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Corporate Social Responsibility, Institutional Environments, and Tax Avoidance: Evidence from a Subnational Comparison in China[☆]

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ABSTRACT

We examine the association between mandatory corporate social responsibility (CSR) disclosure and economic contribution (tax payments) in China, where we expect this association to be affected by a region's institutional attributes. Exploiting a dataset that shows cross-regional variations in institutions, we find that in regions with lower institutional quality, firms claiming to be socially responsible actually avoid taxes, whereas CSR disclosure in other regions is more aligned with the social responsibility aspect of tax compliance. Our study contributes to the literature by demonstrating that in the absence of proper institutions, CSR disclosure is likely to remain a form of window dressing.

1. Introduction

Do Chinese firms that claim social responsibly fully meet their economic responsibilities (in terms of tax payments) to society? Corporate social responsibility (CSR) and the social irresponsibility of corporate tax avoidance have separately attracted a great deal of scholarly attention.¹ Studies examining the relation between CSR and tax avoidance in Australia and the U.S. report mixed results ranging from a negative relation (e.g., Hoi, Wu, & Zhang, 2013; Lanis & Richardson, 2012) to a positive relation (Davis, Guenther, Krull, & Williams, 2016).² Watson (2015) further finds that the negative/positive relation depends on whether firms have surplus

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¹ Hanlon and Heitzman (2010) call for research on the relationship between tax avoidance and environmental or social responsibility constructs. Most of the scholarship on CSR has focused on firms' strategic management, marketing, and financial economics (Park, Chidlow, & Choi, 2014; Yang & Rivers, 2009). Studies on CSR within the Asia Pacific region have focused on voluntary disclosure and its association with financial performance and market valuation (Benson, Clarkson, Smith, & Tutticci, 2015). Li, Fetscherin, Alon, Lattemann, and Yeh (2010) observe that although extensive studies have been conducted on CSR in developed countries, much less is known about CSR in emerging markets. Given that corporate tax avoidance has increased significantly since 2000 and has severe negative effects on economic development and society in general, it can be reasonably argued that tax avoidance is at least as important to society as the environment (McIntyre, Gardner, Wilkins, & Phillips, 2011).

² Tax avoidance is the most widely used term in recent scholarship (Hope et al., 2013). To date, the definition of tax avoidance is still an unsettled issue. While some types of tax avoidance are legal, such as accelerating large purchases of depreciable property to increase tax deductible expenses, others are illegal, such as deliberately omitting income and overstating deductions. We refer to tax avoidance as a firm's (legal or illegal) underreporting of their tax liabilities (Hanlon & Heitzman, 2010). We focus on a broad measure of tax avoidance (i.e., effective tax rate) that is disclosed in financial statements and is relatively easy for the general public to calculate and interpret.

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resources with which to support CSR activities. Studies suggest that a country's institutional environment affects corporate reporting behavior (Atwood, Drake, Myers, & Myers, 2012; Ball, Kothari, & Robin, 2000). For example, it affects tax avoidance (Atwood et al., 2012), perceptions of the importance of corporate ethics and tax compliance (Demirbag, Frecknall-Hughes, Glaister, & Tatoglu, 2013; Riahi-Belkaoui, 2004; Shafer, Fukukawa, & Lee, 2007; Snell & Tseng, 2002), and attitudes toward CSR (Muller & Kolk, 2015). Marquis and Qian (2013) find that regional institutional development in China influences the extent to which reported CSR activities are symbolic or substantive in nature.

Making use of a dataset that displays substantial cross-regional variations in institutions within a single country, this study examines whether there is a difference in the association between mandatory CSR reporting, as measured by an independent CSR rating agency, and tax-based corporate economic contributions to society depending on the quality of the institutional environment in which the firms operate. We argue that firms are less likely to view tax payments as an important social obligation in regions with less developed market economies, insufficient legal infrastructure and professional intermediaries, less ethical awareness and commitment to social obligations, low faith in government, and low-cost consequences of misconduct. However, these firms may engage more in other, less expensive CSR activities as a counterbalance to any negative views associated with their aggressive tax reporting. Therefore, we expect that firms in these regions may adopt more aggressive tax positions while using a less substantive CSR strategy to window dress their CSR reports. In contrast, in regions where (1) stakeholder monitoring of corporate affairs is more active, (2) people are less accepting of unethical behavior and have more faith in government institutions, (3) economic costs imposed on noncompliance with laws and social norms are higher, and (4) managers are more likely to refrain from actions that deviate from the tax obligations expected of them by society, we expect CSR-minded firms to be more likely to view taxes as complementing their CSR activities and to pay fair taxes.

