Political Risk and Corporate Tax Behavior: Firm-Level Evidence

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Abstract

This study investigates the effect of firm-level political risk on corporate tax behavior. Using a novel, firm-level measure of political risk, we find that firms delay tax avoidance investments when facing high political uncertainty, consistent with the implications of the real options theory. In addition, we find that the main effect is more pronounced in firms with greater flexibility to adjust tax positions and firms that are more politically sensitive. Further analyses show that firms with high political risk are associated with less tax planning and consulting fees, less foreign income designated as permanently reinvested earnings, and more lobbying activities. Our findings suggest that the lost tax savings can be a specific channel through which political risk affects shareholder values.

Keywords: Firm-Level Political Risk; Tax Avoidance; Corporate Investment; Under-Sheltering Puzzle

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1. Introduction

In this paper, we study whether firm-level political risk affects corporate tax behavior. It has long been recognized that political changes regularly alter firms' operating environments, for example, changes to national leadership, federal or statewide policies, government budgets, or programs and initiatives aimed at specific firms or industries. Political risk is, therefore, one of the most critical factors affecting companies' behavior (Julio and Yook, 2012; Pastor and Veronesi, 2012, 2013; Gulen and Ion, 2016; Brown and Huang, 2020).[3] Decisions about corporate tax strategy are one of the most important corporate decisions that unambiguously affect a firm's value, and have a significant impact on many corporate policies, such as financing choices, organizational form and restructuring decisions, payout policy, compensation policy, and risk management decisions (Graham, 2003). Our study of the effect of political risk on corporate tax behavior is especially relevant in light of the recent presidential election and economic downturn in the U.S., a time of great uncertainty related to the election outcome, potential tax rate increase, and economic stimulus release.

The impact of political risk on tax avoidance is largely intuitive. Tax avoidance typically covers a wide range of tax-reduction activities, ranging from benign investments in tax-exempt municipal bonds to aggressive strategies that might be reverted if overturned by the tax authorities. Consequently, tax avoidance may create uncertainties regarding the distribution and likelihood of a firm's future outcomes related to its tax positions and cash flows (Christensen,

[3] Anecdotal stories also offer compelling evidence. For example, Twitter shares fell more than 2% after President Trump tweeted about his plans to eliminate Section 230 – a law designed to protect the tech industry from third-party content liability. In another instance, the health insurance industry's share prices sank after polling data suggested Bernie Sanders was in the lead one week before Iowa's Democratic caucuses.

Dhaliwal, Boivie, and Graffin, 2015; Dyreng, Hanlon, and Maydew, 2019).[4] These tax avoidance activities entail large initial costs – costs for planning, consulting, and initial setup – that are irreversible in nature. When political uncertainty heightens, the tax implications that individual firms face are unique and often make it difficult for firm executives to clearly evaluate the tax consequences. As a result, waiting for political resolution is a valuable option until firms can learn more about future payoffs (Bernanke 1983; Rodrik, 1991; Pindyck and Solimano, 1993; Dixit, Dixit, and Pindyck, 1994; Bloom, Bond, and Van Reenen, 2007).[5] Empirical research provides strong evidence that firms delay key corporate functions, such as capital investment and hiring employees, under intensified political uncertainty (Julio and Yook, 2012; Baker, Bloom, and Davis, 2016; Gulen and Ion, 2016). We argue that when political uncertainty is high, firms will delay investment in tax avoidance until the implication of such uncertainties on their tax policies is clear.

Despite being theoretically intuitive, the relation between political risk and tax avoidance can be challenging to quantify empirically because of difficulties in measuring political risk. Prior research has relied heavily on aggregate political uncertainty measures or events. For example, many studies employ an index of economic policy uncertainty (EPU) developed by Baker et al. (2016) based on a newspaper coverage algorithm that picks up many significant political events. However, a major limitation of an aggregate economic policy measure, such as the EPU index, is that it covaries with the general condition of the economy and cannot isolate the cross-sectional variations of political risk that impact individual companies differently (Gad,

[4] Real life examples of the complex tax avoidance schemes include Enron and Tyco that share the convoluted tax structure and systematic planning. Kim, Li, and Zhang (2011) present an excellent discussion on the two cases.
[5] This real options or investment under uncertainty framework suggests that the irreversible nature of tax avoidance decisions can make firms delay their tax planning investment and lower the amount of tax savings when political risk is high. In a similar vein, Pastor and Veronesi (2012, 2013) show that political uncertainty commands a risk premium and raises the optimal threshold for any positive NPV project to clear.

Nikolaev, Tahoun, and van Lent, 2020). Another common approach is to analyze specific shocks to political uncertainty, such as changes in congressional committee chairmanships (Cohen, Coval, and Malloy, 2011), national elections (Julio and Yook, 2012), U.S. gubernatorial elections (Jens, 2017), and changes in legislative boundaries (Denes, Fisman, Schulz, and Vig, 2017). These election-based identifications are important steps in isolating the causal effect of political risk but are subject to a potential drawback: they are silent on the time-series variations of political risks, as elections are only one of many important sources.

We address these challenges by incorporating a novel, firm-level measure of political risk created by Hassan, Hollander, van Lent and Tahoun (2019) (henceforth HHLT). This measure captures the share of conference calls devoted to political risk discussions between analysts and managers. We use HHLT's measure of political risk for two reasons. First, neither of the discussed aggregate approaches speaks to the firm-specific exposures to political risk, which we believe are importantly distinct from the aggregate political environment. Companies are subject to different political risks unique to their industry organization structure, operational location, and supplier and customer bases. Aggregate measures of political uncertainty cannot capture these differences appropriately. Second, as stated by HHLT, 91.69% of the variation in measured political risk "appears to play out at the level of the firm, rather than the level of … sectors or the economy as a whole" (p. 2139). The rich cross-sectional variations in firm-level political risk offer us an opportunity to understand how firm-level political risk affects a firm's optimal tax avoidance strategies.

Using HHLT's political risk measure and four tax-avoidance proxies commonly used in the literature, we find that firms with high political risk exhibit a significantly lower amount of tax avoidance. Specifically, compared with firms in the lowest quintile of political risk, firms in

the highest quintile are associated with a 13.2% standard deviation higher cash effective tax rate. This translates to 5 million dollars of lost tax savings for an average firm in our sample. Our main analyses control for time-invariant unobserved firm fixed effects and industry-by-year fixed effect to mitigate concerns of omitted variables. We also control for political sentiment to eliminate the concerns that we are simply capturing deteriorating performance or ex-ante managerial incentives to blame political risks for bad performance. In additional analyses, we further confirm that our finding is robust to various model specifications and incremental to the effect captured by aggregate EPU. Lastly, we find our results continue to hold if we exclude observations during the 2007 – 2008 financial crisis and use persistent measures of firm-level political risk. We interpret our results as robust to macroeconomic conditions and reflect the persistent nature of political risk rather than temporary fluctuations faced by firms.

Our findings may not necessarily imply causality because unobserved firm-level characteristics may be correlated with both a firm's political risk and its choice in tax planning. We address this issue in several ways. First, we apply propensity-score matching (PSM) to address possible selection issues on self-disclosed political risk during conference calls. We observe similar findings in the PSM sample. Second, we use the U.S. presidential elections as an exogenous shock to a firm's political risk in a natural experiment setting. We observe significantly lower tax avoidance during election years and notice an immediate reverse in the year following an election. This pattern suggests that firms postpone making tax avoidance decisions during election years until the political uncertainty is alleviated in the year after an election, consistent with Julio and Yook's (2012) finding that firm investment patterns correspond to the cycles of national elections. More interestingly, we find that the amount of tax

avoidance reversals post-election is lower than the amount of tax avoidance decreases during election years, indicating that firms suffer a real consequence of political cost in lost tax savings.

We further investigate two channels to explore the underlying sources contributing to the relationship between political risk and tax avoidance. We find that firms facing high political risk pay less in tax planning and consulting fees. This finding is consistent with our argument that firms delay tax avoidance investment when political uncertainty is high. In a subsample of multinational companies, we also discover that the reported permanently reinvested foreign earnings are lower during high political uncertainty periods, revealing one specific tax avoidance strategy. Furthermore, we also find that firms actively manage political risk by engaging in lobbying activities. Results suggest that firms with high political risk are more likely to lobby, and when they lobby, the reduction in tax avoidance is less severe. This indicates the moderating effect of lobbying on the relationship between political risk and tax avoidance.

Lastly, we examine the sources of cross-sectional variations in firm characteristics to understand the mechanisms underlying our findings. First, we find that firms with high tax-planning capacity and, hence, more flexibility to adjust their tax positions, exhibit greater tax avoidance reduction when facing high political uncertainty. This evidence supports our implicit assumption that managers can change tax planning quickly and that changes in tax avoidance represent managers' discretionary response to political risk. Second, we discover that political risk's effect on tax avoidance is more pronounced in politically-sensitive firms (Zimmerman, 1983; Graham, Hanlon, and Shevlin, 2014), consistent with the notion that certain firms suffer more from political risk. Third, we compare firms with strong and weak corporate governance to

rule out managerial rent-seeking as an alternative explanation.[6] A popular stream of the literature views tax avoidance as a tool for managerial rent extraction. This view predicts that opportunistic managers have incentives to reduce tax avoidance when their firms experience a high level of political risk in order to prevent detection and safeguard the prospects of future rent extraction, an alternative explanation to our findings. We test this alternative hypothesis, expecting firms with weak corporate governance to exhibit a greater reduction in tax avoidance at times of political uncertainty. However, we fail to find such a result – the relationship between political risk and tax avoidance is equally strong in both strong and weak corporate governance subsamples. This finding reinforces our argument that political risk is a real shock to the firm (Pastor and Veronesi, 2013) and is not a byproduct of managerial myopia that can be mitigated by corporate governance mechanisms.

Our paper contributes to the literature in the following ways. We add to the literature examining politically-motivated corporate tax behavior. Mills, Nutter, and Schwab (2013) document that federal contractors that are politically sensitive pay more taxes. Wang, Wilson, Zhang, and Zou (2019) argue that firms operating in sin industries pay more taxes because their products and services run contrary to social norms. However, both Mills et al. (2013) and Wang et al. (2019) rely on industry exceptions, and it is challenging to apply their findings to firms in other sectors. Our study is the first to provide empirical evidence based on a large-scale sample that links individual firms' political risk to their tax avoidance behavior.

