenny (1997), Justman and Gradstein (1999), Acemoglu and Robinson (2000), Lizzeri and Persico (2004) and Lott and Kennedy (1999). Barro (1996) finds a u-shaped relationship between democracy and growth. More democracy - as measured by an index of political freedom - seems to enhance growth at low levels of political freedom but depresses growth when a moderate level of political freedom has already been attained.

³ The study is inspired by the work of Turner and Zhan (2010). They analyzed the impact of the 1867 Reform Act in Britain that extended the suffrage to the skilled but propertyless urban classes on stock market prices. They found that investors reacted negatively to the extension of suffrage.

of reduced and increased political participation of the working poor in an environment where other factors remained relatively stable.

Second, the political culture in the kingdom was very polarized. On the one hand the kingdom was a center of the Social democrats, which was the party of the workers, demanding more redistribution, higher taxation of the rich and the extension of public goods. In the elections to the general parliament of the Reich, where much more voters were eligible to vote, the Kingdom was almost completely represented by this party. On the other hand, in the elected parliament of the kingdom, the Social democrats were mostly not represented at all (Ritter 1990).

Third, the Kingdom of Saxony was the third largest state of the German Kaiserreich and its most industrialized region. Furthermore it had a very high level of capitalization.⁴ Joint stock companies listed in Berlin and on regional stock markets had an overall value of nearly fifty percent of the Saxon GDP in 1909.⁵ Reduced investment on the stock market which leads to falling prices of stocks therefore has a strong effect on short- run industrial growth and possibly long run development of the entire region.

Fourth, the German Kaiserreich was a federal system where most important decisions lay within the member states. The Reich was responsible for military and foreign policy, whereas the states were completely autonomous in terms of taxation, education, culture and jurisdiction (Berghahn 2003, pp.360). There was no tax directly paid to the Reich. Saxony had its own taxation and it paid a certain amount of its tax revenues as member state contributions to the Reich (Ullmann 2005, 60). Thus, the state elections were in terms of power and influence more important than the imperial elections.

⁴ For the correlation of stock market capitalisation and growth see for Levine and Zervos (1998).

⁵ Own calculation, Data on GDP see Hoffmann (1959), Capitalisation taken From Salinger Börsenhandbuch (1909).

In the reaction to the changes of the electoral law, we find that an extension of the suffrage to the benefit of the poor leads to negative returns and a reduction of the suffrage to positive returns for Saxon firms listed and traded at the Berlin stock exchange. Thus the positive effects of democracy were obviously less present in 19th century Germany than its possible negative effects for markets. This is not only interesting from a theoretical perspective, the results further show that at least capitalists and possible investors from the middle class remained of the conviction that democratic structures and participation of more citizens, which slowly but constantly spread, was wrong and rather harmful to the economy. This is the first quantitative evidence of such antidemocratic sentiments and contributes to the literature on why Germany remained autocratic for such a long time and the debate about the ability of the Germany Kaiserreich to modernize and change at all⁶.

Although Saxony's constitutional changes were rather special at the time- Retallack (1990, 276) called it 'konstitutioneller Sonderweg', Lässig (1996, 24) points out that contemporary observers from all political camps shared the common belief that the development in Saxony in 1909 may have implications for the entire Reich. Although the highly restrictive suffrage in Prussia persisted until the end of the Kaiserreich, the entire period was characterized by the debate about a possible change and more participation of the working poor.

The paper is organized as follows: The first section describes the historical circumstances and the economic situation of the kingdom of Saxony and shows that it can be treated as a representative case study for the whole Reich at the time, the second section discusses the theoretical framework and related literature and derives the hypotheses, the third section contains the analysis, a fourth section contains robustness checks and a final section concludes.

⁶ See for instance: Dahrendorf (1994), Wehler (1994), Lepsius (1993).

Why Saxony? The Constitution, electoral laws and the Rise of the Social democrats

In the late 19th and early 20th centuries, Saxony was one of the most industrialized regions in Germany. Table 1 gives an overview of the occupational structure in Saxony compared to the whole Kaiserreich.

(Table 1 about here)

The table shows that already in 1882 fifty six percent of the working population was employed in the industrial sector. This was the largest share in the whole Reich and far above the national average of 35 percent. In 1907, the agricultural sector accounted for only about 11 percent of the working population which is comparable to England at the time (Ritter, 1990, 50-52). The most important sectors were textiles, machines and metal working. In all of the 23 constituencies of the imperial election (Reichstagswahlen) the majority of the electorate was working in the industrial sector. In the whole Reich we count 195 out of 397 constituencies where this was the case (Ritter, 1990, 51). Compared to other member states of the Reich, Saxony had also quite a high GDP per capita (Table 2).

(Table 2 about here)

One might raise the question whether it makes sense to study democratic institutions in a kingdom since political participation must have been very limited per se. Since the adoption

of the constitution of 7th September 1831, the political system consisted of a two chamber parliament, where both chambers had equal rights.⁷ The first chamber consisted of members of nobility and knighthood, whereas the second chamber was elected by the population (Blaschke 1997, 18). The king appointed the ministers and the government. He further had the right to dissolve the second chamber at any time without particular reason and exclude persons from the first chamber. The king and both chambers had the right to draft a law and all three had to agree before a law could be passed (§§85/86 of the Saxon Constitution). Thus although participation was limited, the elected politicians were able to actively influence policy. Furthermore none of the kings, neither a grey eminence nor an ambitious woman used their opportunities to participate in the political process, which was mainly left to government and chambers (Blaschke 1997, 16).

The kingdom of Saxony is further a good example since it was theoretically quite classical in terms of its development of voting rights for Europe. In the first phase from 1831 to 1867, the possibility to participate in the political process was dependent on estate criteria. From 1867 to 1896, the electoral law for the second chamber of parliament restricted the right to vote by income and property criteria with an equal weighting of votes. Every male above the age of 25 who paid at least three Marks property tax had the right to vote.⁸ A further difference to the federal franchise for the Reichstag, which was not restricted by income, was the renewal of one third of the members of parliament every two years (Opitz 1887, 51). However, the amount of eligible voters was very small with only about ten to fourteen percent (Ritter 1980, 164).

In 1896 an electoral law similar to the Prussian design was introduced. The new law slightly extended the suffrage to a larger base of voters, but introduced formal inequality through

⁷ For the full text of the constitution see Huber (1986).

⁸ This amount of tax had to be paid for an income of about 600 Marks per year. Men who lost their civil rights were excluded.

different weights on votes (Lässig, 1996, 251). This law, supported by Conservatives, National liberals and Progressives, divided voters into three groups depending on the amount of income and property tax they paid. In every electoral district, each class chose an elector. The members of parliament were then elected by the electors by a simple majority vote in the particular constituency. The first class was constituted by the voters paying the highest amount of direct tax until they represented one third of all taxes, the second class by citizens who paid the second third of taxes and all others voted in the third class. It was a little less severe than the electoral law in Prussia, because tax payments above 2000 Marks were not counted and every citizen who paid more than 300 Marks was a member of the first group and above 38 Marks in the second group. In order to be allowed to vote in the third group, the citizen had to live in Saxony for at least six months and pay tax, independent on the amount. This suffrage excluded a quarter of the voters that had the right to vote in the imperial elections from voting in state elections, which was not much more restricting than the previous law. Still about 15 percent of the population had a right to vote, although this vote might not have had much of an impact. Between 1897 and 1909, 3-4 percent were accredited to vote in the first class, 15-18 percent in the second class and 78 to 81 percent in the third class. The vote of a voter from the first class therefore counted about 20 to 25 times as much as a vote of a third class voter.⁹ That explains why social democrats only managed to win one seat in the whole period (in the year 1905), although they dominated the votes in the third class (Ritter, 1990, 74).¹⁰

The law that was introduced on the 5 of May in 1909 was technically not an “extension” of the suffrage since it slightly reduced the electorate, because it restricted the right to vote to

⁹ Taking into account the modus of election, the 80 percent of voters in the third class could easily be excluded from political power if the delegates of the second and first class cooperated within an electoral district.

