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Do external labor market incentives motivate CEOs to adopt more aggressive corporate tax reporting preferences?

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ABSTRACT

Building on recent theory, we find strong and robust evidence that external labor market incentives motivate CEOs to adopt more aggressive tax policies in order to improve firm performance and their own labor market value. In addition, we find that the tax aggressiveness-labor market incentives relation varies in the cross-section consistently with theory. We find that the relation is attenuated in industries for which the CEO has fewer outside employment options, and we find it to be amplified in industries for which competition for CEO talent is likely greatest, and also among CEOs estimated to have greater ability. Overall, our results suggest that the market for CEOs – an incentive device external to the firm – has a meaningful impact on corporate tax policy.

1. Introduction

Given the magnitude of tax payments made by corporations to the U.S. Treasury, the management of corporate taxes is an important strategic issue for executives. Indeed, the economic importance of the management of taxes is underscored by recent debates over tax inversions (i.e., the relocation of a domestic firm's tax home to an international, often low-tax, jurisdiction) and access to foreign-sourced earnings without a significant repatriation tax cost (Foley et al., 2007; Hanlon and Heitzman, 2010; Hanlon, Lester, and Verdi, 2015).[2] While recent research attention has sought to identify firm specific factors – including the characteristics of executive compensation contracts – that drive this policy choice, there is little empirical evidence addressing the extent to which external, industry-level factors influence corporate tax reporting preferences.[3] Moreover, we have an incomplete understanding of the role of incentive devices in influencing corporate tax outcomes. In this study, we address both questions by

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[2] For example, Foley et al. (2007) suggest that one reason why U.S. multinational firms hold so much cash is because of the large tax cost of repatriating foreign earnings, and Hanlon, Lester, and Verdi (2015) show that the high repatriation tax costs of such firms tend to lead to suboptimal foreign acquisitions.

[3] An exception is a study by Kubick et al. (2015), who present evidence that product market power incentivizes firms to engage in greater tax avoidance, and that firms mimic the tax outcomes of their product market industry leaders.

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building on recent theory in financial economics to investigate whether industry tournament incentives – an incentive device external to the firm – influence CEOs to favor more aggressive tax reporting choices.

Lazear and Rosen (1981) first demonstrated that promotion-based tournaments provide labor with incentives to provide effort, and that the provision of effort is expected to increase with the size of the tournament prize. In support of this theory, Kale, Reis, and Venkateswaran (2009) find that internal tournament incentives to outperform managerial peers, proxied by the difference in compensation between a firm's CEO and senior executives, are associated with greater financial performance. Although the CEO has already won a previous internal promotion tournament, it is also likely that CEOs are affected by tournament incentives that exist in the external market for CEO talent. First, theory and prior research argues that CEOs should be evaluated on a relative basis (e.g., Holmstrom, 1982; Holmstrom and Milgrom, 1987) in order to filter the effect of exogenous shocks such as those within the industry (Albuquerque, 2009), and research on compensation peer groups demonstrates that industry and firm size are important determinants of the peer group composition (Albuquerque, De Franco, and Verdi, 2013; Bizjak, Lemmon, and Nguyen, 2011; Faulkender and Yang, 2010). Second, Murphy and Zabojnik (2007) argue that the requisite skills for successfully managing the modern public firm have evolved with the capital markets such that the demand has increased for demonstrated CEO skill in cultivating and administering relationships with external constituencies such as analysts, financiers, regulators, politicians, and the 24/7 media. As a result, the market demand has grown for a more general CEO skillset relative to firm-specific skills, which Murphy and Zabojnik (2007) argue are more readily implemented by subordinate executives given the dramatic innovations in technology (e.g., the availability and access to firm-specific operational detail in corporate databases). Further, general CEO skills are relatively transferable to other organizations, and with an increased demand for these skills, market forces influence equilibrium wages while increasing the occurrence of external CEO hires.

