Do Constituency Statutes Deter Tax Avoidance?[1]

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July 2019

Abstract: The constituency statutes, passed mainly in the U.S. in the last century, allow firm directors to consider the interests of stakeholders other than shareholders (i.e., non-financial stakeholders) when making business decisions. One type of critical decisions managers make pertains to corporate tax planning, which creates value for the shareholders at the expense of the public interest or social welfare. In this paper, we investigate whether this law change with a permissive nature affects directors, and hence, managers' attitude towards corporate tax avoidance. Employing a staggered difference-in-difference method, we find that firms incorporated in the states that have adopted constituency statutes exhibit significantly higher ETRs based on current tax expense, but not total tax expense or cash tax paid. This causal relationship suggests that managers, with the permission to consider the social impact of tax avoidance, become less aggressive in tax planning. We further find that the effect of adoption is stronger for financially unconstrained firms and firms in retail businesses, where the demand (cost) for tax avoidance is lower (higher). Finally, we show that our main results are driven by firms located in states with a high sense of social responsibility and the firms with high levels of tax avoidance prior to the adoption. Overall, the findings in this paper suggest a positive social impact brought by the passage of constituency legislations.

[1] We thank Andrew Bauer, David Guenther, and an anonymous reviewer at the AAA 2019 Annual Meeting for helpful comments. Financial supports provided by the School of Accounting and Finance at the University of Waterloo are gratefully appreciated.

1. Introduction

Studies in the tax literature suggest that managers create value for the shareholders through engaging in tax planning activities (Desai and Dharmapala 2009; Cheng, Huang, Li, and Stanfield 2012; Rego and Wilson 2012; Law and Mills 2015; Edwards, Schwab, and Shevlin 2016). While managers prioritize shareholders' interests, other parties (i.e., nonfinancial stakeholders), such as creditors, employees, customers, and the public, are also affected by decisions firms make. In particular, firms' decision to avoid corporate taxes directly affects the benefits of the public community in that tax avoidance reduces the government's tax revenue that may be spent on public goods (Doyle and Hughes 2013). Accordingly, understanding how corporate attention to nonfinancial stakeholders affects a firm's tax strategy is an important question for academics and business practitioners.

Research in the accounting literature has attempted to address the relationship between corporate social responsibility and tax avoidance (Hoi, Wu, and Zhang 2013; Lanis and Richardson 2015; Davis, Guenther, Krull, and Williams 2016; Col and Patel 2019). In this study, we examine the potential impact of corporate attention to nonfinancial stakeholders on tax avoidance. Addressing this question is challenging empirically since attention to nonfinancial stakeholders is likely endogenous to tax avoidance. The relationship between attention to nonfinancial stakeholders and tax avoidance could be driven by unobserved firm characteristics that affect a firm's engagement in both less tax avoidance and non-financial stakeholders-friendly initiatives. Such unobserved firm-level attributes could include managerial short-termism (e.g., Flammer, Hong, and Minor 2019) or the interests of board committees (e.g., Luoma and Goodstein 1999). Furthermore, the relationship is subject to reverse causality concerns. For example, a negative correlation between nonfinancial stakeholder focus and tax avoidance may indicate that firms that aggressively avoid taxes generally focus on short term benefits and tend to ignore the interests of non-financial stakeholders. Therefore, it is critical to design a research that provides a better causal inference for the impact of a firm's non-financial stakeholder orientation on tax avoidance.

This study addresses this empirical challenge by exploiting a quasi-natural experiment provided by the enactment of constituency statutes in 35 U.S. states between 1984 and 2007. These statutes allow corporate directors to consider nonfinancial stakeholders' interests when making business decisions. They provide exogenous variation in the weight that U.S. public corporations attend to the interest of nonfinancial stakeholders. While the primary purpose of a constituency statute is to allow directors to consider employees' job security when assessing merger and acquisition deals, it may also have an impact on firms' tax planning policies. In this paper, we examine whether the adoption of constituency statutes provides managers a legal ground to cater to the interests of the public community, and in turn, leads to reduced corporate tax avoidance. Using a staggered difference-in-difference method, we can identify a causal relationship between the enactment of constituency statutes and tax avoidance.

Knowing the answer to this research question is important for two reasons. First, understanding the consequences of a legislation change, whether intended or unintended, informs policy-makers for their future decision-making. While it is unlikely that states passed constituency statutes to influence firms' tax behaviors, unintended tax consequences, if there is any, are certainly of policy-makers' interest as tax is the fuel that keeps the government running. To the extent that firms respond to constituency statutes by paying more taxes, proponents of such statutes would identify another reason to keep proposing legal changes of a similar nature. Second, in the accounting literature regarding corporate social responsibility, there has been a debate on whether socially responsible firms pay more taxes than socially irresponsible ones. For example, Hoi et al. (2013) show that firms with excessive irresponsible CSR activities are more aggressive in avoiding taxes, while Davis et al. (2016) find that firms with good CSR records also engage in more tax avoidance. Taken together, it remains an open question whether an enhanced sense of social responsibility results in lower levels of tax avoidance, with evidence of causal relationship missing in particular.

The answer to the research question is also unclear ex-ante. On the one hand, the adoption of constituency statutes provides directors/managers legal support to consider the social impact of tax

avoidance and protects them against the potential legal charges from the shareholders when their chosen level of tax avoidance differs from the one expected by the shareholders. Thus, to the extent that directors/managers see tax avoidance as socially irresponsible but are obligated to do so due to their fiduciary duty to maximize shareholder value, the adoption of constituency statues should reduce the level of tax avoidance. Furthermore, corporate directors seize the opportunity provided by the enactment of constituency statutes to change director board composition and structure (Luoma and Goodstein 1999) and redesign executive compensation criteria (Flammer et al. 2019). By doing so, they can develop a corporate culture attending to the interest of both financial and nonfinancial stakeholders and supporting less aggressive tax avoidance (Col and Patel 2019).