[6] Implicitly, we assume that managers, acting on behalf of shareholders, undertake tax avoidance activities to reduce corporate tax obligations and maximize after-tax profits. The downside of aggressive tax strategies is financial planning costs and the risk of detection by tax authorities. (Philips, 2003). As political uncertainties heighten, the advantage of delaying risky tax planning investment increases. We share our view with other investment literature (Julio and Yook, 2012; Gulen and Ion, 2016).

This paper's findings also speak to the literature studying the "under-sheltering puzzle," which has been troubling researchers for years (Weisbach, 2002; Desai and Dharmapala, 2006; Hanlon and Heitzman, 2010). In an attempt to explain why firms exhibit different behavior in taking advantage of loopholes in the tax laws, we suggest that political risk may deter firms from engaging in aggressive tax-saving strategies.

We further contribute to the growing literature on firm-level political risk. This line of work recognizes that a substantial amount of political risk concentrates at the firm level (Aye, Balcilar, Demirer, and Gupta, 2018; HHLT, 2019; Gad et al., 2020; Saffar, Wang, and Wei, 2020). We provide evidence that tax avoidance can be a specific channel through which political risk affects shareholder value.

2. Data and empirical design

2.1. Measurement of tax avoidance

We measure corporate tax avoidance using effective tax rates (ETR) calculated on a cash basis and generally accepted accounting principles (GAAP) basis, discretionary permanent book-tax differences (*DTAX*), and a tax-shelter probability (*PROBSHELTER*). The first two proxies, cash ETR (*CETR*) and GAAP ETR (*GETR*), capture a firm's overall tax-planning outcomes through all means of tax reduction strategies, reflected in the firm's cash taxes paid and total tax expenses. *CETR* reflects the outcome of tax-deferral strategies that generate both permanent and temporary book-tax differences, such as accelerated depreciation for tax purposes. *GETR* captures the impact of earnings-related strategies that generate permanent book-tax differences and lower pretax earnings, such as the designation of permanently reinvested foreign earnings. Lower *CETR* and *GETR* correspond to higher levels of tax avoidance, and we expect to observe a positive relationship between political risk and these two ETR measures. Our third measure of

tax avoidance, *DTAX*, is based on Frank, Lynch, and Rego (2009). It computes a firm's discretionary portion of tax avoidance in the permanent differences between its book income and taxable income, which arguably is on the most aggressive end of the tax avoidance continuum (Hanlon and Heitzman, 2010). *DTAX* is shown to be positively correlated with financial reporting aggressiveness (Frank et al., 2009). Finally, a tax shelter is one of the most egregious tax avoidance strategies recognized among researchers. We follow Wilson (2009) and calculate *PROBSHELTER* as the probability of a firm having a tax shelter based on its characteristics. Higher values of *DTAX* and *PROBSHELTER* represent higher levels of tax avoidance, and we expect *DTAX* and *PROBSHELTER* to be negatively related to political risk.

2.2. Measurement of political risk

We use HHLT's *Prisk* to compute firm-level political risk. *Prisk* represents the proportion of quarterly conference call conversations devoted to political risk discussions between analysts and managers.[7] Studies in several disciplines have used *Prisk* as a proxy for firm-level political risk (Darby, Ketchen, Williams, and Tokar, 2020; Gad et al., 2020; Saffar et al., 2020). Specifically, HHLT count the numbers of adjacent two-word combination bigrams with synonyms for "risk" or "uncertainty" and calculate a weighted number of political bigrams divided by the total number of bigrams in a transcript. This produces a quarterly *Prisk* measure. We take the average of the quarterly measures over a given firm-year to create our annual measure and standardize it to facilitate interpretation. A higher measure of *Prisk* indicates a higher degree of firm-level political risk. As HHLT demonstrate, *Prisk* drives over 90% of the

[7] Topics related to political risks are classified into six categories, including economic policy and budget, environment, trade, institutions and political process, health, security and defense, tax policy, and technology and infrastructure.

variation in political risk over time and across sectors and is an accurate measure of firm-level political risk beyond aggregate measures such as sentiment or economic-wide indices.

2.3. Empirical design

To test our expectation that firms delay tax avoidance investment when facing a high level of political risk, we adopt the following empirical model:

$$Tax\ Avoidance_{it} = \beta_0 + \beta_1 Prisk_{it-1} + \sum \beta_k Control_{it} + Firm\ FE + Industry \times Year\ FE + \varepsilon_{it} \quad (1)$$

where *i* indexes the firm and *t* indexes the year. The proxies for tax avoidance and our main independent variable of interest *Prisk* are defined above. We take a one-year lag on *Prisk* to establish temporal precedence. We control for a vector of contemporaneous firm-level variables that are known to affect tax avoidance, including leverage, firm size, return-on-assets, research and development expense, capital expenditure, market-to-book ratio, property plants and equipment, sales growth, cash flow, change in net operating loss, and an indicator for foreign operation. We also include firm fixed effects and industry-by-year fixed effects to account for heterogeneity across firms and industry over time.[8] Standard errors are clustered at the firm level. We provide detailed definitions of the variables in Appendix A.

2.4. Sample

Our sample covers a period from 2003 through 2019. Financial statement data is retrieved from Compustat, and political risk data is acquired from HHLT. We require firms to have nonmissing total assets and positive special items-adjusted pretax income. We also eliminate firms in the financial services industry and utilities industry. These selection criteria yield a sample of 50,863 firm-year observations.

[8] We use Fama-French 48 industry classification in our main analyses.

Table 1 Panel A provides summary statistics for all variables used in our analyses. We winsorize all continuous variables at the 1 percent on each tail to eliminate the impact of outliers. We present the sample distribution by year and by industry (Fama-French 12) in Table 1 Panel B and Panel C, respectively. We confirm that our sample is evenly distributed over years and across industries. We also discover that firms in the healthcare industry have the highest political risk on average, compared with firms in the retail industry with the lowest political risk. This observation is consistent with our argument that certain firms or industries are subject to more political risk beyond the aggregate political environment. Finally, Panel D lists the Pearson correlation between our dependent variables and the independent variable.

[Table 1]

Having examined our sample distribution, we study the property of our main *Prisk* measure. In Figure 1, we plot the time-average of *Prisk* across firms by year in our sample (e.g., solid line) together with the news-based EPU index (e.g., dashed line) developed by Baker et al. (2016), both standardized to have a zero mean and a standard deviation of unity. We find that the two series are highly correlated, with a correlation coefficient equal to 0.837 (significant at the 0.01 level), which indicates that *Prisk* captures many of the same events driving economic policy uncertainty and validates the measure.

3. Main empirical analyses

3.1. Portfolio analysis

We start by establishing a relationship between *Prisk* and our four measures of tax avoidance. In Table 2 Panel A, we rank firms into terciles by *Prisk* and report the sample mean of *CETR*, *GETR*, *DTAX*, and *PROBSHELTER* of each tercile. As *Prisk* moves from the first tercile (i.e., least politically risky firms) into the third tercile (i.e., most politically risky firms),

we observe a monotonically increasing pattern of tax avoidance across all four proxies. In addition, when we compare the sample means of each tax avoidance measure between the first and the third *Prisk* terciles, we find that the differences are all significantly different from zero. We repeat this portfolio analysis and rank firms by *Prisk* into quartiles and quintiles in Panel B and Panel C, respectively, and observe similar patterns in tax avoidance. Overall, the portfolio analyses provide univariate support that a firm engages in less tax avoidance when its firm-specific political risk is high.

[Table 2]

3.2. Multivariate analysis

In this section, we examine the relationship between political risk and tax avoidance in a multivariate setting. First, we estimate model (1) using ordinary least squares (OLS) regression and present our results in Table 3 Panel A. For *CETR* and *GETR*, both the coefficients on *Prisk* are positive and significant at the 1% levels, as reported in columns (1) and (2). These results indicate that the overall tax avoidance level is lower when a firm faces high political risks. In addition, *Prisk* loads significantly negatively on both *DTAX* and *PROBSHELTER* at the 1% level, suggesting that firms respond to high political risk by delaying egregious corporate tax avoidance. Taking the results of all four tax avoidance variables together, and consistent with our expectation, evidence suggests that corporate tax behavior is affected by firm-specific political risk. Firms exhibit less tax avoidance when political uncertainty is high, presumably because managers refrain from investing in tax-reduction projects.

[Table 3]

To further support this first set of results, Table 3 Panels B through F present additional versions of the baseline specification. We first adopt a two-way (firm and year) clustering

strategy and re-run model (1). The results are virtually unchanged. Next, we confirm that controlling for firm fixed effects and year fixed effects does not alter our results. We also use a different industry classification of two-digit Standard Industrial Classification (SIC) code to re-run our industry-by-year fixed effects and learn that this change has no bearing on the conclusion, and we continue to observe political risk's significant negative effect on tax avoidance. We further impose a constant sample requirement and only retain a firm-year observation if it has available data across all four measures of tax avoidance. Although this requirement lowers the number of observations considerably, it does not change our conclusion. Lastly, we omit observations during the 2007 – 2008 financial crisis and find that our results are robust to this exclusion. Overall, we are assured that alternative-model specifications do not alter our main finding that firms engage in less tax avoidance when facing high levels of political risk.

To further corroborate the persistent nature of firm-level political risk, we follow Saffar et al. (2020) and Gad et al. (2020) to measure the average *Prisk* over the past three and five years preceding the measurement of our outcome variables. We reason that if the persistent component in *Prisk* is driving our results, we would expect a similar result using these alternative constructions. Our results in Table 3 Panel G confirm this expectation. The findings are consistent with the economic intuition that our results reflect the persistent nature of political risk rather than temporary fluctuations faced by firms.

4. Additional analyses

Our main findings indicate that political risk is negatively associated with corporate tax avoidance. In this section, we provide further support that our results are robust after considering potential endogeneity. We also perform several further analyses to enhance our understanding of

the relation between political risk and tax avoidance by exploring the channels and cross-sectional variations.

