

TOP MANAGEMENT CONSERVATISM AND CORPORATE RISK STRATEGIES: EVIDENCE FROM MANAGERS' PERSONAL POLITICAL ORIENTATION AND CORPORATE TAX AVOIDANCE

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We investigate whether managers' personal political orientation helps explain tax avoidance at the firms they manage. Results reveal the intriguing finding that, on average, firms with top executives who lean toward the Republican Party actually engage in less tax avoidance than firms whose executives lean toward the Democratic Party. We also examine changes in tax avoidance around CEO turnovers and find corroborating evidence. Additionally, we find that political orientation is helpful in explaining top management team composition and CEO succession. Our paper extends theory and research by (1) illustrating how tax avoidance can serve as another measure of corporate risk taking and (2) using political orientation as a proxy for managerial conservatism, which is an ex ante measure of a manager's propensity toward risk. Copyright © 2014 John Wiley & Sons, Ltd.

INTRODUCTION

The upper-echelons perspective (Hambrick and Mason, 1984) has long recognized that observable characteristics of top executives help explain how they influence firm outcomes by arguing that these characteristics are proxies for their underlying cognitive frames or values (e.g., Miller, Burke, and Glick, 1998). Recent research has improved our understanding of the relation between executive characteristics and firms' strategic choices

by directly measuring executives' attitudes with surveys (Boivie *et al.*, 2011) or by using proxies that more cleanly capture executives' cognitive states such as narcissism (Chatterjee and Hambrick, 2007), core self-evaluation (Hiller and Hambrick, 2005; Simsek, Heavey, and Veiga, 2010), or emotions (Delgado-Garcia and De La Fuente-Sabate, 2010).

Further, upper-echelon research has recently devoted increased attention to factors that affect the risk profile of the firm (Chatterjee and Hambrick, 2007; Devers, Wiseman, and Holmes, 2007; Sanders and Hambrick, 2007). Specifically, researchers have examined firm risk by looking at the price and premium paid for mergers and acquisitions (M&A) (Billett and Qian, 2008; Hayward and Hambrick, 1997) and also by examining firm investments in long-term projects such as research

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and development (R&D) (Devers *et al.*, 2007; Sanders and Hambrick, 2007). In this paper, we connect these two recent trends by employing a unique proxy of executive risk aversion: executives' personal political orientation, as well as a unique measure of firm-level risk: corporate tax avoidance.

Our study extends upper-echelons research in three main ways. First, we explore how an executive's personal political orientation, as indicated by their personal contributions to political campaigns (Hong and Kostovetsky, 2012; Hutton, Jiang, and Kumar, 2014) may serve as a proxy for his/her attitude toward uncertainty and risk. We investigate how managers' personal political orientation influences strategic decision making and ask the question: Does managers' personal political orientation influence corporate tax avoidance?

Initially, one may assume that managers who more closely align themselves with the ideology of the Republican Party may view wealth redistribution through the government less favorably and therefore be more concerned with reducing the firm's taxes than those who are more ideologically aligned with the Democratic Party. Thus, Republican managers may lead their firms to engage in more tax avoidance. Research examining political orientation from a psychological perspective, however, argues that an individuals' political orientation may reveal an individual's motivated social cognition (e.g., Jost *et al.*, 2003), which suggests that individuals with a more conservative political orientation are more risk averse and thus may act more cautiously in establishing their firm's tax position. To resolve this tension, we develop a series of hypotheses to predict how and when executives' political orientation influences their firms' tax avoidance.

From an empirical perspective, by observing how an executive's personal political donations are allocated between political parties, we examine an upper-echelon characteristic that has a number of advantages relative to other proxies of executive risk propensity. Proxies like demographic characteristics (e.g., Carpenter, 2002), although easy to observe *ex ante*, tend to be noisy. Other proxies for characteristics such as narcissism (Chatterjee and Hambrick, 2007) may be more precise in capturing attitudes, but are difficult to observe *ex ante*. In contrast, political orientation, represents an *ex ante* measure of an executive's attitude toward risk that may be cleaner than demographic proxies, such as age, and may also help in assessing an executive's propensity for undertaking risk before

s/he is hired. Given that early-stage strategic decisions may take multiple years to implement, which makes early-stage CEO evaluation difficult (Graffin, Boivie, and Carpenter, 2013), having an *ex ante* measure of an executive's attitude toward risk may have important implications for executive selection and promotion.

Second, we expand the scope of activities considered when examining firm risk to include tax avoidance strategies. We define tax avoidance as anything that reduces the firm's taxes relative to its pretax accounting income (Dyreng, Hanlon, and Maydew, 2010). As all firms are subject to common factors such as tax rates, statutes, and the possibility of detection and punishment (Allingham and Sandmo, 1972), initially one may suspect that firms' tax avoidance is uniform. However, research suggests that there is substantial variation in tax avoidance across firms (see Hanlon and Heitzman, 2010 for a review). In fact a recent article noted that the tax rate paid by S&P 500 companies for the years 2007–2012 varied from only 1 percent to over 60 percent, with a mean of 29 percent (*New York Times*, 2013). Further, tax avoidance is a generalizable measure of risk that applies to firms in all industries. Using this measure of risk makes a contribution because it allows us to examine a broader set of firms compared with prior research, which has relied primarily on M&A activity or investment in R&D as indicators of firm-level risk (e.g., Kor, 2006; Lane, Cannella, and Lubatkin, 1998). Although all measures have strengths and weaknesses, a downside of relying on these two measures of firm risk is that a large number of firms do not engage in these activities even though they still take risks. For example, for firms in ExecuComp from 1992 to 2008, 58 percent reported no spending on R&D during that entire period and 76 percent of all firm-years reported no significant acquisitions.¹ By employing a measure of strategic risk that all managers must evaluate annually, tax avoidance, we can examine risk-taking behaviors on a more comprehensive set of firms.

Third, we explore the process whereby executives' risk preferences influence corporate outcomes. One weakness of prior research is that it

¹ Significant M&A are defined as M&A with deal values greater than one percent of the acquiring firm's total assets (Moeller, Schlingemann, and Stulz, 2005), as identified via SDC Platinum's Merger and Acquisition module.

has mostly explored the presence of particular executive characteristics and then examined whether there is a significant association between that characteristic and firm risk. What this approach does not consider is whether these associations arise *passively* because of firms hiring managers whose risk preferences match those of the firm or whether the managers' personal preferences are *actively* changing the firm's risk profile. As numerous studies suggest that organizational strategic decisions tend to be quite inertial (e.g., Tripsas and Gavetti, 2000), support for the direct effect of upper-echelon characteristics on risk taking may simply reflect long-standing organizational preferences for the type of executives that are hired. Consequently, we develop a set of related hypotheses that test the effect of executives' political orientation both on the selection of other top management team members, as well as new Chief Executive Officers (CEOs) to examine the passive channel of influence. To examine the more active channel of influence, we also develop and test whether distinct changes in CEO political orientation are related to significant changes in firms' tax policies. By exploring these hypotheses we make a contribution to theory by more fully understanding the process through which executive characteristics affect firm policies.

THEORY AND HYPOTHESES

Upper-echelon research has recently focused on how top managers affect the risk profile of firms. We view risk, "as reflecting variation in the distribution of possible outcomes, their likelihoods, and their subjective values" (March and Shapira, 1987: 1404). Typically, when researchers examine firm-level risk taking, they focus on corporate activities related to spending (Billett and Qian, 2008; Chatterjee and Hambrick, 2007; Devers *et al.*, 2007; Kor, 2006). For instance, increased spending on R&D is thought to be riskier because it diverts dollars from more sure short-term uses, like advertising, to less certain future prospects. Consistent with the definition of risk above, R&D spending then can be viewed as risky because there is uncertainty about the distribution of outcomes associated with its use as well as the likelihood of those outcomes. Similarly, scholars use firms' M&A activity as a measure of the firm's risk taking because it can increase performance variance (Chatterjee and Hambrick, 2007). An activity can thus be viewed as

risky if there is uncertainty about both the positive and negative outcomes associated with that activity, as well as the probability of receiving said outcomes.

While prior measures of risk have a number of favorable features, they also have some limitations. First and foremost, R&D and M&As apply only to a limited number of firms. This is because R&D is concentrated almost entirely within a few industries (Graves, 1988), and M&As tend to occur in waves and within certain industries due to macroeconomic forces (Harford, 2005). Second, choosing *not* to spend on R&D or M&As may actually be a riskier strategy, particularly for firms in rapidly changing technological settings.

