THE ORIGINS OF THE BLUE-SKY LAWS: A TEST OF COMPETING HYPOTHESES*

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ABSTRACT

Between 1911 and 1931, 47 of the 48 states adopted state securities, or "blue-sky," laws. This paper employs an event history analysis to analyze public interest, public choice, and ideological explanations for the enactment of blue-sky laws. The data suggest that the decision to adopt a blue-sky law was heavily influenced by the strength of progressive lobbies. However, the type of law adopted was more strongly influenced by the prevalence of small banks that faced competition for depositors' funds from securities salesmen. I also provide evidence that more stringent blue-sky laws increased small-bank profits.

I. INTRODUCTION

Between 1911 and 1931, 47 of the 48 states adopted statutes that regulated the sale of securities. The stated justification for these state securities laws was to prevent the sale of fraudulent securities, particularly to unsophisticated investors. They are known as "blue-sky" laws, purportedly because one of their supporters claimed that many securities salesmen were so dishonest that they would sell "building lots in the blue sky."1

What explains the sudden appearance of blue-sky laws in virtually all states during a 2-decade period? This paper analyzes three explanations drawn from the literature on the blue-sky laws. The first is a public interest hypothesis: securities fraud increased in the early twentieth century, and the blue-sky laws were a reaction. The second is a public choice story in which small banks agitated for blue-sky laws as a means of reducing competition

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1 See Louis Loss & Edward M. Cowett, Blue Sky Law 7 n.22 (1958).
for depositors' funds from securities firms.\(^2\) The third is a political hypothesis: blue-sky laws were adopted at the behest of agrarian and progressive lobbies to curtail the power of financiers.\(^3\)

This paper uses event history analysis to examine factors that may explain which states would be early adopters of blue-sky laws and which states would be later adopters. I analyze proxies for the extent of securities fraud and the lobbying strength of farmers, progressives, and small banks and ask whether variation in these variables among state-years is associated with differences in the timing of blue-sky law adoption.

The results suggest that the decision to adopt a blue-sky law was most heavily influenced by the strength of broad-based coalitions associated with the progressive movement. However, small banks appear to have successfully influenced the type of blue-sky law adopted. They preferred relatively strict, "merit review" statutes that gave the administrator substantial discretion to disallow public offerings. I also present evidence suggesting that merit review statutes did, indeed, help small banks. The findings are broadly consistent with Mark Roe's contention that a combination of self-interest and ideology explains early twentieth-century financial regulation.\(^4\)

The causes of the blue-sky laws should be of interest to securities lawyers and regulators today. These laws were the first substantial attempt to regulate securities markets in the United States and set the stage for federal regulation in the 1930s. The standard view among securities practitioners and scholars is that regulation was a reaction to market excesses.\(^5\) Other commentators challenge the public interest explanation and argue that the securities laws benefited high-prestige securities sellers at the expense of low-prestige firms, which competed on the basis of price.\(^6\) Others argue that politicians sought to win votes by being antagonistic toward business.\(^7\) Learning what we can about the early history of the regulatory state can help to sort out these competing views.

The analysis is also relevant to theories of political choice. Public choice


\(^5\) See, for example, Michael E. Parrish, Securities Regulation and the New Deal 6–7 (1970).


\(^7\) See Roe, supra note 4, at 28–32 (discussing populism as a force for financial regulation).
theories typically stand in opposition to models that incorporate ideology or other (partly) non-self-interested explanations. Securities regulation is a particularly interesting arena for these competing views. Public opinion typically supports more stringent regulation of securities markets, yet economists have generally failed to find evidence that the resulting regulations increase investor welfare, and there is some evidence that they further the interests of securities professionals.\textsuperscript{8} The results in this paper suggest a role for both forms of analysis. The evidence supports the common casual observation that the public's ideological commitments play an important role in deciding whether to regulate an activity, but the private interests of the regulated (and producers of competing or complementary goods) play an important role in deciding the form of the regulation.

Section II briefly describes the blue-sky laws. Sections III, IV, and V discuss the public interest, public choice, and political hypotheses, respectively. Section VI describes the empirical tests and results. Section VII concludes.

II. A Description of the Blue-Sky Laws

The first blue-sky law was adopted in Kansas in 1911, in significant part through the efforts of the state's banking commissioner, J. N. Dolley.\textsuperscript{9} The statute required registration of securities and securities salesmen. Prior to selling a security in Kansas, the issuer had to file an application with the banking commissioner detailing financial and narrative information about its business. No sales could be made unless the commissioner approved the offering.

The statute gave the commissioner extraordinarily broad discretion. He could reject an offering if he concluded that the issuer "does not intend to do a fair and honest business" or "does not promise a fair return on the stocks, bonds, or other securities by it offered for sale."\textsuperscript{10} This broad authority came to be known as "merit review." Dolley was not reluctant to exercise this authority. In his first annual report on the operation of the statute, Dolley noted that his office approved fewer than 7 percent of applications to sell securities in Kansas.\textsuperscript{11}

The Kansas law quickly spread. In 1912 and 1913, 11 states adopted statutes similar to the Kansas statute. Other states adopted less stringent


\textsuperscript{9} The discussion in this section draws on Loss & Cowett, supra note 1, and Macey & Miller, supra note 2.


\textsuperscript{11} See Loss & Cowett, supra note 1, at 9.
### TABLE 1

<table>
<thead>
<tr>
<th>Year</th>
<th>Merit Review</th>
<th>Ex Ante Fraud</th>
<th>Ex Post Fraud</th>
</tr>
</thead>
<tbody>
<tr>
<td>1911</td>
<td>Kansas</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1912</td>
<td>Arizona</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1913</td>
<td>Arkansas, Idaho, Michigan, Montana, North Dakota, Ohio, South Dakota, Tennessee, Vermont, West Virginia</td>
<td>California, Florida, Georgia, Iowa, Missouri, Nebraska, North Carolina, Texas, Wisconsin</td>
<td>Louisiana, Maine, Oregon</td>
</tr>
<tr>
<td>1915</td>
<td>South Carolina</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1916</td>
<td>Mississippi, Virginia</td>
<td></td>
<td>New Hampshire</td>
</tr>
<tr>
<td>1917</td>
<td>Minnesota</td>
<td></td>
<td>New Hampshire</td>
</tr>
<tr>
<td>1919</td>
<td>Alabama, Illinois, Oklahoma, Utah, Wyoming</td>
<td></td>
<td>Maryland, New Jersey</td>
</tr>
<tr>
<td>1920</td>
<td>Indiana, Kentucky</td>
<td></td>
<td>New York</td>
</tr>
<tr>
<td>1921</td>
<td>Massachusetts, New Mexico, Rhode Island</td>
<td></td>
<td>New York</td>
</tr>
<tr>
<td>1923</td>
<td>Colorado, Washington</td>
<td></td>
<td>Pennsylvania</td>
</tr>
<tr>
<td>1929</td>
<td></td>
<td></td>
<td>Connecticut</td>
</tr>
<tr>
<td>1931</td>
<td></td>
<td></td>
<td>Delaware</td>
</tr>
</tbody>
</table>

Source.—State session laws.