¹⁰ Table 2 shows the result of the State elections from 1901 to 1909.

persons who were living in Saxony since two years and were not behind to pay tax for more than one year. More important, however, was the reintroduction of direct voting, abolishment of supplement elections (Elections should now takes place every 6 years), and the introduction of plural voting. Plural voting means that every voter had one vote but could get up to three additional votes according to income, property, education or age. Based on income or property alone up to two additional votes could be gained. Special groups such as civil servants or employees with a notice period above six weeks, who earned above 2500 Marks or a farm owner of more than 8 ha land, could get 4 votes in total. Based on education (at least six years of schooling in middle or high school) one could get one additional vote, if one had no additional vote for any other reason. And last, all citizens above the age of 50 received one additional vote, if they had not already four votes, which was the maximum one could get (Ritter 1980, 167). This new law reduced the bias of the different weighting and thus leads to an extension of the impact of the votes of the working poor. Thus we call the introduction of this law and “extension of the suffrage”. Figure 1 illustrates this fact. The figure reads similar to a Lorenz curve. In 1896 for instance, votes of 80 percent of the voters accounted for about one third of all votes, whereas in 1909 80 percent of the voters held about 60 percent of all votes.

(Figure 1 about here)

Contemporary debates reveal that the restriction of the suffrage in 1896 was clearly aimed at preventing the Social democrats from reaching important administrative positions and thus a “governance of the masses” (Herrschaft der Massen). It is further interesting to note that the new suffrage was introduced after the Social democrats proposed an equal universal suffrage

for men and women in the regional parliament of Saxony (Ritter, 1997, 64). The only difference to the famous Three-class-voting of Prussia was that the vote in Saxony was still secret. This feature remained only because the National liberals feared “terror of workers and Social democrats to small firms in order to influence the outcome of the election” (Ritter 1997, 65). Ritter (1997, 67) further cites a protocol published after the introduction of the new suffrage in which Conservatives, National liberals and Progressives promised to have a special focus on the protection of property rights. This can be interpreted as the reaction of the established parties on the observation that contemporary capitalists were well aware that increased suffrage might damage profits and weaken property rights. The result was dramatic. In the first election after the introduction of the new electoral law in 1897, the Social democrats lost about 40 percent of their seats (see Table 3).¹¹

During the whole period the political system was very polarized: On the one hand – in imperial elections – a very strong Social democracy won almost all seats. And on the other hand a stable conservative-liberal cartel dominated the suffrage restricted elections in the kingdom (Lässig, 1997, 204). The aim to reduce the impact of the Social democrats by introducing a restricted suffrage even increased the polarization between imperial elections and state elections. In 1903, in the first imperial election after the introduction of the restricted suffrage on state level, the Social democrats won all constituencies- with the exception of

¹¹ The Conservatives in Saxony did not possess the strong agrarian character that was typical for the party on Reich level. They also represented the interests of commerce and industry. The liberal character of the party caused the other liberals party, the National liberals, to represent rather right-wing interests, more than elsewhere in Germany at the time (Lässig 1996, 41). The principles of the opposing Social democrats were manifested in the Erfurter Programm of 1891, which contained several practical demands in favor of the working class, such as the improvement of labour conditions, the eight-hour working day, free health care and not at least religion as a private matter (Treue 1954, 72). The Germans (Deutsche Freisinnige Partei) and the Party of Progress (Deutsche Fortschrittspartei) were mainly liberal with an emphasis on civil and parliamentary rights (Treue 1954, 70). The first party represented the interests of the upper classes and commerce, whereas the latter one saw itself as a advocate to the lower middle class and a strong Prussia (Fricke 1983, 623, 657), which is also reflected in the party manifesto of 1861, which included a ‘strong central authority in the hands of Prussia’ (Treue 1954, 48). The Reformer (Deutsche Reformpartei) originated from the splitting of the German Socials (Deutschsoziale Reformpartei) in 1900, both of them were anti-Semitic and saw themselves as ‘Mittelstandspartei’ (middle class) (Fricke 1984, 63, 540)

one- Bautzen. This success of the Social democrats exceeded all their hopes and all fears of capitalists (Lässig, 1996, 101).

(Table 3 about here)

Theoretical Background, related Literature and Hypotheses

The extension of the franchise to social groups with less property and income is associated with greater income redistribution from the rich to the poor (Husted and Kenny 1997, Justman and Gradstein 1999, Acemoglu and Robinson 2000). Lizzeri and Persico (2004) also suggest that an extension of the franchise leads to an extension in the provision of public goods, which also leads to the growth of government expenditure (Husted and Kenny 1997, Lott and Kenny 1999). Aids and Jensen (2009, 379) observe that in Western European countries from 1860 to 1938 broadening of the electorate generally increases government spending and direct taxes, given the population exhibited a certain level of literacy.¹²

All of these possible and expected changes are costly. These additional costs are expected to be financed by higher taxation of richer citizens, but also of industrial firms. An extension of the suffrage to poorer citizens will thus reduce expected profits for industrial firms. Investors, who are not based in the kingdom and therefore unaffected by rising income tax, might step away from investing in Saxony and rather invest in other regions where the power of voters and therefore costs and tax for industrial firms are lower and expected profits higher. Investors, who live in the kingdom, face possible higher taxation through two channels: a rise in income tax and a rise in tax for joint stock companies. Thus, they would possibly substitute

¹² The critical value for this effect is a rate of children enrolled at school of about 62 percent. This is given, since already in the 1880s nearly all children attended in school and illiteracy was extremely rare in imperial Germany. (Kuhlemann 1991, 192)

their investment away from Saxon firms and possibly even reduce investment at all, although the latter only hits after the actual rise of taxation.

On the other hand, we expect that investors anticipate a restriction of the suffrage with lower or at least unchanged taxation, less or unchanged redistribution of incomes and more protection of income and property rights.

From the theoretical literature we can formulate **Hypothesis 1**:

Events associated with an extension of the suffrage will lead to negative returns on the stock market for firms headquartered in Saxony. Events associated with a reduction of the suffrage will have positive effects on their returns on the stock market.

Since in the case of Saxony the latter only ensures that the economic situation remains unchanged, **Hypothesis 2** can be formulated as follows:

The effect of the restriction of the suffrage will be lower than the extension of the suffrage on the stock market, since the latter was associated with direct changes of the political and economic environment rather than just keeping the status quo.