In this paper, we examine a ubiquitous corporate activity that also reflects firm risk but suffers less from these limitations and has received little attention in the management literature: tax avoidance. To be clear, by focusing on tax avoidance in this paper, we are not claiming that it is uniformly "better" than prior measures of risk. Instead we argue that different measures of risk capture various degrees and types of risks and that each measure of risk is associated with different potential consequences. Since all measures have strengths and weaknesses, we believe the unique strengths that tax avoidance possesses make it an attractive measure that researchers may consider using when examining corporate risk taking, depending on their research question.

Tax avoidance and risk

Public firms in the U.S. are required to pay taxes on their income and these taxes amount to the second largest cost for firms in many industries (Houlder, 2010). Therefore, finding ways to reduce taxes can help a firm keep more of its profits. Because of this, one might initially think all firms would want to minimize their taxes. This, however, ignores the fact that tax avoidance can expose the firm to many types of risks. These risks (as we explain below) create uncertainty regarding the distribution and likelihood of the firm's future outcomes and have the potential to inflict harm on the firm. Managers thus have to trade off the benefits of minimizing the firm's tax burden with the risks, potential costs, and uncertainties that tax avoidance exposes the firm to. Consequently, firms make strategic decisions to maximize after-tax returns rather than simply trying to minimize the firm's taxes (Scholes *et al.*, 2008).

Managers can use a wide range of actions to avoid taxes. Hanlon and Heitzman explain that "if tax avoidance represents a continuum of tax-planning strategies where something like municipal bond investments are at one end (lower explicit tax, perfectly legal), then terms such as 'noncompliance,' 'evasion,' 'aggressiveness,' and 'sheltering' would be closer to the other end of the continuum" (2010: 137). Tax strategies all across this spectrum can expose firms to different types of risks. We explore four major risks and uncertainties that tax avoidance exposes the firm to: (1) tax risks, (2) reputational risks, (3) political risks and (4) other risks.

First, tax avoidance often includes the risk that regulators (e.g., the IRS) will not uphold the firm's tax positions, forcing the firm to repay taxes along with fines, penalties, and interest (i.e., tax risk). This risk arises due to factors such as (1) the discretion firms have in measuring profitability and allocating costs, (2) the complexity in business activities, and (3) the complexity and lack of clarity in tax rules throughout the world. For example, firms have discretion in setting transfer prices and allocating overhead expenses across jurisdictions, which can shift profits into low tax regions. They also have discretion regarding how much of employees' time to classify as R&D to claim a tax credit. As a result of these types of issues, firms can face uncertainty regarding whether their tax positions will be sustained, particularly since the legality of a position is typically determined well after the fact (Hanlon and Heitzman, 2010). Since there is often no clear line specifying whether a given position is legal, this is a common risk.

Due to the large number of states and countries in which firms operate and limited disclosures by firms and regulators, it is very difficult to measure the actual fines, penalties, and interest that firms incur. The limited evidence that is available, however, suggests the magnitude of these costs can potentially be substantial (e.g., Dunbar, Kolbasovsky, and Phillips, 2007). For example, in 2008 the IRS levied over \$26.8 billion in audit adjustments against corporations, plus another \$2.1 billion in penalties (IRS, 2008). This does not include the adjustments and penalties of other countries and states. Once interest on the back taxes is added, which generally exceeds the penalties, the realized costs are substantially larger. For example, Wilson (2009) found in a sample of individual tax shelter cases that the median firm's savings from tax shelters, which ultimately had to be repaid (\$66.5 million),

was nearly eclipsed by the additional interest and penalties (\$58 million). Consequently, although uncertain tax positions allow firms to retain and use tax savings while their strategies are being evaluated, there is the possibility that firms may end up worse off financially because of fines, penalties, and interest on the money withheld.

Second, tax avoidance is an appropriate measure of risk because it can expose the firm to reputational risks. In fact, Hanlon and Slemrod note that,

"The mission statement of General Electric's tax department includes a part that states that tax strategies should not be harmful to the company's reputation. They include reputation as a tax risk category and describe the criteria for evaluating this type of risk for a particular strategy as the 'Wall Street Journal Test' (e.g., would it look negative if the company were discussed on the front page of the Wall Street Journal for the strategy?)" (2009: 127).

These reputational risks can also be realized in the form of customer backlash, being targeted by activist groups, and stock price declines (Hanlon and Slemrod, 2009; McIntyre *et al.*, 2011). These risks apply even when managers do not stray into the realm of uncertain tax strategies. For example, when Starbucks' legal tax avoidance in the United Kingdom was revealed, it became the target of protests, negative media coverage, and verbal political attacks to such an extent that its reputation ratings plummeted, numerous store locations were closed, and it voluntarily decided to pay \$32 million in taxes to the U.K. over the next two years (e.g., Bergin, 2012a, 2012b; *New York Times*, 2012; *Wall Street Journal*, 2012).

Given such incidents, it is not surprising that 69 percent of executives cite "potential harm to firm reputation" as a reason for not adopting a particular tax-planning strategy (Graham *et al.*, 2014). Indeed, even if reputational harm does not occur on average (Gallemore, Maydew, and Thornock, 2014), research suggests that executives' perceptions of reputational risk still influence their behavior (e.g., Boivie, Graffin, and Pollock, 2012; Westphal and Deephouse, 2011).

Third, tax avoidance can carry political risks (Hanlon and Slemrod, 2009; Mills, Nutter, and Schwab, 2012). When firms avoid taxes, it can create a public outcry that firms are not "paying their

fair share," which can put pressure on politicians to take action. For example, Apple recently had significant negative publicity about its creative, but legal, tax positions, and its CEO Tim Cook had to testify regarding them before Congress (Schwartz and Duhigg, 2013). In some cases, these political costs are realized in the form of adverse legislative or regulatory action, or tax law changes, thereby harming firms economically. Consistent with this argument, Mills *et al.* (2012) find that politically sensitive firms pay higher federal taxes, all else equal, presumably to avoid losing political benefits (e.g., government contracts).

Fourth, tax avoidance carries with it other risks, which can have significant financial implications. For example, it can create opportunity costs by inhibiting the firm's ability to repatriate profits from overseas, which can influence firms' decisions about how to manage cash, make investments, and pay dividends (Blouin and Krull, 2009; Foley *et al.*, 2007). It can also lead firms to create structures or investments that are costly to change such as locations of factories or transfer pricing arrangements. Further, tax avoidance strategies can expose the firm to greater agency costs (Desai and Dharmapala, 2006, 2009). As noted above, tax avoidance can involve creating complicated business transactions and structures, which are designed to make it difficult for regulators to identify the true economics of the firm. This opacity not only facilitates rent extraction from the government, but it can also obscure underlying firm performance in financial statements, thereby facilitating managerial rent extraction from shareholders as well (Desai and Dharmapala, 2006, 2009).

In summary, even though greater tax avoidance increases current after-tax cash flows, it amplifies uncertainty by increasing future cash flow volatility and reducing future cash flows (Shevlin, Urcan, and Vasvari, 2013). This can occur because tax avoidance exposes firms to tax risks, as well as nontax risks (e.g., reputational, political and other risks) (Scholes *et al.*, 2008). Given that all types of tax strategies can expose firms to risk, we conceptualize tax avoidance as any action that reduces a firm's explicit taxes (Dyreng *et al.*, 2010). Since engaging in tax avoidance has the potential to boost the bottom line directly and can also increase the firm's risk exposure, a firm's tax avoidance can be used as a proxy for the level of risk a firm's leadership is willing to take.

Prior tax avoidance research

Numerous studies have measured factors predicting tax avoidance, including current and past profitability, tax-planning opportunities, R&D intensity, governance and incentive structures, and more (e.g., Hanlon and Heitzman, 2010). For instance, Rego and Wilson (2012) found that larger equity risk-taking incentives are associated with greater tax avoidance, while Chen *et al.* (2010) found that family firm ownership is associated with less tax avoidance. They suggest that "family owners are willing to forgo tax benefits to avoid the nontax cost of a potential price discount, which can arise from minority shareholders' concern with family rent-seeking masked by tax avoidance activities (Chen *et al.*, 2010: 41)".