Statutes that required preclearance of proposed offerings but limited the administrator’s authority to reject them. Typically, the administrator had to conclude that the offering was fraudulent or met other specified criteria in order to deny permission (I call these “ex ante fraud” statutes). Others, including important centers of the securities industry such as New York and New Jersey, adopted statutes that prohibited fraud but did not require preclearance of an offering (I call these “ex post fraud” statutes). Table 1 provides the year of adoption of each state’s blue-sky statute and its type.

The blue-sky statutes, on average, put the greatest burdens on offerings of high-risk (and potentially high-return) securities. Many blue-sky laws forbade the sale of any security by a company that had previously issued securities in exchange for patents, goodwill, or other intangible assets unless the administrator concluded that the intangibles were “fairly” valued on the company’s books. Others singled out for greater scrutiny a class of “speculative” securities, including those whose assets consisted in large measure of intangibles, mining claims, or undeveloped real estate.

The statutes often treated banks more leniently than other securities issuers and sellers. Many states followed Kansas in appointing the state’s banking

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12 See, for example, Act of Sept. 29, 1919, No. 660, § 3, 1919 Ala. Acts 947; Act of March 3, 1921, ch. 44, § 5, 1921 N.M. Laws 98.

13 See, for example, Blue Sky Law, ch. 91, § 1, 1915 N.D. Laws 115.
commissioner as the sole or lead administrator.\textsuperscript{14} The statutes typically exempted bank securities from registration, and in some cases exempted any securities sold by a bank (presumably including those underwritten by banks). Others exempted banks from registration as brokers or dealers.

III. The Public Interest Hypothesis

The leading legal treatise on the blue-sky laws provides a straightforward public interest explanation for their adoption.\textsuperscript{15} As securities markets developed, it became apparent that securities sales provide exceptional opportunities for fraud. The combination of a growing market for corporate securities and the relaxation of nineteenth-century laissez-faire attitudes set the stage for the adoption of blue-sky laws in the early twentieth century. Joel Seligman provides a more historically detailed public interest explanation. He argues that the early twentieth century witnessed a "fraud wave" in which the proportion of dishonest sellers increased dramatically.\textsuperscript{16}

These explanations are economically naive in the sense that they do not explain why investors would participate in markets rife with fraud. More to the point, the evidence offered in support of the existence of widespread fraud in early twentieth-century securities markets is extremely thin. The first piece of evidence consists of the claims of the blue-sky laws' proponents that fraud was rampant.\textsuperscript{17} Standing alone, this is of no weight. We would not expect proponents of a regulatory statute to admit self-interest or other non-public-regarding motivations. They would claim to be combating fraud no matter what their actual motivations.

The second piece of evidence is the fact that once blue-sky laws were in place, the state officials who passed on the soundness of proposed offerings rejected a substantial percentage of these proposals.\textsuperscript{18} This, too, provides no basis for inferring fraud. Merit review statutes gave officials almost unlimited discretion to block an offering. The fact that they rejected many applications, therefore, shows only that they believed it a good idea to do so. What motivated them to believe so—a correct inference of fraud, a misunderstanding of securities markets, an antipathy to certain sellers, or a simple desire to curtail sales of securities—we do not know.

Another drawback to the public interest hypothesis is that it cannot account for the pattern of state adoptions of blue-sky laws. It is not plausible that the social costs of securities fraud were higher in Kansas, Arizona, and

\textsuperscript{14} See, for example, ch. 125, § 1, 1920 Ky. Laws 582; Securities Act, ch. 2068, § 2(a), 1921 R.I. Laws 119.

\textsuperscript{15} See Loss & Cowett, \textit{supra} note 1, at 3–4.

\textsuperscript{16} See Joel Seligman, The Historical Need for a Mandatory Corporate Disclosure System, 9 J. Corp. L. 1, 18–21 (1983).

\textsuperscript{17} See \textit{id.} at 18–19.

\textsuperscript{18} See \textit{id.} at 20–21.
Louisiana (the first three states to adopt blue-sky laws) than in New York, Pennsylvania, and Connecticut (among the last adopters). There should, moreover, be economies of scale in fraud detection and punishment, which would also imply that states with larger financial markets should have been the first to adopt blue-sky laws under the public interest hypothesis.

IV. THE PUBLIC CHOICE HYPOTHESIS

Another economic theory of regulation posits that regulation is the outcome of a process of interest group bidding for government-provided wealth transfers. Groups that can more effectively solve free-rider problems (often producer groups) obtain favorable regulation at the expense of more diffuse groups (typically, but not inevitably, consumers).

Jonathan Macey and Geoffrey Miller offer a public choice account of the adoption of blue-sky laws. They argue that small banks and their regulators were the main forces behind the blue-sky laws. These banks hoped that the blue-sky laws would "stifle[] competition for the funds of potential depositors.'

It is just as possible, of course, that state securities regulation could have been beneficial to the securities industry itself by raising barriers to entry. The investment bankers' trade group, the Investment Bankers Association of America (IBAA), appreciated this possibility and did not object to legislation that would make it more difficult for "unscrupulous" bankers to enter the business. Investment bankers did not, however, view the Kansas-style statutes as beneficial. The IBAA arranged and financed litigation seeking to have the blue-sky laws declared unconstitutional. At the same time, the association and its members lobbied intensively in favor of the ex post fraud type of blue-sky law. This effort was partly successful, as a number of states adopted statutes patterned on the IBAA model. On the whole, however, the qualitative evidence shows that securities firms did not desire or lobby in favor of blue-sky laws.