4.1. Endogeneity

Our model (1) might suffer from endogeneity bias from two potential sources that make it challenging to identify a causal link between political risk and corporate tax avoidance. First, the negative relationship between firm-specific political risk and tax avoidance may arise when they are simultaneously affected by other unobserved factors. Second, since the discussions of political risk between analyses and managers during a conference call might not be random, firms disclosing high political risk could be fundamentally different from the rest of the firms. Such systematic differences may drive the relation between political risk and tax avoidance. We address these concerns next.

We begin by including several measures of firm risk in model (1) to tackle the concerns that our results might be driven by omitted correlated variables. Specifically, we calculate return volatility (*Ret_vol*), firm-level EPU measure (*EPU_firm*), firm-level political sentiment (*Sentiment*), and non-political risk (*Nprisk*). *Ret_vol* controls for overall firm risk that may arise from aggregate political risk and aggregate stock market volatility, and *EPU_firm* controls for a firm's sensitivity to economic policy uncertainty. *Sentiment* controls for managers' political optimism or pessimism, and *Nprisk* controls for a firm's response to risk related to non-political topics. Following HHLT (2019) and Gad et al. (2020), we specifically include the first-moment effect of political exposure, *Sentiment*, to alleviate the concern that ex-ante managers may have incentives to blame poor performance on political risk. Including these variables minimizes the concern of potential measurement errors associated with *Prisk* driving our results. We tabulate the results using *CETR*, *GETR*, *DTAX*, and *PROBSHELTER* as the dependent variable in Table 4

Panels A, B, C, and D, respectively. We add the control variables one-by-one and alongside model (1) in columns (1) through (5). For brevity, we do not report the coefficient estimates on the original control variables listed in model (1). We learn that *Prisk* loads significantly in our expected direction across all four proxies of tax avoidance beyond factors embodied in economic uncertainty and risk measures. This suggests that the negative relationship between political risk and tax avoidance we discover is not attributable to unobserved risk factors, and that *Prisk* truly captures the second-moment effect of political risk and is not contaminated by the conditional means of political risk.

[Table 4]

Next, we perform a propensity-score matching (PSM) procedure to address potential selection bias concerns. We split our sample into quintiles by *Prisk*, and define the top quintile subsample as the treatment group and the bottom quintile as the control group. Since there are no accurate predictors of firm-level political risk, we use all control variables from model (1) to calculate a propensity score of each firm in the treatment group. For each treatment firm, we match it to a control firm with replacement based on the closest propensity score (caliper <0.001) and exclude all observations that do not satisfy the common support condition.[9] In Table 5 Panel A, we discover that the treatment group and the control group exhibit substantial differences prior to matching. However, when we compare the treatment sample with the control sample after matching in Panel B, we learn that the two groups are virtually identical across all the variables used in the PSM procedure. We re-run model (1) using the matched sample and show

[9] PSM without replacement can yield a biased result if the number of control and treatment observations are small. On the other hand, matching with replacement keeps the bias low with a larger variance. We follow the recommendation of Heckman (1979) and perform PSM with replacement. Our results are also robust to matching without replacement.

our regression estimates in Panel C. Evidence suggests that *Prisk* continues to impact all four tax-avoidance proxies significantly and negatively, consistent with our main findings.

[Table 5]

To further establish causality, we exploit a natural experiment setting of the U.S. presidential elections (Julio and Yook, 2012; Kelly et al., 2016). We choose this research setting for two reasons. First, the timing of the elections is fixed by the Constitution and is, therefore, exogenous to individual firms. Second, the recurring nature of the elections helps isolate the impact of political uncertainty from other confounding factors. We begin by validating the assumption that *Prisk* is elevated during election years. We create an *ElectionYearDummy* that takes the value of one for election years, and a *PostElectionDummy* that equals one for the year immediately following an election, and zero otherwise. We then regress *Prisk* on these two indicator variables separately and simultaneously in Table 6 Panel A. In column (1), we find that *Prisk* is significantly higher during an election year. We also confirm in column (2) that *Prisk* is significantly lower in the period after an election. In column (3), we observe a similar pattern --- that political risk increases during election years and drops in the year immediately after the election.

[Table 6]

After validating our research setting, we estimate the following regression to identify the effect of political risk on tax avoidance:

$$Tax\ Avoidance_{it} = \beta_0 + \beta_1 ElectionYearDummy_t + \beta_2 PostElectionDummy_t + \sum \beta_k Control_{it} + Firm\ FE + \varepsilon_{it} \quad (2)$$

where the tax avoidance proxies, *ElectionYearDummy* and *PostElectionDummy*, are previously defined. In addition to the control variables listed in model (1), we also include macro-economic

control variables, such as the term spread (*Term*), the default spread (*Def*), the short-term Treasury bill rate (*Tb*), and the annual growth in real GDP (*GDP-Growth*) to account for business cycle fluctuations (Petkova and Zhang, 2005). We tabulate the results of model (2) in Table 6 Panel B. In columns (1) and (2), where the dependent variables are *CETR* and *GETR*, respectively, both the coefficients on *ElectionYearDummy* are significantly positive at the 1% level, evidence that tax avoidance is lower during an election year when political uncertainty is high. We further find that this effect is reversed in the year following the election, where both *CETR* and *GETR* load negatively and significantly on *PostElectionDummy*. We find similar and strong results when using *DTAX* and *PROBSHELTER* as the dependent variable in columns (3) and (4). We plot the changes in tax avoidance around election years in Figure 2. Both Figure 2 and our regression results from Table 6 illustrate the fluctuations of tax avoidance relative to the election cycles, consistent with the corporate investment patterns documented by Julio and Yook (2012). We further perform tests on the linear combinations of the coefficients of *ElectionYearDummy* and *PostElectionDummy*. The null hypothesis is that the coefficients are indifferent from each other, suggesting a temporal reallocation pattern of tax avoidance activities. We find limited evidence with the *ETR*s but significant evidence rejecting the null hypothesis using *DTAX* and *PROBSHELTER* as the dependent variable. This finding is consistent with the notion that political uncertainty incurs a real cost to firm values. That is, shareholders suffer a substantial loss from missed tax savings when political uncertainty is high during presidential elections.

4.2.Channels

To explore the underlying sources contributing to the relationship between political risk and tax avoidance, we investigate two channels. First, we examine whether firms facing high

levels of political risk reduce tax planning and consulting efforts, manifesting in lower tax consulting and planning fees. Because our measures mainly reflect the equilibrium outcome of a firm's tax avoidance activities, it is important to identify specific channels associated with a firm's tax planning objectives. Following De Simone, Ege, and Stomberg (2015), we gather data on the total tax fees paid to the auditors from Audit Analytics and scale this by total assets to create *Tax Expense*. This variable captures a firm's active engagement in tax planning activities. Holding firm size constant, one would argue that firms associated with greater levels of tax avoidance would spend more on tax planning and consulting to achieve such outcomes. If firms delay tax avoidance investment when political risk levels are high, we would observe lower total tax fees paid. In Table 7 column (1), we use *Tax Expense* as the dependent variable and re-run model (1). We find that *Prisk* is significantly and negatively related to *Tax Expense* at the 1% level, consistent with our expectation that when experiencing high levels of political uncertainty, firms delay tax planning and consulting and pay lower tax fees.

[Table 7]

Next, we focus on a subsample of multinational firms that arguably have more options for tax avoidance strategies. We inspect whether these firms delay designating foreign income as permanently reinvested earnings (PRE), a common approach used by multinational companies to lower U.S. taxes. U.S. GAAP requires that multinational firms record deferred taxes on foreign earnings unless a firm has invested or will invest the undistributed foreign earnings outside of the U.S. indefinitely. We denote *PRE* as the amount of PRE reported in the Audit Analytics Tax Footnote. A higher level of *PRE* suggests more foreign income designated as PRE, corresponding to higher tax avoidance. In column (2), we learn that the coefficient of *PRE* on *Prisk* is significantly negative (p-value <0.01). This finding provides evidence that multinational

firms postpone designating foreign earnings as PRE when levels of political uncertainty are high, presumably waiting until they can assess the risk more clearly or until there is less political risk.

4.3.Active risk management – lobbying activities

So far, we have shown that firm-level political risk reduces the amount of investment in corporate tax planning and results in a lower level of tax avoidance outcomes. This result is consistent with the notion that firms passively respond to the adverse effects of political risk by waiting it out. Do firms actively manage political risks? We explore this question next.

Prior literature suggests that lobbying activities are an effective means for corporations to hedge political risks (Tullock, 1967; Faccio, 2006; HHLT, 2019). Firms facing high levels of political risk would seek support from government officials, hoping to lower firm-specific political risk. We argue that when the marginal benefits of tax savings outweigh the marginal costs of lobbying, firms would engage in more lobbying activities and exhibit less reduction in tax avoidance.

We obtain lobbying data from the Center for Responsible Politics. Specifically, *Lobbying* is an indicator variable that equals one if a firm reports any lobbying expense, and zero otherwise. In column 1 of Table 8, we run a Logit regression to confirm that politically at-risk firms are more likely to engage in lobbying activities. We find a positive and significant coefficient on *Prisk*, indicating that firms are more likely to lobby when they encounter high *Prisk*. Next, we investigate the conditional effect of *Prisk* on tax avoidance measures. In the following columns, we re-run model (1) and include *Lobbying* and an interaction term between *Prisk* and *Lobbying*. Using all four measures of tax avoidance, we find that the coefficients on the interaction terms are negative and significant.[10] This finding is evidence that politically at-

[10] Our results remain qualitatively similar if we use a continuous measure of the dollar amount of lobbying expenditures.

risk firms that lobby has a smaller reduction in tax avoidance than those that do not lobby, indicating the moderating effect of lobbying on the relationship between political risk and tax avoidance. Untabulated tests show that the main effect of *Prisk* on tax avoidance remains significantly negative even in the presence of lobbying, corroborating our argument that political risk incurs a real cost on firms and even active lobbying may not restore the first-best tax-saving level. Lobbying can mitigate but not eliminate the negative impact of political risk on firms (Pastor and Veronesi, 2013).