Tax avoidance as a strategic measure of firm risk

Even though tax avoidance has not been examined in the management literature, it has a number of features that may help to advance theory and research in strategic management broadly and upper echelons specifically. First, tax avoidance may be a more generalizable measure of firm risk than prior measures in the management literature (e.g., R&D and M&A), as previously discussed. Further, research suggests that tax avoidance varies greatly between firms and within and across industries (Hanlon and Heitzman, 2010). Further, tax avoidance is also practically a significant financial matter as firms in our sample, on average, incurred tax expenses that were nearly double the amount spent on R&D (\$199 million vs. \$102 million).

Additionally, variation in tax avoidance across firms is largely unexplained. In this regard Hanlon and Heitzman note that, "Overall, the field cannot explain the variation in tax avoidance very well ... [and] tax avoidance may be highly idiosyncratic" (2010: 145). For example, Dyreng *et al.* (2010) found that individual executives do impact firms' tax avoidance but were unable to identify any executive characteristics that explain this impact and thus concluded that executives' influence on tax avoidance is idiosyncratic. However, if predictive executive characteristics could be identified, they could help explain why tax avoidance varies so much across firms and could help analysts and investors better predict the often large tax component of firms' earnings.

Finally, tax avoidance is a useful measure of risk for management scholars because tax avoidance activities are strategic in nature. Tax avoidance strategies involve making strategic choices regarding where to set up operations, how to compensate executives, when to pay dividends, how to manage cash, and more (Blouin and Krull, 2009; Foley *et al.*, 2007; Scholes *et al.*, 2008). Taken together, the range of potential costs and benefits that result from these strategies suggest that tax avoidance is a useful measure of firm strategic risk. We now move our discussion to the management characteristic that we focus on in this paper.

Managers' political orientation as a proxy for executives' relative risk tolerance

Upper-echelons research attempts to employ unobtrusive measures as proxies for the attitudes and dispositions of top executives (Hambrick and Mason, 1984). Despite considerable research in this area, this goal has met with difficulty because measures often tend to be quite distant from the constructs they are intended to represent (Carpenter, Geletkanycz, and Sanders, 2004). Early studies looked at demographic characteristics such as age, tenure, and functional background with varying levels of predictive success (e.g., Bantel and Jackson, 1989; Sambharya, 1996). Consequently some researchers have turned to more direct measurement of CEOs attitudes (e.g., Boivie *et al.*, 2011) and have found success with unobtrusive measures of CEO personality such as narcissism (Chatterjee and Hambrick, 2007), CEO emotions (Delgado-Garcia and De La Fuente-Sabate, 2010), or the structure of compensation as proxies for executives' attitudes toward risk (Larraza-Kintana *et al.*, 2007).

We extend upper-echelon theory and research by focusing on a managerial characteristic that may reflect executives' underlying attitudes toward risk and uncertainty: personal political orientation. To understand how political orientation can extend upper-echelons research and help explain executive behavior and organizational outcomes, it is helpful to examine the philosophical differences between the major political parties in the U.S. In their reviews of party alignment and polarization, Carmines and Wagner (2006) and Layman, Carsey, and Horowitz (2006) explain that two "deep" issue dimensions exist in the American public: (1) economic and social welfare issues and (2) cultural and moral issues. The first area, economic and

social welfare issues (e.g., taxes, welfare, health care) primarily deals with wealth (re)distribution and is rooted in the question: "Should the government take an active role in fostering social and economic equality among its citizens (Layman *et al.*, 2006: 86)?" The second area, cultural and moral issues (e.g., abortion, school prayer, gun control), is rooted in the question: "Should the government take an active role in promoting traditional notions of morality and social order (Layman *et al.*, 2006: 86)?" The major political parties have taken opposing stands on these issues, with Democrats favoring more wealth redistribution through the government and less government influence in promoting traditional morality and social order, and with Republicans favoring less wealth redistribution through the government and greater government influence in promoting traditional morality and social order.

In terms of the dimension dealing with wealth redistribution, Republicans prefer lower taxes compared to Democrats. This can be clearly seen in promotional materials, such as their national party platforms (Democratic National Committee, 2008; Republican National Committee, 2008). The primary explanation for this preference is that Republicans and Democrats place different weights on the arguments of how wealth is obtained, the consequences of wealth redistribution, and the appropriate size and involvement of government. For example, if one believes that individual effort determines income, and that one has the right to enjoy the fruits of one's effort, s/he will tend to prefer less wealth redistribution and lower taxes. While if one believes that luck, birth, connections, and/or corruption determine wealth, s/he will tend to prefer more wealth redistribution and higher taxes (Alesina and Angeletos, 2005).

However, research in political science and psychology suggests that individuals' personal political orientation is an indicator of underlying psychological differences that may be predictive of executives' influence on their firm's tax avoidance. As we will shortly explain, these psychological differences lead to the opposite prediction of what conventional wisdom would expect. Namely, this research suggests that, on average, firms with Republican-leaning executives may engage in *less* tax avoidance than firms with Democrat-leaning managers.

To understand this prediction better, it is helpful to note that the Republican platform tends to attract more conservative individuals. This is

clearly evidenced in surveys, such as a recent Gallup poll, where Republicans were roughly three times more likely than Democrats to identify themselves as conservative (Saad, 2009), as well as in biennial surveys from 1972 to 2008 conducted by the American National Election Studies, which found that 42–65 percent of Republicans identified themselves as conservative, compared to only 12–18 percent of Democrats (American National Election Studies, 2010). This is consistent with trends shown in the political science literature, which suggest that more conservative people have increasingly been aligning themselves with the Republican Party (Layman *et al.*, 2006). Thus, political orientation may be an indicator of underlying differences in executive conservatism.

Recent research argues that political conservatism is a reflection of a core underlying conservative ideology, which arises from individuals' psychological needs to reduce uncertainty and threats (Jost, Nosek, and Gosling, 2008; Jost *et al.*, 2007). This argument is supported by a large body of empirical evidence (see Jost *et al.*, 2003 for a meta-analysis) and helps explain the positive association between economic and social conservatism (Jost, Federico, and Napier, 2009). In particular, this research reveals that political conservatives tend to fear losses, value financial and job security, and have greater aversion to ambiguity and uncertainty than those who are less politically conservative (Jost *et al.*, 2003). Since managers must constantly make financial decisions under uncertainty (e.g., Schwenk, 1984), these arguments suggest that political ideology may help explain variation in managerial risk tolerance. Consistent with this argument, Hutton *et al.* (2014) find that, on average, firms run by Republican-leaning managers have more conservative financing and investing policies (e.g., lower R&D and leverage and higher capital expenditures). Since Republican-leaning executives appear to be more conservative when it comes to corporate policies, the behavioral consistency theory, which asserts that individuals tend to behave consistently across situations (Allport, 1937; Cronqvist, Makhiya, and Yonker, 2012; Funder and Colvin, 1991), suggests that this conservatism should also spill over into their firm's tax avoidance activities.

As top executives are typically neither tax experts nor generally involved in the details of tax avoidance activities, their impact on tax avoidance is likely to be through setting the "tone at the top" (Dyreng *et al.*, 2010). This can be reflected in many

ways, such as determining what to emphasize (e.g., taking risks, reducing the firm's taxes), deciding how much of the firm's resources to allocate to hiring inside and outside tax advisors, setting compensation incentives for the tax director, etc. Also, since many tax positions are uncertain, the tolerance for risk taking that executives set in the corporate culture should influence the tax strategies the firm engages in. If they set a tone of being conservative, due to their desire to reduce risk and uncertainty, this may translate into encouraging the firm's tax advisors to be more conservative in tax avoidance. Further, many of the decisions required to avoid taxes must be approved by senior executives. Thus, even though conservative executives may favor lower taxes, their lower risk tolerance may cause their firms to engage in *less* tax avoidance. We thus hypothesize:

Hypothesis 1: Firms run by managers with a more conservative political orientation (e.g., Republicans) will engage in less tax avoidance than firms run by managers with a more liberal political orientation (e.g., Democrats).

It is important to note that the arguments that underlie this hypothesis are about *relative* risk tolerance, not *absolute* risk tolerance. Executives in general tend to have higher risk tolerance than average citizens (Graham, Harvey, and Puri, 2013). Based on upper echelons theory, we argue that political orientation is an observable characteristic that helps explain differences in risk tolerance *across* executives, and thus has the potential to help explain variation in risk taking. We are not arguing that Republicans do not take risks, but rather that, among those individuals with adequate risk tolerance to become executives, we expect Republican executives to have *relatively* lower risk tolerance than Democrat executives. We also expect that these preferences exist *on average* and thus may not explain each person's behavior.