The social democrats - the party of the working poor - was the party that gained most by the change in the electoral law 1909. According to their party manifesto signed in the city of Erfurt in 1891, they claimed – among other things- general equal suffrage including the right to vote for women, free schooling and educational material, free legal advice for the poor and free medical health care. They further suggested that the rising government expenditure should be accounted for by higher income and property tax.¹³ This fits perfectly well the expectations from the theoretical literature.¹⁴

¹³ Ausgehend von diesen Grundsätzen fordert die Sozialdemokratische Partei Deutschlands zunächst: 1. Allgemeines, gleiches, direktes Wahl- und Stimmrecht mit geheimer Stimmabgabe aller über 20 Jahre alten Reichsangehörigen ohne Unterschied des Geschlechts für alle Wahlen und Abstimmungen.

The conservatives, who lost many seats were also agitating against capitalists. Kunze, one of the leading politicians of the conservatives was cited in the Newspaper *Sächsische Industrie*, a magazine for industrialist and capitalists, on the 10 of October 1909: “The liberals aim at absolute dominance of capital and thereby leave crafts, tradesmen and agriculture to speculation and exploitation. They have nothing but empty words and false promises for the needs of the working population. They completely fail in moments when the stock markets or the mobile capital could be affected. As the party of large bankers, large industrialists, joint stock companies and syndicates they try to exploit the working poor and the middle class for their political ends.”¹⁵ The expected positive effects caused by the losses of the conservatives might have balanced out the negative effect anticipated from the gains of the Social democrats, but this is very unlikely. In contrast to the conservatives in Prussia or the rest of the Reich where the conservatives were the party of the agricultural elites, the conservatives in Saxony were composed of a broad spectrum that included higher ranks of economy, administration and military (Retallack 1992, 65). It seems quite obvious that they rather tried

Proportionalwahlsystem, und bis zu dessen Einführung gesetzliche Neueinteilung der Wahlkreise nach jeder Volkszählung. Zweijährige Gesetzesperioden. Vornahme der Wahlen und Abstimmungen an einem gesetzlichen Ruhetag. Entschädigung für die gewählten Vertreter. Aufhebung jeder Beschränkung politischer Rechte außer im Falle der Entmündigung [...], Obligatorischer Besuch der öffentlichen Volksschulen. Unentgeltlichkeit des Unterrichts, der Lehrmittel und der Verpflegung in den öffentlichen Volksschulen sowie in den höheren Bildungsanstalten für diejenigen Schüler und Schülerinnen, die kraft ihrer Fähigkeit zur weiteren Ausbildung als geeignet erachtet werden, [...], Unentgeltlichkeit der Rechtspflege und des Rechtsbeistandes. Rechtsprechung durch vom Volk gewählte Richter. Berufung in Strafsachen. Entschädigung unschuldig Angeklagter, Verhafteter und Verurteilter, [...], Unentgeltlichkeit der ärztlichen Hilfeleistung einschließlich der Geburtshilfe und der Heilmittel. Unentgeltlichkeit der Totenbestattung. [...] Stufenweise steigende Einkommens- und Vermögenssteuer zur Bestreitung aller öffentlichen Ausgaben, soweit diese durch Steuern zu decken sind. Erbschaftssteuer, stufenweise steigend nach Umfang des Erbgutes und nach dem Grade der Verwandtschaft. Abschaffung aller indirekten Steuern, Zölle und sonstigen wirtschaftspolitischen Maßnahmen, welche die Interessen der Allgemeinheit den Interessen einer bevorzugten Minderheit opfern. (Erfurter Programm, published in Kautsky, 1892)

¹⁴ In fact tax did not change significantly in the two years after the election. This analysis, however, is about expectations. It does not matter whether the level of tax actually changed or not after the extension of the suffrage. The change in the returns on the stock market can be interpreted as expectations about changes.

¹⁵ “Die Liberalen erstreben die uneingeschränkte Herrschaft des Grosskapitals und geben Kleingewerbe und Handwerk, Grund und Boden der Spekulation und Ausbeutung preis. Sie haben für die Notlage des schaffenden Volkes nur hohle Worte und trügerische Versprechungen, sie versagen vollständig, wenn der Geldbeutel der Börse, des mobilen Großkapitals in Frage kommt. Als Partei der Grossbankiers, der Grossindustriellen, der Aktiengesellschaften und Syndikate suchen Sie den kleinen Mann und den Mittelstand mit schönen Worten vor Ihren Wagen zu spannen.“ (*Sächsische Industrie* 10. Oktober 1909, 3).

to attack the Liberals in order to catch some votes from the left wing. Traditionally, they had no intention to harm capitalists or redistribute property or income (see Wehler 1994, 85).

Furthermore, Ullmann (2005, 88) mentions that public tax morality might have changed in this period and citizens became more sensitive about the questions of how much tax would be acceptable. The conservative politician Kunze as cited in *Sächsische Industrie* on the 10 of October, also claimed that joint stock companies clearly evaded tax and that with another tax (here succession tax) they would try to avoid paying this as well¹⁶.

Thus, if capitalists were indeed in the position to avoid paying tax, the threatening of higher taxation caused by an extension of the suffrage would not have such a negative effect on investment behavior.

Methodology

We study the effect on changes or possible changes in the political rights on Saxon firms on the Berlin stock exchange with standard event study methodology (see Binder 1998, 124)¹⁷.

Figure 2 illustrates the approach. In an estimation period $[T_0, T_1]$, which is unaffected by the event- the estimation window- we estimate expected (normal) returns. In an event window $[T_1, T_2]$ the event under considerations takes place at time 0 and the event can affect the stock market during the event window, i.e., before and after the event takes place. The estimation window for the normal returns is set to 120 trading days before the event window.¹⁸ Five different event windows, measured in days are selected: 28 days $[-14; +14]$, 14 days $[-7; +7]$,

¹⁶ [...] Er wies darauf hin, dass die Aktiengesellschaften den Versuch gemacht hätten, die Talonsteuer zu umgehen und erklärte, von solchen Leuten, die vor aller Welt die Steuern hinterzögen, könne man auch mit Sicherheit erwarten, dass sie bei der Erbschaftssteuer wenigstens im Dunkeln dasselbe versuchen würden.“ ((*Sächsische Industrie* 10. Oktober 1909, 3).

¹⁷ For an overview of this method see MacKinlay (1997)

¹⁸ Excluding Sundays and bank holidays when the stock market was closed.

(i.e. one week before the event and one week after the event), 14 days [-14; 0], 14 days [0; 14], and six days [-3; +3].