[Table 8]

4.4. Cross-sectional variation

In this section, we exploit cross-sectional variations. These tests serve a dual purpose. First, they further our understanding of which firms are more sensitive to political uncertainty and, hence, suggest evidence for the underlying channels of the effect. Second, by identifying firm characteristics that affect the relationship between political risk and tax avoidance, we further alleviate concerns that our findings are driven by unobservable factors.

4.4.1. High vs. low tax planning capacity

The first set of cross-section tests is based on tax planning capacity. Our findings of the strong effect of political risk on tax avoidance rely on one important underlying assumption: that managers can change tax planning strategies quickly. In that sense, firms with more tax planning options should have greater flexibility when choosing the amount of tax avoidance to fit the company's needs. In contrast, firms with less tax planning options would not have many investment options related to tax avoidance to choose from. Therefore, we expect the effect of political risk on tax avoidance to be more pronounced in firms with high tax planning capacity.

Following Chen and Lin (2017), we capture a firm's tax planning capacity with three measures: the number of segments, whether a firm is multinational, and the presence of a tax haven. In Table 9 Panel A, we first partition our sample into high and low segment subsamples based on the sample median, and re-run model (1) within each group using all four of our tax-avoidance proxies. To preserve space, we only display the coefficients on *Prisk* in the table. We find that the relationship between political risk and tax avoidance is significantly more pronounced in column (1), for the high tax planning capacity subsample, than in column (2), for the low tax planning capacity subsample. Next, we split our sample into multinational versus non-multinational firms in columns (3) and (4), and we observe that the negative relationship between political risk and tax avoidance mainly exist in multinational companies. Lastly, in columns (5) and (6), comparing firms with and without subsidiary locations in tax havens, we find that the effect of political risk on tax avoidance is more prominent in firms with a tax haven. Overall, these results support our prediction that firms with greater tax planning capacities can adjust to high political risk by altering tax avoidance levels with more flexibility.[11]

[Table 9]

4.4.2. High vs. low political sensitivity

Our next set of cross-sectional tests is based on political sensitivity. Politically-sensitive industries, such as pharmaceuticals, defense, petroleum and natural gas, are vulnerable to changes in the political environment, and their economic fortunes may depend on certain political outcomes (Herron, Lavin, Cram, and Silver, 1999). Therefore, politically-sensitive firms should be more motivated to alter firm behavior as a result of changes in levels of political risk.

[11] Our results should not be interpreted as evidence that high tax planning capacity firms pay more taxes on average than low tax planning capacity firms, as cross-sectional tests do not speak to the levels of tax avoidance between the two subsamples.

We expect that politically-sensitive firms should have greater incentives to lower tax-related political costs than insensitive firms and are thus more likely to postpone tax avoidance investment during uncertain times. Our proxies of political sensitivity include firm size and whether a firm operates in a politically-sensitive industry (Zimmerman, 1983; Graham et al., 2014; Julio and Yook, 2012). We present our findings in Table 9 Panel B. In columns (1) and (2), where we compare large and small firms, we observe that large firms exhibit a substantial reduction in tax avoidance when facing high levels of political uncertainty, but the coefficients are only marginally significant or insignificantly different from zero in small firms. We find a similar pattern in columns (3) and (4), where we compare firms operating in politically-sensitive industries with those that are not. These findings provide evidence that the impact of political risk on tax avoidance is more severe in politically-sensitive firms.

4.4.3. High vs. low corporate governance

In our last set of cross-sectional analyses, we consider managerial rent-seeking incentives as an alternative explanation of our main findings. A popular view of tax avoidance perceives it as a tool to facilitate managerial rent extraction (e.g., Kim et al., 2011). Under this view, opportunistic managers would lower tax avoidance during periods of greater political uncertainty, not to delay investment and wait for the uncertainty to clear up, but to prevent being detected and preserve future rent-extraction potential. In this case, we would also observe a negative relation between *Prisk* and tax avoidance. We test this alternative explanation by splitting our sample into strong and weak corporate governance subsamples. Because corporate governance curbs opportunistic managerial behavior, the myopic managerial view would predict a stronger effect of political risk on tax avoidance in firms with weaker corporate governance. We use analyst following and institutional ownership as our corporate governance measures (Yu,

2008; Kempf, Manconi, and Spalt, 2017). Table 9 Panel C columns (1) and (2) compare the high and low analyst coverage subsamples. We find that the coefficients of tax avoidance on *Prisk* in both subsamples are effectively the same using all four proxies of tax avoidance. We find similar conclusions when we split our sample into high and low institutional ownership groups in columns (3) and (4) – firms in both groups present similar behavior towards tax avoidance when *Prisk* is high. This seemingly surprising finding bolsters our real options argument and rules out the alternative explanation that our results are driven by managerial myopia that can be mitigated by strong corporate governance mechanisms.

5. Conclusion

Using a large sample of U.S. firms between 2003 and 2019, this paper employs a novel, firm-specific political risk measure and shows a strong negative relationship between political risk and tax avoidance. This relationship is robust across various model specifications and incremental to the aggregate level of EPU. We further strengthen the causal argument by incorporating PSM and a natural shock to political risk from national elections. Additional analyses indicate that when facing high levels of political risk, firms reduce the effort of tax planning and consulting, delay designating foreign income, and increase lobbying expenses, consistently suggesting that shareholders may suffer a real cost due to political instability. Finally, we show that the main effect is more pronounced in firms with greater flexibility to adjust tax positions and firms that are more politically sensitive.

Our study is not without limitations. The biggest challenge is that our measure of political risk may not necessarily capture the "true" political uncertainty a firm faces, as quantifying such an effect is often a formidable task for empirical studies due to the unobservable nature of the construct. Nevertheless, our focus on the firm-level measure is a meaningful step given that

extant literature that acknowledges the effect of political risk has largely relied on aggregate political uncertainty measures or events. Typical for research studying corporate tax behavior, our paper is also limited to the available tax avoidance measurements calculated based on financial statement data because corporate tax returns are not publicly available. The lack of data on corporate tax positions likely introduces noises to our measures.

Our paper contributes to the expanding literature on the political motivations of corporate tax behavior. As tax avoidance becomes increasingly central to corporate decision-making, firms can take advantage of the complicated corporate tax code in more elaborate ways. Understanding what factors affect corporate tax policy is important to both academics and policymakers. Our findings suggest that political risk can have a meaningful impact on a firm's tax avoidance policies and provide a rational justification to the "undersheltering" puzzle.

We further contribute to the literature studying firm-specific political risk, which adds substantial depths to the EPU studies. Knowledge about how political risk is perceived by managers and how it interacts with other financial decisions represents an important venue for understanding the consequences of political risks for shareholder welfare. We find that firm-level variations in exposure to political risk can generate rich patterns in both time-series and cross-section tendency to engage in various tax-avoiding strategies. Overall, our findings suggest that tax avoidance can be a specific channel through which political risk affects shareholder value.

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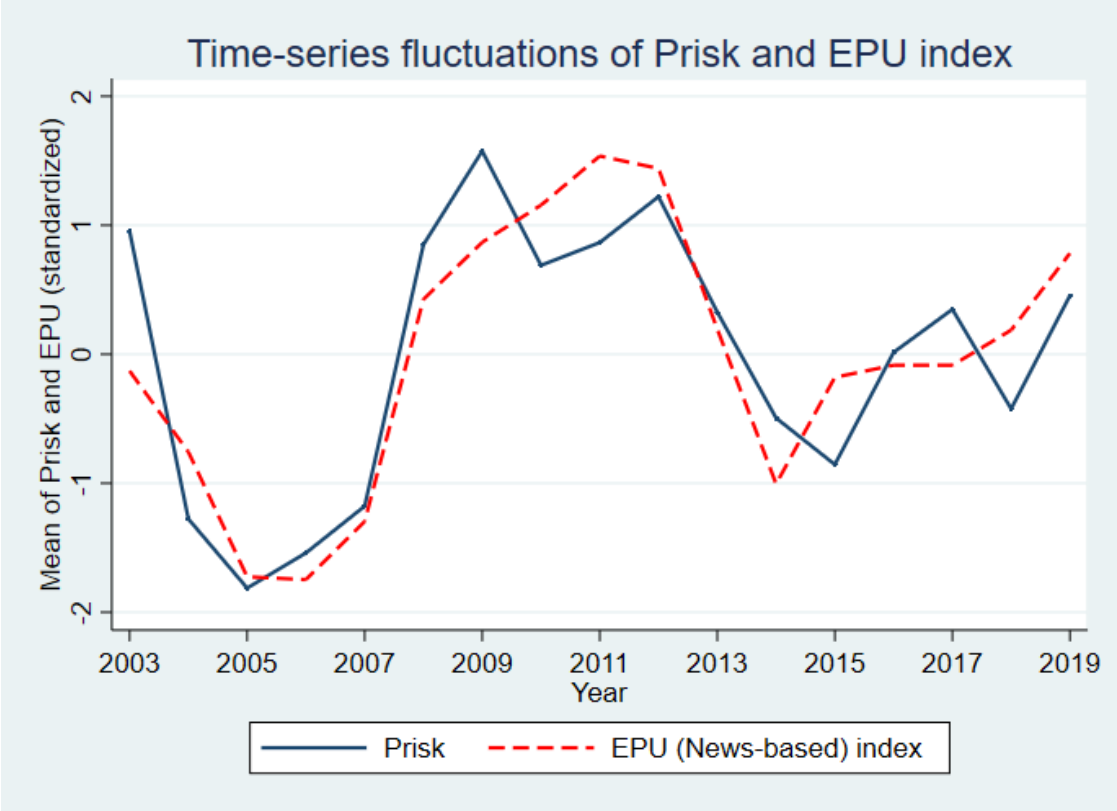
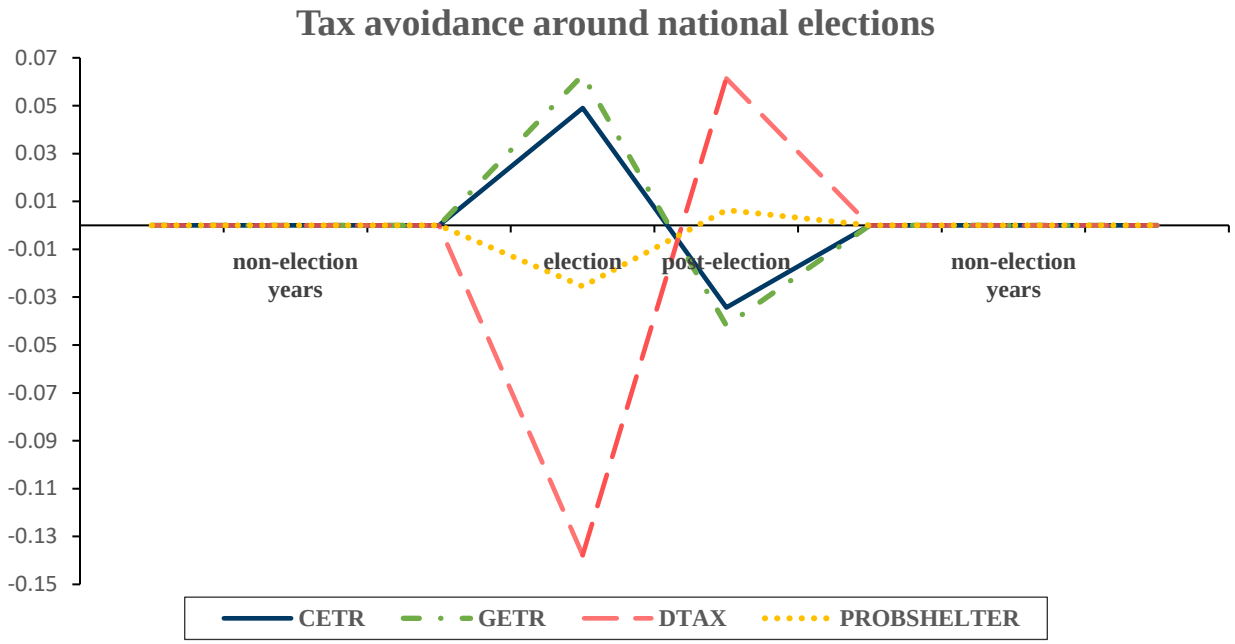
Figure 1.