To the extent that managers' personal political preferences are helpful in explaining a firm's tax avoidance, these preferences should be more pronounced in certain settings, such as when executives are entrenched (i.e., difficult to punish in the event their performance is unsatisfactory) (Cronqvist *et al.*, 2012; Finkelstein and D'Aveni, 1994; Haynes and Hillman, 2010). Specifically, CEO entrenchment is thought to limit the board's ability

to monitor effectively CEOs (e.g., Finkelstein and D'Aveni, 1994). For instance, Haynes and Hillman (2010) recently found that CEO entrenchment influences the degree to which boards can impact strategic change and suggest this reflects the fact that powerful or entrenched CEOs can overcome board preferences and have a greater ability to influence strategic decisions. Because entrenchment empowers managers to express personal preferences, we hypothesize:

Hypothesis 2: Managers' personal political orientation is more helpful in explaining the firm's tax avoidance when managers are entrenched.

Changes in tone at the top

It is important to note that managers do not end up at firms randomly. Rather, managers and firms are attracted to each other based on certain characteristics that lead them to contract with each other (e.g., Datta and Guthrie, 1994). For example, Cronqvist *et al.* (2012) find that CEOs' personal leverage choices are highly correlated with their firm's leverage choices. This type of firm–manager matching can affect the way managers influence corporate tax avoidance. If firms tend to hire managers with similar attributes over time, due to firm–manager matching, this should result in the influence of new managers being felt more *passively* as they maintain corporate culture and policies, which affect a firm's tax avoidance. Alternatively, managers' influence on a firm's tax avoidance may occur more actively by managers *changing* the corporate culture and/or policies. To explore these dynamics, our next two hypotheses consider how political orientation affects changes in the top management team (TMT) and the CEO.

A great deal of research has found that individuals evaluate others who are like themselves more favorably and prefer to associate with these individuals (see McPherson, Smith-Lovin, and Cook, 2001 for a review). Numerous studies within the organizational literature have also found that top executives prefer to surround themselves with similar individuals (e.g., Westphal and Zajac, 1996). Consequently, we expect that executives prefer to hire and/or promote executives who share similar attitudes toward uncertainty and risk.

Further, since CEOs often have influence over the selection of their successor (e.g., Shen and

Cannella, 2002), we expect that a departing CEO is likely to encourage the board to fill his/her position with a similar individual to continue his/her legacy (e.g., Vancil, 1987). For example, in a series of interviews with CEOs, Vancil found that a primary concern for a CEO when selecting his or her successor was the extent to which this individual would build upon or tear down the legacy s/he had spent his/her career building. If a CEO's successor differs in his/her political orientation, however, this individual may differ in willingness to undertake risks that are consistent with those of the prior CEO. Consequently, due to homophily and a CEO's desire to promote a like-minded individual as a successor, we make the following predictions:

Hypothesis 3: The political orientation of current top executives will be positively related to the personal political orientation of new TMT members.

Hypothesis 4: The personal political orientation of the departing CEO will be positively related to the personal political orientation of the incoming CEO.

At the same time, while we expect the prior CEO's political orientation will be predictive of an incoming CEO's political orientation, this may not always be the case. A tenet of CEO succession research is that a change in a firm's CEO should lead to strategic change (Finkelstein, Hambrick, and Cannella, 2009). If a CEO's political orientation is truly an indicator of his/her attitude toward risk, then we would expect to see a change in the firm's tax avoidance when a change in the CEO results in the new CEO having a different political orientation from the prior CEO. Indeed, support for our prior hypotheses would suggest that some of the managerial influence on tax avoidance is occurring passively through firm–manager matching. However, if we observe a change in a firm's tax avoidance following a change in political orientation for the firm's CEO, this provides evidence that is consistent with more active managerial influence also occurring. Since CEOs appear to have the strongest impact on tax avoidance (Dyreng *et al.*, 2010), CEO turnover provides a powerful setting to observe active changes in the firm's corporate culture and/or policies. Therefore our final prediction is:

Hypothesis 5: A CEO succession that results in change in political orientation will result in a change in the firm's tax avoidance.

In summary, these last three hypotheses allow us to explore the process whereby managerial risk preferences translate into firm actions. While Hypotheses 3 and 4 focus on managers exerting a more passive influence, Hypothesis 5 focuses on managers exerting a more active influence.

METHOD

Sample and data

The sample started with all executives listed on the ExecuComp database for the years 1992–2008. We then used executives' personal political contributions from the Federal Election Commission (FEC) to identify their political orientation, consistent with Hutton *et al.* (2014). This provided coverage of nearly one-third of the executives in ExecuComp, who in turn represent roughly 85 percent of ExecuComp firms. We then restricted the sample only to the firm-years where an executive's political orientation is observable. To be consistent with prior literature on tax avoidance, we also excluded (1) firms incorporated outside of the U.S., (2) highly regulated firms (SIC 6000–6999 and 4900–4949), (3) firm-years with negative pretax income, (4) instances in which the firms' financial accounting tax rate or cash effective tax rate is below 0 or above 1, and (5) firms-years missing necessary data to calculate control variables. These criteria resulted in a final sample size of 14,174 firm-year observations covering 1,879 firms. For additional insights, we ran separate tests for CEOs and chief financial officers (CFOs) since they appear to be important policy makers of a firm when it comes to taxes (Dyreng *et al.*, 2010). We obtained firm financial data from COMPUSTAT, executive characteristics and governance measures from *ExecuComp* and *Risk Metrics*, firm political orientation from political action committee (PAC) contributions in the *FEC* database, managers' disclosed political orientation from *Marquis Who's Who* database and *Gale Biography in Context*, presidential voting outcomes from *CQ Political Reference Suite*, and firm headquarters from *Audit Analytics* and COMPUSTAT.

Dependent variable

We operationalized tax avoidance using two common measures: the firm's financial accounting effective tax rate and the firm's cash effective tax rate, similar to Chen *et al.* (2010) and Dyreng *et al.* (2010). Consistent with prior literature, we use the abbreviations GAAP ETR and Cash ETR respectively. Specifically, the firm's *GAAP ETR* was calculated using worldwide total income tax expense divided by worldwide total pretax accounting income, while the firm's *Cash ETR* was calculated using worldwide cash taxes paid divided by worldwide total pretax accounting income. Since firms' effective tax rates (1) are typically used by the media and activist groups to target firms (Chanel, 2012; McIntyre *et al.*, 2011), (2) capture some degree of uncertain tax avoidance (along with some legal tax avoidance), and (3) are a primary focus of managers (Graham *et al.*, 2014), we suggest these measures capture multiple dimensions of risk and thus are appropriate for our setting. Although the results reported use a one-year Cash ETR measure, our inferences are substantively unchanged using other measures of tax avoidance, such as three- and five-year Cash ETRs, the ETR differential (i.e., the difference between the statutory tax rate and GAAP ETR) and book-tax differences (i.e., the difference between pretax financial accounting income and estimated taxable income scaled by beginning total assets).

Independent variables

To identify managers' personal political orientation, we followed Hong and Kostovetsky (2012) and Hutton *et al.* (2014) and inferred political orientation via personal political contributions. We began by collecting political contributions made to senate, house, or presidential candidates between the years of 1991 and 2008. These contributions are tracked by the Federal Election Commission (FEC), as required by the Federal Election Campaign Act, and any contribution of \$200 or above made since 1979 is available on the FEC website (<http://www.fec.gov>). Managers have two primary ways to make political contributions: (1) donate indirectly through their own company-sponsored Political Action Committees (PACs) or (2) donate directly to candidates or party committees. Because company-sponsored PACs usually contribute to multiple parties at the same time (Cooper, Gulen,

and Ovtchinnikov, 2010), only the second form on contributions allowed us to identify individual managers' personal political ideology. One other thing to note is that these individual contributions are subject to limits, which generally increase over time. For example, individual contribution limits for the 2011–2012 election cycle were \$2,500 to a candidate, \$30,800 to a national party, and \$5,000 to a PACs with an overall (biennial) contribution limit of \$117,000 (www.fec.gov).

We obtained managers' individual political contributions from the FEC's "detailed files." These files list the donor's employer and job title, which along with the donor's name are the key identifiers for linking the FEC data to ExecuComp. This linking was done by tying ExecuComp managers in a fiscal year to the most recent election cycle. We used a computer-based algorithm to identify potential matches and then visually inspected those with an imperfect matching score to validate their accuracy. This process produced approximately 70,000 separate contributions that could be linked to over 10,000 top executives of S&P 1500 firms. Specifically, we were able to identify over 3,500 CEOs, 1,600 CFOs, and 5,000 other top executives.