(Figure 2 about here)

The expected returns can be estimated with different methods. We estimate them with two standard models: the market model or the constant mean return model. The market model is a statistical model which relates the return of any given security to the return of the market portfolio¹⁹. The model's linear specification follows from the assumed joint normality of the asset returns. For any security *i* the expected returns are estimated according to the following equation using the market model:

$$E(R_{it}) = \alpha_i + \beta_i R_{mt} + \varepsilon_{it} \quad (1)$$

With $E(\varepsilon_{it}) = 0$ and $Var(\varepsilon_{it}) = \sigma_{\varepsilon_i}^2$

Where R_{it} and R_{mt} are the period-*t* returns on stock *i* and the market portfolio, respectively. ε_{it} is the error term, whose variance is assumed to be constant over time. R_{mt} is based on the stock market index published by Gelman and Burhop (2008). This index is based on 27 firms

¹⁹ Returns of firm *i* are calculated as the difference of the logarithms of the corrected share prices between *t* and *t-1*: $\ln(p_{it} + SZ_{it}) - \ln(p_{it-1} + SZ_{it-1})$, where SZ_{it} denotes the accumulated fraction of the Stückzins (see footnote 29) and P_{it} the price of firm *i* time *t*. We also include dividends, which were taken from Berliner Börsenzeitung.

that were continually listed on the Berlin stock exchange. In order to avoid a bias and to construct an appropriate benchmark portfolio, firms based in Saxony were removed.²⁰

The second way to calculate the normal returns is the constant mean return model. For any security i , the constant mean return model is:

$$E(R_{it}) = \mu_i + \zeta_{it} \quad (1)$$

With $E(\zeta_{it}) = 0$ and $Var(\zeta_{it}) = \sigma_{\varepsilon_i}^2$

We then calculate abnormal returns in the event window. Specifically, abnormal returns of the shares of firm i at time t are calculated as:

$$AR_{it} = R_{it} - E(R_{it}),$$

where R_{it} is a stock's realized return for time t and where $E(R_{it})$ is its expected return in the absence of the event, as calculated above.

We then calculate the average cumulated abnormal return (ACAR) from $t=T_1$ to $t=T_2$

$$ACAR = \frac{1}{N} \sum_{i=1}^N \sum_{t=T_1}^{T_2} AR_{it} \quad (3),$$

where N is the number of stocks in our sample during each event. To test the significance of the ACARs, the variance of the ACARs is estimated by using cross-sectional variance across the cumulative abnormal returns of the various companies. This cross-sectional approach takes account of increase in event period variance (Campbell et al. 1997; 168, Turner and Zhan 2012, 620). Using the cross-sectional approach to form an estimator of the variance gives:

²⁰ The authors thank Carsten Burhop for the provision of the detailed data set on which the stock market index is based.

$$\text{Var}(ACAR) = \frac{1}{N^2} \sum_{i=1}^N (CAR_i - ACAR)^2 \quad (4),$$

The test statistic is then calculated as:

$$t = \frac{ACAR}{\sqrt{\text{Var}(ACAR)}},$$

which is asymptotically standard normal.

To verify the robustness of these results, we further apply the generalised rank (GRANK) test as described in Kothari and Pythonnen (2011), which accounts for both event-induced volatility and cross-sectional correlation of abnormal returns among firms. The latter is of particular concern, since the event-day is the same for all firms, i.e. we face “event-date clustering”. Such clustering can lead to a correlation of abnormal returns among firms on the event-date, which bias the test-statistic downwards and leads to an over-rejection of the null-hypothesis of no abnormal returns. The generalised rank test corrects the event-day standard deviation by the average correlation of abnormal returns in the sample.²¹ Additionally, unlike other modifications of the rank test, the generalised rank test also allows for multiple-day event windows in the analysis, which is useful since in our particular context we can apply the same event windows as above and compare whether the results remain significant. This can be done by aggregating abnormal returns over the event window similar to the standard ACAR-approach and then assigning a single rank to the cumulated abnormal return of each firm.²² Another advantage of using non-parametric tests such as the generalised rank test is that we do not need to make specific assumptions about the distribution of the returns (see Campbell et al. 1996, 172).

²¹ See Kolari and Pythonnen (2010) for details.

²² A formal exposition of the GRANK test is given in the Appendix.

Events

We study the effects of six events that occurred in the period from 1896 to 1909 (see Table 4). Our main source to detect event dates was the *Frankfurter Zeitung*, one of the most important national newspapers and financial dailies in Imperial Germany. Except for the mass demonstration and the day when the law passed in the parliament 1909 we take the first day when the event appeared in the Germany wide newspaper ‘*Frankfurter Zeitung*’. The mass demonstration and the change in law in 1909 were only mentioned in regional newspapers. The first event that we analyze is the day on which the new law that restricted the suffrage was published, the 28 of March 1896 (Gold 1995, 42). The new law was mentioned for the first time in a newspaper on the 29 of March – a Sunday. Since stock markets were closed on Sundays, we test the 30th of March as the first day after the notification when the stock market was open. The debates in the parliament before the law was signed were heated (Lässig, 1996, 80). Thus the effect on stock returns might not be apparent since the market might have anticipated the event in advance.

The second event is the first election with the restricted law. In the forefront of the election some Social democrats agitated at possible candidates for abstention in the election. Eventually the regional organization of the Social democrats left the decision to their members whether they wanted to run for the election or not. The election brought the expected effect. The Social democrats lost seats and influence (Lässig 1996, 87f). *Frankfurter Zeitung* wrote on the 28th of September: “indeed a splendid victory for the supporters of the

three-class franchise.”²³ Furthermore, the low turnout within the third and the second class of voters was mentioned in the press.²⁴

The third event took place in November 1905. Here, Social democrats organized mass demonstration in cities all over the kingdom, claiming for a revision of the electoral law in Saxony. This was not the first time Social democrats organized political protests on the streets agitating for the revision of the electoral law, but this time Social democrats organized this event not only as a reaction to changes or possible changes but they also demonstrated their power. This was since 1896 the first kingdom wide mass demonstration, which was characterized by its very well organized, disciplined, calm and peaceful flow (Lässig, 1996, 144f). However, in the forefront of the demonstrations, the fear that they would end up in violent riots was high and the military was put on alert on the 18th of November 1895.²⁵

The fourths and fifths event took place in 1909: We first study the effects of the day when the law that extended the suffrage again was passed and the day when the first election with the new law took place in which the Social democrats gained so many seats. The first event, the day when the law passed in the parliament, was not mentioned in the newspapers. As Lässig (1996, 233) points out, all parties, their members and supporters were equally insecure about the actual effects of the electoral law. The conservatives warned that the new elections would bring about a government of the mass, whereas Social democrats claimed that the effects of the law would probably be very limited. Unsurprisingly, first results quickly appeared in the Newspapers and were extensively debated. For instance, Frankfurter Zeitung published the first results on the same day of the election - the 22. of October - and reported a ‘defeat of the

²³ ‘[...]Führwahr, ein stolzer Sieg der Anhänger des Dreiklassenwahlrechts‘ (Frankfurter Zeitung Nr. 269, 28th of September 1897. Evening edition)

²⁴ ‘In den meisten Wahlkreisen, in denen gestern von der dritten und heute von der zweiten Klasse der Urwähler die Wahlmänner für den Landtag gewählt wurden, war die Beteiligung auffallend schlecht.[...]‘ (Frankfurter Zeitung Nr. 270, 29th of September 1897. Evening edition)

²⁵ ‘Dresden, 18. November. Die hiesige Arbeiterzeitung erfährt: Wegen der Wahlrechtsprotestversammlungen, die heute Abend stattfindende, wurde Militär in den Kasernen konsigniert. Sämtliche Mannschaften des Garnisonsbezirks haben vierzig scharfe Patronen erhalten.’ (Frankfurter Zeitung Nr. 321, 19th November 1905. First morning edition)

Saxon conservatives' as great success for the social democrats.²⁶ Similarly, Berliner Börsen-Zeitung noted a 'remarkable swing to the left'.²⁷ Table four summarizes the results and the expected effect of the stock market.

(Table 4 about here)

Data

All data was hand collected from different historical sources: Information about which firms were listed on the stock market was taken from Salinger Börsenhandbuch 1896, 1897 and 1909. Daily prices, Stückzinsen²⁸ and dividends were taken from Berliner Börsenzeitung.