This figure shows the time-average of *Prisk* (standardized by its standard deviation in the time series) across firms in each year, together with the news-based firm-level Economic Policy Uncertainty (*EPU_firm*) from Baker, Bloom, and Davis (2016). The Pearson correlation between the two series is 0.837 with a p-value less than 0.01.

Figure 2.



This figure displays estimates from the regression results reported in Table 6 Panel B of the following specification:
$Tax\ Avoidance_{it} = \beta_0 + \beta_1 ElectionYearDummy_t + \beta_2 PostElectionDummy_t + \sum \beta_k\ Control_{it} + Firm\ FE + \varepsilon_{it}$.
The vertical axis represents tax avoidance levels relative to the averages of nonelection years, which are the periods neither during an election year nor immediately after an election. The solid line displays changes in *CETR*; the dashed-dotted line represents changes in *GETR*; the dashed line displays changes in *DTAX*; and the dotted line represents changes in *PROBSHELTER*.

Appendix A: Variable Definitions

Variables	Definition
CETR	Cash taxes paid divided by (pretax income - special items).
GETR	Total tax expense divided by (pretax income - special items).
DTAX	Discretionary book tax differences calculated following Frank et al. (2009).
PROBSHELTER	Probability of a firm engaging in tax sheltering following Wilson (2009).
Prisk	Firm-level political risk measure defined in HHLT. *Prisk* is measured as the average of the quarterly levels over a given firm-year and standardized by its standard deviation.
Size	The natural logarithm of total assets.
Leverage	Total long-term debt scaled by total assets.
ROA	Pretax income scaled by total assets.
Cash Flow	Operating cash flow scaled by total assets.
Sale Growth	One-year change in total sales scaled by total assets.
Capex	Capital expenditures scaled by total assets.
R&D	Research and development expense scaled by total assets.
MTB	Market-to-book value of assets.
PPE	Property, plant, and equipment scaled by total assets.
ΔNOL	Change in net operating loss carryforwards scaled by total assets.
Foreign	An indicator variable that equals 1 if a firm has foreign income, and 0 otherwise.
Ret_vol	The standard deviation of a firm's daily stock returns over the past two years.
EPU_firm	Firm-level economic policy uncertainty from Alfaro, Bloom, and Lin, (2018).
Sentiment	Political sentiment measure from HHLT, measured as the average of the quarterly levels over a given firm-year and standardized by its standard deviation.
Nprisk	Firm level non-political risk measures from HHLT, measured as the average of the quarterly measure of a given firm and year standardized by its standard deviation.
ElectionYearDummy	An indicator variable that equals 1 for a year of a U.S. presidential election, and 0 otherwise.
PostElectionDummy	An indicator variable that equals 1 for a year immediately following a U.S. presidential election, and 0 otherwise.
Term	Yield spread between ten-year and one-year government bond.
Def	Default spread between Moody's Baa and Aaa corporate bonds from Federal Reserve Economic Data.
Tb	One-month Treasury bill rate from Kenneth R. French's website.
GDP-Growth	The annual growth in real GDP.
Tax Expense	Total tax fees paid to the auditors scaled by total assets.
PRE	The amount of foreign income designated as permanently reinvested earnings.
Prisk_3yr	The past 3-year moving average *Prisk.*
Prisk_5yr	The past 5-year moving average *Prisk.*
Lobbying	An indicator variable that equals 1 if a firm reports any lobbying expenses, and 0 otherwise
Num. of Segments	The number of business segments in the firm.
Multinational Firm	An indicator variable that equals 1 if the firm is a multinational corporation, and 0 otherwise.

Tax Haven	An indicator variable that equals 1 if a firm has at least one tax haven presence in a given year, and 0 otherwise.
Politically Sensitive Industries	An indicator variable that equals 1 if a firm belongs to a politically-sensitive industry following Julio and Yook (2012), and 0 otherwise.
Analyst Coverage	The number of analysts following a firm during a year.
Institutional Holding	The average of quarterly aggregate institutional ownership within a fiscal year.

Table 1: Summary Statistics

Panel A: Descriptive statistics

	N	Mean	Std	P25	Median	P75
Tax Avoidance:						
CETR	33,624	0.231	0.204	0.080	0.204	0.316
GETR	35,807	0.260	0.191	0.129	0.268	0.357
DTAX	43,379	0.060	1.190	-0.089	0.026	0.259
PROBSHELTER	48,948	0.641	0.314	0.399	0.738	0.916
Political Risk:						
Prisk	50,863	0.905	1.000	0.292	0.598	1.122
Firm Characteristics:						
Size	50,863	6.740	2.039	5.307	6.667	8.093
Leverage	50,863	0.229	0.255	0.004	0.168	0.346
ROA	50,863	0.065	0.073	0.018	0.040	0.081
Cash Flow	50,863	0.057	0.194	0.029	0.088	0.145
Sale Growth	50,863	0.084	0.243	-0.016	0.051	0.157
Capex	50,863	0.057	0.071	0.016	0.034	0.068
R&D	50,863	0.062	0.122	0.000	0.003	0.073
MTB	50,863	2.925	2.547	1.221	2.127	3.729
PPE	50,863	0.287	0.283	0.074	0.183	0.417
ΔNOL	50,863	0.064	0.292	0.000	0.000	0.020
Foreign	50,863	0.484	0.500	0.000	0.000	1.000
Other Variables:						
EPU_firm	29,757	0.495	0.253	0.316	0.434	0.606
NPrisk	50,863	1.007	1.000	0.370	0.713	1.280
Sentiment	50,863	1.817	1.000	1.142	1.783	2.465
Ret_vol	45,807	0.031	0.015	0.020	0.028	0.039
Tax Expense	45,758	0.282	0.556	0.000	0.053	0.299
PRE	10,624	0.154	0.174	0.026	0.089	0.221
Term	50,863	1.581	0.999	0.670	1.810	2.420
Tb	50,863	1.242	1.496	0.070	0.850	1.840
Def	50,863	1.065	0.350	0.870	0.990	1.100
GDP_Growth	50,863	2.034	1.456	1.800	2.300	2.900

Panel B: Sample distribution by year

Year	Firm	Freq.
2003	2,423	4.76
2004	2,600	5.11
2005	2,847	5.60
2006	2,977	5.85
2007	3,143	6.18
2008	3,253	6.40
2009	3,171	6.23
2010	3,113	6.12
2011	3,191	6.27
2012	3,170	6.23
2013	2,825	5.55
2014	3,087	6.06
2015	3,053	6.00
2016	2,847	5.64
2017	3,109	6.11
2018	3,133	6.16
2019	2,907	5.72
Total	50,863	100.00

Panel C: Sample distribution by industry

Industry	Num. of Obs.	Percent	*Prisk*
Consumer nondurables	2,787	5.48	0.666
Consumer durables	1,437	2.83	0.790
Manufacturing	5,706	11.22	0.893
Energy	3,333	6.55	0.961
Chemicals and allied products	1,463	2.88	0.901
Business equipment	12,196	23.98	0.843
Telephone and TV transmission	2,413	4.74	0.780
Wholesale, retail, and some services	5,644	11.10	0.637
Healthcare	7,068	13.90	1.213
Others	8,816	17.33	1.028
Total	50,863	100.00	0.905

Panel D: Correlation

	1	2	3	4	5
1. *CETR*	1.000				
2. *GETR*	0.338	1.000			
3. *DTAX*	0.007	-0.039	1.000		
4. *PROBSHELTER*	-0.034	-0.047	0.028	1.000	
5. *Prisk*	0.048	0.039	-0.014	-0.034	1.000

Table 1 reports descriptive statistics. Panel A presents summary statistics for all variables used in the regressions. Panel B and Panel C show the composition of observations by year and by Fama-French 12 industries, respectively. Panel D reports the Pearson correlations between *Prisk* and the tax avoidance proxies. See Appendix A for detailed variable descriptions.

