RESEARCH BRIEF

Tax Planning Knowledge Diffusion via the Labor Market

Based on BFI Working Paper No. 2019-64, “Tax Planning Knowledge Diffusion via the Labor Market,” by John Barrios, Washington University at St. Louis & NBER; and John Gallemore, Associate Professor and Charles E. Merrill Faculty Scholar, Booth School of Business

KEY TAKEAWAYS

✓ Corporations have a strong incentive to lower their tax costs
✓ However, some firms are better at tax avoidance than others
✓ A key difference is the effectiveness of individual tax planners within each firm
✓ This new research reveals how and why tax planners move from firm to firm, offering insights into how tax-avoidance knowledge spreads

US corporations go to great lengths to avoid paying taxes, and some of those avoidance schemes—like moving profits to offshore tax havens—regularly make headlines. However, there are many more subtle techniques to reduce a corporation’s tax bill, and those methods are often practiced by tax accountants with firm- or industry-specific skills. Employing these tax experts can have beneficial effects and provide competitive advantages for firms.

While there has been considerable research about the determinants and consequences of corporate tax planning at a broad level, there has been little work on the impact of human capital within tax departments. Specifically, what is the labor market’s role in facilitating the exchange of tax-planning knowledge among firms? That is a motivating question for John Barrios and John Gallemore in their paper, “Tax Planning Knowledge Diffusion via the Labor Market.”
Barrios and Gallemore reveal that tax-related human capital is often specific in nature, with corporations seeking employees with experience gained from firms similar to theirs, for example, those in the same industry, geographic location, and market scope. When those employees with specific tax-avoidance skills arrive at a new firm they tend to lower that firm's tax bill, especially if those new employees are in roles of authority.

May the best tax department win

Taxes are a significant expense for corporations, so it pays to have the best tax accountants available to reduce that cost. This puts a premium on specialized expertise that certain preparers gain within a particular industry or company. To that point, the authors define tax-related human capital as the sum of an individual's training and work experience in corporate tax departments. Their focus on the labor market stems from two general, and powerful, insights:

• Employee movements serve as an important mechanism for the diffusion of knowledge. In other words, firms rarely generate all their know-how from within. Rather, firms must turn to external sources for this knowledge, with those sources determined, in part, by firm-specific capabilities and resources. Importantly, knowledge built from experience, or tacit knowledge, is key, and this tacit knowledge is imbedded in individuals.

• Knowledge acquired via working in a corporate tax department, especially one successful in tax planning, is likely of first-order importance and tacit in nature. Simultaneously managing multiple corporate objectives—from tax minimization to efficiency and compliance issues—may require a unique set of experiences and skills that are difficult to acquire outside of a corporate tax department. Additionally, some of these skills may have greater usefulness in certain

Notes: This figure examines the pre-treatment and post-treatment dynamics in corporate tax planning around hiring tax department employees from tax aggressive firms. We estimate a simple difference-in-differences model (similar to equation 1), where we saturate the model with event-time indicator variables interacted with Hire from TA Firm, using year t-1 (the year prior to the hire) as the base period. We plot the coefficients on the interactions of Hire from TA Firm and the following time periods: year t-3, year t-2, year t (the hire year), year t+1, and year t+2. We also present 90 percent confidence intervals (blue shading) using standard errors clustered by firm.
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manage their tax planning functions, but this new work sheds light on how and why tax-related talent shifts from firm to firm, and the importance of tax-related human capital that is specific in nature. By exploring these questions, and by exploiting a robust dataset, the authors describe how a firm’s level of tax avoidance increases when hiring employees from low ETR firms. This finding also describes how tax-related human capital serves as a mechanism to spread tax-planning knowledge across firms.

For firms themselves these questions are also important, as large corporations consider whether to outsource their tax-planning functions to public accounting firms. To the degree that this outsourcing occurs, it is possible that public firms will gain specific knowledge about certain industries or practices. If so, corporations may be drawn to their services and abandon their own tax departments and this specific knowledge will disseminate more broadly.

The authors also offer evidence for the role of specialized human capital in shaping firm decisions and performance. Past research has focused on overall human capital and firm performance; however, by focusing on a specific type of human capital, Barrios and Gallemore provide new insight into the particular effects of such expertise. Finally, by exploiting employee movement between firms, the authors establish a novel methodological approach that can benefit future research.

CLOSING TAKEAWAY

Much research has been conducted on disparities among corporations, and how they manage their tax planning functions, but this new work sheds light on how and why tax-related talent shifts from firm to firm, and the importance of tax-related human capital that is specific in nature.