We observe two mayor periods of changes. The first period was the period from December 1895 to end 1896, in which the suffrage was restricted by the parliament against strong agitation of Social democrats. The second period was the change of this electoral law to a more open and modern suffrage against agitation of industrialist in 1909. Our analysis is based on all industrial firms headquartered in Saxony and listed at the Berlin Stock Exchange, the major German stock market, in these periods. Thus we have two samples of industrial firms which mostly overlap (1895-1896 and 1909). Furthermore, we added a third sample to

²⁶ 'Niederlage der sächsischen Konservativen. [...]Neben der Verluste der Konservativen bilden die Erfolge der Sozialdemokraten die hervorstechende Erscheinung des gestrigen Wahltages[...]' (Frankfurter Zeitung Nr.293, 22nd of October 1909. Evening edition)

²⁷ '[...]So viel geht jedoch aus dem bisherigen Wahlausgang schon hervor, daß sich im Sächsischen Landtag ein bemerkenswerter Ruck nach links vollzieht' (Berliner Börsen-Zeitung Nr. 497, 23rd of October 1909)

²⁸ Stückzinsen at the Berlin stock exchange were a fixed yearly dividend payment of 4 per cent of the face value in most cases, which was paid at the beginning of a trading year. When trading a share, the accumulated fraction of the Stückzinsen was added to the quoted share price (Saling 1897, 217ff.). The resulting drop in prices at the beginning of a trading year has to be recognized when performing the share price correction for dividend payments.

study the effects of the mass demonstrations in 1905, which mainly consist of the sample of 1909, except for two firms who went public on the Berlin stock exchange in 1906.

In 1896 the sample contains 24 industrial firms. Figure 3 shows the market capitalization of the sample for the period from November 1895 to November 1897 on a daily basis. One can already see the impact of the events. After the new law passed, the market experienced a period of relatively stable positive market returns up to the election. Shortly before the election the prices fall- which can be interpreted as a general insecurity of the electoral outcome. Afterwards the prices quickly recover.

(Figure 3 about here)

In 1909 the sample contains of 35 industrial firms. Figure 4 shows the market capitalization of the firms and the events in 1909. Some large banks which had a large amount of capital are excluded, thus the market capitalization of the sample is about ten percent of the GDP of the kingdom.²⁹

The capitalization of the portfolio reaches its peak on the 22 of September with a value of about 254 million Marks. It then falls until the 8. November to a level of about 248.5 million Marks and then steadily rises again. On a first view it looks as if indeed the election had a negative effect, starting shortly before the election. The stock market, however quickly recovered. The day when the law passes seems not to influence the stock market, possibly because in contrast to the election, the change in law was not discussed in the *Frankfurter Zeitung*.

²⁹For the GDP of the kingdom see Fuhrmann (1914) and Hoffman (1959)

(Figure 4 about here)

Results Event Study

Table 5 provides the results for the five events applying market model and mean return model. At a first glance, the impact of the political changes had a strong impact, which alone is an interesting result, since event studies concerning regulatory changes perform often weakly as a result of information leakage and anticipation of the event long before (Binder, 1998, 123).

In March 1896 the new law that restricted the suffrage and introduced three class voting had- as expected- significant positive abnormal returns in the two week and in the four week window. If we split the four week window, we can see that the positive effect happened after the introduction of the law. The extent of the restriction might not have been anticipated before but was clearly positively received among capitalists in the following period.

So far the results perfectly fit Hypothesis 1. Capitalists and investors anticipated a reduction of democratization positively. This is the first quantitative evidence that capitalists and civil elites in the German Kaiserreich expected negative effect on the economy in case of more political participation of the working poor.

The results of the first election after the introduction of the new law in 1896, however, do not perfectly fit the picture. Before and after the elections the situation on the market was pessimistic and the abnormal returns were negative. This might be driven by a general nervousness of how much the change in the law may influence the electoral results. However,

the significance diminishes in the two weeks after the event, indicating the relief of the investors after the publication of the election results.

The mass demonstration again fits the picture: the market reacted negatively, although only significant in the four week window. Again it is interesting to note that the negative effect can mainly be observed in the two weeks before the demonstrations. Capitalist probably expected revolutionary and destructive protests and not the calm and well organized demonstrations that turned out. Thus after the event the market relaxed. This can also be interpreted as the beginning of acceptance of the Social democrats as a serious political power.

The law passed in 1909 without echo in the press (We could not find a note in a newspaper). This might explain why this event had not much impact on the market. In the two weeks before the law passed the abnormal returns were significantly positive. However, after the law was passed this positive effect disappeared. This could indicate that investors reacted – although only slightly- in a negative way.

In order to understand more about investors and their behavior to the changes in the political system, we break our sample into two. The first sample contains the largest firms. In 1896 we consider five firms, which hold together 49 % of the total market capitalization in terms of capital stocks. In 1905 and 1909 we consider seven firms, who held 51 percent and 50 percent of the total capitalization, respectively.

These results provide evidence for asymmetric information among investors. The prices of small firms reacted much heavier (more significantly) to the mass demonstration in 1905 and the passing of the law in 1909, the events that were not discussed in national wide newspapers. These firms were probably financed by regional investors, who recognized the atmosphere of change.

Large firms, on the other hand, who probably mainly attracted non regional investors, reacted far less to regional events such as the mass demonstrations, which could – apart from the information asymmetry - be explained by the fact that those investors did not fear higher income taxation and only a possible rise in taxation for the Saxon firms, in which they invested.

Altogether the results support well hypothesis 1 that events associated with an extension of the suffrage such as the day when the electoral law passes or the first election with the new law lead to negative returns on the stock market and vice versa. Hypothesis 2 that the restriction of the suffrage had a lower effect than the extension of the suffrage on the stock market, since the latter might be associated with direct changes of the political and economic environment rather than just keeping the status quo, is only slightly supported. The effect of the restriction of the suffrage in 1896 was less significant if the event window was smaller. For larger event windows the effect was equally as strong. The election, however, after the extension of the suffrage had a much stronger effect than the election after the introduction of the three-class-voting.

(Table 5 -7 about here)

The results above are robust. Table 8 gives a comparison of the results from the standard event-study methodology and the generalised rank test.³⁰ We compare for all event windows the sign of the abnormal return, i.e. whether it was positive or negative and whether the observed abnormal return was significant. Since the GRANK test standardises the data, a direct comparison of the average cumulated returns in the event window does not make sense.

³⁰The exact results of the GRANK test are included in the Appendix.

We can use the average rank of all firms in the event-window: recalling that the GRANK test assigns ranks to the abnormal returns, a value below (above) the mean rank of 0.5 (i.e. the expected value of the abnormal return on the event day under the null-hypothesis) is equivalent to a negative (positive) ACAR. The table reads as follows: the columns marked “sign” show whether both the ACAR and the GRANK method produced the same result regarding the sign of the abnormal return. The corresponding entry for each event is “yes”, if both ACAR is below zero (above zero) and the corresponding average rank of the cumulated event-period from the GRANK test is below 60 (above 60). It is “no” if they do not coincide. The column “significance” compares the p-values of each test. The corresponding entry for each event is “yes”, if both are insignificant (at the 5 per cent level) or both are significant (at the 5 per cent level) and “no” otherwise.