On the other hand, however, constituency statutes are permissive, rather than mandatory, in nature. Directors/managers are not required to consider the social impact of tax avoidance. They may not necessarily refrain from conducting aggressive tax avoidance if they do not personally see the benefits of reducing tax avoidance, or if they face overwhelming pressures from their fiduciary duty. For those companies that have not established a culture attending to the interest of nonfinancial stakeholders, due to the permissive nature, constituency statutes may have no impact on tax avoidance. For those companies with a culture attending to the interest of both financial and nonfinancial stakeholders, companies' attention to nonfinancial stakeholders may divert valuable resources away from profit-maximizing activities (Flammer and Kacperczyk 2016). In order to meet the short-term requirements from financial stakeholders (e.g., meet or beat analysts' quarterly earnings expectations), managers may engage in more aggressive tax-saving activities to make up for the profit loss resulting from diverting valuable resources for attending to non-financial stakeholders. Alternatively, firms that are friendly to non-financial stakeholders may not see paying taxes as the best way to deliver their social responsibilities. Firms with this mentality may prefer contributing resources to socially responsible initiatives on their own and see saving taxes as one way to accumulate such resources. The main finding in Davis et al. (2016) provides

implicit support for this argument. In either case, the enactment of constituency statutes may cause firms to become more aggressive in tax avoidance.

Using a staggered difference-in-difference method, we find robust empirical evidence that firms reduce the level of tax avoidance after the adoption of the constituency statute. Specifically, over a ten-year window centered at the adoption year[2], firms' ETR, which is based on current tax expense (TXC)[3], increases by 2.8 percentage points[4], which is economically significant given an average Current ETR of 27.8% over our sample period. We also use Cash (GAAP) ETR as an alternative measure of tax avoidance and find a weak (no) result. Obtaining result with Current ETR but not Cash ETR is likely due to data limit on cash taxes paid (TXPD) in Compustat; U.S. firms started reporting TXPD in 1987, a year around which many states adopted the legislation.

Based on the argument that firms faced with financial constraints have a higher demand for tax avoidance (Law and Mills 2015; Edwards et al. 2016), we further find that the increase in ETR is driven by the firms that are less financially constrained, where the level of financial constraints is proxied by the WW index (Whited and Wu 2006). The finding of financial constraints suggests that the social impact of tax avoidance is ignored with the urge to generate cash flows internally through tax avoidance and is consistent with the non-mandatory nature of constituency statutes. In addition, consistent with the notion that the firms in the retail sector bear a higher cost in tax avoidance (Hanlon and Slemrod 2009), we also find that retail firms drive the increase in ETR.

Furthermore, we examine the underlying assumption that managers with an inherent sense of social responsibility would respond more strongly to the adoption of constituency statutes. In other words, those managers engage in aggressive tax avoidance because they are obligated by their fiduciary duty to the shareholders and their preferred level of tax planning would be lower without such an obligation.

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[2]. The adoption year is omitted from the window in order to have a clearer identification.
[3] We later refer to it as "Current ETR" for brevity.
[4]. The estimation of 2.8 percentage points is based on an unweighted regression. When weighted regression is used, the increase is 5.3 percentage points.

Following Hasan, Hoi, Wu, and Zhang (2017), we use state-level social capital and organ donation as proxies for a local sense of social responsibility and find that our main result is driven by firms headquartered in the states where the sense of social responsibility is higher. Finally, we show that our main results are driven by the firms that exhibit higher levels of tax avoidance prior to the adoption of constituency statutes, as those firms have both the motivation and the flexibility to abandon tax avoiding strategies.

Our paper makes two important contributions. First, we show that legislation changes in favor of non-financial stakeholders' interest has an impact on corporate tax avoidance. This finding informs policy makers for their future decisions regardless whether such an impact aligns with their original intention in making and adopting constituency statutes. Second, we contribute to the tax literature in accounting research. That is, complementing the mixed conclusions drawn by Hoi et al. (2013) and Davis et al. (2016), we provide large-sample evidence of a causal relationship between a promoted sense of social responsibility and corporate tax avoidance. Namely, we show that allowing directors/managers to consider the social impact of tax avoidance, in addition to their fiduciary duty to the shareholders, deters tax avoidance. It implies that directors/managers do see paying corporate taxes as a social responsibility, and would fulfill such responsibility when they are legally permitted to. This finding enriches researchers' understanding of corporate tax avoidance from a social perspective.

2. Institutional background, prior literature, and hypotheses development

According to the shareholder primacy argument made by Adolf A. Berle in the 1930s, managers at public corporations should direct their efforts exclusively to maximizing shareholders' value. This view, which sees shareholders as the only trustees managers serve to, was challenged at the time by E. Merrick Dodd, who advocated that corporations should not only perform as a profit-making function but also cater to the interests of other stakeholders, including creditors, employees, suppliers, customers, and the society as a whole. The debate between Berle and Dodd has lasted ever since. The takeover waves in the 1980s, which gleaned profits for the acquirers and target shareholders but created losses for other stakeholders, reignited the debate on whether managers should consider other stakeholders' interests when making decisions. Practitioners and academics argue that takeovers create value for shareholders through expropriating rents from other corporate stakeholders such as employees and suppliers. In particular, Shleifer and Summers (1988) argue that hostile takeovers break the implicit contracts between managers and employees and lead to drastic cuts in employment and wages.

Concurrent with the anti-takeover laws that were legislated in response to the takeover waves, many states adopted constituency statutes in the 1980s and 1990s. Between 1984 and 2007, 35 states in the U.S. adopted constituency statutes, which in general allow managers and directors of public corporations to consider an expanded group of interests when making decisions concerning the course of the corporation's business (Ortz 1992). For example, the original Pennsylvania statute says, "the board of directors…may, in considering the best interests of the corporation, consider the effects of any action upon employees, suppliers, and customers of the corporation, communities in which offices or other establishments of the corporation are located, and all other pertinent factors." In short, constituency statutes provide directors, and in turn, managers, a legal ground to consider other stakeholders' interests, which do not always align with the interests of the shareholders.

