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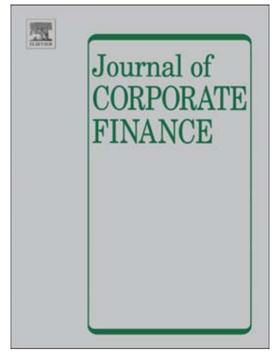

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The Role of Taxes and the Interdependence Among Corporate Financial Policies: Evidence from a Natural Experiment

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Abstract

In this paper, we investigate whether and how firms respond to an exogenous tax variation at the investor level by examining their financial decisions following a tax reform for pension funds in Brazil. Consistent with the tax-preference theory of dividends, we find that after implementation of the new law, firms tend to distribute more tax-deductible dividends — called Interest on Equity (IOE) — when the largest or second largest shareholder is a pension fund rather than other types of agents. Surprisingly, control firms also increased (but less than treated firms) their tax-deductible dividend payments, probably to attract more institutional investors and to reduce their cost of capital. We also find that treated firms reduced their leverage relative to control firms after the new law, suggesting that equity tax shields and debt tax shields act as substitute financial instruments. These results are robust to falsification tests and an alternative control group of firms based on a Propensity Score Matching procedure. Overall, our evidence suggests that tax is a first-order determinant of corporate financial decisions and firms adjust their policies in consideration of the interdependence among alternative financial instruments.

Keywords: taxation, dividend policy, interdependence of corporate financial decisions, tax shields, natural experiment.

JEL: G30, G35, G38

1. Introduction

In the Miller & Modigliani (1958) and Miller & Modigliani (1961) frictionless and symmetric information world, corporate financial decisions are irrelevant to firm value. However, when we add market imperfections such as corporate or personal taxes, transaction costs, and asymmetric information, corporate financial decisions become important. Although particular attention has been paid to the influence of taxes on financial decisions, many issues remain unsolved, including whether tax effects are of first-order importance and whether corporate actions are affected by investor-level taxes (Graham, 2003). Fama (2011) also argues that understanding how corporate policies interact with tax incentives is still a significant remaining challenge in corporate finance.

In this paper, we investigate if a taxation shock at the shareholder level causes changes in invested firms' behavior. We also analyze whether these effects are isolated or broader because of the interdependence among firms' financial

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