(Table 8 about here)

In general, however, the results from both methods coincide for almost every event and event window. This suggests that non-normality of abnormal returns or cross-correlation between them does not seem to have been an issue in the original inference. Since possible cross-correlation between abnormal returns might lead to an over-rejection of the null-hypothesis, we are particularly interested whether the highly significant results across all event-windows for the election of 1909 remain significant applying the generalised rank test. Table 8 shows that this is indeed the case. Two of the originally significant results for the publication of the new election law in 1909, however, are here insignificant.

Conclusion

Saxony was one of the most industrialized regions at the time and also one of the strongholds of the Social democrats. It was further the only region in the Kaiserreich where the electoral law was changed twice. One change was introduced with the official aim to maintain the power of the powerful, which was for a long time a cartel of the National liberals and the Conservatives. In 1909, however, the suffrage was extended to the benefit of the working poor due to the pressure of the Social democrats and mass protests on the streets (Lässig 1997).

Theory suggests that an extension of the electoral law to the poor working class is followed by a rise in government spending and taxes (Husted and Kenny 1997, Lott and Kenny 1999) and an extension in the provision of public goods (Lizzeri and Persico 2004) in order to reallocate income from the rich to the poor and to achieve higher equality (Husted and Kenny 1997, Justman and Gradstein 1999, Acemoglu and Robinson 2000). This leads to more political freedom and subsequently to economic freedom which is needed for long run sustainable economic growth. However, the extension of democracy also leads to higher taxation and redistribution of income which reduced possible investment. This might have growth retarding features.

In this context we tested two hypotheses how investors anticipated the changes. Hypothesis 1 tested whether events associated with an extension of the suffrage lead to negative returns on the stock market and vice versa. The results clearly provided evidence for this hypothesis. However, the reactions were significant but only lasted for a short period. We often find dropping prices before events that were associated with an extended suffrage and a very quick recovering shortly after. Although Wehler (1994, 90) and others were right and capitalist clearly opposed the democratic development- they seemed to get used to it and the

revolutionary potential was obviously not too threatening. In fact we interpret our results as the beginning of the acceptance of Social Democracy and subsequently a larger participation of the working poor.

Hypothesis 2 tested whether the restriction of the suffrage had a lower effect than the extension of the suffrage on the stock market, since the latter might be associated with direct changes of the political and economic environment rather than just keeping the status quo. This hypothesis was only slightly supported. The effect of the restriction of the suffrage in 1896 was less significant if the event window was smaller. For larger event windows the effect was equally as strong. Furthermore the election in 1909 had a very strong negative impact, which clearly supports this hypothesis.

Furthermore the results provide evidence that the stock market was relatively efficient in the 19th century since it reacted strongly, although not as quick as a modern market would do, i.e. we cannot observe effects in a one week event window.

The paper also seems to provide some information about who actually invested. While large firms based in Saxony attracted investors from all over the country, who did not get every regional information, smaller firms possibly attracted rather regional investors. Prices of smaller regional firms reacted much stronger, indicating that their investors were more afraid of an extension of the power to the poor in the Kingdom than investors of larger firms. The explanation might be that they could be affected twice: once by higher taxation of the firms and by higher taxation of their income.

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TABLE 1: DEVELOPMENT OF THE ECONOMIC STRUCTURE IN SAXONY AND GERMANY IN PERCENT

Sector	1882		1895		1907	
	Saxony	Germany	Saxony	Germany	Saxony	Germany
Agriculture	20.0	42.5	15.1	35.8	10.7	28.6
Industry	56.2	35.5	58.0	39.1	59.3	42.8
Trade/Transport	12.0	10.0	14.0	11.5	15.2	13.4
Servants	1.8	2.1	1.2	1.7	1,0	1.3
Public Service	4.9	4.9	5.4	5.5	5,5	5,5
Without occupation	5.1	5.9	6.3	6.4	8,3	8,4

Source: Lässig (1996, 34), data from the occupation census.

TABLE 2: ECONOMIC INDICATORS FOR DIFFERENT STATES

State	1900			1910		
	GDP p.c. in marks	Pop. in 1000	interest payments on public debt in Billion marks	GDP p.c. in marks	Pop. in 1000	interest payments on public debt in Billion marks
Baden	533	1856	12	669	2132	21
Hesse	485	1113	9.8	596	1276	14.6
Prussia	504	34267	231	651	39922	334
Saxony	644	4163	27	799	4782	28

Source: Hoffman (1959, 86)

TABLE 3: RESULTS STATE ELECTIONS 1893-1909 (SEATS)

Year	Conservatives	National liberals	Party of Progress	Germans	German social	Liberals	Reformer	Social democrats	Total
1893	43	14	8	1	1		1	14	82
1895	44	16	6		1		1	14	82
1897	50	21	3					8	82
1899	52	22	3					4	81
1901	58	21	2			1		0	82
1903	57	22		1		1	1	0	82
1905	54	23		2		1	1	1	82
1907	46	31		3			1	1	82
1909	24	28		8			6	25	91

Source: Ritter (1990, 72)

TABLE 4: OVERVIEW EVENTS

Date (first appearance in newspaper)	Event	Participation of the working poor	Effect on return according to	
			H1	H2
30. März 1896	New electoral law gets published	Restricted	Positive	lower
28. September 1897	Election	Restricted	Positive	lower
18/19. November 1905	Mass demonstration in Leipzig	“Extended”	negative	higher
5 May 1909(no newspaper notice)	New electoral law gets published	Extended	negative	higher
22. October 1909	Election	Extended	negative	higher

TABLE 5: RESULTS EVENT STUDY

Date	Event		One week window (-3; +3)		two week window (-7; +7)		4 week window (-14; +14)		two weeks before (-14; 0)		two weeks after (0; 14)	
			ACAR	p-value	ACAR	p-value	ACAR	p-value	ACAR	p-value	ACAR	p-value
30. März 1896	New electoral law gets published	Market Model	0.002	0.511	0.015	0.003	0.020	0.045	-0.004	0.218	0.026	0.002
		Mean Return	0.004	0.219	0.019	0.000	0.024	0.015	-0.003	0.372	0.027	0.001
28. September 1897	Election	Market Model	0.000	0.911	-0.002	0.497	-0.026	0.000	-0.015	0.004	-0.006	0.156
		Mean Return	-0.001	0.739	-0.004	0.289	-0.030	0.000	-0.017	0.002	-0.009	0.051
18. November 1905	Mass demonstrations	Market Model	0.000	0.968	0.000	0.925	-0.013	0.167	-0.012	0.092	-0.001	0.913
		Mean Return	0.005	0.300	0.001	0.769	-0.039	0.000	-0.031	0.000	-0.006	0.269
5 May 1909	New electoral law gets published	Market Model	-0.004	0.153	0.008	0.127	0.014	0.025	0.015	0.000	-0.008	0.121
		Mean Return	-0.006	0.201	0.009	0.091	0.015	0.010	0.017	0.001	-0.009	0.098
22. October 1909	Election	Market Model	-0.011	0.000	-0.010	0.000	-0.024	0.009	-0.014	0.002	-0.014	0.000
		Mean Return	-0.013	0.000	-0.011	0.000	-0.032	0.000	-0.018	0.020	-0.016	0.000