The impact of constituency statutes on firms' governance and operations has been studied in the literature. Luoma and Goodstein (1999) find that firms incorporated in states that have adopted

constituency statutes have more non-shareholder stakeholders on their board. Using the staggered passage of constituency statutes as a natural experiment, Flammer and Kacperczyk (2016) find that the enactment of constituency statutes leads to increased innovation, measured in terms of the number of patents and citations per patent. They interpret theirs as evidence that constituency statutes provide managers with legal support to engage in activities that promote innovation, which benefits non-financial stakeholders and does not usually pay off in the short run. Without such legal support, pressure from shareholders may prevent managers from investing in innovations. More recently, Gao, Li, and Ma (2018) find that the cost of debt decreases for the firms incorporated in states that have passed constituency statutes, an effect that is stronger for the firms whose stakeholders' interests are more likely ignored. Consistently, Radhakrishnan, Wang, and Wang (2019) find that those firms reduce the level of conservatism in their financial reporting. They argue that accounting conservatism, which imposes higher standards for the verification for good news than for bad news, protects creditors and other non-financial stakeholders from downside risk. After the passage of constituency statutes, the demand for accounting conservatism decreases as managers are legally endorsed to pay attention to the interests of other stakeholders.

One business decision that would create a conflict of interests between shareholders and the other stakeholders is corporate tax avoidance. On the one hand, tax avoidance likely creates firm value as it generates additional after-tax cash flows. In the tax literature, many studies address this point from an incentive perspective. For example, based on the notion that equity incentives (e.g., stock options) induce managers to work more diligently for the firm, Rego and Wilson (2012) find a positive association between equity incentive and tax avoidance. Consistently, Cheng et al. (2012) document that firms targeted by hedge fund activists experience increases in tax avoidance, suggesting a sub-optimal level of tax avoidance before the intervention. Financially constrained firms can use tax avoidance as a channel to save cash and finance positive NPV projects that they cannot afford otherwise (Edwards et al. 2016; Law and Mills 2015). For financially constrained firms, the ability to finance and launch positive NPV projects certainly creates value.

On the other hand, however, other stakeholders may not necessarily benefit from tax avoidance. For example, the financial interests of employees and suppliers are usually stable as long as the firm continues to operate, and additional profits obtained through avoiding taxes likely do not matter to these constituents. Unlike employees and suppliers, customers, and the government, as constituents of the society, would likely hurt from firms avoiding corporate taxes. The government raises tax revenue to finance public goods that are consumed by the entire society, which includes both existing and potential customers. In 2017, corporate income taxes constituted 8.9% of the total U.S. government revenues (Statista). Therefore, corporate tax avoidance reduces the government's capacity to provide public services, and society would eventually bear the cost. Although employing tax strategies to maximize shareholder value is not necessarily unethical, it would still damper a firm's reputation as a decent corporate citizen, especially for those that deal directly with their customers. Anecdotes suggest that corporate tax avoidance could lead to customer backlash. For example, The Ethical Consumer magazine in the U.K. called for a boycott against Amazon after learning that the firm paid only 0.1% of its U.K. sales in taxes. In 2015, Amazon committed to abandoning tax strategies that succeeded in legally reducing its tax bills (Dyreng, Hoopes, and Wilde 2016).

While anecdotes suggest that public pressure leads firms to pay more taxes, it is still unclear whether socially responsible firms pay more taxes without external intervention. In the literature, continuous attempts have been made to examine this empirical question but the findings remain mixed. Using firms' tax disputes as a proxy for tax avoidance, Lanis and Richardson (2015) find that a higher level of CSR performance is related to a lower likelihood of tax avoidance. Similarly, Hoi et al. (2013) find that firms with excessive irresponsible CSR activities are more likely engaged in tax-sheltering activities. In contrast, Davis et al. (2016) report a negative relation between CSR and Cash ETR, suggesting that socially responsible firms also avoid more taxes. In a recent study, Col and Patel (2019) find that firms CSR ratings increase substantially after they first open tax haven affiliates, suggesting that

they anticipate tax avoidance to bring a negative social perception on them and actively manage their reputation through engaging in positive CSR activities.

Since directors and managers set the tone at the top for a firm's operations, whether socially responsible firms pay more taxes essentially boils down to whether directors and managers regard paying the fair share of taxes as their social responsibility. The adoption of constituency statutes allows directors to consider the interests of the society when making business decisions, including decisions with regard to tax planning. If directors and managers see paying corporate taxes as a socially responsible action but are obligated to avoid more taxes than they would like to due to the pressure exerted from the shareholders, the adoption of constituency statutes would lend them legal protection so they can refrain from engaging in aggressive tax avoidance. Thus, we expect the level of tax avoidance to decrease after the adoption.

Nevertheless, a deterring effect of constituency statutes on tax avoidance may not necessarily exist. First of all, those statutes are usually broadly worded without specifying the firm decisions pertaining to which other stakeholders' interests may be considered. In the context of this study, we are not aware of any statute that explicitly allows managers to evaluate the social impact of corporate tax avoidance. Also, constituency statues appear to have had very little use in the courtroom other than for merger and acquisition cases (Ortz 1992), and the statutes do not seem to have been decisive for the outcome in cases that do mention such statutes (McDonnell 2004). More importantly, given the permissive nature of the statutes, directors, and hence managers, are only *allowed*, rather than *required*, to accommodate the interests of the community. To the extent that directors/managers do not have an inherent sense of social responsibility, or their urge to fulfill social responsibilities is overridden by the fiduciary duties to the shareholders, the adoption of constituency statutes may not result in lower levels of tax avoidance.