China provides a good setting in which to examine the issue of cross-jurisdictional effects on social responsibility reporting practices. First, although all firms operate within a common national environment and consequently share a common national culture, there exists considerable inter-regional disparity in market development, corruption and government monitoring in business, law enforcement and investor protection, corporate trustworthiness and business behavior, and the professionalism of business intermediaries in the reporting process (Cai, Fang, & Xu, 2011; Fan, Wang, & Zhu, 2011; Li & Ma, 2015; Sun, 2014; World Bank, 2006; Zhang & Ke, 2002; Zhou, Li, Sheng, & Shao, 2014). We expect these differences to influence corporate strategies toward CSR in general and toward tax as a CSR element in particular. Our single-country study is similar to the international studies in the sense that we also exploit institutional differences, but at the subnational level.³

Second, the transition from a command economy to a market economy in China has led to many business practices that are not ethical or socially responsible (e.g., Lu, 2009; Shafer et al., 2007; Snell & Tseng, 2002). Such unethical and irresponsible practices have been specifically attributed to weaknesses in the institutional environments (such as legal systems) in China that have persisted through the country's long economic transition (e.g., Snell & Tseng, 2002; Zhou & Poppo, 2010). Finally, the evolution of CSR remains at a preliminary stage in China (Yin & Zhang, 2012), and there are substantial differences in the amount of information disclosed on specific CSR activities by Chinese firms (China WTO Tribune, 2009) that enable us to determine whether a CSR report reflects a firm's symbolic exercises or is indicative of substantive activities.⁴ These characteristics increase the likelihood that our statistical tests have sufficient power to assess the influence of the strength of a region's institutions on the association between CSR reporting and corporate action.

Following recent studies (Chen, Chen, Cheng, & Shevlin, 2010; Cheng, Lin, & Wong, 2016; Hasan, Hoi, Wu, & Zhang, 2014; Hope, Ma, & Thomas, 2013; Lanis & Richardson, 2012; Muller & Kolk, 2015; Robinson, Kises, & Weaver, 2010), we use the effective tax rate (ETR) less the firm's applicable rate as our primary measure of tax avoidance. Our use of the spread between a firm's ETR and its applicable tax rate captures deviations from the "fair share" of tax payable. To measure the level of CSR reporting, we rely on the CSR index scores from the Rankins CSR Ratings (RKS), an independent third-party social responsibility rating agency that evaluates Chinese listed firms' CSR reporting substantiveness using international reporting guidelines. We argue that the relationship between CSR reporting and corporate tax payments is moderated by the strength of the institutional environments in which firms operate.

To measure the quality of regional institutions, we use the most recent National Economic Research Institute (NERI) index of the economic marketization and legal environments of China's provinces. This index investigates the existence of market intermediaries and professionalism in a local population, the level of economic development across regions, the extent of government interference and monitoring in local economies, the maturity of debt and commodity markets, the efficiency and effectiveness of regulatory oversight and legal enforcement, and the adequacy of intellectual property and consumer rights protection. We classify a province with above-median (below-median) index scores as a region with strong (weak) institutions, and then interact this indicator variable with the firm's overall CSR rating score to examine whether the relation between ETR and CSR hinges on the quality of regional institutions.

³ International studies have been criticized for correlated omitted variable problem. For example, given cross-country differences in currency, legal system, culture, religion, politics, and laws and regulations, it is difficult to attribute the effect on tax avoidance to a cross-jurisdictional difference in a specific institutional factor (Shackelford & Shevlin, 2001). Our within-country approach overcomes some of the inherent difficulties of between-jurisdiction studies because in China there is uniformity in the tax and accounting rules, currency, state laws, and political system across regions.

⁴ For example, according to the Research Report on Corporate Social Responsibility of China issued by the national government in 2009, the top 100 Chinese enterprises received an average score of 31 (out of 100) for social responsibility, responsibility management, market responsibility, and environmental responsibility. Although 15% of the firms achieved 60 points, 40% had fewer than 20. Furthermore, during 2008–2009, only 2.4% of the CSR reports were verified by external auditors, and only 3.7% of these reports followed the GRI guidelines (Cheng et al., 2016). The lack of external verification of CSR implementation (although tax payments are subject to tax authority scrutiny) induces firms to use CSR reports for public relational purposes and thus enables us to determine whether these reports are informative.

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