CEO Incentives and Tax Avoidance

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Abstract

An increasingly important component of corporate social responsibility is corporate tax responsibility, i.e., the extent to which a company pays its fair share of taxes. We develop a model of a company where the shareholders may care about corporate tax responsibility, but the CEO does not. We show that when shareholders care at least to some extent about corporate tax responsibility, they condition the CEO's compensation on both before-tax and after-tax profits.

However, and surprisingly, we find that such a compensation contract may also be optimal for purely selfish shareholders. The reason is that, under quite plausible conditions, a mix of before- and after-tax profit incentives gives stronger incentives to the CEO to invest and exert effort than relying on after-tax profits only. Tax avoidance activities decline when before-tax profits play a more prominent role in the CEO incentive contract. Hence, the price to be paid for the additional investment and managerial effort is a higher tax burden of the firm.