Discussion of "The Cost of Misaligned Tax Incentives: Evidence from Tax-Motivated Special Dividends"

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Discussion by

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Paper overview

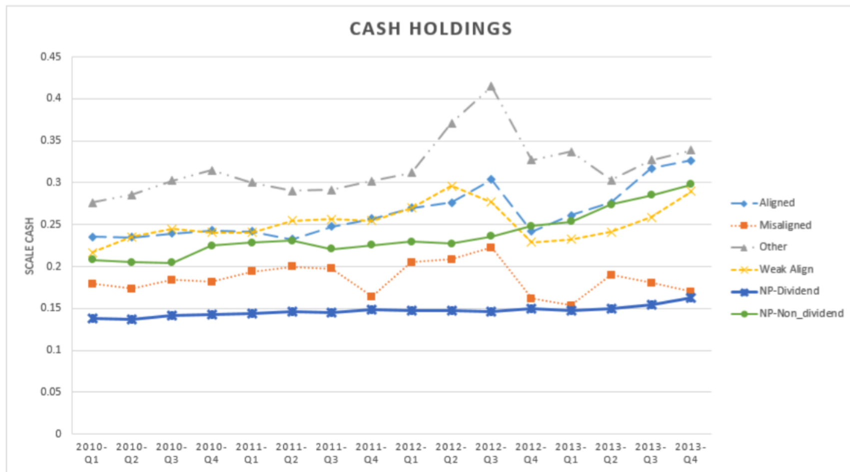
- Punchline: agency problems affect how firms finance tax-motivated dividends (TMDs)
- Three main results:
  1. Firms *do* reduce investments to fund TMDs
  2. Depends on incentive alignment between shareholders and insiders: weakly aligned reduce CAPEX while misaligned reduce R&D
  3. Abnormal returns around TMDs are *higher* for firms with aligned incentives
- Combine standard datasets (CRSP-COMPUSTAT/SEC EDGAR/ExecuComp) and use the expiration of the Bush dividend tax cuts around 2013 as policy experiment

Comment #1: credit access/liquidity vs. ownership structure

- Are firms "aligned" simply because they are early in the life cycle and therefore don't have access to bank lines of credit?
- More general point: can we separate the ownership structure from financing frictions?
- Paper does not show results for cash holdings or other measures of liquidity beyond Figure 4, which shows the aligned have a 10 p.p. higher cash share than misaligned
- Standard pecking order theory: cash $\succ$ debt $\succ$ equity
  - Misaligned firms: large, but low cash and high leverage $\Longrightarrow$ issue debt and cut R&D because lower capacity to self-finance and credit limit may bind (Table 4.B)
  - Aligned firms are smaller, have low leverage but have more cash relative to assets $\Longrightarrow$ don't need to make the same cuts other firms do (Table 5)

Comment #1: aligned firms have higher cash holdings

Figure 4 – Cash Holdings over Time



Cash holdings represent cash and cash equivalents scaled by average 2011 assets. Tax-motivated dividend payers are split into *ALIGNED*, *MISALIGNED*, *WEAK_ALIGN*, and *OTHER*. Other firms that do not pay tax-motivated special dividends (non-paying [NP]) are split into Q4 2012 regular dividend payers (NP-Dividend) and non-payers (NP-Non_Dividend).

Comment #1: credit access/liquidity vs. ownership structure

- How much of the heterogeneity in tax-motivated dividends is due to financing constraints?

$$SPECIAL_PAID_{i,2012Q4} = \beta_1 \cdot CHEQ_{i,2011} + \beta_2 \cdot EXEC_{i,2011} \times TII_{i,2011} + \varepsilon_i$$

$$SPECIAL_PAID_{i,2012Q4} = \beta_1 \cdot HP_{i,2011} + \beta_2 \cdot EXEC_{i,2011} \times TII_{i,2011} + \varepsilon_i$$

- Where *HP* refers to a commonly used liquidity measure in the CF literature like Hadlock-Pierce (2010) index of age/size
- Does the loading on the alignment factor survive controls for liquidity?
- Or, if run DID specifications and control for cash, do we see similar investment responses?

Comment #2: how much policy uncertainty is there really?

- As of 2012Q4 uncertainty is on the size of the tax hike, not whether hike will occur
- Important for how we interpret the pre-trends or lack thereof in the event studies
- Timing of the response differs by category
  - Pre-trend for CAPEX but two-quarter lag for R&D spending cut
  - Are external monitors less uncertain about the dividend tax hike?
  - Debt issuance only spikes in 2013Q3 (why?)
- What do the event studies look like for each alignment group? (drop industry FEs)

Comment #3: generalized pecking order theory

- Standard pecking order theory of Myers & Majluf (1984) emphasizes role of asymmetric information between insiders and outsiders for financing sources
- This paper: firms can also finance payouts by cutting R&D spending or CAPEX
- What is the full pecking order when we account for competing tax incentives?
- My interpretation of the results:
  1. Aligned (standard): cash $\succsim$ debt $\succsim$ equity $\succsim$ CAPEX $\succsim$ R&D
  2. Weakly aligned: cash $\succsim$ CAPEX $\succsim$ equity $\succ$ debt $\succsim$ R&D
  3. Misaligned: cash $\succsim$ debt $\succ$ R&D $\succ$ CAPEX $\succsim$ equity

Comment #3: generalized pecking order theory

- Other loose ends: what is special about the distinction between R&D and PPE?
  - Argument here: managers in misaligned firms are myopic and view R&D as a "slush fund"
- But other motivations for pecking order between CAPEX and R&D investment:
  - Harder to reverse PPE investments (e.g. purchasing land/machines)
  - Bonus depreciation and other tax incentives for tangibles
  - R&D expensed immediately
- Really need to nail down financing constraints to interpret the results as corporate preferences over different options for funding dividend payouts

Minor comments & extensions

- Robustness: scale CAPEX by total assets like rest of the outcome variables, winsorizing both outcome variables and special dividend payouts
- Closer link to literature on whether investment goes up or down w.r.t. payout taxation?
  - Moon (2019 JMP): old vs. new view in public finance (cash constraints matter!)
  - This paper: old view holds since anticipated dividend tax hike $\implies$ investment cuts
- More discussion on how alignment status is measured
  - Off-the-shelf method but some description so reader knows whether correlations with balance sheet variables in Table 2 are purely mechanical
  - What is a tax-insensitive institution (TII)?
- Other heterogeneity: tangible vs. intangible capital intensiveness of the firm? Does production function dictate ownership structure?

Overall assessment

- Very interesting paper with careful data work!
- Main contribution appears to be more on the corporate finance rather than the public finance side (link between alignment and real investment decisions)
- Paper could benefit from some bigger framing
  - Not just a story about how firms respond to tax incentives
  - More generally about when shock to returns, what has to change in the corporate budget constraint to compensate stakeholders?
  - Really gets at some big questions in corporate finance: when does Modigliani-Miller not hold, and is there heterogeneity in the pecking order?