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How do powerful CEOs manage corporate tax aggressiveness?

Issam Laguir
Groupe Sup de Co Montpellier Business School, Montpellier Research in Management (MRM)

Raffaele Staglianò
Groupe Sup de Co Montpellier Business School, Montpellier Research in Management (MRM)

Abstract

We explore how powerful CEOs manage the tax aggressiveness (TAG) of their firms. The agency view suggests that CEOs invest in TAG to enhance their own private benefits. On the contrary, the stream of corporate social responsibility theories argues that CEOs avoid investment in TAG as, although a corporation exists primarily to increase shareholder value, it must also satisfy the needs of its other stakeholders. Using a panel of hand-collected data from listed Italian firms, we show that the association between CEO power and TAG is non-monotonic. When the CEO is relatively less powerful, an increase in CEO power leads to less TAG engagement. However, as the CEO becomes substantially more powerful, he is more entrenched and invests more in TAG. In fact, when CEO power goes beyond a certain threshold, more powerful CEOs significantly increase TAG.

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Contact: Issam Laguir - i.laguir@supco-montpellier.fr, Raffaele Staglianò - r.stagliano@supco-montpellier.fr.
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1. Introduction

Issues related to corporate tax aggressiveness have increasingly drawn the attention of scholars and professionals alike (Desai and Dharmapala 2006, Frank et al. 2009, Chen et al. 2010 and Lanis and Richardson 2011). Indeed, management policies designed to optimize corporate taxes by means of tax aggressive activities are today a fairly common feature of the worldwide corporate environment. In line with existing research (e.g., Frank et al. 2009 and Chen et al. 2010), we define tax aggressiveness as downward management of taxable income through tax planning activities. Tax aggressiveness in our paper encompasses tax planning activities that are legal or that may fall into the gray area, as well as activities that are illegal. Thus, tax aggressive activities do not necessarily indicate that the firm has done anything improper. Further, we use the term tax aggressiveness throughout the paper but the term can be used interchangeably with tax avoidance and tax management. Most of the empirical research on tax aggressiveness uses various corporate governance proxies (Shackelford and Shevlin 2001 and Hanlon and Heitzman 2010), but neglects the influence of CEO power. The purpose of this paper is therefore to examine the impact of CEO power on tax planning activities in a sample of Italian listed firms from the respective views of agency theory and the stream of corporate social responsibility theories in order to answer a key research question: *how do powerful CEOs manage the tax aggressiveness of their firms?*

Our findings show that, when a CEO has relatively low power, an increase in power will prompt him to reduce corporate tax aggressiveness, thus supporting the CSR theories view. However, when CEO power reaches a certain point, a further increase in power will result in a significant increase in tax aggressiveness, thus supporting the agency theory view. Hence, the relationship is non-monotonic, and the increase/decrease in corporate tax aggressiveness depends on the CEO's degree of power. It seems that, when a CEO's power is sufficiently potent, he believes himself to be so deeply entrenched that he engages in aggressive corporate tax planning activities in order to enhance his private benefits. Corporate tax aggressiveness thus increases significantly when the CEO becomes very powerful. Indeed, deeply entrenched CEOs view a decline in their firm's tax aggressiveness as depriving them of the free cash flow they could otherwise exploit, particularly to enhance their own private benefits.

The rest of the paper is organized as follows. In Section 2, we review the prior literature. Section 3 introduces the dataset and the model. In Section 4, we present the empirical results. Section 5 concludes.

2. Tax aggressiveness and CEO power

According to agency theory, tax aggressiveness can be a tax-saving vehicle that reduces costs and increases shareholder wealth (e.g., Graham and Tucker 2006 and Hanlon and Heitzman 2010). Thus, to determine the level of tax aggressiveness they will engage in, firms trade off the marginal benefits against the marginal costs of managing taxes (Chen et al. 2010). The marginal benefits include greater tax savings, whereas the marginal costs include the potential penalty imposed by tax administrations, implementation costs (time/effort and transaction costs of implementing tax transactions), and the agency costs that accompany tax aggressive activities (Desai and Dharmapala 2006). Indeed, Desai and Dharmapala (2006) modeled the complementary relation between rent extraction and tax aggressiveness, pointing out that tax planning activities often comprise very complex transactions designed to obscure the underlying intent and avoid detection by tax administrations. Hence, insiders may be able to

