The Revolving Door and Regulatory Enforcement

– Firm-level Evidence on Tax Rates and IRS Audits

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The Revolving Door and Forbearance

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• I show: IRS less like to audit firms with legislators on staff.
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- Firms pay big money to hire former legislators.
  1. Forbearance is a powerful instance of regulatory capture.
  2. Differential enforcement is costly & raises equity concerns.
- Obstacles to inference:
  1. No public data on IRS’s firm-level enforcement.
  2. Not random which firms hire legislators.
Preview of Approach and Results

• New data matching firm finances to:
  – Careers of former Members of Congress (MCs).
  – Hand-collected data on IRS audits from 10-Ks.

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• Diff-in-diff design: Only sample firms that hire legislators.

Hiring a legislator is related to:

• Lower effective tax rates.
• Lower probability of being audited by the IRS.
• MCs with oversight and many connections behind effects.
Three Components of the Theory

Why are legislators valuable?

- They know how to navigate the bureaucracy → can be leveraged by employer to avoid enforcement.
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→ Other possible mechanisms: ‘flexing muscle’, trust.
Identification

Not random which firms hire former legislators.

- Sampling firms, then identifying connections will place never-connected firms in the control group.
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Instead:

- Focus only on firms that hire MCs.
- Trends of firms that become connected vs. firms that already are, or will be soon.
- ID: trends evolve parallel if firm chose to hire at different time.
- Timing unrelated to trends in unobserved conditions.
We need data from a wide variety of sources:

- Firms that hire legislators:
  - Start from list of retiring MCs, identify firms that employ them.
  - Sources: Bloomberg CVs, EDGAR, press releases, press coverage, LinkedIn, Wikipedia.
  - Data on 89 MCs hired by 264 publicly listed firms 2004-2015.
Data for Main results

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- **IRS enforcement:**
  - Manually comb through ≈ 2,500 10-K reports.
  - Code indicator for whether an IRS audit of the firm is initiated.
Model specification

- Revolving Door: first year a former MC is employed coded 1.
- GAAP Effective Tax Rate. One-year lead, log transformed.
- Firm + year fixed effects – difference-in-differences w/ variation in timing (see Goodman-Bacon 2018).
- Firm-level finances: collected through Datastream.
The Raw Correlation
The Argument
Research Design
Main Results
More Implications
Summing Up

Average results

No Controls
Controls for Size
Controls for Performance
Controls for Market Attention
Exact Match on Pre-Tax and Sector
Next Year's Treated as Control

Baseline
Placebo
Average results

-30% -20% -10% 0% 10%

Coefficient on Revolving Door

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Baseline
Placebo
Political Connections and IRS Enforcement

![Graph showing coefficients on Revolving Door with placebo and baseline comparisons.](image-url)
Connections or other non-market strategies?

- Revolving door is one of many non-market strategies.
- If strategies are correlated, difficult to infer that the legislator is effective.
Connections or other non-market strategies?

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I present three sets of evidence:

1. The effect is driven by the connectedness of the legislator.
2. Revolving door is unrelated to lobbying activities.
3. Foreign firms that hire MCs do not experience decreased tax rates.
Measuring Legislator ‘Connectedness’

Revolver’s history with the IRS

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Revolver’s history with the IRS


Revolver’s connectedness

- Collect all bills sponsored for all Congresses in the period 102nd-113th
- Construct cosponsorship networks for each Congress.
- Average betweenness score proxies connections to different blocs in Congress.
Connected legislators drive the effect

A and B: Twoway interactions

A: Committee with oversight of IRS

B: Connectedness of MC

C and D: Threeway interaction

C: Connectedness - No oversight

D: Connectedness and oversight
Connected Firms Do Not Lobby More
Connected Firms Do Not Lobby More

- A: Extensive Margin
- B: Intensive: # Contacts
- C: Intensive: Expenditure

Revolving Door
Oversight=Yes
Revolving Door
Revolving Door X
Oversight
Revolving Door
| Oversight=Yes

Estimate

-0.05 0.00 0.05 -0.2 -0.1 0.0 0.1 -1.5 -1.0 -0.5 0.0 0.5 1.0
Using Foreign Firms as Placebo Sample
Using Foreign Firms as Placebo Sample

- No Controls
- Controls for Size
- Controls for Performance
- Controls for Market Attention
- Exact Match on Pre-Tax and Sector

Coefficient on Revolving Door

-20% 0% 20% 40%
• Rule changes could impact enforcement.
• If so, rule change – not forbearance – could cause observed patterns.
Enforcement or Rule Change?

- Rule changes could impact enforcement.
- If so, rule change – not forbearance – could cause observed patterns.

We would expect:
1. Tax drop to diffuse to other firms in the same industry.
2. Tax depreciation schedules tailored to the firm’s asset portfolio (Richter et al. 2009).
3. Persist for a relatively long period of time.
Positive Diffusion, No Heterogeneities

Coefficient

-0.1 0.0 0.1

Neighborhood Effect

Capital Intensity X Revolving Door

Size X Revolving Door

Returns on Assets X Revolving Door

Employees X Revolving Door

Intro  The Argument  Research Design  Main Results  More Implications  Summing Up
The Effect is Short-Lived
• Hiring revolver related to lower tax rates, because tax law is enforced more leniently.
• Decrease is largest among best connected former politicians.
• Not driven broad rule changes or other non-market strategies.
My future work will focus on:

1. Why the IRS reacts to political connections.
2. Does revolving door have similar effects in other regulatory spaces?

Covariate Balance

Wald p−value = 0.752
Adjusted $R^2 = -0.2$

Lag Tax Rate
Lag Total Capital
Lag Total Assets
Lag Enterprise Value
Lag # Employees
Lag $ Profit
Lag Gross Income
Lag Stock Turnover
Lag Stock Market Value
Lag Stock Price

Coefficient Estimate
(90 % confidence intervals)

Points
-6 -4 -2 0 2 4 6

Points
Robustness to FE Weighting Problems

Baseline

Average ATT

Event-by-Event

2-by-2 DiD

Estimate
Table: Robustness to Alternative Measure of Aggressiveness

<table>
<thead>
<tr>
<th></th>
<th>Tax Rate</th>
<th>Book-Tax Difference</th>
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<tbody>
<tr>
<td>Revolving Door</td>
<td>−0.076*</td>
<td>0.058**</td>
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<tr>
<td></td>
<td>(0.030)</td>
<td>(0.021)</td>
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<td>Firm Fixed Effects?</td>
<td>Yes</td>
<td>Yes</td>
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<td>Year Fixed Effects?</td>
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Note: *p<0.05; **p<0.01