CORPORATE TAX AVOIDANCE AND POLITICAL UNCERTAINTY: EVIDENCE FROM THE PRESIDENTIAL AND GUBERNATORIAL ELECTIONS IN U.S.

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ABSTRACT

We examine the impact of political uncertainty on corporate tax avoidance. Covering presidential elections in U.S. (1993-2017), we investigate the effect of political affiliation and transition of power on corporate tax avoidance. We find that firms are engaging in corporate tax avoidance activities, one year before and over the election years. We explore these firm's possible channels of spending and show that firms are spending more on capital expenditures and dividends in pre-election and over the election years. Furthermore, we find that when Republican presidents are in office, there are less corporate tax avoidance activities. We observe an increase in corporate tax avoidance activities when there is a transition of power from Democrats to Republicans and vice versa. We also covered gubernatorial elections in all 50 states during 1993-2017. We find that firms headquartered in NY, CA and TX increase their corporate tax avoidance activities over the gubernatorial election periods.

***Keywords**: corporate tax avoidance; political uncertainty; leverage; cash effective tax rate; political affiliation; transition of power; pre-election; post-election; presidential elections; gubernatorial elections.*

1. INTRODUCTION

The Tax Cuts and Jobs Act (TCJA) signed into law in 2017 by President Trump reduced the statutory corporate tax rate from 35 percent to 21 percent. Institute on Taxation and Economic Policy (ITEP) reports that profitable American fortune 500 companies paid an average effective rate federal income tax rate of 11.3 percent in 2018 (https://itep.org/corporate-tax-avoidance-in-the-first-year-of-the-trump-tax-law/). There is a consensus among researchers that corporations have been able to reduce effective tax rates by using favorable tax provision offered by tax laws (Gravelle, 2013; Dyreng et al., 2017).Political uncertainty refers to uncertainty about who will be making policy decisions and what those policies will be. As regards tax policies, Congress has the ultimate authority but the president, as the top leader of the nation, can exert significant influence over the direction of tax laws. The big picture presidential agendas are laid out during campaigns, and potential changes in tax policies have been an integral part of election campaigns. In this paper we investigate how the uncertainty about future tax policies affects tax avoidance behavior amidst political uncertainty during presidential elections. This paper can increase our understanding of the effect of political uncertainty on tax avoidance behavior which has implications for regulators, researchers, managers, or shareholders. As of February 2020, U.S. stock market accounted for over 50 percent of world stock market (https://www.statista.com/statistics/710680/global-stock-markets-by-country/), so focusing on political uncertainty in the world's biggest stock market and its effect on the corporate tax avoidance behavior of firms can provide significant value to all market participants.

In this paper, we investigate the effect of political uncertainty on corporate tax avoidance behavior. We use presidential elections and gubernatorial elections as a proxy for political uncertainty. We also examine the effect of political affiliation of the president on corporate tax avoidance. Additionally, we investigate if transition of power at the white house from democrats to republicans (and vice versa) affects corporate tax avoidance behavior.

In this study we focus not only on political uncertainty around national elections but also on political uncertainty around gubernatorial elections. We use U.S. presidential pre-election, election, and post-election years as a proxy for political uncertainty. We also investigate if the affiliation of the current president (Democrat or Republican) affects the level of corporate tax avoidance. We also investigate if the