conceal rent extraction through tax aggressiveness if the actions of rent extraction and tax aggressiveness are complementary. Yet this might create significant agency conflicts with liquidity shareholders and, even though tax aggressive activities save shareholders' wealth, these shareholders may be tempted to limit the potential for managerial self-dealing and react favorably to regulatory actions that prevent managers from transferring corporate resources through tax transactions. From this perspective, it is therefore reasonable to assume that more the CEO is powerful, the more he can be expected to engage in tax planning activities (to enhance his own private benefits).

In contrast, according to the stream of corporate social responsibility theories (particularly legitimacy and stakeholder theories), although a corporation exists primarily to increase shareholder value, it must also satisfy the needs of its other stakeholders (see, e.g., Freeman and Reed 1983 and Mitchell et al. 1997). These latter can withdraw resources destined for the company and thereby endanger its existence. They therefore need to be managed to ensure their continued support and to ultimately ensure that corporate objectives are met (Mitchell et al. 1997 and Roberts, 1992). Moreover, firms usually seek to legitimize and sustain relationships in the broader social and political environment in which they operate and, without such legitimacy, they will not survive, irrespective of how well they may perform financially (Gray et al. 1995). Indeed, given the growth in community awareness and concern, a firm today is expected to take measures to ensure that its activities and performance are acceptable to the community (Wilmshurst and Frost 2000). However, should there be a perceived mismatch between organizational activities and societal values, a legitimacy gap will develop (Haniffa and Cooke 2005) and may threaten the organization's status within the broader social system. For example, if a firm embarks on a scheme whose sole or dominant purpose is to avoid paying taxes, then it is generally deemed not to be paying its "fair share" of tax to the government to ensure the financing of public goods (Freedman 2003 and Friese et al. 2008). This shortfall in corporate income tax revenue generates hostility, reputational damage and, at worst, could even result in the cessation of a corporation's business operations (Hartnett 2008 and Lanis and Richardson 2011). The logic from this perspective suggests that the more the CEO is powerful, the less he can be expected to engage in tax planning activities.

3. Data and methods

The sample consisted of a panel of Italian listed firms (Blue Chip and Ordinary segments) for the years 2002 to 2007. Data on CEO compensation were retrieved manually from the Documents and Reports section available on the Italian Bourse website. Accounting data were obtained from Datastream. The final sample comprised 290 firm-year observations from 103 listed firms, after excluding firms that fell into the following categories:

(1) Financial corporations, because government regulations are likely to affect their effective tax rates (ETRs) differently from those of other corporations;

(2) Foreign corporations, since these corporations may be subject to resident country tax laws that differ from Italian tax laws;

(3) Corporations with missing financial data and/or CEO compensation data;

(4) Corporations with negative income or tax refunds, because their ETRs are distorted (Zimmerman 1983);

(5) Corporations with ETRs exceeding one, as this can cause model estimation problems (Stickney and McGee 1982).

We measured tax aggressiveness (TAG) using items based on ETRs. In conventional research, ETRs are measured on the basis of information collected from financial statements, such as tax liability divided by income. However, the appropriate definitions of both the numerator and the denominator of this equation are open to debate (see, e.g., Plesko 2003 and Hanlon and Heitzman 2010). We used ETRs in this study for two main reasons. First, recent empirical tax research has found that ETRs encapsulate TAG (see, e.g., Richardson and Lanis 2007, Chen et al. 2010 and Chun et al. 2013). Second, ETRs also denote the proxy measure of TAG most frequently used by academic researchers (see, e.g., Rego 2003; Dyreng et al. 2008). To improve the robustness of our empirical results, we used the following two measures of ETRs (see, e.g.,Gupta and Newberry 1997). The first (ETR1) is defined as income tax expense currently payable divided by book income, and the second (ETR2) is defined as income tax expense currently payable divided by operating cash flows. Hence, the higher the ETR is, the lower the TAG level will be, and the lower the ETR is, the higher the TAG level will be. As the ETRs are bound to fall between 0 and 1, we estimated the model using a double-censored Tobit regression. All of our specifications were estimated using random-effects Tobit models of the following base form:

$$ETR_{it} = \alpha + \beta CSP_{it} + \gamma X_{it} + \nu_i + \varepsilon_{it}$$

where the dependent variable, ETR_{it}, is the corporate effective tax rate proxy for firm i in year t. The independent variables include proxies for the CEO pay slice (CPS). X_{it} is a vector of specific control variables, vi is the firm's random effects, and ε_{it} is the error term.

We measured CEO power by assessing each CEO's relative compensation among the top executives. Bebchuk et al. (2011) argued that the CPS captures the relative significance of the CEO in terms of abilities, contribution, or power. As such, CPS provides a useful proxy for the relative centrality of the CEO in the top management team. Based on their approach, we defined CPS (i.e., the CEO pay slice) as the CEO's total compensation as a fraction of the combined total compensation of the top executives (including the CEO) in a given company. Total compensation thus included salary, bonuses, other annual pay, long-term incentive payouts, the total value of restricted stock granted that year, the Black–Scholes value of stock options granted that year, and all other total compensation.

Although our regressions do not warrant causal interpretation, the control variables do account for many important characteristics that would systematically affect tax aggressiveness. In particular, we control for size (SIZE), return on assets (ROA), capital intensity (CINT), and leverage (LEV). In addition, we used year dummies and dummy sets for the industry categories. The firms are classified into nine industries according to the official classification on the Milan stock exchange.

4. Empirical analysis

Table 1 shows the summary statistics and Pearson correlation results. The ETR1 score averages 0.3861 with a standard deviation of 0.1844, and the ETR2 score averages 0.2991 with a standard deviation of

0.2382. Overall, an acceptable range of variation is observed for all of the variables presented in Table 1, as well as a reasonable level of consistency between the means and medians, reflecting the normality of distributions (see, e.g., Hair et al. 2006).

Table 1: Summary statistics and Pearson correlation results

Variables	Mean	S.D.	median	ETR1	ETR2	CSP	SIZE	ROA	LEV	CINT
ETR1	0.3861	0.1844	0.3874	1.0000						
ETR2	0.2991	0.1453	0.2986	0.6530 (0.000)	1.0000					
CSP	0.4677	0.2382	0.4358	0.0813 (0.037)	0.0477 (0.057)	1.0000				
SIZE	13.9834	1.8141	14.0390	-0.1998 (0.000)	-0.2(21 (0.000)	-0.0987 (0.032)	1.0000			
ROA	0.0487	0.0391	0.0385	-0.3568 (0.000)	-0.2123 (0.000)	-0.0810 (0.079)	-0.0103 (0.524)	1.0000		
LEV	0.5754	0.1773	0.5978	0.1785 (0.000)	-0.0241 (0.446)	0.0345 (0.592)	0.2183 (0.000)	-0.3300 (0.000)	1.0000	
CINT	0.3040	0.2245	0.2417	-0.1365 (0.007)	-0.1265 (0.011)	-0.1109 0.027)	0.1750 (0.000)	-0.0464 (0.315)	-0.0227 (0.623)	1.0000

Furthermore, Table 1 shows only moderate levels of collinearity between the explanatory variables used in our study. The highest correlation coefficient is between ETR1 and ETR2: 0.6530 ($p<0.01$). Moreover, we also calculate variance inflation factors (VIFs) when estimating our base regression model to test for signs of multi-collinearity among the explanatory variables. We find that no VIFs exceed five for any of our explanatory variables, so multi-collinearity is not problematic in our base regression model.

Table 2 displays the Tobit regression results.

