Discussion of:

Supporting Tax Policy Change Through Accounting Discretion: Evidence from the 2012 Elections

Baloria and Klassen (2013)

By
Laura Wellman, Arizona State University
Overview:
linking two strands of literature

- An enormous literature investigates the antecedents, strategy choices and outcomes of corporate political activity (CPA), see Hillman et al. (2004), Lux et al. (2011).

- In the tax arena, several studies document that politically active firms are successful in achieving desired tax policy objectives (Freed and Swenson, 1995; Gupta and Swenson, 2003; Roberts and Bobek, 2004; Lee, 2012; Brown et al. 2013).

- Literature on political cost investigates to what extent firms will incur a financial reporting cost (i.e. report higher GAAP ETRs) in order to
  - avoid political scrutiny (Zimmerman, 1983; Guenther, 1994; Northcut and Vines, 1998), or
  - preserve ongoing political relationships (Jones, 1991; Ramanna and Roychowdhury, 2010; Mills et al. 2013).
Contribute to these two strands of literature:

- Firms will incur financial reporting costs in order to **reinforce** their overall political strategy, and

  - are less likely to do so when this strategy choice is more visible to political watchdogs (e.g. CTJ), and officials that govern political contracts (see Mills et al. 2013).

**Firm’s political strategy then becomes:**

- **Utilize financial reporting discretion** (i.e. avoid reporting ETRs that are “too low”)
- **Support affiliated candidates** (re)election (i.e. shield these candidates from voter scrutiny)
- **Ultimate goal of placing affiliated candidates in office that have goal congruent tax policy objectives**
Overview:
empirical strategy

**RQ:** Do firms support candidates’ (re)election campaigns by opportunistically managing their GAAP ETR in an effort to shield affiliated candidates from voter scrutiny?

1. Identify key election issue: a reduction in the statutory corporate tax rate
2. Identify candidates positions on the issue:
   - Search campaign websites
   - in favor of a “lower statutory corporate tax rate”
3. Link these candidates to significant corporate donors:
   - 20 largest donors (of any type) that support candidates from step (2) for the 4 years prior to the election
   - Narrow to corporations, then classify “supporting firms” as those that support two or more of the candidates from step (2)
4. Analyze the reporting choices of the corporate donors:
   - Difference – in – difference design
Overview:
summary of findings

• **Main finding:**
  • Reform-supporting firms exhibit higher ETRs than other politically active firms during the pre-election period
  • This finding is consistent with the idea that firms report higher GAAP ETRs during pre-election periods in order to shield affiliated candidates from voter scrutiny

• **Cross-Sectional tests:**
  • Investigate whether political scrutiny reinforces or offsets the incentives to support candidates (re) election campaigns
  • Find: less “visible” firms are more likely to engage in this behavior.

• **Robustness:**
  • Alternate how the time period cut-offs are defined
  • Alternate how “supporting-firms” are defined
A large body of literature (previously discussed) focuses on candidates using their power to grant political favors to connected firms.

In contrast, relatively few studies consider the flow of benefits from the firm to the candidates:

- Politicians as shareholders:
  - Benefiting (i.e. stock returns) from their own private information (Ziobrowski et al. 2004; Ziobrowski et al. 2011), or from information from management (Eggers and Hainmueller 2010)
  - Improving (re)election prospects through opportunistic management* of:
    - Real activities at the firm-level (Bertrand et al. 2006)
    - Accruals (Ramanna and Roychowdhury 2010)
RQ: Do firms support candidates’ (re)election campaigns by opportunistically managing their GAAP ETR in an effort to shield affiliated candidates from voter scrutiny?

Link 1*: Voting behavior can be influenced by changes in interim estimates of GAAP ETR.

Link 2: The firm (acting in the interest of the candidate) opportunistically manages GAAP ETR in an effort to influence voting behavior.
• Assume voter *irrationality*: Voters are *naïve* about (1) the way they form expectations about changes in GAAP ETR, and (2) the way they assess a policymakers influence over changes in GAAP ETR.

• Why do *rational* voters respond to pre-electoral manipulation?
  • **Signaling effect**: gimmicks have an effect because they are taken to provide relevant information about candidates for office (Rogoff 1990; and Rogoff and Sibert, 1988)

  • **In this setting**: Firms are able to signal the extent of their political connections, and therefore potential for future political favors.
Several studies document the association with “pre-election conditions” and voting patterns, focusing primarily on macroeconomic conditions (see Drazen 2001 for a review).

A common model modified to test your hypothesis specifically (see Fair (1978, 1982, 1988):

\[
\text{Votes} = \alpha + \beta_1 \Delta \text{ETR} + \beta_2 \text{Controls} + \text{error}
\]

- \text{VOTES} = aggregate the number of “relative” votes received by all reform supporting candidates connected to firm \( i \) in quarter \( t \) (“relative” to some benchmark such as other candidates in the same race).
- \( \Delta \text{ETR} \) = change in ETR from the beginning of the “pre-election” period to the end of the “pre-election” period \( (H1 = \beta_1 > 0) \)
- \text{Controls} = change in real GNP, Inflation (Fair 1978), firm-specific employment (Bertrand et al. 2006), and discretionary accruals (Ramanna and Roychowdhury 2010) others?

The assumption underlying this work is that right-wing and left-wing parties have different positions on economic issues (Drazen 2001).

These partisan differences often create a source of uncertainty over operating and investing (see Boutchkova et al. 2012, Julio and Yook 2012).
• APB Opinion No. 28 (1973) requires managers of the firm to compute the provision for income taxes by estimating the ETR that they expect to be applicable to ordinary income for the full fiscal year.

• This estimate should reflect anticipated tax credits, foreign tax rates, percentage depletion, capital gains rates, other available tax planning alternative (FASB 1977, Interpretation No. 18).

• Interim estimates, and particularly estimates of tax expense are inherently difficult to calculate. As such, managers may choose to make conservative estimates, or upwardly biased estimates during interim quarters (Comprix et al. 2012).
Electoral uncertainty has a real effect on firms’ operating and investing decisions and performance outcomes, which potentially leads to heightened estimation difficulty.

MID-2012 also represents a period of high policy uncertainty, and thus a source of estimation difficulty over income and expenses.

Consistent with this, a conservative response to policy uncertainty might be to report relatively high GAAP ETR during the Mid-2012 period, and adjust GAAP ETR downward in the post period once uncertainty is resolved.

Additional control for information uncertainty:
- Dispersion in analysts’ forecasts (Imhoff and Lobo 1992; Christensen 2002)
- Earnings predictability (Lipe 1990)
Comments: cross-sectional predictions

“(Do) firms incur financial reporting costs specifically to influence corporate tax policy?” – pg. 2 (emphasis added)

- Expectation: financial reporting costs should constrain firms from managing GAAP ETR upward

- Are these firms actually incurring financial reporting costs?:
  - Firms bias interim ETR estimates upward, conditional on already beating earnings targets (Comprix et al. 2012).
  - Partitions based on: (1) firms' quarterly earnings-meeting or beating analyst forecasts, (2) avoiding losses, and (2) avoiding earnings decreases

- Explore other financial reporting costs: does such wide variation in interim GAAP ETR induce earnings volatility? (significant market implications, see e.g., Minton et al. 2002; Dichev and Tang 2009)
Conclusion:

- Interesting paper!

- Able to identify a timely and interesting setting in which to investigate their hypothesis

- Findings are relevant to academic studies across several disciplines

- Contributes to a relatively underexplored area: the flow of benefits from the firm to the candidates

- Do firms attempt to appeal to voter sentiment in other ways?
  - MD&A?
  - Press releases?