Table 2: Portfolio Analysis of Political Risk and Tax Avoidance

Panel A: Tercile	*CETR*	*GETR*	*DTAX*	*PROBSHELTER*
1 (Least risky)	0.224	0.254	0.082	0.655
2	0.227	0.258	0.065	0.646
3 (Most risky)	0.244	0.269	0.034	0.620
Difference (3 – 1)	0.020***	0.016***	-0.048***	-0.035***
	(0.003)	(0.003)	(0.014)	(0.004)
Panel B: Quartile	*CETR*	*GETR*	*DTAX*	*PROBSHELTER*
1 (Least risky)	0.222	0.252	0.085	0.655
2	0.227	0.257	0.063	0.652
3	0.231	0.261	0.069	0.645
4 (Most risky)	0.248	0.271	0.025	0.611
Difference (4 – 1)	0.026***	0.019***	-0.060***	-0.044***
	(0.003)	(0.003)	(0.017)	(0.004)
Panel C: Quintile	*CETR*	*GETR*	*DTAX*	*PROBSHELTER*
1 (Least risky)	0.220	0.252	0.096	0.655
2	0.227	0.255	0.066	0.651
3	0.228	0.257	0.061	0.647
4	0.237	0.263	0.059	0.644
5 (Most risky)	0.247	0.273	0.019	0.604
Difference (5 – 1)	0.027***	0.021***	-0.077***	-0.051***
	(0.004)	(0.003)	(0.018)	(0.005)

Table 2 reports portfolio analysis of *Prisk* and tax avoidance proxies. Panel A, Panel B, and Panel C rank firms into terciles, quartiles, and quintiles, respectively, by *Prisk* and shows the sample mean of *CETR*, *GETR*, *DTAX*, and *PROBSHELTER* within each tercile, quartile, or quintile.

Table 3: Multivariate Regression Analysis

Panel A: Baseline results	*CETR*	*GETR*	*DTAX*	*PROBSHELTER*
	(1)	(2)	(3)	(4)
Prisk	0.005***	0.003***	-0.015***	-0.007***
	(0.001)	(0.001)	(0.005)	(0.001)
Leverage	0.005	-0.029***	0.080*	-0.228***
	(0.009)	(0.008)	(0.043)	(0.007)
Size	0.025***	0.014***	0.059***	0.078***
	(0.004)	(0.004)	(0.013)	(0.002)
ROA	-0.169***	0.315***	0.827***	0.748***
	(0.025)	(0.025)	(0.070)	(0.015)
R&D	0.189***	-0.092*	-0.499**	0.301***
	(0.063)	(0.056)	(0.201)	(0.030)
Capex	0.132***	-0.076**	-0.132	0.054***
	(0.038)	(0.034)	(0.111)	(0.021)
MTB	-0.000	-0.000	0.001	-0.000
	(0.000)	(0.000)	(0.001)	(0.000)
PPE	0.004	0.045***	-0.109**	0.033***
	(0.017)	(0.015)	(0.052)	(0.010)
Sale Growth	-0.063***	-0.029***	-0.023	-0.002
	(0.008)	(0.006)	(0.027)	(0.004)
Cash Flow	-0.282***	-0.169***	-0.006	-0.131***
	(0.025)	(0.022)	(0.082)	(0.015)
ΔNOL	0.019*	-0.003	0.370***	0.495***
	(0.010)	(0.011)	(0.037)	(0.007)
Foreign	-0.004	-0.004	0.009	0.245***
	(0.006)	(0.029)	(0.023)	(0.005)
Constant	0.091***	0.152***	-0.301***	-0.004
	(0.031)	(0.029)	(0.093)	(0.018)
Firm FE	Yes	Yes	Yes	Yes
Industry × Year FE	Yes	Yes	Yes	Yes
Observations	33,624	35,807	43,379	48,948
Adjusted R-squared	0.310	0.258	0.599	0.876

Panel B: Double cluster standard errors	*CETR*	*GETR*	*DTAX*	*PROBSHELTER*
	(1)	(2)	(3)	(4)
Prisk	0.005***	0.003**	-0.015**	-0.007***
	(0.002)	(0.001)	(0.006)	(0.001)
Controls	Yes	Yes	Yes	Yes
Firm FE	Yes	Yes	Yes	Yes
Industry × Year FE	Yes	Yes	Yes	Yes
Observations	33,624	35,807	43,379	48,948
Adjusted R-squared	0.310	0.258	0.599	0.876

Panel C: Firm and year fixed effects	*CETR*	*GETR*	*DTAX*	*PROBSHELTER*
	(1)	(2)	(3)	(4)
Prisk	0.005***	0.004***	-0.020***	-0.007***
	(0.001)	(0.001)	(0.008)	(0.001)
Controls	Yes	Yes	Yes	Yes
Firm FE	Yes	Yes	Yes	Yes
Year FE	Yes	Yes	Yes	Yes
Observations	33,624	35,807	43,379	48,948
Adjusted R-squared	0.301	0.246	0.091	0.876

Panel D: Alternative industry classification	*CETR*	*GETR*	*DTAX*	*PROBSHELTER*
	(1)	(2)	(3)	(4)
Prisk	0.005***	0.003***	-0.016***	-0.007***
	(0.001)	(0.001)	(0.005)	(0.001)
Controls	Yes	Yes	Yes	Yes
Firm FE	Yes	Yes	Yes	Yes
Industry × Year FE	Yes	Yes	Yes	Yes
Observations	33,624	35,807	43,379	48,948
Adjusted R-squared	0.310	0.257	0.676	0.876

Panel E: Balanced sample	*CETR*	*GETR*	*DTAX*	*PROBSHELTER*
	(1)	(2)	(3)	(4)
Prisk	0.006***	0.003**	-0.012**	-0.007***
	(0.002)	(0.001)	(0.006)	(0.001)
Controls	Yes	Yes	Yes	Yes
Firm FE	Yes	Yes	Yes	Yes
Industry × Year FE	Yes	Yes	Yes	Yes
Observations	27,648	27,648	27,648	27,648
Adjusted R-squared	0.316	0.242	0.642	0.896

Panel F: Excluding 2007- 2008	*CETR*	*GETR*	*DTAX*	*PROBSHELTER*
	(1)	(2)	(3)	(4)
Prisk	0.005***	0.004***	-0.014**	-0.006***
	(0.002)	(0.001)	(0.006)	(0.002)
Controls	Yes	Yes	Yes	Yes
Firm FE	Yes	Yes	Yes	Yes
Industry × Year FE	Yes	Yes	Yes	Yes
Observations	29,497	31,312	37,960	42,818
Adjusted R-squared	0.315	0.260	0.609	0.877

Panel G: Persistence of political risk measure	*CETR*	*GETR*	*DTAX*	*PROBSHELTER*
	(1)	(2)	(3)	(4)
Prisk_3yr	0.006**	0.005**	-0.017*	-0.006***
	(0.002)	(0.002)	(0.009)	(0.001)
Controls	Yes	Yes	Yes	Yes
Firm FE	Yes	Yes	Yes	Yes
Industry × Year FE	Yes	Yes	Yes	Yes
Observations	32,899	34,975	41,740	47,052
Adjusted R-squared	0.308	0.255	0.605	0.876
	CETR	*GETR*	*DTAX*	*PROBSHELTER*
	(1)	(2)	(3)	(4)
Prisk_5yr	0.008***	0.005**	-0.015	-0.005***
	(0.003)	(0.002)	(0.011)	(0.002)
Controls	Yes	Yes	Yes	Yes
Firm FE	Yes	Yes	Yes	Yes
Industry × Year FE	Yes	Yes	Yes	Yes
Observations	31,086	33,010	38,469	43,426
Adjusted R-squared	0.300	0.245	0.597	0.876

Table 3 Panel A shows estimates from the following regression:
$Tax\ Avoidance_{it} = \beta_0 + \beta_1 Prisk_{it-1} + \sum \beta_k Control_{it} + Firm\ FE + Industry \times Year\ FE + \varepsilon_{it}$,
where *i* indexes the firm and *t* indexes the year. *Tax Avoidance* takes on one of four proxies: *CETR*, *GETR*, *DTAX*, and *PROBSHELTER*. *Prisk* is the firm-level political risk measure from Hassan, Hollander, van Lent and Tahoun (2019) and is standardized by its standard deviation. Standard errors are clustered by firm. Panel B clusters standard errors by firm and year. Panel C replaces the firm and industry-by-year fixed effects in the model with firm and year fixed effects, where industry classification follows Fama-French 48. Panel D uses two-digit SIC code for industry classification. Panel E presents the regression results based on a balanced sample. Panel F excludes observations during the financial crisis between 2007 and 2008. Panel G measures *Prisk* based on a 3- and 5-year average. See Appendix A for detailed variable definitions. Continuous measures are winsorized at the 1% on each tail. Standard errors are reported in brackets. ∗, ∗∗, and ∗∗∗ represent statistical significance at the 10%, 5%, and 1% level, respectively.