By contrast, small banks lobbied aggressively in favor of blue-sky laws. Macey and Miller present extensive qualitative evidence showing that rural banks and their regulators worked to secure enactment of these laws. The most plausible public choice account, therefore, pits small, rural banks against securities firms.

There are a few possible reasons why smaller banks may have been particularly eager to fend off competition from securities sellers. One has to do

19 See Macey & Miller, supra note 2.
20 See id. at 365.
21 This appears to have been true for the first of the federal securities law. See Mahoney, supra note 6.
22 A report on these efforts appears in Blue Sky Legislation, in Proceedings of the Third Annual Convention of the Investment Bankers Association of America 75 (1914).
with the fragmentation of banking in the early twentieth century. The dominant model of banking was a "unit banking" model under which a bank was limited to a single place of business. Branching was permitted in only a handful of states, and often within only a limited geographical area. Banks could, for example, establish multiple branches within New York City but not in rural areas. The consequence was that there were a great many banks, and those outside metropolitan areas were often very small.

The more difficult question is whether there was strong competition among these many banks or whether rural banks had an effective territorial monopoly. State banking laws gave banking departments broad discretion to reject applications to create new banks, particularly when a community was already served by a bank. Incumbent banks in smaller towns may, therefore, have had the ability to block new entry. One study suggests that unit banking restrictions caused operating inefficiencies that increased banks' costs, but the resulting lack of competition more than compensated, and on net, unit banking increased bank profitability.

On the other hand, a new entrant could seek a federal rather than a state charter. The minimum capital required to charter a national bank in small towns was reduced from $50,000 to $25,000 in 1900. Subsequently, the number of banks in the United States nearly doubled from about 13,000 in 1900 to about 25,000 in 1910. During the same period, new state-chartered institutions, such as trust companies and mutual savings associations, increasingly competed with banks for depositors' funds. An alternative possibility, then, is that smaller banks in the 1910s and 1920s faced increased competition that put pressure on their profit margins and made the prospect of yet another new class of competitors (securities firms) especially unwelcome.

Of course, the existence of securities markets benefited banks as well, as banks could invest in securities. However, banks could do so even if blue-sky laws succeeded in keeping securities sellers out of rural areas. Small
banks typically deposited funds with larger banks in major cities and could have used those balances to invest in securities. So long as New York could be expected to have a lenient blue-sky law, then banks could invest in securities. It seems plausible, by contrast, that the banks’ rural customers were more likely to invest in securities through local brokers than through distant brokerage houses in major cities, with whom they could have communicated only by mail. So long as blue-sky laws could increase the cost of local solicitation, then, they would improve the banks’ competitive position.

V. POLITICAL HYPOTHESES

A separate theory of regulation holds that ideology is the principal force behind policy shifts. Keith Poole and Howard Rosenthal, for example, argue that legislators can be meaningfully located on a simple left-right spectrum that, for present purposes, measures the preferred level of economic regulation.29 They show that this measure of ideological preference does a good job of predicting roll-call votes in Congress.

An important distinction between public choice and political explanations lies in the way interested parties are assumed to overcome the barriers to collective action. Public choice theory focuses on groups that are small and have a lot at stake or groups that can overcome free-rider problems by providing benefits to their members (such as trade associations or labor unions). Political explanations, by contrast, posit that broad-based coalitions with similar preferences can influence policy choices even absent mechanisms for sharing the resulting gains.30 One might therefore say that political theories contend that ideology is a substitute for material incentives in solving the free-rider problem and permitting collective action.

I focus here on two potential ideological or political explanations for the blue-sky laws. One sees them as an offshoot of agrarian hostility to finance and the other as a part of the progressive movement.

A. The Agrarian/Populist Hypothesis

Many early adopters of blue-sky laws were midwestern and southern states. Supporters often described themselves as foes of big-city financiers and friends of farmers and other small borrowers who relied on bank credit.31

It is possible, then, that the blue-sky laws were the result of populist politics. Beginning in the late nineteenth century, farmers and their allies attempted to create a viable third party, ultimately called the Populist or

30 See id.
31 See Macey & Miller, supra note 2, at 365–70.
People's Party, to represent their interests. James Weaver, the Populist presidential candidate in 1892, received 8.5 percent of the popular vote and carried five midwestern and western states. In 1896, the Populists nominated the unsuccessful Democratic candidate, William Jennings Bryan, and the party was never again an important independent force at the national level.

The Populists' policy focus was on increasing farmers' wealth. In particular, they demanded expansion of the money supply in order to increase commodity prices and reduce the real burden of farm debt. This crusade brought Populists into direct conflict with financiers, who wanted to maintain a stable currency to protect the value of outstanding debt securities. Thus, Populism was, in part, an episode in an existing political struggle between agrarian and financial interests over the desired level of inflation.

The Populist movement as a formal political program was dead by the time of the blue-sky laws. However, populist rhetoric and ideas—particularly the antipathy to financiers that predated the Populist movement—survived in agricultural areas. Macey and Miller note that the availability of farm credit played an important role in debates over the blue-sky laws. Farmers believed that money invested in securities was taken out of the banking system, where it could be lent to farmers and small businesses, and put into "unproductive" speculative activity.

B. The Progressive Hypothesis

An alternative political story identifies the blue-sky laws as a progressive reform. They were adopted during a burst of economic and political regulation known as the Progressive Era. In the first 2 decades of the twentieth century, social reformers obtained state legislation on child labor, compulsory school attendance, workmen's compensation, and electricity rate regulation. They also pursued political reforms such as direct primaries, initiative and referendum procedures, and merit systems for state employees. Theodore Roosevelt left the Republican party to run for president in 1912 as a Progressive Party candidate. Opposed by Wilson (Democrat) and Taft (Republican), Roosevelt won 27 percent of the popular vote.

One common feature of progressive thought was a distaste for large ec-

34 In contrast to Populism, there is debate about whether there was an identifiable "Progressive movement" with a defined policy agenda. See Daniel T. Rogers, In Search of Progressivism, 10 Rev. Am. Hist. 113 (1982). That debate is not relevant for present purposes, however. No one disputes that the early twentieth century saw the rise of issue-oriented political coalitions that, by the 1910s, referred to themselves as "progressives."
onomic units, which progressives called "monopolies" or "trusts" whether or not these were monopolies in the economist's sense. Although the reasons are debatable, some progressives found in early twentieth-century American finance the seeds of "monopoly."