Table 2 : Tobit regression results

VARIABLES	Model1 ETR1	Model2 ETR1	Model 3 ETR2	Model4 ETR2
CSP	0.0004	0.3091*	0.0125	0.2602*
	(0.047)	(0.173)	(0.037)	(0.138)
$(CSP)^2$		-0.3110**		-0.2493***
		(0.138)		(0.071)

ROA	-2.5694***	-2.5510***	-1.1236***	-1.1104***
	(0.298)	(0.296)	(0.239)	(0.238)
LEV	-0.2054**	-0.2076**	-0.3241***	-0.3271***
	(0.097)	(0.096)	(0.079)	(0.078)
CINT	-0.0792	-0.0876	0.0106	0.0036
	(0.064)	(0.063)	(0.053)	(0.053)
SIZE	-0.0043	-0.0039	-0.0052	-0.0048
	(0.008)	(0.008)	(0.007)	(0.007)
Constant	0.6476***	0.5848***	0.4836***	0.4326***
	(0.117)	(0.120)	(0.097)	(0.099)
Year dummies	Yes	Yes	Yes	Yes
Industry dummies	Yes	Yes	Yes	Yes
Observations	290	290	290	290
Chi-square	95.16***	100.00***	62.56***	66.93***
LR test	56.84***	54.60***	76.85***	74.06***

Notes: We fit random-effects Tobit models. The LR test is a likelihood-ratio test comparing the random-effects model with the pooled (Tobit) model. Standard errors are in parentheses.
* Statistical significance at 10% level.
** Statistical significance at 5% level.
*** Statistical significance at 1% level.

Model 1 and model 3 include CPS and all control variables. The coefficient of CPS is not significant. Model 2 and Model 4 add the quadratic term of CPS. The coefficient of CPS is now significantly positive, whereas the coefficient of the quadratic term is significantly negative. Thus, it appears that the association between CEO power and ETRs is non-monotonic. At the lower range of CEO power, the relationship is positive. At the higher range of CEO power, the relationship turns negative. The points at which the relationship turns from positive to negative are close to the mean and median (0.4969 for ETR1 and 0.5218 for ETR2). These points are obtained by differentiating the ETR functions (Model 2 and Model 4; Table 2) with respect to CPS and solving for the maximum point when the first derivative is set to zero. The results thus corroborate the hypothesis generated by CSR theories when CEO power is relatively low. With an increase in power, CEOs tend to reduce TAG as a way of managing a range of stakeholders to ensure their continued support and to ultimately ensure that corporate objectives are met. When the CEO commands much more power, however, the CSR view does not appear to be supported and instead the data buttress the agency hypothesis because the relationship turns negative. We conjecture that, at the higher end of CEO power, powerful CEOs are so entrenched in their firms that the additional stakeholder support gained through a TAG decrease is probably considered to be trivial compared with what they stand to gain through engaging in aggressive tax planning activities. If this is the case, then the CEO is more likely to view a decline in TAG as depriving him of the free cash flow he could otherwise exploit, particularly to enhance his own private benefits. As a consequence, he will increase TAG significantly. The alternative interpretation of our data is as follows. When a CEO is truly powerful and deeply entrenched in a firm, he can afford not to care, not only about shareholders, but also about other stakeholders. None of these stakeholders would be powerful enough to remove the CEO. Therefore, the powerful CEO has no real incentive to please them through a TAG decrease.

5. Conclusion

Our study examines how powerful CEOs manage tax aggressiveness. The evidence shows that the degree of CEO power has a significant influence on tax aggressiveness. In particular, a rise in CEO power leads to a drop in tax aggressiveness. Nevertheless, when CEO power reaches a certain threshold, the CEO significantly increases tax aggressiveness. The evidence appears to be consistent with the interpretation suggested by the CSR stream of theories when CEO power is relatively low and with the interpretation suggested by agency theory for the highest range of CEO power. As a CEO becomes more powerful, he reduces tax aggressiveness, suggesting that he is managing a variety of stakeholders to ensure their continued support. However, when the CEO consolidates his power beyond a certain point, he is so entrenched and invulnerable that he no longer views a decrease in tax aggressiveness favorably and therefore engages in aggressive tax planning activities. Very powerful CEOs seem to view low tax aggressiveness as depriving them of the free cash flow they could otherwise exploit, particularly to enhance their own private benefits.

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