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Corporate charitable foundations, executive entrenchment, and shareholder distributions

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ABSTRACT

We show that firms with corporate charitable foundations increased shareholder distributions by less than one half as much as similar firms without foundations following the 2003 capital income tax cut, even after controlling for common explanatory factors such as executive shareholding. The findings are robust to alternative explanations and to common threats to causal identification. Further exploration reveals that our estimates capture a greater reluctance of foundation firms to initiate or rapidly increase shareholder payouts, but not a greater tendency to reduce or eliminate shareholder payouts. Additional analyses suggest managers direct funds that would have been paid out toward executive compensation and capital investment. In light of the fact that firms with foundations are more likely to exhibit a high degree of managerial entrenchment, we interpret these findings as evidence that foundations are both a sign of and vehicle for managerial self-dealing.

1. Introduction

Many large business corporations have charitable foundations; 203 of the S&P 500 publicly traded companies had such foundations as of 2013. The existence, let alone ordinariness, of such foundations is surprising. Charitable foundations are burdensome to create, costly to administer, may be constrained by payout requirements and excise taxes, and are not necessary for corporations to make charitable donations. That corporate foundations nevertheless persist for so many large firms suggests that despite these costs, foundations create substantial benefits for corporations or corporate managers.

We explore the role of corporate foundations in managerial decision-making by comparing firms with and without pre-existing charitable foundations in the presence of a shock to the cost of shareholder distributions. More precisely, we use a difference-in-differences research design to compare the payout behaviors of firms with and without foundations before and after the 2003 Bush tax cuts to dividend and capital gains rates. We find that firms with foundations increased payouts by significantly less than firms without foundations after the tax cuts. While firms with foundations did not eliminate or reduce payouts after the reform, they were less likely to initiate or increase payouts. Following a developed literature that suggests increased payouts in response to the tax changes were in the best interest of shareholders, our analysis reveals that firms with foundations make very different, and less shareholder-friendly, financial decisions than firms that do not.

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Critically, the magnitude of the difference in the payout response between foundation and non-foundation firms is an order of magnitude larger than the value of total corporate philanthropy. Therefore the vast majority of the estimated behavior cannot be explained by substitution between payouts and philanthropic activities.

This finding is, however, consistent with an agency theory of the firm in which corporate foundations enhance the value of "pet projects" for corporate managers, and indeed may be the visible tip of a larger, unobserved iceberg of managerial entrenchment in the firm's culture and processes. In support of this interpretation, we demonstrate that firms with high scores on the Bebchuk et al. (2009) index of managerial entrenchment are far more likely to have charitable foundations. This explanation is further supported by two other recent papers that explore corporate pro-social behavior around the same tax reform. These papers show that spending on corporate charity or social responsibility initiatives are negatively correlated with payout increases for firms with greater separation of ownership and control (Cheng et al., 2016; Masulis and Reza, 2014).

While these studies buttress our conclusion that corporate foundations themselves are a signal of managerial entrenchment, our strategy, which focuses on the presence of the corporate foundation (as opposed to the level of giving or CSR), allows us to draw causal inferences based on plausibly exogenous variation.[1] Because corporate charitable foundations, once established, are seldom closed down, and because the 2002 Sarbanes–Oxley rules have made the establishment of new corporate foundations rare, the presence of foundations within the largest firms is not influenced by the 2003 tax change itself.

The key threat to our primary empirical design is that other time-varying shocks coinciding with the tax rate cuts may differentially affect firms that do and do not have charitable foundations. Throughout the paper we work to address this concern, providing several pieces of evidence that our findings are not driven by spurious inference or alternative channels. First, a semi-parametric implementation of our difference-in-differences design shows that payout behaviors of firms with and without foundations were similar in four years prior to 2003 but diverge sharply upon policy impact. Second, differential payout responses cannot be explained by executive ownership, firm age, prior payout behavior, differences in firm exit rates, nor potential determinants of corporate foundation establishment such as excess free cash flows or investment opportunities. Third, when the sample is balanced and treatment is redefined as firms with long-lived foundations, the significance and magnitude of our results are unchanged, reinforcing the exogeneity of foundation status. Fourth, we show that foundation firms used the funds that would have been paid out to increase executive compensation and capital investment. These and other checks confirm the robustness of our main result; foundation firms are significantly less responsive to tax cuts, and likely suffer from principal-agent problems.

Our study contributes to two literatures. The first, initialized by Schwartz (1968), Clotfelter (1985), and Navarro (1988), studies the role and purpose of corporate charitable giving.[2] The second, on the separation of ownership and control within the firm, characterizes misaligned incentives between executives and shareholders, as in Jensen and Meckling (1976), Shleifer and Vishny (1986), and Myers (2001). More recently, Chetty and Saez (2010) propose a new agency model of the firm, in which managers who vary in the extent of their incentive alignment with shareholders and degree of positional entrenchment allocate resources to shareholder payouts, revenue-generating investments, and "pet projects." Linking these literatures, we show that shareholder distribution decisions differ across firms with and without foundations, suggesting that foundations are an observable indicator of the potential for pet projects in the firm.

The remainder of the paper is organized as follows: Section 2 explains our empirical strategy. Section 3 describes our data set. We present evidence that foundations are strongly associated with executive entrenchment in Section 4, before testing our hypothesis following the 2003 capital income tax cuts in Section 5. We test for threats to identification and alternative explanations in Section 6, and explore the intensive and extensive margins of payout behavior in Section 7. We extrapolate our framework to other uses of retained earnings to determine how foundation firms allocate funds which would counterfactually have been distributed to shareholders in Section 8. We summarize and interpret our findings in Section 9 before concluding in Section 10.

2. Understanding corporate charitable foundations

Our goal is to better understand the role of corporate foundations in the firm. To do so, we generate a novel empirical strategy that tests alternative theories of foundations by comparing payout behaviors of firms with and without corporate foundations before and after a significant change in the tax cost of payouts. This section develops our strategy. First, we motivate our use of charitable foundations, rather than corporate giving flows, as a lens through which to understand corporate charity. We then detail the Jobs and Growth Tax Relief Reconciliation Act (JGTRRA), a tax policy that changed the tax cost of corporate payouts. Finally, we discuss how the interaction of corporate foundation presence and the tax cost shock can deepen our understanding of the role of foundations in the firm and corporate charity more generally.

[1] Although there is some evidence that corporate charity is associated with agency monitoring problems, this evidence is found in case studies (Barnard, 1997) or simply correlates charity with larger boards, lower leverage, or excess free cash flows (Brown et al., 2006; Card et al., 2010; Seifert et al., 2004).

[2] These early papers rejected empirically the possibility that corporate charity is a profit-maximizing behavior by showing giving responds to marginal tax rates. These studies are based on the logic that if corporate charitable contributions are a fully deductible production input then corporate tax rates should not affect giving.