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Labor unions and tax aggressiveness ☆

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ABSTRACT

We examine the impact of unionization on firms' tax aggressiveness. We find a negative association between firms' tax aggressiveness and union power and a decrease in tax aggressiveness after labor union election wins. This relation is consistent with labor unions influencing managers' in one, or both, of two ways: (1) constraining managers' ability to invest in tax aggressiveness through increased monitoring; or (2) decreasing returns to tax aggressiveness that arise from unions' rent seeking behavior. We also find preliminary evidence that the market expects these reductions around union elections and discounts firms that likely add shareholder value via aggressive tax strategies.

1. Introduction

Do all of a firm's stakeholders benefit when corporate taxes are reduced? While the answer to this question is potentially yes, a more interesting issue that we focus on is whether firms' tax planning outcomes provide more or less benefit to some stakeholders or cause some stakeholders to bear more or less risk than others. Specifically, we examine an important stakeholder—labor unions—and investigate a previously unexplored link between labor unions and corporate tax aggressiveness.

Because taxes are a significant cost faced by all of a firm's stakeholders, a narrow view of corporate tax policy could lead researchers to expect firms to invest in aggressive tax strategies with abandon. However, as Scholes, Wolfson, Erickson, Maydew, and Shevlin (2005) point out, and recent research into the agency view of tax avoidance shows, this view ignores the effect of nontax agency costs that can negatively affect firm value (Desai and Dharmapala, 2008; Chen, Chen, Cheng, and Shevlin, 2010). More important, this view inappropriately treats diverse stakeholders as homogeneous in their utilities for tax aggressiveness without appealing to potential variation in risk preferences. Prior literature suggests that labor unions have distinct incentives, political motivations, and risk preferences that manifest in conservative investment and financial reporting (Faleye, Mehrotra, and Morck, 2006; Leung, Li, and Rui, 2012). It follows that the observed level of corporate tax aggressiveness could at least partially reflect labor unions' presence and influence. More specifically, based on their incentives, political motivations, and risk preferences, labor unions likely prefer less tax aggressiveness and corporate outcomes

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reflect this preference. Prior literature also suggests that unions exhibit rent seeking behavior that draws managerial responses (Klasa, Maxwell, and Ortiz-Molina, 2009; Matsa, 2010; Connolly, Hirsch, and Hirschey, 1986). Our study allows for the possibility that as the influence of unions and their ability to capture firm profits increases, managers face diminishing returns on marginal investment in tax aggressiveness. To the extent that tax aggressiveness increases after-tax cash flows that are vulnerable to union capture, managers could be less willing to invest in aggressive tax strategies.

We acknowledge that if labor unions are successful in bargaining away a share of firms' after-tax profits, one might expect unions to prefer more tax aggressiveness, calling into question our predictions. However, this argument applies only if there is no risk or cost associated with tax aggressiveness and if all stakeholders exhibit similar risk preferences. While unions try to bargain for a share of firms' after-tax profits, they are unlikely to be indifferent to the various means of profit generation. In fact, prior research supports unions' assessments of managers' investment decisions that are consistent with a bondholders' perspective, generally suggesting that unions prefer less risk than shareholders or managers (Faleye, Mehrotra, and Morck, 2006; Chen, Kacperczyk, and Ortiz-Molina, 2012). Because tax aggressiveness can simultaneously impact a firms' tax risk (Hanlon and Heitzman, 2010; Crocker and Slemrod, 2005) and hamper unions' ability to assess the extent of firms' tax risk due to agency costs (Desai and Dharmapala, 2006, 2008), we expect unions to prefer less tax aggressiveness. In addition, once union contracts are set, increased after-tax cash flows derived from tax aggressiveness accrue to shareholders and managers, but not necessarily immediately to unions. In the interim period before contract renegotiations, union members bear the risk of aggressive tax position reversals that could result in additional taxes and Internal Revenue Service (IRS) penalties without a concurrent benefit.[1] To the extent that all stakeholders suffer from adverse consequences associated with tax aggressiveness, unions likely suffer more because their time horizon in firms is likely much longer than that of managers or shareholders who have the ability to leave firms or quickly sell their interests and invest elsewhere. Finally, our predictions do not necessarily require that unions have a direct impact on corporate tax policy. Given unions' potential capture of after-tax cash flows, managers are less likely to invest in aggressive tax strategies at the margin if they expect to share the benefits with unions.[2]

To test our assertions and expectations regarding the link between labor unions and corporate tax aggressiveness, we examine the association between tax aggressiveness and unionization rate, a proxy for union strength and bargaining power (Connolly, Hirsch, and Hirschey, 1986; Bronars and Deere, 1991; Matsa, 2010; Klasa, Maxwell, and Ortiz-Molina, 2009), at the establishment and industry levels. We define industries following prior research (Connolly, Hirsch, and Hirschey, 1986; Bronars and Deere, 1991; Matsa, 2010; Klasa, Maxwell, and Ortiz-Molina, 2009). Establishments are defined consistent with the National Labor Relations Board (NLRB) as the separate location for a company's business activity that has employees. Because not all employees at an establishment are represented by a labor union, bargaining power is defined as the bargaining unit size (number of employees covered by the union contract) divided by the total number of establishment employees. In both establishment and industry settings we find that union power is associated with a lower level of corporate tax aggressiveness.

Next, we examine changes in tax aggressiveness around labor union elections in an event study setting, conditioning our analyses on whether a union wins or loses the unionization election. Employees at a firm become unionized when the union wins the election. Subsequently, these employees are represented by the union in the formation of a labor agreement through a collective bargaining process with firms' management. Consistent with our expectation, we find that tax aggressiveness decreases in the period after labor union election wins. This result provides further evidence that labor unions are negatively associated with tax aggressiveness.

In an additional test, we present some preliminary evidence on the valuation implications of unions' impact on tax aggressiveness within the Desai and Dharmapala (2006, 2008) framework. They predict that tax aggressiveness is value accretive to firms in the presence of strong corporate governance. In a weak corporate governance environment, managers could use the obfuscation inherent in tax avoidance activities to divert resources from shareholders. Consistent with the theoretical underpinnings of this framework, we find that the market discounts tax aggressiveness by well-governed firms around union elections. This result suggests that the market expects managers' rational response to potential union rent extraction, or unions' incentives to constrain managerial behavior, to reduce value increasing aggressive tax activities in well-governed firms.

We make several contributions to the literatures on labor unions and tax aggressiveness. First, we echo scholars (Scholes, Wolfson, Erickson, Maydew, and Shevlin, 2005; Desai and Dharmapala, 2004, 2006) who call for more research into the examination of tax aggressiveness within an agency context. Because unions cannot perfectly contract with firms' management, they are forced to entrust managers with the competent oversight of their claims on firm resources and the adequate deployment of their contributions to firms. This creates an agency dynamic not yet considered in the tax planning setting. Our study allows us to examine this dynamic and,

[1] As per the Graham and Tucker (2006) study that examined 44 tax shelter cases, IRS penalties and litigation costs could represent a significant drain on corporate resources. For instance, this study cites GlaxoSmithKline P.L.C. as owing $5.2 billion in back taxes and penalties as result of tax sheltering activities. Such economically significant settlements potentially threaten firm profitability and labor unions' negotiating positions.

[2] Another possibility that we do not visit in this paper and leave open for future research is that unions impose fixed costs upon managers, *i.e.*, tax deductible wages and benefits that are substitutes for tax aggressiveness.