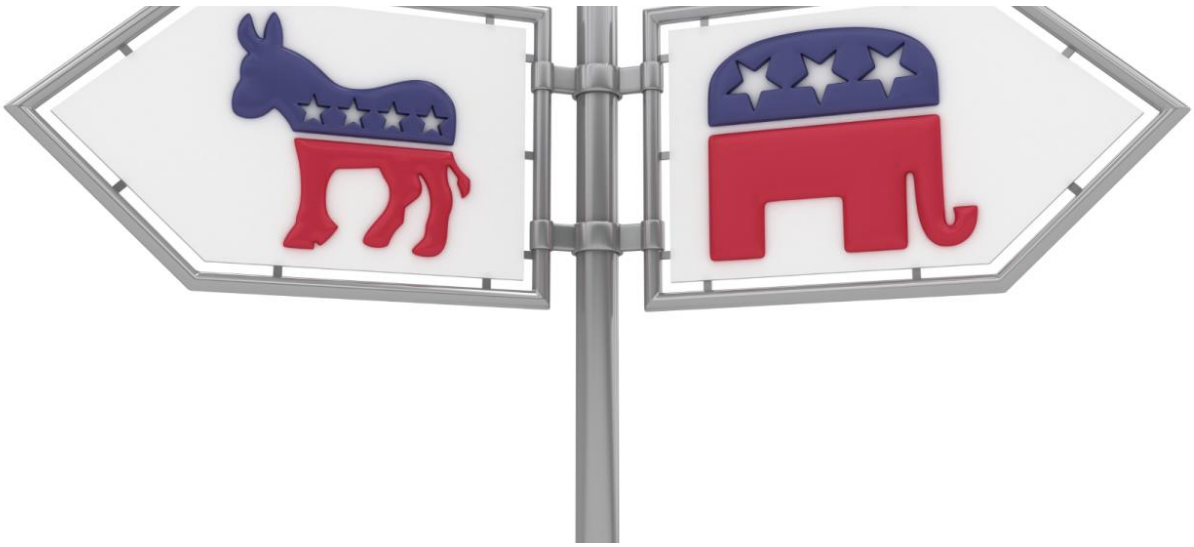
Should Investors Worry About the Political Affiliation of CEOs?



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Evidence suggests that the political leanings of CEOs can impact the dividends their companies pay to shareholders.

During the last two months of 2012, the world watched with concern and businesses writhed with anxiety as the United States approached the fiscal cliff, a perfect storm of spending cuts and tax increases due to come into effect by December 31st. Tax rates on dividends were predicted to increase from 15 percent to 43 percent as it was widely expected that President Obama would let the Bush-era tax cuts expire. This led to some evasive action by corporations to bring forward dividend payments and reflected their political leanings.

About 400 firms responded to this event by accelerating or bringing forward dividend payments from 2013 to December 2012 or by paying extra dividends. Others, however, did nothing, although accelerating dividends from early 2013 to December 2012 seems like a costless activity for the 199 firms that paid a dividend during the first three months of 2013.

Political motivations

In our paper ***Political Affiliation and Dividend Tax Avoidance: Evidence from the 2013 Fiscal Cliff***, we explore various hypotheses to explain this difference in corporate behaviour. One factor is the political affiliation of the CEO: as Democrats are more favorable to “taxing the rich”, we expect Republicans to be tax avoiders (either through accelerating dividends or paying extra dividends). In the U.S. it is possible to find out the political affiliation of the CEO via the website **http://fec.gov** which lists all political donations of all individuals in the U.S.

We measure the political affiliation by adding all the donations to Republican politicians, subtracting the donations to Democrat politicians and then dividing by total donations. We also classify a CEO as “a Democrat for tax purposes” if his/her name was on a “Fix the debt” **list of 80 CEOs published in the Wall Street Journal** on October 24 2012. CEOs on this list proposed increasing taxes to reduce the debt.

Personal gains

Other factors considered are: the personal gain of the CEO from accelerating or paying extra dividends (or the loss from not taking any evasive action), the percentage of insider holdings and the size of the company, a proxy for reputation risk. We find that all political affiliation, the personal wealth gain of the CEO and the percentage of shares held by insiders are all statistically and economically significant and positively related to the probability that the firm avoids the extra tax on dividends.

For example, if the CEO is a Republican he/she is three times more likely to be a tax avoider. However, the personal wealth impact of the CEO is more important: the CEO who accelerated dividends or paid extra dividends saved on average US$332,000 and US$659,000 in taxes, respectively. On the other hand, the CEOs who did not make an effort to lower taxes on their wealthy shareholders only paid US$24,800 in extra taxes. So, although politics matter, the CEO’s wallet dominates. This once again illustrates that companies where the CEO has “skin in the game”, and owned by a significant number of insiders, are likely to protect shareholders’ interests.

Size matters

Firm size is negatively related to the probability of tax avoidance. We interpret this as evidence of the importance of reputation risk: the decision to help rich people to avoid paying taxes may be costly for large and therefore visible firms during a period of high unemployment.

Our findings are consistent with other streams of research that links finance and politics. For example firms with Republican CEOs and founders have **lower corporate social responsibility (CSR) rankings than firms run by Democrats**. Democrat mutual fund managers are **less likely to hold socially irresponsible companies in their portfolio than Republican fund managers**. Note that all current political research is based on U.S. data thanks to the public availability of the **http://fec.gov** website. So one suggestion for the CEOs and asset managers from other countries: make it clear what your beliefs and values are so that investors can incorporate them when they make investment decisions.

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