From a financial reporting standpoint, a heighted sense of social responsibility may lead managers to use tax avoidance as a tool to manage earnings. Flammer and Kacperczyk (2016) argue that engaging in socially responsible activities may divert valuable resource away from profit-maximizing

activities. As such, managers may find it more difficult to meet or beat earnings targets due to profits lost to investments in socially responsible activities. As a result, managers may turn to tax avoidance as their last chance to manage earnings (Dhaliwal, Gleason, and Mills 2004). Lastly, it is also possible that directors/managers possess a sense of social responsibility but do not see paying taxes as an activity that benefits society as a whole. Studies investigating the relation between CSR and tax avoidance usually frame these two as either substitutes or complements. While a complementary relation suggests that firms with good CSR records should consistently avoid less tax, a substitutive relation suggests that those firms may instead invest their tax savings in socially responsible activities themselves via better compensating their employees or donating to charities, as they believe firms are more efficient than governments in allocating resources (Davis et al. 2016; McGee 2010; Lantos 2001). In a nutshell, an empirical investigation is warranted to shed light on the impact that constituency statutes have on corporate tax avoidance.

H1: The level of tax avoidance decreases after the adoption of constituency statutes.

Financially constrained firms demonstrate higher levels of tax avoidance (Law and Mills 2015; Edwards et al. 2016). For those firms, external financing is inaccessibly expensive and therefore funding positive NPV projects with funds internally generated via avoiding taxes is a forced alternative. Although constituency statutes allow directors/managers to consider the social impact of tax avoidance, serving the interests of the shareholders is still likely the priority, particularly with the permissive nature of the statutes. Under financial constraints, shareholders would have a stronger demand for tax avoidance because otherwise, the firm would have to forgo value-creating investment opportunities. As a result, directors/managers may barely consider the social impact of tax avoidance, even when constituency statutes allow them to do so. Therefore, we expect the effect stated in H1 to be stronger for financially unconstrained firms.

H1a: The level of tax avoidance decreases after the adoption of constituency statutes, and this effect is stronger for the firms that are not financially constrained.

Firms in retail businesses may face a heightened cost in tax avoidance as a negative public image often leads to customer backlash. For example, after being exposed to have paid little tax relative to its profits made in the UK, Starbucks voluntarily paid 10 million in GBP to the UK tax authority as an effort to save its public image and avoid customer boycott. Findings reported by prior studies are consistent with this observation. For instance, Hanlon and Slemrod (2009) find that stock price reaction to news about corporate tax aggressiveness is more negative for firms in the retail sector.

We argue that retail firms should be more sensitive to the adoption of constituency statutes as being a responsible corporate citizen paying their fair share of taxes matters critically to their popularity among media and individual customers. In addition, the adoption of constituency statutes would raise the entire society's awareness of firms' social responsibility, especially for retail firms with a more visible public image. Therefore, we expect the effect stated in H1 to be stronger for retail firms.

H1b: The level of tax avoidance decreases after the adoption of constituency statutes, and this effect is stronger for the firms that are in the retail sector.

The assumption underlying H1 is that managers have an inherent motivation to accommodate social benefits when making corporate decisions and the adoption of constituency statutes lends them legal support not to engage in excessive tax avoidance. In that sense, managers with a stronger sense of social responsibility should have a stronger response to the passage constituency legislation. Although managers' social attitude is hard to observe, numerous studies show that local social norms affect individuals' decision-making (e.g., Cialdini and Goldstein 2004; Hoi, Wu, and Zhang 2018; Hasan, Hoi, Wu, and Zhang 2017; Boone, Khurana and Raman 2013; McGuire, Omer, and Sharp 2012; Hilary and Hui 2009).

For example, Hoi, Wu, and Zhang (2018) find that the level of social capital, as captured by the strength of civic norms and density of social networks, is positively related to firms' CSR activities. Using the same data, Hasan et al. (2017) find a negative association between local-level social capital and tax

avoidance, consistent with the notion that the sense of social responsibility and collectivism discourages managers from engaging in corporate tax avoidance. Therefore, to the extent that managers view paying taxes as a socially responsible activity, we expect the effect stated in H1 to concentrate on the firms headquartered in the states where the sense of social responsibility is high.

H1c: The level of tax avoidance decreases after the adoption of constituency statutes, and this effect is stronger for the firms headquartered in the states with a high sense of social responsibility.

If a promoted sense of social responsibility would induce managers to pay more taxes, this inducing effect should be stronger for the firms that have avoided more taxes before the adoption of constituency statutes, relative to their industry peers. There are two reasons. First, firms avoiding more taxes relative to their peers likely employ more tax planning strategies and thus would have more flexibility to unwind those strategies when they intend to lower the level of tax avoidance. For instance, after being accused of having paid very little tax in the U.K., Starbucks said it would not claim tax deductions for royalties, coffee purchases, interest on intercompany loans, or capital allowances, and would not carry forward tax losses,[5] all of which are common tax planning practices. Second, firms hesitate to appear more aggressive in tax planning than their peers. Recent studies find that firms benchmark their level of tax avoidance against their competitors and adjust their tax planning strategies to avoid standing out as a tax avoider. Using executive turnover as exogenous shocks, Bird, Edwards, and Ruchti (2018) find that peer firms respond to shocks in tax behavior by changing their GAAP ETR in the same direction. Similarly, using two distinct research settings, Armstrong, Glaeser, and Kepler (2019) find that firms exhibit strategic reactions to changes in their industry-competitors tax planning. In sum, we expect the effect stated in H1 to be stronger for the firms that have avoided more taxes prior to the adoption of constituency statutes.

[5] See Financial Times article at https://www.ft.com/content/ac97bb1e-3fa5-11e2-b0ce-00144feabdc0.

H1d: The level of tax avoidance decreases after the adoption of constituency statutes, and this effect is stronger for the firms that have avoided more taxes before the adoption.

3. Research design and sample selection

3.1 Regression Model

Since constituency statutes have been adopted in different years across the states, we employ a staggered difference-in-difference model to test the hypotheses. The model is as follows:

$$ETR_{i,t} = \alpha_0 + \alpha_i + \alpha_t + \beta \times Constituency_{k,t} + \sum Controls_{i,t} + \varepsilon \qquad (1)$$

Where α_i and α_t are firm and year fixed-effects. Firm-fixed effects are required to establish a staggered difference-in-difference model. ETR stands for a one-year effective tax rate, which is measured based on cash tax paid (TXPD), total tax expense (TXT), or current tax expense (TXC). A higher ETR indicates a lower level of tax avoidance. Constituency, the variable of interest, is a binary variable equal to 1 for the five years following the adoption of constituency statute in state k[6], and zero for the five years prior to the adoption. The year of adoption is excluded from the sample. The states that have never passed the legislation are also excluded from the sample. We limit our testing period to a ten-year window for each adopting state to 1) obtain a balanced sample between treated and control firms, and 2) to reduce the concern that long-term economic factors unrelated to the adoption of constituency statutes may influence our results. Due to the staggered difference-in-difference setting, firms before the adoption are used as their own controls. According to H1, we expect β to be positive.