TABLE 6: RESULTS EVENT STUDY LARGEST FIRMS ONLY

LARGEST FIRMS			One week window (-3; +3)		two week window (-7; +7)		4 week window (-14; +14)		two weeks before (-14; 0)		two weeks after (0; 14)	
Date	Event		ACAR	p-value	ACAR	p-value	ACAR	p-value	ACAR	p-value	ACAR	p-value
30. März 1896	New electoral law gets published	Market Model	-0.008	0.252	0.006	0.417	0.008	0.341	-0.006	0.334	0.011	0.093
		Mean Return	-0.005	0.415	0.013	0.037	0.015	0.046	-0.004	0.532	0.015	0.013
28. September 1897	Election	Market Model	-0.008	0.113	-0.020	0.000	-0.047	0.000	-0.015	0.004	-0.030	0.000
		Mean Return	-0.011	0.032	-0.026	0.000	-0.050	0.000	-0.023	0.000	-0.039	0.000
18. November 1905	Mass demonstrations	Market Model	0.014	0.435	-0.012	0.368	-0.040	0.138	-0.038	0.195	0.009	0.525
		Mean Return	0.019	0.285	-0.011	0.418	-0.064	0.033	-0.055	0.075	0.004	0.781
5 May 1909	New electoral law gets published	Market Model	-0.001	0.758	0.006	0.445	0.000	0.961	0.005	0.425	-0.007	0.587
		Mean Return	-0.002	0.519	0.007	0.394	0.001	0.914	0.007	0.219	-0.008	0.503
22. October 1909	Election	Market Model	-0.008	0.004	-0.006	0.035	-0.027	0.000	-0.014	0.002	-0.016	0.002
		Mean Return	-0.011	0.002	-0.009	0.003	-0.038	0.000	-0.019	0.000	-0.021	0.001

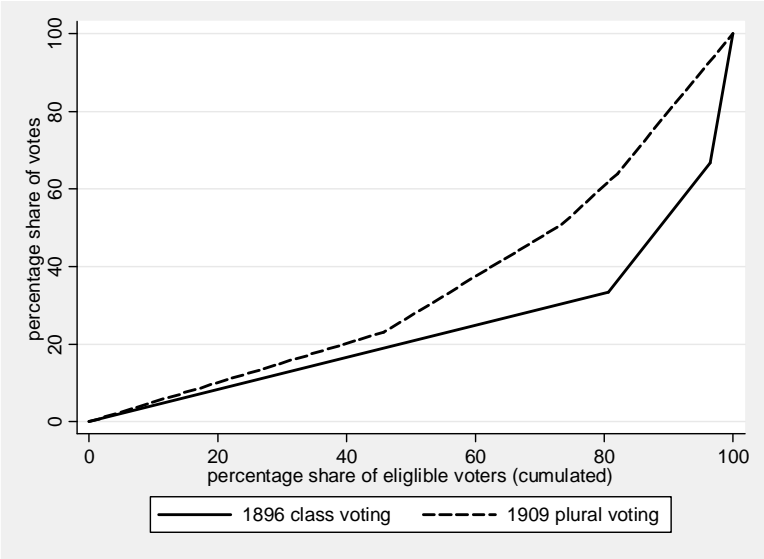
Note: sample reduced to 1896: 5 firms, 49% of total market capitalisation; 1905: 7 firms 51% of total market capitalisation, 1909: 7 firms, 50 % of total market capitalization

TABLE 7: RESULTS EVENT STUDY, SMALLER FIRMS

Date	Event		One week window (-3; +3)		two week window (-7; +7)		4 week window (-14; +14)		two weeks before (-14; 0)		two weeks after (0; 14)	
			ACAR	p-value	ACAR	p-value	ACAR	p-value	ACAR	p-value	ACAR	p-value
30. März 1896	New electoral law gets published	Market Model	0.005	0.177	0.017	0.004	0.023	0.059	-0.004	0.343	0.029	0.003
		Mean Return	0.006	0.095	0.020	0.001	0.026	0.031	-0.003	0.471	0.031	0.002
28. September 1897	Election	Market Model	0.002	0.349	0.002	0.490	-0.021	0.004	-0.015	0.018	0.000	0.971
		Mean Return	0.002	0.499	0.002	0.634	-0.015	0.021	-0.015	0.023	-0.002	0.694
18. November 1905	Mass demonstrations	Market Model	-0.004	0.049	0.003	0.376	-0.005	0.566	-0.005	0.295	-0.003	0.561
		Mean Return	0.001	0.652	0.004	0.189	-0.030	0.000	-0.023	0.000	-0.008	0.129
5 May 1909	New electoral law gets published	Market Model	-0.003	0.263	0.010	0.094	0.020	0.005	0.021	0.000	-0.007	0.177
		Mean Return	-0.006	0.087	0.010	0.132	0.019	0.007	0.020	0.000	-0.009	0.129
22. October 1909	Election	Market Model	-0.012	0.000	-0.011	0.001	-0.023	0.039	-0.014	0.010	-0.014	0.000
		Mean Return	-0.013	0.000	-0.012	0.000	-0.030	0.005	-0.017	0.000	-0.015	0.000

Note: Sample without largest firms (see table 6)

FIGURE 1: THE BIAS OF THE WEIGHTED VOTES



Note: the law before 1896 had an equal weighting of votes, thus if we would draw a line it would be the 45degree line. This would be misleading, since the overall number of eligible voters was far below the laws in later years.

Source: own calculations, data from Ritter (1980, 172).

FIGURE 2: ESTIMATION AND EVENT WINDOW

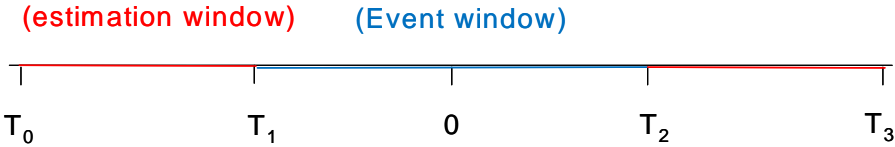
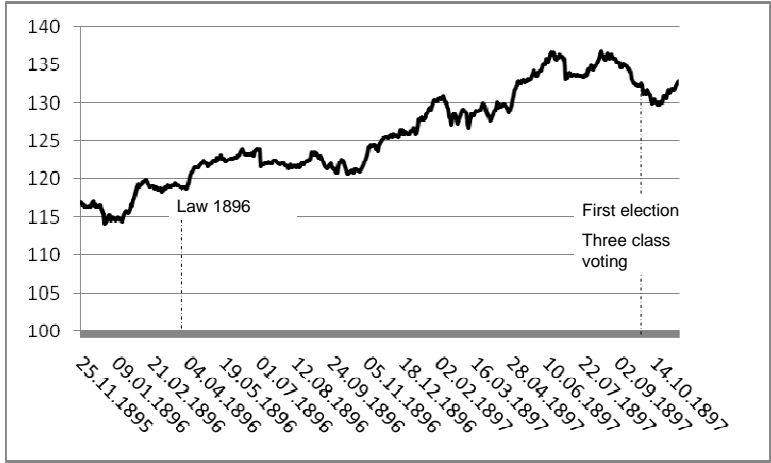
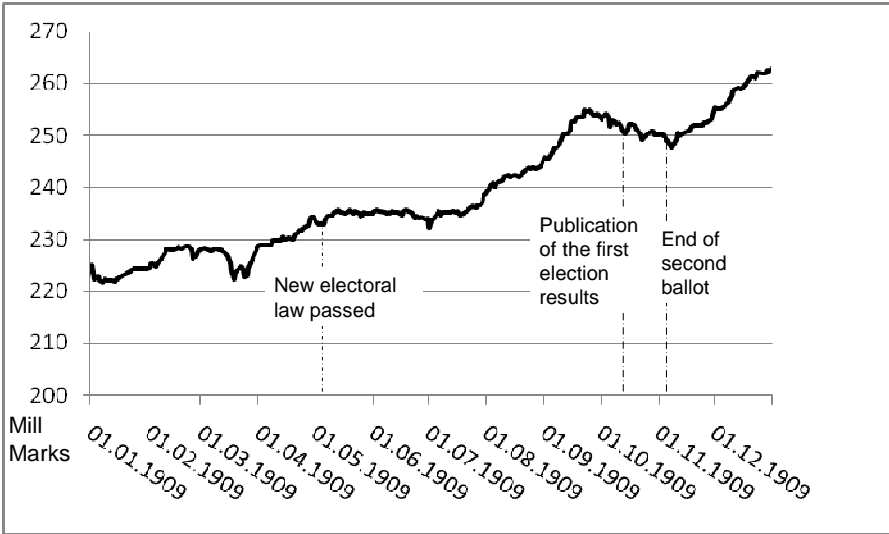