Louis Brandeis's famous call for financial regulation, Other People's Money, argues that the financial industry is an "oligarchy." The book opens with a 1911 quote from Woodrow Wilson that "[t]he great monopoly in this country is the money monopoly." Congress held hearings in 1912, now known as the Pujo hearings, to investigate the "money trust." The blue-sky laws, then, were adopted in the middle of a series of attacks on the financial industry as a "monopoly" or "trust," and those concepts were an important part of Progressive rhetoric.

VI. EVIDENCE FROM THE TIMING OF ADOPTION

Following George Stigler and others, I assume that the timing of adoption of a regulatory statute is a proxy for the intensity of a state's desire to regulate the relevant activity, with earlier adopters being the most eager. The same motivation underlies the use of event history analysis in other regulatory contexts.

A. Methodology

I employ an event history model that estimates the effects of a set of (mostly) time-dependent covariates on the probability of adoption of a blue-sky statute, given that adoption has not already occurred. The model is a discrete-time system and treats a state-year as the unit of analysis.

My sample consists of 237 state-years beginning in 1910 and continuing, for each state, until the adoption of a blue-sky law. Only state-years for which the relevant state's legislature was in session, and therefore in which a law could be adopted, are included. Two states, Delaware and Nevada, had not yet adopted a blue-sky law by 1930. Observations on those states are included up to 1930. Event history analysis is designed to deal successfully with right-truncated cases such as these.

37 Louis D. Brandeis, Other People's Money and How the Bankers Use It (1967 (1914)).
38 Id. at 1.
41 For a description of hazard rate models and other methods of event history analysis, see Paul D. Allison, Event History Analysis: Regression for Longitudinal Event Data (1984).
The dependent variable is coded as zero for each state-year in which a law was not adopted and as one for each state-year in which a law was adopted. Dates of adoption are determined from state session laws. The effect of the covariates on the log-odds of adoption is analyzed using a logistic regression. The model assumes that we can express the probability that a state will adopt a blue-sky law in a given state-year, given that it has not already done so ($P_{BS}$), as a function of the following form:
\[
\log \left( \frac{P_{BS}}{1 - P_{BS}} \right) = \alpha + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3,
\]
where $X_1$ is a vector of covariates measuring the incidence of fraud and $X_2$ and $X_3$ are vectors of covariates measuring the influence of small banks and the prevalence of populist and progressive political groups, respectively.

**B. Covariates**

My measure of fraud incidence is the number of securities fraud cases in each state per million of economically active population during the decade ending on January 1, 1911. This variable is time invariant to avoid the possibility of reverse causation, that is, that adoption of a blue-sky law could increase the number of litigated fraud cases. I began with all cases included in the LEXIS/NEXIS state securities law database for the relevant dates. A few of those cases are clearly in the database by mistake because of the use of words like "stock" and "bond"—they include cases involving livestock and surety bonds, for example. I exclude those cases. Others involve promissory notes made in connection with face-to-face commercial transactions, and I exclude those as well. The most difficult cases to categorize are those that involve simple contract disputes between a customer and a broker or bank. Some of these cases, for example, involve the question whether the broker has the contractual right to sell securities held for the customer's account when the customer fails to meet a margin call. Although they are presented as contract or fiduciary duty claims, under current law, the customer might try to state some claim under the federal securities laws. I accordingly define the fraud variable in two ways, a "narrow" variable that excludes these contract disputes and a "broad" one that includes them. None of the results described below is sensitive to which of these variables is used. (See the Appendix for a description of data and sources.)

The number of litigated cases is, of course, an imperfect measure of the underlying incidence of fraud. Differences among states may also be a function of the quality of the court system and the strictness with which particular states applied the doctrinal limitations on fraud claims. It is, however, the only objective measure available.

My proxy for the influence of small banks is the log of average assets per bank. I discuss other potential proxies below. The populist story is essentially
one of farmers versus finance. I accordingly include the fraction of the economically active population engaged in agriculture as a proxy for populism. Other covariates are intended to serve as proxies for the strength of the progressive movement. One measure is the percentage of a state’s popular vote that went to Roosevelt in 1912.\textsuperscript{42} I also use a “progressive index” developed by Price Fishback and Shawn Kantor that measures the number of specified progressive statutes adopted by the relevant state (including, among others, compulsory school attendance, welfare laws, and civil service reform).\textsuperscript{43}

I also include more comprehensive measures of the party composition of the state legislature and executive for each state-year. I define a dummy variable that takes the value of one if the state had a Democratic governor and zero otherwise. Two additional variables measure the percentage of Democrats and third-party candidates, respectively, in the state’s legislature (averaging the percentage in the upper and lower houses).

Regardless of the reasons behind a legislature’s decision to adopt a blue-sky law—whether those reasons reflect primarily the public interest, the lobbying efforts of small banks, or ideological commitments—we would expect adversely affected industries to oppose those laws. The securities industry was most directly affected, and, as described above, it opposed blue-sky laws other than the ex post fraud variety. The reports of the annual convention of the IBAA provide the number of IBAA member offices in each state for each year in the sample following the IBAA’s creation in 1912. I take that number and divide it by the number (in millions) of persons employed for each state-year to create a rough measure of the relative importance of investment banking. The number is extrapolated for 1911 and 1910. Census data also provide the number of stockbrokers in each state for 1910, 1920, and 1930. I calculate that number as a fraction of the total employed population for those years and interpolate for the intervening years.

The mining industry was also disproportionately affected. Many blue-sky laws divided companies into classes according to the perceived amount of risk and subjected high-risk firms to greater scrutiny. Newly formed mining companies, because they typically had a large amount of intangible assets (mining claims), would often have fallen into the high-risk category. Indeed, some blue-sky statutes explicitly put all mining companies into the highest-

\textsuperscript{42} One might ask whether votes for Wilson would also be indicative of progressive sentiment. Although Wilson was “progressive” in comparison to other Democrats, he was nevertheless encumbered by traditional Democratic positions, unlike Roosevelt, who campaigned as the Progressive Party candidate. In any event, the results discussed below are unaffected by inclusion of Wilson’s share of the vote as an additional variable. The inferences on the other variables and the pseudo-$R^2$ are unaffected, and the estimated coefficient on the new variable is insignificant. If Wilson’s vote is substituted for Roosevelt’s, the new variable has an insignificant estimated coefficient, the inferences on the remaining variables are unaffected, and the pseudo-$R^2$ falls. The same is true if we substitute the sum of the Roosevelt and Wilson vote.