We calculated a manager's political orientation by taking the dollar value of his/her contributions to the Republican Party minus the dollar value of his/her contributions to the Democratic Party, all divided by the dollar value of his/her contributions to both parties (*Politics*). This produced a continuous measure of political orientation bounded between +1 and -1 where a value of +1 indicates that all contributions were made to the Republican Party, while a value of -1 indicates that all contributions were made to the Democratic Party. This leaves values between +1 and -1 to gauge which direction the executive's political orientation leans. As a robustness check, we reran the analyses using a dummy variable that takes on a value of 1 when executives are net contributors to the Republican Party and found generally similar results.

The political orientation measure was calculated for each manager in each two-year election cycle. We then took the average of these measures for each manager across all election cycles where the manager made contributions to create our final measure of a manager's political orientation. We employed this approach of averaging across election cycles to reduce measurement error that may be introduced if a manager were to make donations during an election cycle to try and obtain some political

benefits. For example, Gupta and Swenson (2003) show that in response to a proposed tax law change, managers in the early 1980s made political contributions to tax-writing members of Congress and that the size of these contributions was larger when the law's expected harm on the firm or managers was larger. Thus, calculating our measure in this manner helps control for the potential for political contributions to be made for opportunistic reasons that might obscure a manager's personal political orientation.

Further, because prior research suggests an individual's political party identification is generally established in adolescence or early adulthood and remains stable over the individual's entire adult life (Green, Palmquist, and Schickler, 2002), taking the average across election cycles should produce a measure that more accurately reflects the manager's true political orientation. As a robustness check, we found that this measure was correlated at over 88 percent with alternative measures that use: (1) contributions from just the first election cycle in which a manager makes contributions and (2) the average political orientation score for the manager from election cycles before the beginning of a fiscal year. Additionally, when executives' political orientation scores from individual election cycles were compared to their lifetime political orientation score, 92 percent of the time both scores were leaning toward the same political party. It thus appears that political orientation is a stable personal characteristic and that this measure is a reasonable proxy for a manager's political orientation.

As an additional validity check, we hand-collected CEO's self-reported political orientation from the *Marquis Who's Who* database. We then supplemented this data by identifying CEOs' political orientation using biographies in *Gale's Biography in Context* archive. Using this approach, we were able to identify 210 CEOs who had disclosed their political orientation and had also made political contributions. For this subset of CEOs, the political orientation measure (described above) correctly classified their political orientation as a Republican or Democrat 86 percent of the time. After examining the misclassifications, the bulk of them were for individuals with political orientation scores near 0. Since approximately two thirds of all executives who made political contributions donated to just one party, we also examined how accurately political

contributions identified the political orientation of these “polar” individuals and found that accuracy improved to 96 percent. These results provide additional validity for our measure of political orientation.

Because we performed our tests at the firm level, we took our measure of political orientation for each executive and aggregated it to the firm-level each year. Although each executive’s measure of political orientation remains constant during the sample period, this firm-level political orientation measure varies over time as managerial composition at the firm changes. Because the influence of each executive at the firm is unlikely to be equal, we use a weighted average measure that puts more weight on executives who likely are more influential at the firm (*Politics_TMT*). Specifically, the weight assigned to each executive was the inverse of the manager’s rank at the firm, where the manager’s rank was determined based on his/her compensation. So the highest paid executive gets assigned a weight of 1, the second highest gets a weight of 1/2, the third highest gets a weight of 1/3, etc. As an aside, however, the results and conclusions were substantially unchanged when we equally weight each executive’s political orientation.

Control variables

We also employed control variables identified in prior research to address confounding factors that could affect the results. Since tax avoidance is influenced by current and past profitability, we controlled for pretax return on assets (ROA), leverage, tax-loss carryforwards, change in tax-loss carryforwards, and the change in pretax cash flow from operations. These variables were measured as follows: *ROA* as pretax income before extraordinary items divided by beginning total assets; *Leverage* as the sum of current and long-term debt divided by beginning total assets; *Net Operating Loss* coded as 1 if the company had a tax-loss carryforward at the beginning of the year; 0 otherwise; *Change in net operating losses* as the change in tax-loss carryforwards divided by beginning total assets; *Change in pretax cash flow* as the change in pretax operating cash flow from continuing operations from year t to $t - 1$ divided by beginning total assets.

Since income earned in foreign countries is typically taxed at lower rates than income earned in the U.S., we also controlled for *Foreign Income*,

which was measured as pretax foreign income divided by beginning total assets. To control for basic operating decisions that may have unintentional tax consequences, as well as for differences in financial reporting and tax reporting rules, we included the following controls: gross property, plant and equipment divided by beginning total assets (*PPE*); capital expenditures divided by gross property, plant and equipment (*Capex*), intangible assets divided by beginning total assets (*Intangibles*), research and development expense divided by beginning total assets (*R&D*), and equity earnings in subsidiaries divided by beginning total assets (*Earnings from Subs*).

Lastly, we controlled for firm size and the market-to-book ratio to capture differences in the propensity to invest in tax-favored assets. *Size* was measured as the natural log of beginning market value of equity and *Market to Book* was defined as beginning market value of equity divided by beginning book value of equity. Additionally, since tax-planning opportunities can vary by industry and over time, regressions were run with year and industry dummy variables (using the 48 industries in Fama and French, 1997) to address omitted variables that are not captured by the other controls. All continuous variables were winsorized at the top and bottom 1 percent to alleviate the effect of outliers, and standard errors were clustered by firm to address serial correlation in the residuals. Lastly, variance inflation factors for all variables in the models were below 3, indicating that multicollinearity was not a problem (Kennedy, 2008).

Models and robustness tests

To test our first four hypotheses, we conducted our analysis using ordinary least squares (OLS) regressions and tested our fifth hypothesis using an ordered logistic regression. To test our tax avoidance hypotheses (Hypotheses 1, 2, and 5), we employed the following model:

$$\begin{aligned} \text{Tax Avoidance}_{it} = & \beta_0 + \beta_1 \text{Political Orientation}_{it} \\ & + \sum_k \beta_k \text{Controls}_{it} + \epsilon_{it} \quad (1) \end{aligned}$$

To test our executive succession hypotheses (Hypotheses 3 and 4), we employed the following model:

$$\begin{aligned} & \text{New Executive's Political Orientation}_{it} \\ & = \beta_0 + \beta_1 \text{Old Executive's Political Orientation}_{it} \\ & + \sum_k \beta_k \text{Controls}_{it} + \epsilon_{it} \end{aligned} \quad (2)$$

We also ran an extensive list of robustness tests to address alternative explanations and increase confidence in the empirical results. For more information, see the Appendix S1.

RESULTS

Turning now to the descriptive statistics, in Table 1A we first compared the relative number of Democrats to Republicans based on their political orientation score. Executives with a score greater than 0 were classified as Republicans, executives with a score less than 0 were classified as Democrats, and executives with scores of 0 were classified as neutral. Based on this approach, the data suggests top executives' political preferences tend to lean toward the Republican Party. The approximate two to one ratio of Republicans to Democrats is fairly consistent between the executives who were linked to the FEC database and the executives who were included in the final sample.

Table 1B provides descriptive statistics for the variables used in the regression analyses. From this table, it is evident that the data provides much better coverage of CEOs' political preferences than of CFOs'. Also the correlations between managers' political orientation and their firms' tax measures were positive, which is consistent with the argument that Republican-leaning managers are more conservative than their Democrat-leaning counterparts, which in turn leads the firms they manage to have higher effective tax rates.

In Table 2, multivariate results using OLS paint a similar picture. The coefficient for managers' political orientation was positive and statistically significant in almost all specifications, suggesting that firms with Republican-leaning managers tend to engage in less tax avoidance than firms with Democratic-leaning managers. The strongest results were found for the top executive team and for CEOs, with results for CFOs coming in mixed. These results provide support for Hypothesis 1. To calculate the practical significance of this finding, we set all variables to their mean and evaluated

the change in the TMT's political orientation from one party to the other. This change results in a *Cash ETR (GAAP ETR)* that is 2.5 percent (1.2%) higher for a firm with Republican-leaning managers (*Politics_TMT* = 1) compared to a firm with Democrat-leaning managers (*Politics_TMT* = -1). Relative to the sample mean *Cash ETR (GAAP ETR)* of 28.0 percent (34.8%), this change appears to be economically significant.