To test H1a, we split the sample into high/low financial constraints partitions, using WW index. WW index is defined in Appendix A. We expect β to be stronger for the group with a lower level of financial constraints.

[6] Following prior studies on staggered legislation adoptions across the states in the U.S., such as Bertrand and Mullainathan (2003), I use the state of incorporation to define k.

To test H1b, we separate our firms in the retail industry based on Fama-French 12 and 17 industries. We do not use Fama-French 30 or 48 industries as doing so results in two subsamples too much different in size. We expect β to be stronger for the firms in the retail industry. When FF12 is used, firms under the category of "Wholesale, Retail, and Some Services" are defined as retail firms. When FF17 is used, those under the category of "Retail Stores" are defined as retail firms.

To test H1c, we follow Hasan et al. (2017) and split our sample into high/low social responsibility partitions, based on state-level social capital[7] and per capita organ donation[8]. We expect β to be stronger for the group with a higher level of social responsibility.

To test H1d, we calculate a firm's three-year Current ETR prior to the adoption of constituency statutes and compare that to the industry median based on Fama-French 48 industries. The firms with a Current ETR below (above) the median are marked as having a high (low) level of prior tax avoidance. We expect β to be stronger for the group with a higher level of prior tax avoidance.

Our sample period starts from 1979, 5 years prior to the first adoption of constituency statute in Ohio, and ends in 2012, 5 years after the last adoption in Nebraska. Following prior studies in tax avoidance, we exclude the firm-years with non-positive pretax book income (PI), adjusted for special items (SPI). We also remove firms in the financial and utility industries. Finally, we require firms to have at least 10 million in total assets (AT). ETR variables are winsorized at 0 and 1, and all the continuous variables are winsorized at 1% and 99%.

Data availability for the ETR variables varies. In the literature, Cash ETR has been the primary measure of tax avoidance, which is cash tax paid (TXPD) scaled by pre-tax book income (PI), adjusted for special items (SPI). Since U.S. firms are required to disclose TXPD only after 1987, the Cash ETR sample has fewer observations than the samples for GAAP ETR and the ETR based on current tax

[7] Social capital data are obtained from the website of Northeast Regional Center for Rural Development (NRCRD).
[8] Organ donation data are obtained from the website of Organ Procurement and Transplantation Network (OPTN).

expense (TXC), which we refer to as Current ETR. The main difference between GAAP and Cash ETR is that GAAP ETR does not reflect tax avoided using deferral-based strategies. There are two primary differences between Current ETR and Cash ETR; Cash ETR excludes unrecognized tax benefit (UTB) and tax expense on employee stock options, while Current ETR does not. The sample size for Current ETR and GAAP ETR is 10,167 and 9,162, respectively, whereas the sample size for Cash ETR is 5,355. Due to the data availability on Cash ETR and the fact that GAAP ETR does not capture deferral-based tax avoidance, we see the Current ETR as the most appropriate measure for this study.

4. Descriptive statistics and regression results

Table 1 shows the years of adoption for the constituency statutes in each of the 35 states. Most of the adoptions took place in the 1980s and early 1990s, which coincided with the 1986 tax reform that reduced the statutory corporate tax rate to 35%. Therefore, it is critical that year fixed-effects are included.

[Insert Table 1 Here]

Table 2 shows the sample composition for the Current ETR sample. 33 of the 35 adopting states are covered by our sample. The majority of the sample comes from New York, Massachusetts, Pennsylvania, Ohio, New Jersey, Florida, Georgia, Minnesota, Texas, Virginia, and Wisconsin. Noticeably, Delaware is not included in the sample. Among the 10,167 observations, 5,297 are treated observations and 4,870 are control observations.

[Insert Table 2 Here]

Table 3 shows descriptive statistics on the variables. Current ETR, GAAP ETR, and Cash ETR have means of 27.8%, 35.7%, and 31.8%, respectively.

[Insert Table 3 Here]

Table 4, Panel A presents the results for the baseline regression model (Equation 1). Columns (1) to (3) show the results from unweighted regressions, while Columns (4) to (6) show the results from weighted regressions. Guenther (2018) suggests that weighting makes a difference when the sub-groups in a sample have different amounts of observations. In our case, the number of observations differs significantly across states (e.g., 1,514 in New York vs. 3 in Idaho). Without weighting, New York observations would have a dominating impact on the results whereas it makes more sense to let each state have the same influence. Thus, we assign a weight of 1/N to each observation, with N being the number of observations in a state.

In unweighted regressions, a positive and significant coefficient on Constituency (β=0.028, t=2.56) is only observed when Current ETR is used. Results are insignificant when GAAP or Cash ETR is used. When weighted regressions are used, the coefficient is still positive and significant (β=0.053, t=2.34) with Current ETR, and the coefficient becomes weakly significant (β=0.054, t=1.73) when Cash ETR is used. Overall, the results in Table 4 show that the adoption of constituency statutes leads firms' Current ETR to increase, suggesting reduced tax avoidance.

[Insert Table 4 Here]

Table 5 shows the results for the financial constraints partitions based on weighted regressions. Consistent with H1a, the coefficient on Constituency is positive and significant (β=0.068, t=2.21) only when the level of financial constraints is low, which suggests that managers would only forgo aggressive tax avoidance when there is little need to yield cash flows internally through tax planning.