FIGURE 3: MARKET CAPITALISATION OF SAXON INDUSTRIAL FIRM ON THE BERLIN STOCK EXCHANGE 1895 1897



Source: Salinger Börsenpapiere 1895/1896/1897, Berliner Börsenzeitung

FIGURE 4: MARKET CAPITALISATION OF SAXON INDUSTRIAL FIRM ON THE BERLIN STOCK EXCHANGE 1909



Source: Salinger Börsenpapiere 1909, Berliner Börsenzeitung

APPENDIX

Formal presentation of the generalised rank (GRANK) test

Following Kothari and Pythonnen (2011) , let $t=0$ denote the event-day, $t=T_0+1, \dots, T_1$ is the estimation period. T_1+1, \dots, T_2 are the days in the event window. Additionally, let $L_1= T_1 - T_0$ be the length of the estimation period and $T_2 - T_1$ the length of the event period.

Abnormal returns are calculated as above using the market model. Standardised abnormal returns for the estimation period are then given by

$$SAR_{it} = \frac{AR_{it}}{S_{it}} \text{ for } t=T_0+1, \dots, T_1 .,$$

where $S_{i,t} = \sqrt{\sum_1^{T_1} (AR_{i,t} - (\bar{AR}_i))^2}$ is the standard deviation of abnormal return in the estimation period. The cumulated abnormal return of firm i in the event period is defined as

$$CAR_{i,T_2-T_1} = \sum_{t=T_1+1}^{T_2-T_1} AR_{it} .$$

Divided by the standard deviation of the abnormal returns of firm i $S_{CAR_{i,\tau}}$ (which is given by $\sqrt{Y'VY}$, where Y is a vector of ones with the length of the event-window and V is the conditional covariance matrix of the event-window returns.¹), yields the standardised cumulated abnormal return $SCAR_{i,\tau}$ for firm i .

$$SCAR_{i,T_2-T_1} = \frac{CAR_{i,T_2-T_1}}{S_{CAR_{i,T_2-T_1}}} ,$$

¹For details, see Campbell et al (1997, 159-160)

Then the standardised CAR's are re-standardised with the cross-sectional standard deviation corrected for cross-sectional correlation

$$SCAR_{i,t}^* = \frac{SCAR_{i,T_2-T_1}}{S_{SCAR_{i,T_2-T_1}}}$$

where $S_{SCAR_{i,T_2-T_1}} = \frac{1}{n-1} \sum_{i=1}^n (SCAR_{i,T_2-T_1} - \overline{SCAR_{T_2-T_1}})^2$ and \bar{r} is the average correlation in the sample.

Generalised standardized abnormal returns, GSAR, are then defined as follows

$$GSAR_{i,t} = \begin{cases} SCAR_{i,t}^* & \text{for } T_1+1 \leq t \leq T_2 \\ SAR_{i,t} & \text{for } t = T_0+1, \dots, T_1 \end{cases}$$

In brief, the event period is considered as one point in time with the value $SCAR_{i,t}^*$ for firm i , while the estimation period GSAR's are the normal standardised values for each day. Treating the event period returns as one single observation leads to a new number of total observations, i.e. the number of observations in the estimation period plus 1.

For each firm, ranks (K_1, K_2, \dots, K_T) are assigned to the GSAR's, so that $GSAR_t \geq GSAR_s$ implying $K_t \geq K_s$, i.e. the lowest rank 1 is assigned to the lowest return of firm i and the highest rank T is assigned to the highest return. Divided by $T+1$ and minus 0,5 - the mean rank², yields $U_{i,t}$.

²Using the Gaussian sum formula, one can easily verify that the mean rank for any series of ranks from 1 to T is given by $\frac{(T+1)}{2}$. If one first divides each rank by $T+1$, the mean rank is then given by 0,5.

$$U_{i,t} = \frac{\text{rank}(GSAR_{i,t})}{T+1} \cdot 0.5^3$$

These can be used to formulate the test statistic, t_{grank} , :

$$t_{\text{grank}} = Z \left(\frac{T-2}{T-1-Z^2} \right)^{0.5}, \text{ where } Z = \frac{\bar{U}_0}{S_{\bar{U}}} \text{ and } S_{\bar{U}} = \left(\frac{1}{T} \sum_{t=1}^T \bar{U}_t^2 \right)^{0.5}.$$

\bar{U}_0 and \bar{U}_t are the averaged ranks over firms on the event day and point in time t , respectively. $S_{\bar{U}}$ is the standard deviation of the average rank over time. Under the null hypothesis of no abnormal returns on the event day, the distribution of the test statistic is asymptotically normal.

³ See Corrado and Zivney (1992).

Results of the GRANK test

The following table reproduces the results of the GRANK test for the different events and event-windows.

Date	Event	Model	One week window (-3,+3)		Two week window (-7,+7)		4 week window (-14,+14)		Two weeks before (-14;0)		Two weeks after (0,+14)	
			average rank	p-value	average rank	p-value	average rank	p-value	average rank	p-value	average rank	p-value
12. December 1895	Social Democrats claim new electoral law	Market Model	50,000	0,377	38,909	0,079	34,455	0,033	48,909	0,333	31,500	0,018
30. March 1896	New electoral law gets published	Market Model	71,818	0,395	92,318	0,017	81,318	0,122	57,955	0,817	91,000	0,023
28. September 1897	Election	Market Model	58,909	0,827	57,364	0,706	32,909	0,004	34,091	0,006	45,273	0,105
18. November 1905	Mass demonstrations	Market Model	61,467	0,958	61,500	0,956	31,800	0,000	27,267	0,000	51,233	0,227
5 May 1909	New electoral law passed	Market Model	45,938	0,094	74,531	0,145	71,875	0,250	75,844	0,117	56,594	0,641
23. October 1909	Election	Market Model	25,688	0,000	33,250	0,001	30,813	0,000	36,750	0,002	24,094	0,000

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