\textsuperscript{43} See Fishback & Kantor, supra note 35, at 328.
TABLE 2
DESCRIPTIVE STATISTICS

<table>
<thead>
<tr>
<th>Variable</th>
<th>Minimum</th>
<th>Maximum</th>
<th>Mean</th>
<th>Standard Deviation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of securities fraud cases, 1901-10, per million employed</td>
<td>.00</td>
<td>9.38</td>
<td>1.15</td>
<td>2.31</td>
</tr>
<tr>
<td>Log of average assets ($ millions) per bank</td>
<td>-2.10</td>
<td>2.50</td>
<td>.09</td>
<td>1.08</td>
</tr>
<tr>
<td>Agricultural employment as % of total</td>
<td>3.00</td>
<td>77.20</td>
<td>28.18</td>
<td>19.76</td>
</tr>
<tr>
<td>Roosevelt's share of popular vote in 1912 (%)</td>
<td>.00</td>
<td>50.60</td>
<td>24.03</td>
<td>9.45</td>
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<tr>
<td>Progressive laws index</td>
<td>.00</td>
<td>8.00</td>
<td>5.05</td>
<td>1.74</td>
</tr>
<tr>
<td>Democratic governor (0 = no, 1 = yes)</td>
<td>.00</td>
<td>1.00</td>
<td>.49</td>
<td>.50</td>
</tr>
<tr>
<td>Democrats as % of legislature</td>
<td>1.71</td>
<td>100.00</td>
<td>46.50</td>
<td>27.85</td>
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<tr>
<td>Other parties as % of legislature</td>
<td>.00</td>
<td>25.74</td>
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<td>IBAA member offices per million employed</td>
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<td>64.05</td>
<td>10.60</td>
<td>14.51</td>
</tr>
<tr>
<td>Stockbrokers as % of employed</td>
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<tr>
<td>Mining employment as % of total</td>
<td>.00</td>
<td>21.35</td>
<td>3.23</td>
<td>4.51</td>
</tr>
</tbody>
</table>

NOTE.—IBAA: Investment Bankers Association of America.

It seems clear from Table 1 that there are both some geographical and temporal trends in the adoption of the blue-sky laws. I therefore include dummy variables for year and region. I use the U.S. Office of the Comptroller of the Currency’s division of the country into six regions (New England, East, South, Midwest, West, and Pacific) as my source for the regional variables. A list of variables (omitting the regional and year dummies) with descriptive statistics appears in Table 2.

C. Results

The effects of the covariates on the adoption of a blue-sky law are shown in Table 3. The second column contains coefficients of the logistic regression model, which estimate the effects of the covariates on the log-odds of adoption. The fifth column provides a more intuitive measure by showing the marginal probabilities—that is, the change in probability of adoption resulting from a 1-standard-deviation increase in the covariate, holding all other covariates constant at their sample means. The baseline probability reported in the first line is the probability of adoption when all variables are set at their sample means.

It is first worth noting that the number of securities fraud cases does not

44 The pseudo-$R^2$ reported for the regressions uses the methodology suggested in Daniel McFadden, Conditional Logit Analysis of Qualitative Choice Behavior, in Frontiers in Econometrics 105, 121 (Paul Zarembka ed. 1974).

Table 3
Effect of Explanatory Variables on the Adoption of a Blue-Sky Law

<table>
<thead>
<tr>
<th>Variable</th>
<th>Coefficient</th>
<th>Standard Error</th>
<th>p-Value</th>
<th>Marginal Probability</th>
</tr>
</thead>
<tbody>
<tr>
<td>Baseline probability</td>
<td>.039</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Securities fraud cases</td>
<td>-.198</td>
<td>.188</td>
<td>.294</td>
<td>-.016</td>
</tr>
<tr>
<td>Log of average bank assets</td>
<td>.551</td>
<td>1.099</td>
<td>.616</td>
<td>.024</td>
</tr>
<tr>
<td>Agricultural employment</td>
<td>.064</td>
<td>.052</td>
<td>.219</td>
<td>.078</td>
</tr>
<tr>
<td>Roosevelt's share of popular vote in 1912</td>
<td>.109</td>
<td>.046</td>
<td>.018</td>
<td>.056</td>
</tr>
<tr>
<td>Progressive laws index</td>
<td>.999</td>
<td>.284</td>
<td>.000</td>
<td>.136</td>
</tr>
<tr>
<td>Democratic governor</td>
<td>-1.476</td>
<td>.797</td>
<td>.064</td>
<td>-.021</td>
</tr>
<tr>
<td>Democrat share of legislature</td>
<td>.039</td>
<td>.020</td>
<td>.055</td>
<td>.059</td>
</tr>
<tr>
<td>Other parties' share of legislature</td>
<td>.035</td>
<td>.059</td>
<td>.557</td>
<td>.003</td>
</tr>
<tr>
<td>IBAA member offices</td>
<td>.011</td>
<td>.024</td>
<td>.643</td>
<td>.003</td>
</tr>
<tr>
<td>Stockbrokers as % of employed</td>
<td>-23.566</td>
<td>10.283</td>
<td>.022</td>
<td>-.028</td>
</tr>
<tr>
<td>Mining employment</td>
<td>-.059</td>
<td>.077</td>
<td>.443</td>
<td>-.011</td>
</tr>
<tr>
<td>New England states</td>
<td>1.265</td>
<td>1.699</td>
<td>.456</td>
<td>.019</td>
</tr>
<tr>
<td>Eastern states</td>
<td>-.732</td>
<td>1.471</td>
<td>.619</td>
<td>-.012</td>
</tr>
<tr>
<td>Southern states</td>
<td>2.320</td>
<td>1.580</td>
<td>.142</td>
<td>.045</td>
</tr>
<tr>
<td>Midwestern states</td>
<td>.535</td>
<td>1.079</td>
<td>.620</td>
<td>.004</td>
</tr>
<tr>
<td>Western states</td>
<td>1.183</td>
<td>1.076</td>
<td>.272</td>
<td>.015</td>
</tr>
</tbody>
</table>