To test our second hypothesis that personal preferences are more likely to be exhibited when managers are entrenched, we partitioned the sample based on the median entrenchment score, which was calculated using the Entrenchment Index created by Bebchuk, Cohen, and Ferrell (2009). This score ranges from 0 to 6 based on the presence of any of the following firm-level characteristics: staggered boards, poison pills, golden parachutes, limits to shareholder bylaw amendments, and super-majority requirements for mergers and for charter amendments. Firms with entrenchment scores at or above the median score in the sample were considered entrenched. As the results for the top management team and CEOs were the strongest in the prior tests, we focused the cross-sectional test on them.

Consistent with Hypothesis 2, Table 3 reveals that main results from Table 2 appear to be primarily driven by the sub-sample of firms where managers were entrenched. For the sub-sample of firms that were not entrenched, managers' personal political orientation had little explanatory power for their firms' tax avoidance.² These results are consistent with the argument that managers' personal preferences are more influential when governance is weaker.

Table 4A presents the results of our test for Hypothesis 3, which predicted that the political orientation of current top executives will be positively related to the personal political orientation of new TMT members. Consistent with this prediction, the political orientation of the current TMT

² We partition our sample for two reasons: (1) Hypothesis 2 focuses on the concentration rather than the strength of the effect, and (2) partitioning allows the model to be less restrictive when estimating the coefficients. Since entrenchment can influence many different decisions made by firms, which in turn can influence tax avoidance, it is reasonable to expect variation in the control variables across entrenched and nonentrenched firms. With that said, if we use an interaction test instead of partitioning the sample, the interaction term is significant when *Cash ETR* is the dependent variable ($p < 0.01$), but not significant when *GAAP ETR* is the dependent variable (unpublished).

Table 1. Descriptive statistics

		N		Democrat (-1 ≤ politics < 0) (%)						Neutral (politics = 0) (%)						Republican (0 < politics ≤ 1) (%)					
		10,253		33.1						4.9						62.0					
		6,818		31.4						4.4						64.2					
(A) Variation in political orientation																					
		Mean	S.D.	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18
1. Politics_TMT		0.221	0.458	1.00																	
2. Politics_CEO		0.375	0.723	0.86	1.00																
3. Politics_CFO		0.360	0.805	0.64	0.41	1.00															
4. Cash_ETR		0.280	0.153	0.04	0.05	0.02	1.00														
5. GAAP_ETR		0.348	0.084	0.03	0.02	0.03	0.31	1.00													
6. ROA		0.144	0.100	-0.01	-0.01	0.02	-0.02	0.02	1.00												
7. Leverage		0.247	0.216	0.01	0.02	-0.03	-0.05	0.08	-0.25	1.00											
8. Net Operating Loss		0.262	0.440	-0.01	-0.01	0.03	-0.14	-0.11	-0.11	0.06	1.00										
9. ΔNet Operating Loss		0.001	0.031	0.00	0.00	-0.02	0.03	0.04	-0.03	0.05	-0.09	1.00									
10. Foreign Income		0.021	0.037	-0.01	-0.01	0.04	-0.08	-0.23	0.17	-0.09	0.12	0.03	1.00								
11. PPE		0.362	0.264	0.10	0.13	0.05	-0.08	0.06	-0.03	0.29	-0.10	0.02	-0.12	1.00							
12. Intangibles		0.162	0.213	-0.06	-0.06	-0.11	-0.01	0.05	-0.10	0.29	0.12	0.08	0.00	-0.27	1.00						
13. Earnings from Subs.		0.001	0.004	-0.01	0.00	-0.04	-0.01	-0.05	0.00	0.05	0.01	0.00	0.07	0.08	-0.02	1.00					
14. Size		7.364	1.583	-0.08	-0.04	-0.05	-0.02	-0.08	0.04	0.02	0.07	0.03	0.32	-0.02	0.12	0.14	1.00				
15. Market to Book		3.599	3.351	-0.06	-0.05	-0.05	-0.02	0.41	-0.03	0.00	0.02	0.21	-0.08	0.01	0.00	0.31	1.00				
16. R&D		0.028	0.050	-0.08	-0.09	-0.02	-0.14	-0.21	0.23	-0.23	0.07	0.00	0.28	-0.08	-0.06	0.06	0.22	1.00			
17. ΔPretax Cash Flow		0.029	0.077	-0.02	-0.01	0.00	-0.11	-0.02	0.39	-0.07	0.01	-0.02	0.05	0.07	-0.01	-0.02	-0.06	0.12	0.15	1.00	
18. Capex		0.138	0.091	-0.09	-0.10	-0.02	-0.06	0.06	0.38	-0.12	-0.07	0.00	-0.02	0.00	-0.08	-0.10	0.23	0.21	0.21	1.00	

^a N = 14,174 for all variables except Politics, CEO (N = 11,594) and Politics, CFO (N = 3,999).

All continuous variables have been winsorized by year at the 1 and 99 percent levels.

Table 2. Influence of political orientation on tax avoidance

Model:	Tax avoidance = $\beta_0 + \beta_1$ Political Orientation + $\sum \beta_k$ Controls + ϵ					
	Top executives		CEO		CFO	
	Cash ETR	GAAP ETR	Cash ETR	GAAP ETR	Cash ETR	GAAP ETR
Politics_TMT	0.012*** (0.004)	0.006** (0.002)				
Politics_CEO			0.010*** (0.003)	0.003* (0.002)		
Politics_CFO					0.001 (0.004)	0.005** (0.002)
ROA	0.044** (0.021)	0.063*** (0.014)	0.048** (0.023)	0.064*** (0.015)	0.036 (0.034)	0.043* (0.025)
Leverage	-0.041*** (0.010)	0.003 (0.006)	-0.041*** (0.011)	0.005 (0.007)	-0.043** (0.018)	0.004 (0.011)
Net Operating Loss	-0.029*** (0.004)	-0.005* (0.003)	-0.027*** (0.005)	-0.006* (0.003)	-0.027*** (0.007)	0.000 (0.004)
ΔNet Operating Loss	0.181*** (0.051)	0.095** (0.038)	0.222*** (0.057)	0.083* (0.043)	-0.043 (0.061)	-0.032 (0.063)
Foreign Income	-0.146** (0.057)	-0.312*** (0.040)	-0.134** (0.062)	-0.306*** (0.044)	-0.015 (0.103)	-0.268*** (0.067)
PPE	-0.068*** (0.011)	-0.004 (0.006)	-0.073*** (0.012)	-0.006 (0.007)	-0.057*** (0.018)	0.006 (0.010)
Intangibles	0.011 (0.011)	0.039*** (0.007)	0.015 (0.013)	0.037*** (0.008)	0.020 (0.019)	0.034*** (0.010)
Earnings from Subs.	-0.313 (0.397)	-0.686*** (0.258)	-0.322 (0.405)	-0.634** (0.274)	0.597 (0.479)	-0.076 (0.325)
Size	0.005*** (0.002)	0.001 (0.001)	0.004** (0.002)	0.000 (0.001)	0.005** (0.002)	-0.001 (0.001)
Market to Book	-0.001** (0.001)	0.000 (0.000)	-0.002*** (0.001)	0.000 (0.000)	-0.001 (0.001)	0.000 (0.000)
R&D	-0.265*** (0.051)	-0.152*** (0.033)	-0.257*** (0.057)	-0.120*** (0.036)	-0.338*** (0.112)	-0.179** (0.080)
ΔPretax Cash Flow	-0.138*** (0.019)	-0.033*** (0.011)	-0.139*** (0.021)	-0.029** (0.011)	-0.141*** (0.036)	-0.014 (0.020)
Capex	-0.085*** (0.021)	0.019 (0.013)	-0.093*** (0.024)	0.019 (0.014)	-0.038 (0.037)	0.066*** (0.020)
Intercept	0.283*** (0.023)	0.330*** (0.013)	0.297*** (0.025)	0.333*** (0.013)	0.208*** (0.034)	0.341*** (0.028)
Industry fixed effects	Yes	Yes	Yes	Yes	Yes	Yes
Year fixed effects	Yes	Yes	Yes	Yes	Yes	Yes
Cluster by firm	Yes	Yes	Yes	Yes	Yes	Yes
Adj. R ²	12.2%	16.6%	12.2%	16.0%	12.2%	18.4%
N	14,174	14,174	11,594	11,594	3,999	3,999

* $p < 0.10$; ** $p < 0.05$; *** $p < 0.01$; two-tailed p -values. Coefficient estimates are reported with standard errors in parentheses. All continuous variables have been winsorized by year at the 1 and 99 percent levels. Tests of hypotheses are in bold.

was positive and statistically significant. Table 4B presents the results of our test for Hypothesis 4, which predicted that the personal political orientation of the departing CEO will be positively related to the personal political orientation of the incoming CEO. The coefficient on the political orientation of the departing CEO was positive and statistically significant, which supports Hypothesis 4.