Table 4: Addressing Omitted Variable Concerns

Panel A: CETR	Add *Ret_vol*	Add *EPU*	Add *Sentiment*	Add *Nprisk*	Add all
	(1)	(2)	(3)	(4)	(5)
Prisk	0.005***	0.005**	0.004***	0.004***	0.004***
	(0.002)	(0.002)	(0.001)	(0.001)	(0.001)
Ret_vol	-0.211				-0.184
	(0.236)				(0.398)
EPU_firm		-0.016			-0.014
		(0.016)			(0.021)
Sentiment			-0.015***		-0.015***
			(0.002)		(0.003)
Nprisk				0.003**	0.004**
				(0.001)	(0.002)
Controls	Yes	Yes	Yes	Yes	Yes
Firm FE	Yes	Yes	Yes	Yes	Yes
Industry × Year FE	Yes	Yes	Yes	Yes	Yes
Observations	30,842	20,910	33,624	33,624	20,900
Adjusted R-squared	0.312	0.295	0.312	0.310	0.298

Panel B: GETR	Add *Ret_vol*	Add *EPU*	Add *Sentiment*	Add *Nprisk*	Add all
	(1)	(2)	(3)	(4)	(5)
Prisk	0.003***	0.004***	0.003**	0.003**	0.003**
	(0.001)	(0.002)	(0.001)	(0.001)	(0.002)
Ret_vol	-0.780***				-0.494
	(0.225)				(0.371)
EPU_firm		-0.030**			-0.012
		(0.015)			(0.019)
Sentiment			-0.005***		-0.006***
			(0.002)		(0.002)
Nprisk				0.003*	0.002*
				(0.001)	(0.001)
Controls	Yes	Yes	Yes	Yes	Yes
Firm FE	Yes	Yes	Yes	Yes	Yes
Industry × Year FE	Yes	Yes	Yes	Yes	Yes
Observations	32,469	21,337	35,807	35,807	21,327
Adjusted R-squared	0.267	0.258	0.258	0.258	0.259

Panel C: DTAX	Add *Ret_vol*	Add *EPU*	Add *Sentiment*	Add *Nprisk*	Add all
	(1)	(2)	(3)	(4)	(5)
Prisk	-0.014**	-0.014*	-0.015***	-0.013**	-0.011**
	(0.006)	(0.007)	(0.005)	(0.006)	(0.005)
Ret_vol	1.059				1.562
	(0.669)				(1.210)
EPU_firm		-0.010			-0.071
		(0.042)			(0.061)
Sentiment			-0.008		-0.003
			(0.006)		(0.008)
Nprisk				-0.009*	-0.010*
				(0.005)	(0.006)
Controls	Yes	Yes	Yes	Yes	Yes
Firm FE	Yes	Yes	Yes	Yes	Yes
Industry × Year FE	Yes	Yes	Yes	Yes	Yes
Observations	38,706	24,410	43,379	43,379	24,083
Adjusted R-squared	0.605	0.595	0.599	0.600	0.596

Panel D: PROBSHELTER	Add *Ret_vol*	Add *EPU*	Add *Sentiment*	Add *Nprisk*	Add all
	(1)	(2)	(3)	(4)	(5)
Prisk	-0.006***	-0.005***	-0.006***	-0.006***	-0.005***
	(0.001)	(0.001)	(0.001)	(0.001)	(0.001)
Ret_vol	-0.355***				-0.205
	(0.113)				(0.181)
EPU_firm		-0.013*			-0.003
		(0.007)			(0.009)
Sentiment			0.006***		0.005***
			(0.001)		(0.001)
Nprisk				-0.002**	-0.001*
				(0.001)	(0.001)
Controls	Yes	Yes	Yes	Yes	Yes
Firm FE	Yes	Yes	Yes	Yes	Yes
Industry × Year FE	Yes	Yes	Yes	Yes	Yes
Observations	33,624	29,145	48,948	48,948	29,112
Adjusted R-squared	0.879	0.888	0.877	0.878	0.888

Table 4 Panels A, B, C, and D present the regression results using *CETR*, *GETR*, *DTAX*, and *PROBSHELTER* as the dependent variable, respectively, with additional control variables one-by-one in columns (1) – (4) and alongside in columns (5). The additional control variables include return volatility (*Ret_vol*), firm-level economic policy uncertainty (*EPU_firm*), firm-level political sentiment (*Sentiment*), and non-political risk (Nprisk). See Appendix A for detailed variable definitions. Standard errors, clustered by firm, are reported in brackets. ∗, ∗∗, and ∗∗∗ represent statistical significance at the 10%, 5%, and 1% level, respectively.

Table 5: PSM

Panel A: Pre-matching	Treatment sample		Control sample		Difference	
	Mean	Std	Mean	Std	Mean	t-Stat
	(1)	(2)	(3)	(4)	(5)	(6)
Size	6.590	2.192	6.479	1.925	0.111**	2.11
Leverage	0.212	0.250	0.232	0.265	-0.020***	-3.65
ROA	-0.038	0.284	0.010	0.225	-0.049***	-8.76
Cash Flow	0.024	0.232	0.066	0.181	-0.042***	-9.44
Sale Growth	0.065	0.241	0.104	0.257	-0.040***	-9.99
Capex	0.052	0.068	0.058	0.069	-0.005***	-3.87
R&D	0.080	0.146	0.054	0.113	0.026***	8.74
MTB	2.954	2.665	2.866	2.496	0.088	1.64
PPE	0.271	0.284	0.285	0.273	-0.015**	-2.24
Δ*NOL*	0.096	0.355	0.055	0.280	0.041***	7.55
Foreign	0.437	0.496	0.471	0.499	-0.034***	-2.88
Observations	10,172		10,173			
Panel B: Post-matching	Treatment sample		Control sample		Difference	
	Mean	Std	Mean	Std	Mean	t-Stat
	(1)	(2)	(3)	(4)	(5)	(6)
Size	7.026	1.755	7.052	1.698	-0.026	-0.49
Leverage	0.218	0.232	0.221	0.228	-0.003	-0.41
ROA	0.100	0.104	0.099	0.096	0.001	0.37
Cash Flow	0.125	0.097	0.122	0.090	0.003	1.17
Sale Growth	0.097	0.210	0.101	0.203	-0.005	-0.99
Capex	0.056	0.067	0.056	0.060	0.001	0.36
R&D	0.030	0.064	0.031	0.063	-0.000	-0.16
MTB	2.898	2.338	2.939	2.317	-0.041	-0.63
PPE	0.286	0.282	0.283	0.254	0.003	0.35
Δ*NOL*	0.004	0.126	0.003	0.115	0.001	0.57
Foreign	0.530	0.499	0.526	0.499	0.003	0.22
Observations	4,627		4,627			

Panel C: OLS results of PSM sample	*CETR*	*GETR*	*DTAX*	*PROBSHELTER*
	(1)	(2)	(3)	(4)
Prisk	0.004***	0.003**	-0.014**	-0.010***
	(0.001)	(0.001)	(0.006)	(0.002)
Leverage	0.016	-0.013	0.003	-0.255***
	(0.023)	(0.020)	(0.121)	(0.014)
Size	0.022***	0.024**	0.024	0.091***
	(0.007)	(0.009)	(0.032)	(0.002)
ROA	-0.108**	0.352***	0.402	0.836***
	(0.048)	(0.053)	(0.232)	(0.042)
R&D	0.121	-0.182	0.198	0.064
	(0.112)	(0.182)	(0.128)	(0.106)
Capex	0.153**	-0.046	-0.353*	0.022
	(0.068)	(0.066)	(0.185)	(0.045)
MTB	0.000	-0.001	-0.005**	-0.000
	(0.000)	(0.000)	(0.002)	(0.000)
PPE	-0.048	0.002	0.001	0.010
	(0.038)	(0.036)	(0.112)	(0.020)
Sale Growth	-0.064***	-0.016	0.027	-0.004
	(0.018)	(0.013)	(0.059)	(0.009)
Cash Flow	-0.276***	-0.124**	-0.230	-0.101***
	(0.049)	(0.045)	(0.215)	(0.033)
Δ*NOL*	0.015	0.002	0.400*	0.533***
	(0.023)	(0.031)	(0.193)	(0.041)
Foreign	0.002	0.002	-0.026	0.268***
	(0.012)	(0.010)	(0.057)	(0.008)
Constant	0.118**	0.091	-0.109	-0.059
	(0.055)	(0.065)	(0.233)	(0.034)
Firm FE	Yes	Yes	Yes	Yes
Industry × Year FE	Yes	Yes	Yes	Yes
Observations	9,254	9,254	9,254	9,254
Adjusted R-squared	0.288	0.250	0.611	0.897

Table 5 presents statistics of propensity-score matching. Panel A presents the sample statistics of firm characteristics before matching. Columns (1) and (2) show the sample mean and standard deviation of the treated group; Columns (3) and (4) show the sample mean and standard deviation of the control group; and Columns (5) and (6) show the mean differences between the two groups and the t-statistics. Panel B presents the sample statistics of firm characteristics after matching. Panel C shows the regression estimates of the effect of political risk on tax avoidance using the propensity-score matched sample. See Appendix A for detailed variable definitions. Standard errors, clustered by firm, are reported in brackets. ∗, ∗∗, and ∗∗∗ represent statistical significance at the 10%, 5%, and 1% level, respectively.

Table 6: Natural Experiment – U.S. Presidential Election Cycles

Panel A: Presidential elections and political risk	*Prisk* (1)	*Prisk* (2)	*Prisk* (3)
ElectionYearDummy	0.029***		0.028***
	(0.008)		(0.009)
PostElectionDummy		-0.012**	-0.011*
		(0.005)	(0.006)
Constant	1.034***	1.054***	1.036***
	(0.084)	(0.104)	(0.085)
Controls	Yes	Yes	Yes
Firm FE	Yes	Yes	Yes
Observations	50,863	50,863	50,863
Adjusted R-squared	0.302	0.302	0.302

Panel B: Presidential elections and tax avoidance	*CETR* (1)	*GETR* (2)	*DTAX* (3)	*PROBSHELTER* (4)
ElectionYearDummy	0.010***	0.012***	-0.164***	-0.008***
	(0.003)	(0.003)	(0.019)	(0.001)
PostElectionDummy	-0.007***	-0.008***	0.073***	0.002*
	(0.002)	(0.002)	(0.013)	(0.001)
Term	0.012***	0.020***	-0.093***	-0.007***
	(0.003)	(0.003)	(0.021)	(0.002)
Def	0.005	-0.007	0.952***	0.018***
	(0.006)	(0.005)	(0.037)	(0.003)
Tb	0.015***	0.013***	-0.011	-0.008***
	(0.002)	(0.002)	(0.012)	(0.001)
GDP-Growth	-0.006***	-0.002*	0.171***	-0.002***
	(0.001)	(0.001)	(0.009)	(0.001)
Controls	Yes	Yes	Yes	Yes
Firm FE	Yes	Yes	Yes	Yes
Industry × Year FE	No	No	No	No
Observations	33,624	35,807	43,379	48,948
Adjusted R-squared	0.294	0.239	0.067	0.876
Tests for linear combinations of coefficients				
ElectionYearDummy + *PostElectionDummy*	0.003	0.004	-0.091***	-0.006***
t-statistic	0.76	1.10	-3.24	-2.60

Table 6 Panel A shows the effect of U.S. presidential elections on *Prisk*. *ElectionYearDummy* takes the value of one for election years, and zero otherwise. *PostElectionDummy* equals one for the year

immediately following an election, and zero otherwise. Panel B presents estimation results for the following regression:

$$Tax\ Avoidance_{it} = \beta_0 + \beta_1 ElectionYearDummy_t + \beta_2 PostElectionDummy_t + \sum \beta_k Control_{it} + Firm\ FE + \varepsilon_{it},$$

where *i* indexes the firm and *t* indexes the year. *Tax Avoidance* takes on one of four proxies: *CETR*, *GETR*, *DTAX*, and *PROBSHELTER*. See Appendix A for detailed variable definitions. Standard errors, clustered by firm, are reported in brackets. $*$, $**$, and $***$ represent statistical significance at the 10%, 5%, and 1% level, respectively.