Note. —The table does not report estimated coefficients for year dummy variables that are also included as covariates. Log likelihood = -60.7. McFadden pseudo-$R^2 = .48$.

explain the adoption of a blue-sky law. The estimated coefficient has the wrong sign (a negative coefficient predicts a lower probability of adoption), and it is not statistically significant. The table reports the result using the “narrow” fraud variable described above. I also estimated the regression using the “broad” definition of securities fraud cases. The broader definition did not affect the inference on the variable and reduced the pseudo-$R^2$. Given the limitations of this measure of fraud, we cannot rule out the possibility that an unobservable “fraud wave” explains part of the timing of adoption. Nevertheless, the best available data provide no support for the public interest hypothesis.

Of the political and public choice variables, the one with by far the largest effect and greatest explanatory power is the progressive laws index. That index counts the number of progressive laws adopted out of a set of eight. Increasing that number from its sample mean of 5 to 6.7, a 1-standard-deviation increase, increases the probability of adoption of a blue-sky law in a given state-year by almost 14 percent. This suggests that some of the same political coalitions active in the adoption of progressive legislation also worked for the passage of blue-sky laws. Further support is provided by the fact that greater support for Roosevelt in 1912 is associated with a positive, statistically and practically significant increase in probability. The negative and marginally significant coefficient on the dummy variable for Democratic governors is also suggestive, as many staunchly progressive states had Republican governors.
The agriculture variable that serves as a proxy for populist politics is not associated with a higher probability of adopting a blue-sky law—nor is the average bank size variable that serves as a proxy for the public choice analysis. We must be careful in interpreting these results, however, because the agriculture variable is highly correlated with average bank size. As a check, I reestimated the model excluding one variable, then the other. Neither the agricultural employment variable nor the bank size variable has a statistically significant estimated coefficient when the other is excluded. Moreover, using a $\chi^2$ likelihood-ratio test of joint significance, we cannot reject the hypothesis that the coefficient on both variables is zero when both are included in the model.

Finally, a stronger securities industry presence, as measured by the number of stockbrokers as a percentage of total employment, tended to delay enactment of a blue-sky law. Both the IBAA membership variable and the mining employment variable, however, have small and statistically insignificant effects. None of the regional dummy variables has a statistically significant estimated coefficient.

D. Sensitivity Checks

To determine the sensitivity of the result to the event history methodology, I counted the number of years (ignoring those in which the legislature did not sit) from 1910 until the date of adoption of a blue-sky law for each state. I then used that count as the dependent variable in an ordinary least-squares regression, taking the starting values of each covariate for each state as the independent variables. The results were consistent with those from the event history analysis. In particular, the progressive index variable and the percentage vote for Roosevelt predict more rapid adoption, and the stockbroker variable predicts slower adoption; in each case, the result is statistically significant.

I also consider whether the lack of a significant estimated coefficient on the bank asset variable is a consequence of that variable being a poor proxy for the prevalence of small banks. Ideally, one would want to know the proportion of banking assets held by small banks. This information is not, however, available for the period of interest for all banks in the standard compilations of banking data. An alternative is to consider state-chartered banks to be a proxy for small banks. Smaller banks tended to operate under a state charter, while larger banks tended to operate under a federal charter, although the correlation is not perfect. I therefore measure the proportion of banks operating under a state charter and use that as an alternative proxy for small banks. None of the results reported in Table 3 or in Table 4, described

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46 Kroszner & Strahan, supra note 3, uses such a measure as a proxy for small-bank lobbying strength.
below, is sensitive to the use of this alternative proxy. As a further alternative, I consider whether the regulatory environment was hospitable to small banks. The principal regulatory factors that enabled small banks to survive were antibranching restrictions and low minimum capital requirements. I accordingly reestimated the event history model using the percentage of banks operating branches and the minimum capital level as proxies for small banks. The estimated coefficients on these variables were neither individually nor jointly significant. Despite Macey and Miller’s evidence that small banks lobbied in favor of blue-sky laws, I find no association between several different proxies for the prevalence of small banks and early adoption of a blue-sky law.

To summarize, the data provide strong support for the progressive ideology hypothesis but little or no support for either the populist, public choice, or public interest hypotheses. The data also show that states with relatively more stockbrokers were less eager to adopt blue-sky laws.

E. Evidence from the Type of Blue-Sky Law

As discussed above, different states adopted different types of blue-sky laws, and those statutes can be readily grouped into three categories. Merit review statutes gave state administrators the greatest opportunity to curtail securities offerings, followed by ex ante fraud and ex post fraud statutes.

The decision to adopt a particular type of law may be different from the decision to adopt a law or not. Ideologically motivated voters and legislators may be more interested in "making a statement" by adopting a statute regardless of its details. Indeed, more dispersed interests such as farmers and progressives might have paid little attention to the details of the legislation compared to directly affected and concentrated interests such as banks and brokers. A bank wishing to suppress competition would favor a statute giving the administering official (often a bank commissioner, who might be sympathetic to the banks' point of view) maximum authority to prevent securities offerings. Thus, a reasonable hypothesis is that the public choice variables would be relatively more and the political variables relatively less influential in explaining the type of blue-sky law adopted in comparison to the timing of adoption.

I therefore add a second step to the analysis and examine the choice among the three basic types of blue-sky law. First, I restrict the sample to the state-years in which blue-sky laws were adopted. I then employ a multinomial logit model to estimate the effects of the covariates on the choice among an ex post fraud, ex ante fraud, or merit review statute. One issue in doing so is the fact that the merit review statutes are limited to the early part of the sample. This is a particular problem for drawing any inference with respect to the average bank asset variable. Because bank assets generally were increasing over time, the result would be biased in the direction of associating
smaller banks with merit review, which is one of the hypotheses to be tested. In order to resolve the problem, I use for each state the log of average bank assets for the first year of the sample. The limited temporal (and to a lesser extent geographical) variation in the type of statute and the reduced number of degrees of freedom make it impossible to estimate the model with the year and region variables. I discuss these drawbacks in more detail below.