To test Hypothesis 5, which predicts that a CEO succession that results in a change in political orientation will result in a change in the firm's tax avoidance, we modify the "levels" specification in (1) to a "changes" specification and look at CEO turnovers where the political orientation of both the outgoing and incoming CEOs are observable. To allow time for the CEO's presence to impact the

Table 3. Cross-sectional tests

Dependent variable	High entrenchment		Low entrenchment	
	Cash ETR	GAAP ETR	Cash ETR	GAAP ETR
(A) Entrenchment of top management team (TMT)				
Politics_TMT	0.025*** (0.006)	0.009** (0.003)	0.001 (0.006)	0.007* (0.003)
Controls	Yes	Yes	Yes	Yes
Industry fixed effects	Yes	Yes	Yes	Yes
Year fixed effects	Yes	Yes	Yes	Yes
Cluster by firm	Yes	Yes	Yes	Yes
Adj. R ²	12.9%	18.7%	13.1%	18.6%
N	5,703	5,703	5,279	5,279
(B) Entrenchment of chief executive officer (CEO)				
Politics_CEO	0.018*** (0.004)	0.005* (0.002)	0.001 (0.004)	0.004 (0.003)
Controls	Yes	Yes	Yes	Yes
Industry fixed effects	Yes	Yes	Yes	Yes
Year fixed effects	Yes	Yes	Yes	Yes
Cluster by firm	Yes	Yes	Yes	Yes
Adj. R ²	12.4%	17.7%	13.6%	18.6%
N	4,759	4,759	4,404	4,404

* $p < 0.10$; ** $p < 0.05$; *** $p < 0.01$; two-tailed p -values. Coefficient estimates are reported with standard errors in parentheses. All continuous variables have been winsorized by year at the 1 and 99 percent levels. Tests of hypotheses are in bold.

firm's tax avoidance, we constructed our changes measures by comparing the three-year period after the CEO took office against the three-year period before the CEO took office. Specifically, for each variable, we calculated its average value for the three full fiscal years *after* the CEO has taken office (years $t + 1$, $t + 2$, $t + 3$) and then subtracted its average value during the last three full fiscal years before the CEO turnover (years $t - 1$, $t - 2$, $t - 3$). Thus, the year of CEO turnover was excluded from the sample unless turnover occurred within the first week of the fiscal year. Using the same types of restrictions as in prior tests, we were left with 238 unique CEO turnover observations with adequate data to perform the test.³

Since the change in *GAAP ETR* and change in *Cash ETR* measures had outliers after

winsorization, we transformed them using decile-ranking (Mendenhall, 2004), and accordingly used an ordered logistic regression (although results are similar using OLS). We also demeaned each of the three-year average variables by their industry average over those three years, before calculating the change variables, to control for time and industry trends (Greene, 2011).

To perform this test, we chose not to use continuous measures of each CEO's political orientation when calculating the change in political orientation of the firm's CEO (Δ Politics_CEO). The reason for this was that the political favors hypothesis would argue that differences between the old and new CEOs political orientation is likely just a reflection of the firm's political environment changing and CEO responding to those changes in the environment by adjusting the mix of their political contributions. Thus, this change in the environment would explain changes in the firm's tax avoidance. To address this concern, we used a dummy variable to identify each manager's political orientation, so as to make the change in political orientation measure (Δ Politics_CEO) as insensitive as possible to changes in the firm's political environment and as sensitive as possible to the individual's personal political orientation. Thus, this variable equaled 1 if a Republican replaced a Democrat as CEO, -1 if a

³ We identified CEO turnovers between 1992 and 2008 via ExecuComp's variable BECAMECEO. We excluded observations when (1) the firm was incorporated outside U.S., (2) the firm was regulated (SIC 6000–6999 and 4900–4949), (3) average pretax income in either the pre- or post-turnover periods was negative, (4) average ETRs in the pre- or post-turnover period were below 0 or above 1, (5) there was missing firm-year data in the three years before and after the turnover that is needed to calculate variables. We also required the former CEO to be at the firm during the three years before turnover, and the new CEO to be at the firm during the three years after turnover. Lastly, all variables were winsorized at the top and bottom 1 percent levels, and standard errors were clustered by firm.

Table 4. Influence of political orientation on executive hiring

(A) Hiring of new executives		
Dependent variable	New executive's political orientation	
	Coefficient	Std. error
Politics_TMT	0.314***	(0.079)
New executive's age	0.003	(0.004)
New executive is female	-0.299**	(0.129)
Red state	0.085	(0.066)
Politics_firm (lagged)	0.373***	(0.126)
Size	-0.020	(0.020)
ROA (lagged)	0.025	(0.189)
Intercept	0.532*	(0.276)
Industry fixed effects	Yes	
Cluster by firm	Yes	
Adj. R ²	7.9%	
N	902	

(B) Hiring of new CEO		
Dependent variable	New CEO's political orientation	
	Coefficient	Std. error
Politics_old_CEO	0.272***	(0.055)
New CEO's age	0.001	(0.005)
New CEO is female	-0.046	(0.201)
Red state	0.018	(0.073)
Politics_firm (lagged)	0.251*	(0.141)
Size	-0.023	(0.024)
ROA (lagged)	0.385	(0.275)
Intercept	0.173	(0.506)
Industry fixed effects	Yes	
Cluster by firm	Yes	
Adj. R ²	10.2%	
N	489	

* $p < 0.10$; ** $p < 0.05$; *** $p < 0.01$; two-tailed p -values. Coefficient estimates are reported with standard errors in parentheses. All continuous variables have been winsorized by year at the 1 and 99 percent levels. Tests of hypotheses are in bold.

Democrat replaced a Republican, and 0 if the political orientation was unchanged. Since the construct validity tests have shown the sign of individual executive's political orientation scores in different election cycles was the same as their lifetime political orientation score 92 percent of the time, political party preferences appear to be quite stable, so this approach seems reasonable.

Results of the analysis in Table 5 show that the coefficient on Δ Politics_CEO was positive and statistically significant for both Δ Cash ETR ($p < 0.05$) and Δ GAAP ETR ($p < 0.05$), suggesting that when CEOs who lean to the Democratic party (i.e., liberal CEOs) are replaced by CEOs who lean to the

Republican party (i.e., conservative CEOs), the firm begins to engage in less tax avoidance. These results provide evidence consistent with prior results, as well as evidence of managerial influence on a firm's tax avoidance occurring beyond just passive firm–manager matching.

DISCUSSION AND CONCLUSION

The goal of this study was to extend upper-echelons research by examining whether knowing the political orientation of top managers helps explain tax avoidance at the firms they manage. We found robust support for our hypothesis that firms led by Republican-leaning executives, on average, engage in less tax avoidance than firms led by Democrat-leaning executives. This suggests that even though Republican managers may prefer lower taxes, on average this preference is subordinate to their underlying tendencies to be conservative. Based on these findings, this paper makes two notable contributions to theory and research on upper echelons. First, it broadens the scope of activities to consider when examining firm risk to include a firm's tax avoidance. Second, it demonstrates that executives' political contributions can be used to construct predictive proxies for their underlying conservatism.

These findings also reconcile nicely with Allingham and Sandmo's (1972) theory that risk aversion affects the extent to which individual tax payers attempt to avoid taxes. Our findings thus illustrate how their theory can extend into the realm of corporate tax avoidance, which helps provide additional insight into understanding why we see so much variation in firms' willingness to avoid taxes. The results of the CEO turnover test also illustrate how knowing the political orientation of managers can help predict changes in the tax component of a firm's earnings, which could be useful to investors and other financial statement users.