Fee and Hadlock (2003) provide some evidence of the size of the tournament prize for CEO hires. Specifically, CEOs hired as CEO by another firm increase their salary by an average of 50 percent, receive grants (e.g., bonuses, stock, and options) four times as valuable as those they likely forfeit by leaving their previous CEO position, and move to a firm on average 4.5 times larger than their previous employer. Supporting their argument that the demand for transferable general CEO skills has increased over time, Murphy and Zabojnik (2007) report that the number of outside CEOs hired with previous CEO experience in the 1990s was three times as large as the same count in the 1970s, and that almost half of CEO hires in the 1990s were of CEOs with prior CEO experience.

Recent research has investigated the importance of external tournament incentives for project selection, firm risk (Coles, Li, and Wang, 2013), and earnings management (Huang, Jiang, and Xie, 2014). However, our research question allows us to offer the following innovations to the current corporate tax research domain. First, executive influence over corporate policy choices is likely determined by the extent to which these choices are economically valuable to the manager. The literature on CEO incentives and tax aggressiveness has thus far focused on compensation incentives internal to the firm. For example, researchers have analyzed the effects of bonus compensation (Gaertner, 2013; Powers, Robinson, and Stromberg, 2014), equity incentives (Rego and Wilson, 2012), pay-for-performance sensitivity (Minnick and Noga, 2010), and inside debt holdings (Chi, Huang, and Sanchez, 2014; Kubick, Lockhart, and Robinson, 2014) on taxes. Our work complements this stream of research by investigating whether the CEO responds to external labor market incentives to manage taxes. Second, because external labor market incentives are external to the firm, we have an arguably cleaner setting relative to other studies to test our hypothesis.

We follow Coles, Li, and Wang (2013) and construct a measure of the incentives provided by the managerial labor market to the CEO for a large sample of Execucomp firms over fiscal years 1994 through 2012. A CEO's industry tournament incentive is empirically defined as the difference between the CEO's total compensation and the total compensation for the near-highest paid CEO of that industry, with industry split at the size of the median firm. The assumption is that CEOs with greater industry-defined compensation differences (i.e., industry tournament incentives) face greater potential payoffs to success in the managerial labor market, and will pursue policies to increase the probability of achieving success in the labor market. Further, Albuquerque (2009) shows systematic evidence of CEO compensation relative performance evaluation when the comparison group is based on both industry and firm size. Accordingly, we argue that CEOs facing greater industry tournament incentives are more likely to favor aggressive tax reporting preferences to improve firm performance, thereby increasing their human capital value, and hence, their probability of winning the industry tournament.

We use three measures of corporate tax reporting aggressiveness. Our first is the discretionary book-tax differences measure of Frank, Lynch, and Rego (2009), which is designed to capture management's influence over *discretionary* tax reporting choices that result in permanent book-tax differences (i.e., differences that result in lower taxable income but not lower book income). Frank, Lynch, and Rego (2009) empirically validate their measure using a sample of actual tax shelter firms, and it has been regarded in the literature as reflecting more aggressive tax reporting choices (Armstrong, Blouin, and Larcker, 2012; McGuire, Omer, and Wang, 2012). Our second measure of tax aggressiveness is the difference between the average GAAP effective tax rate of a firm's size quintile for the industry-fiscal year and the firm's own GAAP effective tax rate (Armstrong et al., 2015; Balakrishnan et al., 2012). Our third measure of tax aggressiveness is the tax sheltering likelihood obtained from using the Wilson (2009) tax sheltering prediction model.

We find robust evidence that industry tournament incentives are positively associated with tax reporting aggressiveness. Examining the pair-wise relationship between industry tournament incentives and tax reporting aggressiveness, we observe a near monotonic relationship and a strong positive correlation. In multivariate tests, we find strong and robust results in favor of our hypothesis using OLS, firm fixed effects, CEO fixed effects, changes, and instrumental variables, using generalized methods of moments (GMM-IV) estimation. We also find these results to be economically significant. For example, a one-standard deviation increase in the log of the industry pay gap – our empirical proxy for industry tournament incentives – is associated with a