The results of the multinomial logit regression are reported in Table 4. Compared with Table 3, there is a shift in the importance of the public choice and political variables. The estimated coefficients on the progressive index and political composition variables are in each case insignificant. Bank size, by contrast, is a significant predictor of the type of statute. An increase in average bank size is associated with a reduced probability of a merit review or ex ante fraud statute, compared to an ex post fraud statute. This is consistent with small banks preferring a more stringent blue-sky statute. A larger stockbroker presence predicts a lower probability of adopting a merit review statute, although the result is marginally significant. Interestingly, a larger mining industry presence predicts a higher likelihood of adopting a merit review statute, although again the result is marginally significant. Mining companies may not have been as successful as stockbrokers in lobbying for a less stringent statute.

This test, like the event history analysis, is complicated by the strong correlation between the average bank asset and agricultural employment variables. The model estimated in Table 4 does not include the agricultural employment variable. With both variables included, the bank asset variable loses significance in the upper panel ($p = 0.114$), although it retains significance in the lower panel. However, the pseudo-$R^2$ of the model remains the same, and a likelihood-ratio test shows that the bank asset variable, but not the agricultural variable, improves the predictive power of the model. It therefore appears that the presence of small banks, and not agricultural employment, is associated with a greater likelihood of a more stringent statute.

In order to determine whether these results are a consequence of the lack of controls for year and region, I employed an ordinal regression procedure as an alternative to the multinomial logit procedure. The ordinal regression procedure imposes a restriction that the slopes in the regression equation be the same for the choice between any of the types of statute. The corresponding

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47 As expected, the association between small banks and merit review is even stronger if the values for the year of adoption are used.

48 An alternative that would allow for more observations and therefore for increased power would be a nested logit model that treats the choice to adopt a law and the type of law as related decisions. However, such a model can be estimated only if some of the covariates vary by decision type and not merely by subject-year (for example, if we had some measure of the "cost" to a legislature of adopting different types of statutes). This is not the case for my data.

49 I employed a proportional-odds model with a logit link function as described in Peter McCullagh, Regression Models for Ordinal Data (with Discussion), 42 J. Royal Stat. Soc'y B 109 (1980).
Table 4

Effects of Explanatory Variables on the Type of Blue-Sky Law Adopted

<table>
<thead>
<tr>
<th>Variable</th>
<th>Coefficient</th>
<th>Standard Error</th>
<th>p-Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Impact on log-odds of adopting a merit review statute:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Number of securities fraud cases</td>
<td>.848</td>
<td>1.095</td>
<td>.439</td>
</tr>
<tr>
<td>Log of average bank assets</td>
<td>-4.789</td>
<td>2.350</td>
<td>.042</td>
</tr>
<tr>
<td>Roosevelt's share of popular vote in 1912</td>
<td>.171</td>
<td>.163</td>
<td>.293</td>
</tr>
<tr>
<td>Progressive laws index</td>
<td>.347</td>
<td>.739</td>
<td>.639</td>
</tr>
<tr>
<td>Democratic governor</td>
<td>- .961</td>
<td>3.417</td>
<td>.778</td>
</tr>
<tr>
<td>Democratic share of legislature</td>
<td>-.011</td>
<td>.056</td>
<td>.846</td>
</tr>
<tr>
<td>Other parties' share of legislature</td>
<td>-.137</td>
<td>.300</td>
<td>.649</td>
</tr>
<tr>
<td>IBAA member offices</td>
<td>.101</td>
<td>.155</td>
<td>.516</td>
</tr>
<tr>
<td>Stockbrokers as % of employed</td>
<td>-131.013</td>
<td>71.023</td>
<td>.065</td>
</tr>
<tr>
<td>Mining employment</td>
<td>.802</td>
<td>.417</td>
<td>.055</td>
</tr>
<tr>
<td>Impact on log-odds of adopting an ex ante fraud review statute:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Number of securities fraud cases</td>
<td>1.224</td>
<td>.820</td>
<td>.135</td>
</tr>
<tr>
<td>Log of average bank assets</td>
<td>-4.125</td>
<td>1.729</td>
<td>.017</td>
</tr>
<tr>
<td>Roosevelt's share of popular vote in 1912</td>
<td>.013</td>
<td>.143</td>
<td>.925</td>
</tr>
<tr>
<td>Progressive laws index</td>
<td>-.016</td>
<td>.554</td>
<td>.976</td>
</tr>
<tr>
<td>Democratic governor</td>
<td>-.792</td>
<td>2.179</td>
<td>.716</td>
</tr>
<tr>
<td>Democratic share of legislature</td>
<td>-.004</td>
<td>.038</td>
<td>.907</td>
</tr>
<tr>
<td>Other parties' share of legislature</td>
<td>-.354</td>
<td>.215</td>
<td>.100</td>
</tr>
<tr>
<td>IBAA member offices</td>
<td>-.092</td>
<td>.066</td>
<td>.163</td>
</tr>
<tr>
<td>Stockbrokers as % of employed</td>
<td>25.196</td>
<td>24.905</td>
<td>.312</td>
</tr>
<tr>
<td>Mining employment</td>
<td>.395</td>
<td>.337</td>
<td>.241</td>
</tr>
</tbody>
</table>


The benefit is that it can accommodate a larger set of explanatory variables, including year and region dummies. The results from the ordinal model closely track those of the multinomial logit model. In particular, smaller average bank size is a significant predictor of a stricter statute (whether or not the agricultural employment variable is included).

The fit of the ordinal regression model, however, is poor in comparison to that of the multinomial logit model, which suggests that the covariates may affect the choice between an ex ante fraud and ex post fraud statute differently than the choice between an ex ante fraud and a merit review statute. This is not surprising. It seems plausible that some of the lobbying groups might have viewed a merit review statute to be especially (un)desirable but have been indifferent between ex ante and ex post fraud, while others might have viewed the difference between ex ante and ex post fraud to be important, but not the difference between ex ante fraud and merit review.