Table 7: Channels - Tax Expense and Permanently Reinvested Earnings

	Tax Expense	*PRE*
	(1)	(2)
Prisk	-0.007***	-0.004***
	(0.003)	(0.001)
Leverage	0.032	0.033***
	(0.021)	(0.011)
Size	-0.142***	-0.017***
	(0.010)	(0.006)
ROA	-0.099***	0.068***
	(0.033)	(0.016)
R&D	0.495***	0.055
	(0.100)	(0.064)
Capex	0.150**	0.063
	(0.066)	(0.048)
MTB	0.001	-0.001**
	(0.001)	(0.000)
PPE	-0.018	0.063**
	(0.028)	(0.026)
Sale Growth	0.092***	-0.001
	(0.015)	(0.006)
Cash Flow	0.025	0.066***
	(0.039)	(0.023)
ΔNOL	0.009	0.010
	(0.015)	(0.009)
Foreign	0.040***	-0.010
	(0.014)	(0.007)
Constant	1.161***	0.260***
	(0.069)	(0.050)
Firm FE	Yes	Yes
Industry × Year FE	Yes	Yes
Observations	45,758	10,624
Adjusted R-squared	0.564	0.816

Table 7 reports regression estimates using *Tax Expense* in column (1) and *PRE* in column (2) as the dependent variable. *Tax Expense* is the total tax fees paid to the auditors, scaled by total assets. *PRE* is the amount of foreign income designated as permanently reinvested earnings. See Appendix A for detailed variable definitions. Standard errors, clustered by firm, are reported in brackets. ∗, ∗∗, and ∗∗∗ represent statistical significance at the 10%, 5%, and 1% level, respectively.

Table 8: Active Political Risk Management – Lobbying Activities

	Lobbying	*CETR*	*GETR*	*DTAX*	*PROBSHELTER*
	(1)	(2)	(3)	(4)	(5)
Prisk	0.069**	0.006**	0.005**	-0.023**	-0.007***
	(0.030)	(0.003)	(0.002)	(0.012)	(0.002)
Prisk × *Lobbying*		-0.002**	-0.001*	0.006***	0.002**
		(0.001)	(0.000)	(0.002)	(0.001)
Lobbying		-0.004	-0.004	0.014	0.003
		(0.006)	(0.006)	(0.024)	(0.003)
Leverage	0.436**	0.010	-0.026***	0.042	-0.228***
	(0.163)	(0.009)	(0.008)	(0.056)	(0.007)
Size	1.098***	0.027***	0.016***	0.062***	0.078***
	(0.066)	(0.004)	(0.004)	(0.019)	(0.002)
ROA	0.047	-0.157***	0.320***	0.813***	0.752***
	(0.263)	(0.025)	(0.025)	(0.088)	(0.015)
R&D	0.316	0.178***	-0.090	-0.466*	0.305***
	(0.588)	(0.063)	(0.055)	(0.242)	(0.030)
Capex	1.261	0.185***	-0.059*	-0.332**	0.055***
	(0.789)	(0.038)	(0.034)	(0.145)	(0.020)
MTB	-0.021	-0.002**	-0.003***	-0.006	-0.000
	(0.014)	(0.001)	(0.001)	(0.004)	(0.000)
PPE	-0.177	-0.014	0.041**	0.066	0.036***
	(0.318)	(0.016)	(0.015)	(0.069)	(0.010)
Sale Growth	0.443***	-0.065***	-0.025***	0.016	-0.002
	(0.142)	(0.008)	(0.006)	(0.034)	(0.004)
Cash Flow	-0.494	-0.273***	-0.159***	-0.141	-0.128***
	(0.325)	(0.025)	(0.022)	(0.110)	(0.015)
Δ*NOL*	0.086	0.016	-0.007	0.318***	0.496***
	(0.106)	(0.010)	(0.011)	(0.042)	(0.007)
Foreign	-0.197*	-0.004	-0.006	-0.312	0.244***
	(0.110)	(0.005)	(0.005)	(0.238)	(0.005)
Firm FE	Yes	Yes	Yes	Yes	Yes
Year FE	Yes	Yes	Yes	Yes	Yes
Observations	50,863	33,624	35,807	43,379	48,948
Adj./ Pseudo R-squared	0.260	0.308	0.258	0.599	0.876

Table 8 column (1) reports estimated results using a Logit regression of *Lobbying* on *Prisk*. *Lobbying* is an indicator variable that equals one if a firm reports any lobbying expense, and zero otherwise. Columns (2) – (5) shows the OLS regression estimates using the four proxies of tax avoidance and include *Lobbying* and an interaction term between *Prisk* and *Lobbying*. See Appendix A for detailed variable definitions. Standard errors, clustered by firm, are reported in brackets. ∗, ∗∗, and ∗∗∗ represent statistical significance at the 10%, 5%, and 1% level, respectively.

Table 9: Cross-Sectional Results

Panel A: Tax planning capacity	Num. of Segments			Multinational Firm			Tax Haven		
	High	Low	Diff-test	Yes	No	Diff-test	Yes	No	Diff-test
	(1)	(2)	(p-value)	(3)	(4)	(p-value)	(5)	(6)	(p-value)
CETR	0.007***	0.002	2.16*	0.008***	0.003	2.35**	0.006**	0.003**	1.94*
	(0.002)	(0.002)	(0.06)	(0002)	(0.004)	(0.02)	(0.002)	(0.001)	(0.07)
GETR	0.005**	0.001	1.91*	0.005**	0.002	1.91*	0.007**	0.003*	1.96*
	(0.002)	(0.001)	(0.08)	(0.001)	(0.002)	(0.06)	(0.002)	(0.002)	(0.06)
DTAX	-0.018**	0.003	2.11**	-0.016***	-0.002	2.28**	-0.014**	-0.010	1.35
	(0.008)	(0.004)	(0.04)	(0.006)	(0.005)	(0.02)	(0.005)	(0.007)	(0.15)
PROBSHELTER	-0.009***	-0.006**	1.72*	-0.007***	-0.004*	2.15**	-0.008***	0.001	3.93***
	(0.002)	(0.002)	(0.08)	(0.001)	(0.002)	(0.03)	(0.001)	(0.002)	(0.01)
Controls	Yes		Yes	Yes		Yes	Yes		Yes
Firm FE	Yes		Yes	Yes		Yes	Yes		Yes
Industry × Year FE	Yes		Yes	Yes		Yes	Yes		Yes

Panel B: Political sensitivity	Size			Politically Sensitive Industries		
	Large	Small	Diff-test	Yes	No	Diff-test
	(1)	(2)	(p-value)	(3)	(4)	(p-value)
CETR	0.005***	0.003	1.79*	0.007*	0.004	0.95
	(0.001)	(0.002)	(0.09)	(0.004)	(0.003)	(0.29)
GETR	0.006**	0.004	1.68	0.004**	0.003	0.58
	(0.002)	(0.004)	(0.12)	(0.002)	(0.002)	(0.42)
DTAX	-0.015**	-0.011*	2.06*	-0.023***	-0.013*	2.75***
	(0.006)	(0.006)	(0.06)	(0.009)	(0.006)	(0.01)
PROBSHELTER	-0.009***	-0.005	2.79**	-0.007***	-0.005*	1.85*
	(0.002)	(0.003)	(0.02)	(0.001)	(0.003)	(0.09)
Controls	Yes		Yes	Yes		Yes
Firm FE	Yes		Yes	Yes		Yes
Industry × Year FE	Yes		Yes	Yes		Yes

Panel C: Corporate governance	Analyst Coverage			Institutional Holding		
	High	Low	Diff-test	High	Low	Diff-test
	(1)	(2)	(p-value)	(3)	(4)	(p-value)
CETR	0.006**	0.004**	0.69	0.005***	0.005**	0.03
	(0.002)	(0.002)	(0.49)	(0.002)	(0.002)	(0.98)
GETR	0.003**	0.003**	0.04	0.004**	0.004*	0.13
	(0.002)	(0.002)	(0.96)	(0.002)	(0.002)	(0.89)
DTAX	-0.018**	-0.013**	0.52	-0.018**	-0.013*	0.34
	(0.008)	(0.007)	(0.60)	(0.007)	(0.007)	(0.74)
PROBSHELTER	-0.007***	-0.006***	0.12	-0.008***	-0.006**	1.43
	(0.001)	(0.001)	(0.90)	(0.002)	(0.001)	(0.15)
Controls	Yes	Yes		Yes	Yes	
Firm FE	Yes	Yes		Yes	Yes	
Industry × Year FE	Yes	Yes		Yes	Yes	

Table 9 explores cross-sectional differences of the effect of political risk on tax avoidance. Panel A compares firms with high and low tax planning capacity, which is captured by one of three measures: number of segments, whether a firm is a multinational firm, and the existence of a tax haven. Panel B compares firms with high and low political sensitivity, which is measured by one of two measures: firm size and whether a firm operates in a politically-sensitive industry. Panel C compares firms with strong and weak corporate governance, which is proxied by analyst coverage and institutional holding. See Appendix A for detailed variable definitions. Standard errors, clustered by firm, are reported in brackets. ∗, ∗∗, and ∗∗∗ represent statistical significance at the 10%, 5%, and 1% level, respectively.