[Insert Table 5 Here]

Table 6 shows the results for the retail sector partitions based on weighted regressions, where the retail sector is defined using Fama-French 12 and 17 industry classifications. Consistent with H1b, the coefficient on Constituency is positive and significant only for retail firms (β=0.109, t=3.59 for FF12; β=0.133, t=3.06 for FF17), suggesting that firms in the retail sector are more responsive to the adoption of constituency statutes.

[Insert Table 6 Here]

Table 7 shows the results for the social responsibility partitions based on weighted regressions, where social responsibility is proxied by state-level social capital and state-level per capita organ donation. Consistent with H1c, the coefficient on Constituency is only positive and significant (β=0.07, t=2.34 for social capital; β=0.065, t=2.25 for organ donation) when the level of social responsibility is high. This is consistent with the notion that managers with an inherent sense of social responsibility are more likely to reduce the level of tax avoidance after the adoption of constituency statutes.

[Insert Table 7 Here]

Table 8 shows the results for the prior tax avoidance partitions based on weighted regressions, where the level of prior tax avoidance is defined based on a firm's degree of tax avoidance relative to its industry peers during the three years prior to the adoption. Consistent with H1d, the coefficient on Constituency is only positive and significant (β=0.065, t=3.63) when the level of prior tax avoidance is high. This is consistent with the notion that firms that have avoided more taxes prior to the adoption of constituency statutes have both the flexibility and the motivation to reduce the level of tax avoidance.

[Insert Table 8 Here]

5. Robustness checks

5.1 Anti-Takeover Law Falsification Test

In response to the hostile takeover waves, many of the states adopted anti-takeover legislation in the late 1980s, in conjunction with the passage of constituency statutes. For example, Arizona passed both legislations in 1987. Prior studies have examined the impact of anti-takeover laws on firm performance (e.g., Bertrand and Mullainathan 2003; Atanassov 2013). To assess the possibility that the main results actually reflect the effect of anti-takeover laws, we perform a falsification test where we replace the treatment with the passage of anti-takeover legislation. Specifically, we take the Current ETR sample used to test H1 (10,167 observations) and replace the treatment variable based on the years in which anti-takeover laws were passed. Notice that all the states included in this sample have passed constituency statute at some point but not all of them have passed anti-takeover law. For the states that have never had anti-takeover law, the treatment variable is always zero.

Table 9 shows the results for the falsification test. Using unweighted regression, the treatment variable is weakly significant (β=0.016, t=1.72). Compare that to the coefficient in Table 4, Column (1): β=0.028, t=2.56. When weighted regression is used, the coefficient is not significant at all (β=0.03, t=1.32). Therefore, the falsification test confirms that our main results are not a reflection of the passage of anti-takeover laws.

[Insert Table 9 Here]

5.2 Randomizing adoption years

To verify that the results are truly due to the staggered adoptions of constituency statutes rather than some unidentified long-term effects, we randomly assign the adoption years to the 35 adopting states and re-estimate the regression for Current ETR for multiple times. We are unable to reproduce the main result with randomized adoption years.

We also replace all the adoption years with the years immediately before and after. When adoption years are replaced with the years before them, the coefficient of Constituency becomes insignificant (β=-0.001, t=-0.20 for unweighted regression and β=-0.001, t=-0.04 for weighted regression). Similarly, when adoption years are replace with the years after them, the coefficient is insignificant (β=0.003, t=0.31 for unweighted regression and β=0.004, t=0.17 for weighted regression).

5.3 Testing parallel trend

Testing whether treated firms already exhibit a different trend relative to control firms is a common robustness test when difference-in-difference is used. For this study in particular, if treated firms already show an up-going trend in ETR before the passage of the legislation, our main results may be spurious. To alleviate this concern, we perform a parallel test. Table 10 shows the results. Pre3, Pre2, and Pre1 represent the three years leading up to the adoption of constituency statute, respectively. Similarly, Post1, Post2, and Post3 represent the three years following the adoption. When unweighted regression is used, none of the Pre variables is significant, whereas Post1 and Post3 are weakly significant. When

weighted regression is used, all of those variables are insignificant, except for Pre1, which is negative and significant. Overall, there is no evidence that treated firms already exhibit an increasing trend in ETR prior to the adoption.

[Insert Table 10 Here]

6. Conclusion

This paper investigates the effect of constituency statutes on corporate tax avoidance. Using the staggered adoptions of the statute across the U.S., we find evidence that firms' ETR based on current tax expense increases after the adoption, consistent with the idea that endorsing managers with the legal support to cater to the interests of the society has a deterring effect on corporate tax avoidance. We further find that the result is stronger for the firms with a lower level of financial constraints, firms operating in the retail sector, firms headquartered in the states with a higher sense of social responsibility, and firms that have avoided more taxes prior to the adoption. Our main results withstand a battery of robustness tests. Overall, results from our study suggest a positive social impact brought by the adoption of constituency statutes and a causal relationship between a promoted sense of social responsibility and reduced corporate tax avoidance.

Appendix A

Variables	Definition
Current ETR	Current Income Tax Expense (TXC) scaled by Pretax Book Income (PI) less Special Items (SPI), winsorized at [0,1]
GAAP ETR	Total Income Tax Expense (TXT) scaled by Pretax Book Income (PI) less Special Items (SPI), winsorized at [0,1]
Cash ETR	Cash Tax Paid (TXPD) scaled by Pretax Book Income (PI) less Special Items (SPI), winsorized at [0,1]
Constituency	A binary variable equal to one if the state of incorporation has passed constituency statute in this year, 0 otherwise.
Size	The logarithm of Total Assets (AT)
PP&E	PPENT scaled by lagged AT
NOL	Indicator variable equal to one if TLCF is non-zero and non-missing, zero otherwise
ΔNOL	the change in the amount of NOL
R&D	XRD scaled by lagged AT, with missing XRD replaced with zero
MTB	Market-to-book ratio, calculated as (CSHO*PRCC_F)/CEQ
Sales growth	The change in SALE scaled by lagged SALE
Intangible	INTAN scaled by lagged AT
Leverage	Sum of DLTT and DLC scaled by lagged AT
Pretax ROA	Pretax book income (PI) scaled by lagged AT
Capital expenditure	CAPX scaled by AT
WW index	Financial constraint index developed by Whited and Wu (2006), calculated as -0.091*(IB+DP)/AT-0.062*dividend paying indicator+0.021*DLTT/AT-0.044*Ln(AT)+0.102*Average yearly sales growth at three-digit SIC level-0.035*(firm's sales growth).
Social capital	State level social capital data obtained from the Northeast Regional Center for Rural Development (NRCRD) at the Pennsylvania State University.
Organ donation	State level organ donation data in the United States from the Organ Procurement and Transplantation Network (OPTN).