The results are consistent with Macey and Miller’s qualitative discussion. It appears that small banks lobbied in favor of stricter statutes, while stockbrokers opposed merit review. Progressive political coalitions seem to have had little impact on the type of statute even though they strongly influenced the rapidity with which a state adopted a blue-sky law.
TABLE 5
BLUE-SKY LAWS AND RURAL BANK PROFITS

<table>
<thead>
<tr>
<th>Type of statute</th>
<th>Coefficient</th>
<th>Standard Error</th>
<th>p-Value</th>
<th>Adjusted $R^2$</th>
</tr>
</thead>
<tbody>
<tr>
<td>All</td>
<td>.334</td>
<td>.853</td>
<td>.695</td>
<td>.487</td>
</tr>
<tr>
<td>Ex post fraud</td>
<td>-.205</td>
<td>.781</td>
<td>.794</td>
<td>.939</td>
</tr>
<tr>
<td>Ex ante fraud</td>
<td>.255</td>
<td>1.033</td>
<td>.828</td>
<td>.471</td>
</tr>
<tr>
<td>Merit review</td>
<td>4.987</td>
<td>1.877</td>
<td>.009</td>
<td>.765</td>
</tr>
</tbody>
</table>

NOTE.—The estimated coefficient is in each case on a dummy variable that equals one when a blue-sky law is in effect.

F. Evidence of Changes in Bank Profitability

A related inquiry is whether the enactment of a blue-sky law was, in fact, beneficial to small banks. The most relevant available data are from the U.S. Office of the Comptroller of the Currency annual reports. These provide information on the rate of return (profits divided by capital and surplus) for national banks grouped by state. While we do not have comprehensive income data for state-chartered banks, the comptroller’s data are fortunately presented separately for city and country banks. I use the latter as a rough proxy for the profitability of small banks in a state. To be sure, the data do not cover the smallest banks (which would have been state chartered), but being able to limit the analysis to national banks outside the main cities is the next best alternative.

I measure average annual profitability of each state’s country banks for the 5 years prior to enactment of a blue-sky law and the 5 years after enactment. I omit Connecticut (adopted in 1929) and Delaware (adopted in 1931) to avoid confounding effects from the Depression. This leaves 460 observations, enough to permit a full fixed-effects regression with dummy variables for each state and each year. Including a dummy variable that switches from zero to one after enactment of a blue-sky law allows me to estimate the effect of a blue-sky law on profitability, controlling for the state and year. The average annual rate of return in the sample is 8.9 percent with a standard deviation of 4.0 percent; the range is from −6.5 to 29.1 percent.

Table 5 shows the results of the fixed-effects model. If all blue-sky laws are considered as a single group, it appears that the adoption of a statute had no effect on bank profits. The estimated coefficient is positive, but it is not statistically significant. When we break the sample down into three subsamples, one for each of the three types of blue-sky law, however, a different picture emerges. Neither an ex post fraud law nor a more stringent ex ante fraud law has a significant effect, although the estimated coefficient increases as we move from the first to the second. A merit review statute, however, has a very large and highly significant effect on the rate of return. If small
banks attempted to influence the type of statute that was enacted rather than whether a statute was enacted, these results suggest that their behavior was rational. The result also fits well with the fact that the Kansas bank commissioner was able to use a merit review statute to reject the vast majority of proposed bond and stock offerings in Kansas.

One possible objection to the analysis is that the merit review statutes are all in the early part of the sample. If there was something unique about bank profitability trends in the early part of the sample period, it could bias the result. The year dummies attempt to control for this possibility, but if the slope (and not merely the intercept) of the relationship between a blue-sky law and bank profits varied over time, the results could remain biased.

To determine whether this is the case, I reestimated the regressions after limiting the sample to those states that adopted a blue-sky law in 1911, 1912, or 1913. Fortunately, there are examples of all three types of statute during that period. The results remain the same—neither an ex ante nor ex post fraud statute is associated with a change in bank profits, but profits increase by a statistically significant amount after enactment of a merit review statute.

I also examine the effect of blue-sky laws on the interest rates paid by rural banks on savings accounts. If banks correctly believed that a blue-sky law would reduce competition for depositors' funds, then banks should have been able to pay a lower rate of interest on deposits in states with more stringent blue-sky laws. Unfortunately, data restrictions make it impossible to carry out a test similar to the above analysis of bank profits. In addition to the National Monetary Commission's survey of savings deposit interest in 1909, the U.S. Office of the Comptroller of the Currency published comprehensive data on deposit interest rates only sporadically prior to the 1930s. However, the comptroller's reports do contain comprehensive deposit interest rate data for 1924. That year is later than the adoption of all but two blue-sky laws, and 1909 is two years prior to the first adoption. For each state that adopted a blue-sky law before 1924, I accordingly measure the difference between the interest rate paid in 1924 and that paid in 1909, limiting myself again to rural banks. Interest rates rose generally during this period. However, as shown in Table 6, they rose least in states with a merit review statute and most in states with an ex post fraud statute. The test is, however, not very powerful, and using a single-factor analysis of variance test, the differences are not statistically significant. However, with that caveat, the interest rate evidence is consistent with the evidence from small-bank profitability.

VII. Conclusion

Analyses of the timing of blue-sky laws, the types of laws adopted, and their effects on bank profitability suggest an intriguing and coherent story about the political and economic forces behind their adoption. It appears that
broad-based political movements had the greatest effect on the basic decision to adopt a blue-sky law.

Lobbying by small banks, however, appears to have had the strongest impact on the type of statute ultimately adopted. The greater the prevalence of small banks, the more likely it is that a state would adopt merit review, the most stringent form of blue-sky law, all other things equal. Similarly, the greater the presence of stockbrokers, the less likely it is that a state would adopt merit review. Banks appear to have correctly predicted the impact of giving blue-sky commissioners (who often were bank regulators) extensive discretion to stop securities offerings. In the 5 years following adoption of a merit review statute, bank profits increased on average by nearly 5 percentage points, controlling for state and year.

The data suggest that public choice analysis, although useful, does not tell the entire story behind the growth of economic regulation in early twentieth-century America. Ideologically motivated political coalitions appear to have played a role as well. Although the public interest hypothesis cannot be ruled out definitively, there is no evidence that the statutes responded to actual instances of fraud.

APPENDIX

All variables, except as noted below, were downloaded from Price V. Fishback’s Web site, http://www.arizona.edu/~econ/fishback.html, in December 2000. The current URL, as of October 2002, is http://info-center.ccit.arizona.edu/~econ/fishbackdf.html.


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