Additionally, we found support for the idea that the effect of political orientation is more helpful in explaining variation in tax avoidance when managers were entrenched. This finding is consistent with prior studies, which suggest that entrenched managers are more able to express and implement policies that match their attitudes and preferences (e.g., Cronqvist *et al.*, 2012).

Further, our findings extend theory and research in upper echelons by demonstrating the passive and

Table 5. Ordered logistic regression of ranked changes in tax avoidance on changes in CEO political orientation due to CEO turnover

Model:	$\Delta\text{Tax avoidance} = \beta_0 + \beta_1 \Delta\text{Political Orientation} + \beta_k \Delta\text{Controls} + \epsilon$			
	$\Delta\text{Cash ETR}$		$\Delta\text{GAAP ETR}$	
Dependent variable	Coefficient	Std. error	Coefficient	Std. error
$\Delta\text{Politics_CEO}$	0.461**	(0.221)	0.560**	(0.237)
ΔROA	0.095	(2.435)	5.706**	(2.629)
$\Delta\text{Leverage}$	2.074*	(1.083)	2.038**	(0.997)
$\Delta\text{Net Operating Loss}$	0.071	(0.311)	-0.335	(0.331)
$\Delta\Delta\text{Net Operating Loss}$	8.548	(9.768)	-21.699*	(11.506)
$\Delta\text{Foreign Income}$	5.546	(5.791)	1.665	(5.662)
ΔPPE	-0.084	(1.291)	-0.888	(1.327)
$\Delta\text{Intangibles}$	-2.084*	(1.212)	-0.313	(1.158)
$\Delta\text{Earnings from Subs.}$	-17.769	(31.563)	-35.629	(28.647)
ΔSize	0.122	(0.273)	-0.126	(0.300)
$\Delta\text{Market to Book}$	-0.037	(0.040)	-0.040	(0.036)
$\Delta\text{R&D}$	8.409	(8.467)	-3.743	(10.400)
$\Delta\Delta\text{Pretax Cash Flow}$	1.012	(3.498)	-3.019	(3.415)
ΔCapex	1.084	(2.524)	-0.428	(2.445)
Intercept	Yes		Yes	
Demean by industry & time	Yes		Yes	
Cluster by firm	Yes		Yes	
Chi ²	166.81***		166.01***	
N	238		238	

* $p < 0.10$; ** $p < 0.05$; *** $p < 0.01$; two-tailed p -values. Each of the variables is constructed as an average over a three-year period. Each three-year average is then adjusted by subtracting the industry average value over those three years to control for industry and time trends. The Δ prefix indicates the change in the variable from the three full fiscal years after CEO turnover (years $t+1, t+2, t+3$) compared to three full fiscal years before CEO turnover (years $t-1, t-2, t-3$). The dependent variables have been ranked by deciles to mitigate the effects of extreme observations. All continuous variables have been winsorized at the 1 and 99 percent levels. All coefficient estimates are reported with standard errors in parentheses. Tests of hypotheses are in bold.

active channels through which executives influence tax avoidance. If firms tend to hire managers with similar attributes over time, this should result in the influence of new managers being felt *passively* as they maintain corporate culture and policies, which affect a firm's tax avoidance. Consistent with this idea, we found that the political orientation of current executives is predictive of the political orientation of newly hired executives, and we also found the political orientation of the outgoing CEO is predictive of the political orientation of the incoming CEO. Additionally managers' influence on a firm's tax avoidance may occur more actively by managers *changing* the corporate culture and policies. We found support for this idea by examining CEO turnovers, where we observed that when the political orientation of a newly hired CEO differs from the former CEO we see a change in a firm's tax avoidance. This is consistent with research on CEO succession that shows how characteristics of newly hired CEOs influence strategic change (e.g., Dalton and Kesner, 1985). Taken together our

results suggest that executives influence corporate tax avoidance both passively and actively, which contributes to our understanding of the process by which executive characteristics affect firm risk.

Moreover, our confidence in our findings was strengthened by our supplemental analyses, which are detailed in the Appendix S1. These tests included controlling for other known determinants of executive risk taking, such as compensation-based risk-taking incentives, age, gender, etc. We also addressed other alternative explanations such as the idea that executives may donate to political candidates to gain political favors. However, it is not clear why donating to the Republican Party instead of the Democratic Party should lead to firms having *higher* ETRs. Based on the political parties' ideologies, it would seem more likely that donating to the Republican Party would lead Republican politicians to pass legislation that would *lower* firms ETRs. We also controlled for the possibility that the firm's local or overall political climate may be driving our results. However, our

results were unchanged when we included these additional control variables. Lastly, our results were robust to controls to capture differences in tax-planning opportunities across industries and states. Thus, our results and conclusions are robust to several potential alternative explanations.

We also found that an executive's political orientation is highly stable over time. Specifically, we found that an executive's political orientation within a particular election cycle was consistent with his/her political orientation across the sample period in over 90 percent of cases. Thus, political orientation seems to capture enduring differences in individuals' attitudes toward financial uncertainty and suggests that political orientation is an influential characteristic that may help predict an executive's decisions before s/he is even hired. In contrast, numerous executive characteristics examined in the upper-echelon literature are contingent on other members of the TMT (e.g., TMT heterogeneity) or can only be inferred post hoc from prior strategic decisions (e.g., hubris) or from prior public relations decisions (e.g., narcissism). However, given that political orientation can be measured from publicly available records and is relatively stable over the course of an executive's career, it may be an important means by which an executive's willingness to undertake risk may be inferred *ex ante*. Such inferences may help researchers predict the degree to which a newly appointed CEO will be risk seeking or risk averse. Further, this variable may have implications for boards of directors who wish to understand an executive's risk profile before s/he is hired or promoted.

Given our initial encouraging results, future research could examine other firm outcomes and characteristics that may be influenced by executives' personal political orientation, such as corporate governance structures. For example, we found that managerial entrenchment scores (Bebchuk *et al.*, 2009) tended to be greater at firms run by Republicans (untabulated). Given that conservatives prefer greater job security (Jost *et al.*, 2003), this finding is consistent with conservative managers (1) creating an environment where it is harder or more costly to fire them, or (2) choosing to work for firms where this environment already exists. Researchers could further explore these implications.

Future research could also explore how political orientation influences entrepreneurial activities and career choices. Since our findings and Hutton

et al.'s (2014) suggest political orientation is correlated with relative risk aversion, Democrats might be more likely to be entrepreneurs. Yet at the same time, our data identifies more Republican executives than Democrat executives. Since firms in our sample and Hutton *et al.*'s tend to be well established and stable (i.e., S&P 1500 firms), which may attract more Republicans, future research could investigate if our findings generalize to smaller firms and if Republicans are more or less likely to start new companies.

Further, as we noted earlier, two "deep" issue dimensions exist in the American public: (1) economic and social welfare issues and (2) cultural and moral issues (Layman *et al.*, 2006). While our study focused on how executive political orientation impacts economic issues, in terms of corporate tax avoidance, future research could also examine the impact of executives' political orientation on social welfare issues or other moral aspects of running a firm. For instance, Chin, Hambrick, and Treviño (2013) found that firms run by Democrat CEOs tend to invest more in corporate social responsibility (CSR). To some extent, these findings fit with our arguments, since we would expect conservative executives to be less inclined to spend corporate resources in such controversial, nontraditional ways. Yet at the same time, in light of our findings, an interesting paradox emerges: although Democrats ideologically favor greater wealth redistribution through the government, the firms they run appear more inclined to pursue wealth redistribution outside of government channels (i.e., via CSR), rather than by providing resources to the government to redistribute (i.e., corporate taxes).⁴ The reverse is true for Republicans. Thus, future research could investigate this issue, as well as how political orientation relates to other social issues such as investment in employee benefits and wages, corporate philanthropy, environmental issues, etc.

Lastly, this study is the first in the management literature that uses tax avoidance as an indicator of firm risk. Thus there are many interesting avenues for future research, such as examining the factors that affect the relation between tax avoidance and firm value. Although tax avoidance can generate cash flow savings, this value can be offset by the accompanying tax risks and nontax risks (e.g., Desai and Dharmapala, 2009; Shevlin *et al.*, 2013).

⁴ We thank an anonymous reviewer for offering this insight.

As a result, the relation between tax avoidance and firm value appears quite contextual. Thus, exploring the ways in which tax avoidance contributes to or detracts from firm value appears to have a lot of potential.

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SUPPORTING INFORMATION

Additional supporting information may be found in the online version of this article:

Appendix S1. Additional details on robustness tests and summary of variable definitions.