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Table 1 List of States with Constituency Statutes

State	Year	State	Year
Ohio	1984	Massachusetts	1989
Illinois	1985	Missouri	1989
Maine	1986	New Jersey	1989
Arizona	1987	Oregon	1989
Minnesota	1987	Mississippi	1990
New Mexico	1987	Pennsylvania	1990
New York	1987	Rhode Island	1990
Wisconsin	1987	South Dakota	1990
Idaho	1988	Wyoming	1990
Louisiana	1988	Nevada	1991
Tennessee	1988	North Carolina	1993
Virginia	1988	North Dakota	1993
Florida	1989	Connecticut	1997
Georgia	1989	Vermont	1998
Hawaii	1989	Maryland	1999
Indiana	1989	Texas	2006
Iowa	1989	Nebraska	2007
Kentucky	1989		

This table shows the years of adoption of constituency statutes in each of states. Source: Flammer and Kacperczyk (2008), p1988. Nebraska was added to this table.

Table 2 Sample Composition

State	N	Before	After
Arizona	44	24	20
Connecticut	129	75	54
Florida	539	234	305
Georgia	467	221	246
Hawaii	28	19	9
Iowa	74	40	34
Idaho	3	2	1
Illinois	118	54	64
Indiana	391	197	194
Kentucky	40	24	16
Louisiana	84	41	43
Massachusetts	827	409	418
Maryland	332	172	160
Maine	53	30	23
Minnesota	566	245	321
Missouri	145	62	83
Mississippi	24	11	13
North Carolina	319	134	185
Nebraska	22	12	10
New Jersey	626	317	309
New Mexico	13	6	7
Nevada	621	223	398
New York	1,514	780	734
Ohio	745	360	385
Oregon	142	67	75
Pennsylvania	824	403	421
Rhode Island	52	25	27
South Dakota	6	0	6
Tennessee	191	86	105
Texas	415	231	184
Virginia	427	210	217
Wisconsin	367	149	218
Wyoming	19	7	12
Total	10,167	4,870	5,297

Table 3 Descriptive Statistics

	N	Mean	SD	Q1	Median	Q3
Primary Variables						
Current ETR	10,167	0.278	0.223	0.054	0.302	0.407
GAAP ETR	9,162	0.357	0.159	0.308	0.377	0.429
Cash ETR	5,355	0.318	0.225	0.168	0.307	0.409
Constituency	10,167	0.521	0.499	0	1	1
Control Variables						
Size	10,167	4.794	1.723	3.457	4.529	5.772
PP&E	10,167	0.372	0.261	0.179	0.311	0.506
ΔNOL	10,167	0.0003	0.009	0	0	0
NOL	10,167	0.215	0.411	0	0	1
R&D	10,167	0.026	0.052	0	0	0.029
MTB	10,167	2.069	2.027	0.966	1.561	2.534
Sales Growth	10,167	0.158	0.385	-0.006	0.089	0.218
Intangible	10,167	0.053	0.114	0	0	0.052
Leverage	10,167	0.291	0.261	0.098	0.245	0.405
Pretax ROA	10,167	0.071	0.163	0.006	0.079	0.154
Capital Expenditure	10,167	0.090	0.106	0.030	0.059	0.108

This table shows the descriptive statistics of the variables. All the variables are defined in Appendix A.

Table 4 Main Regressions

	Unweighted Regressions			Weighted Regressions		
	(1)	(2)	(3)	(4)	(5)	(6)
	Current ETR	GAAP ETR	Cash ETR	Current ETR	GAAP ETR	Cash ETR
Constituency	0.0280**	0.00581	0.0255	0.0533**	0.0113	0.0540*
	(2.557)	(0.725)	(1.460)	(2.340)	(0.819)	(1.730)
Size	0.0477***	0.0259***	0.0302**	0.0504***	0.0300***	0.0670***
	(6.771)	(3.762)	(1.977)	(4.608)	(2.741)	(3.042)
PP&E	-0.0848***	-0.0259	-0.0163	-0.0910*	-0.0848	-0.111
	(-2.943)	(-1.001)	(-0.299)	(-1.824)	(-0.906)	(-0.923)
ΔNOL	0.610**	-0.0497	1.980***	0.539	1.386**	2.323*
	(2.313)	(-0.145)	(3.380)	(1.291)	(2.057)	(1.938)
NOL	-0.0782***	0.00944	-0.0631***	-0.102***	-0.0103	-0.0434
	(-7.303)	(0.922)	(-3.682)	(-6.629)	(-0.897)	(-1.285)
R&D	0.0173	-0.347**	0.476*	-0.0908	-0.333	0.398
	(0.163)	(-2.121)	(1.804)	(-0.657)	(-1.551)	(1.023)
MTB	-0.00143	-0.00557***	-0.00625**	-0.00115	-0.00319	-0.0142***
	(-1.120)	(-2.728)	(-2.131)	(-0.535)	(-0.631)	(-2.946)
Sales Growth	0.00501	-0.00703	-0.0520***	-0.00393	0.0422	-0.0236
	(0.834)	(-0.745)	(-2.836)	(-0.342)	(1.052)	(-0.822)
Intangible	0.0238	0.0364	0.0701	0.0314	0.0162	0.0926
	(0.621)	(1.062)	(1.309)	(0.440)	(0.286)	(1.205)
Leverage	-0.0457***	0.000801	0.00667	-0.0446**	0.0374	-0.128
	(-2.825)	(0.0494)	(0.198)	(-2.159)	(0.991)	(-1.603)
Pretax ROA	0.211***	0.457***	-0.375***	0.234***	0.359***	-0.323***
	(9.892)	(12.03)	(-5.895)	(5.173)	(3.399)	(-2.871)
Capital Expenditure	0.00221	-0.167***	0.199***	0.0613	-0.0482	0.379***
	(0.0564)	(-5.105)	(2.733)	(0.967)	(-0.618)	(2.908)
Year FE	Yes	Yes	Yes	Yes	Yes	Yes
Firm FE	Yes	Yes	Yes	Yes	Yes	Yes

Observations	10,167	9,162	5,355	10,167	9,162	5,355
R-squared	0.125	0.079	0.027	0.126	0.063	0.020

This table shows the unweighted/weighted regression results from estimating Equation (1). Dependent variables are Current ETR, GAAP ETR and Cash ETR, respectively. Results on fixed-effects are omitted for simplicity. T-stats are reported in the parentheses. ***, **, and * represent significance levels at 10%, 5% and 1%, respectively. All variables are defined in Appendix A.

Table 5 Financial Constraints Partitions

	Financial Constraints (WW index)	
	Low	High
Constituency	0.068**	0.036
	(2.21)	(1.54)
Controls	Yes	Yes
Year FE	Yes	Yes
Firm FE	Yes	Yes
Observations	5,069	5,068
R-squared	0.054	0.167

This table shows the weighted regression results from estimating Equation (1). The sample is partitioned into high/low financial constraints groups, using WW Index. The dependent variable is Current ETR. Results on control variables and fixed-effects are omitted for simplicity. T-stats are reported in the parentheses. ***, **, and * represent significance levels at 10%, 5% and 1%, respectively. All variables are defined in Appendix A.

Table 6 Retail Sector Partitions

	Fama-French 12		Fama-French 17	
	Retail	Non Retail	Retail	Non Retail
Constituency	0.109***	0.022	0.133***	0.024
	(3.59)	(1.31)	(3.06)	(1.55)
Controls	Yes	Yes	Yes	Yes
Year FE	Yes	Yes	Yes	Yes
Firm FE	Yes	Yes	Yes	Yes
Observations	1,821	8,346	1,014	9,153
R-squared	0.073	0.141	0.077	0.136

This table shows the weighted regression results from estimating Equation (1). The sample is partitioned into retail/non retail groups, using Fama-French 12 and 17 industry classifications. The dependent variable is Current ETR. Results on control variables and fixed-effects are omitted for simplicity. T-stats are reported in the parentheses. ***, **, and * represent significance levels at 10%, 5% and 1%, respectively. All variables are defined in Appendix A.

Table 7 Social Responsibility Partitions

	State-Level Social Capital		State-Level Organ Donation	
	Low	High	Low	High
Constituency	0.034	0.070**	0.033	0.065**
	(1.53)	(2.34)	(1.50)	(2.25)
Controls	Yes	Yes	Yes	Yes
Year FE	Yes	Yes	Yes	Yes
Firm FE	Yes	Yes	Yes	Yes
Observations	5,592	4,490	5,212	4,904
R-squared	0.109	0.105	0.123	0.108

This table shows the weighted regression results from estimating Equation (1). The sample is partitioned into high/low social responsibility groups, using data on state-level social capital and per capital organ donation (Hasan et al. 2017). The dependent variable is Current ETR. Results on control variables and fixed-effects are omitted for simplicity. T-stats are reported in the parentheses. ***, **, and * represent significance levels at 10%, 5% and 1%, respectively. All variables are defined in Appendix A.

Table 8 Prior Tax Avoidance Partitions

	Prior Tax Avoidance	
	Low	High
Constituency	-0.004	0.065***
	(-0.16)	(3.63)
Controls	Yes	Yes
Year FE	Yes	Yes
Firm FE	Yes	Yes
Observations	3,502	2,858
R-squared	0.087	0.1027

This table shows the unweighted/weighted regression results from estimating Equation (1). The sample is partitioned into high/low prior tax avoidance groups, based on Fama-French 48 industries. The dependent variable is Current ETR. Results on control variables and fixed-effects are omitted for simplicity. T-stats are reported in the parentheses. ***, **, and * represent significance levels at 10%, 5% and 1%, respectively. All variables are defined in Appendix A.

Table 9 Anti-Takeover Law Falsification Test

	Unweighted	Weighted
Anti-Takeover	0.016*	0.030
	(1.72)	(1.32)
Controls	Yes	Yes
Year FE	Yes	Yes
Firm FE	Yes	Yes
Observations	10,167	10,167
R-squared	0.125	0.129

This table shows the unweighted/weighted regression results from estimating Equation (1), with the variable of interest replaced based on the adoption of anti-takeover laws. The dependent variable is Current ETR. Results on control variables and fixed-effects are omitted for simplicity. T-stats are reported in the parentheses. ***, **, and * represent significance levels at 10%, 5% and 1%, respectively. All variables are defined in Appendix A.

Table 10 Parallel Trend Test

	Unweighted	Weighted
Pre3	-0.004	-0.007
	(-0.47)	(-0.60)
Pre2	0.002	0.016
	(0.21)	(0.95)
Pre1	-0.011	-0.036**
	(-1.23)	(-2.59)
Post1	0.014*	0.023
	(1.66)	(1.30)
Post2	0.008	0.010
	(0.91)	(0.65)
Post3	0.012*	0.005
	(1.68)	(0.46)
Controls	Yes	Yes
Year FE	Yes	Yes
Firm FE	Yes	Yes
Observations	10,167	10,167
R-squared	0.126	0.130

This table shows the unweighted/weighted regression results from estimating Equation (1), with the variable of interest replaced with the relative years around the adoption of anti-takeover laws. The dependent variable is Current ETR. Results on control variables and fixed-effects are omitted for simplicity. T-stats are reported in the parentheses. ***, **, and * represent significance levels at 10%, 5% and 1%, respectively. All variables are defined in Appendix A.