G Model
WORBUS 854 No. of Pages 12

ARTICLE IN PRESS

Journal of World Business xxx (2016) xxx–xxx

Contents lists available at ScienceDirect

Journal of World Business

journal homepage: www.elsevier.com/locate/jwb

Competition and corporate tax evasion: An institution-based view☆

Omer N. Gokalp[a,*], Seung-Hyun Lee[b], Mike W. Peng[b]

[a] Suffolk University, Sawyer Business School, 120 Tremont Street, Suite 370, Boston, MA 02108, United States
[b] University of Texas at Dallas, Jindal School of Management, 800 W. Campbell Road, SM 43, Richardson, TX 75080, United States

ARTICLE INFO

Article history:
Received 24 June 2016
Received in revised form 14 December 2016
Accepted 15 December 2016
Available online xxx

Keywords:
Informal economy
Competition
Institutions
Corporate tax evasion

ABSTRACT

Why do firms evade taxes? We tackle this question by studying firms in the formal sector operating in countries with different institutional backgrounds, and comparing the incentives and constraints of staying within the formal sector against the competitive pressures originating from the informal sector. We argue that it is the combination of these factors that largely explains formal firms' tax evasion decisions. Our findings highlight the dark side of competition, particularly when it originates from perceivably unfair sources (i.e. from the informal sector). We also shed light on how this effect is moderated by the institutional conditions of the environment.

1. Introduction

In international business, the institution-based view asserts that firm behaviors around the world are affected by the rules of the game—specifically institutions that govern the "do's" and the "don'ts" (Dunning & Lundan, 2008; North, 1990; Peng, Ahlstrom, Carraher, & Shi, in press; Peng, Wang, & Jiang, 2008). However, not all firms comply with all the rules and regulations. Instead, corporate misconduct is frequent around the world. One of the most ubiquitous illegal corporate behaviors in almost every country is corporate tax evasion, which is defined as a managerial decision not to fully report taxable corporate profit in order to reduce tax payments (Sandmo, 2005).[1] Past research has identified several factors that influence the likelihood of corporate tax evasion (Andreoni, Erard, & Feinstein, 1998), such as public sector corruption (Friedman, Johnson, Kaufmann, & Zoido-Lobaton, 2000; Goerke, 2008), tax rates (Cowell, 2004; Fisman & Wei, 2004), degree of penalties (Gordon, 1990), fairness of the tax code (Cullis and Lewis, 1997), and effectiveness of corporate governance mechanisms (Desai & Dharmapala, 2006; Desai, Dyck, & Zingales, 2007). However, the interplay between formal and informal firms is underexplored in the literature (Mathias, Lux, Crook, Autry, & Zaretzki, 2015). Due to significant variations in the prevalence of the informal economy across countries, international business (IB) research would benefit from a better understanding of the dynamics of competition between these two groups of firms, and the resulting effects on formal firms' tax compliance decisions.

Specifically, what is the effect of *informal* economic activity on formal firms' tax evasion decisions? What are some boundary conditions that affect formal firms' tolerance of such informal competitive pressures? Defined as "economic activities that occur outside of formal institutional boundaries but which remain within the informal institutional boundaries for large societal groups" (Webb, Bruton, Tihanyi, & Ireland, 2012, p. 599), the informal economy operates in every country. Today the informal economy contributes between 10%–20% of the gross domestic product (GDP) in developed economies, and 40%–60% of GDP in developing economies (Godfrey, 2011; Webb et al., 2012). Informal firms are defined as "businesses that are unregistered but derive income from the production of legal goods and services" (Nichter & Goldmark, 2009, p. 1456; see also: Bruton, Ireland, & Ketchen, 2012). Following such a definition, our definition of informal firms does not include firms that are dealing with illegal goods and services (i.e. drugs, weapons that are traded outside of the law, or other sorts of criminal activity). Instead, we focus on the informal firms that transact in the market of legal products and services, albeit not complying with governments' reporting requirements. Thus, it is the means they choose to carry out their business that

☆ We thank the editor and two anonymous referees for their insightful suggestions on earlier drafts of this paper. We also thank Greg Dess, Orlando Richard, and participants at the AOM 2014 conference in Philadelphia for their helpful comments. We are indebted to the World Bank for providing the data used in this research.

* Corresponding author.
E-mail addresses: ogokalp@suffolk.edu (O.N. Gokalp), lee.1085@utdallas.edu (S.-H. Lee), mikepeng@utdallas.edu (M.W. Peng).

[1] Tax evasion is different from tax avoidance, which is defined as exploiting loopholes in tax law in order to reduce the firm's tax liability within legal boundaries (Sandmo, 2005). In other words, tax evasion is often illegal, and tax avoidance is often legal.

http://dx.doi.org/10.1016/j.jwb.2016.12.006
1090-9516/

Please cite this article in press as: O.N. Gokalp, et al., Competition and corporate tax evasion: An institution-based view, Journal of World Business (2017), http://dx.doi.org/10.1016/j.jwb.2016.12.006

situates them outside of the formal economy. On the other hand, formal firms are defined as the registered businesses bound by governments' rules and regulations.

The old view that "the informal sector is the traditional economy that will wither away with modern industrial growth" is replaced with the understanding that the informal economy is here to stay—in practically every country (Chen, 2008, p. 5). For instance, studying the size of the informal economy in 151 countries, Schneider, Buehn, and Montenegro (2010) found that on average, the share of the informal economy has remained largely the same between 1999 and 2007 (33% and 31% of GDP, respectively, as world average).

Given that informal firms are not going away, the strategies used by formal firms to cope with such "unfair" competition from the informal sector are therefore of particular interest. While the activities of informal firms circumvent any government regulation, many formal firms also locate themselves on the boundaries of formality by not fully complying with the regulatory authorities (Bruton et al., 2012). Scholars have called for research on this topic to "examine in a more nuanced way what drives the decision regarding where along the formal-informal continuum a firm chooses to locate" (Bruton et al., 2012, p. 3). We look at both informal and formal institutional factors that affect such choices. Leveraging the institution-based view (Ahuja & Yayavaram, 2011; Khanna, Palepu, & Sinha, 2005; Meyer & Peng, 2016; Peng, Sun, Pinkham, & Chen, 2009), we argue that the degree of competition from the informal economy changes the rules of competition such that formal firms must not only deal with other formal firms, but also with informal firms. Informal firms have inherent advantages through cost savings generated by circumventing government oversight in matters such as taxes, labor laws, and other regulations (Karlinger, 2014; Schneider & Enste, 2000). Formal firms may therefore refrain from fully reporting their revenues for tax purposes in an effort to survive and compete with informal competition.

Furthermore, while increased informal competition may lead firms in the formal sector to evade taxes, the efficiency of the formal institutions will likely determine the degree to which such informal competition is tolerated by firms in the formal sector. We find that when the costs of compliance with formal rules increase (i.e. a burdensome tax system), firms will lower their compliance levels to stay competitive vis-a-vis the informal sector. On the other hand, when institutions provide sufficient advantages to firms staying within the formal sector (i.e. ease of access to finance), the effects of competitive threats from the informal sector will likely be less pronounced. A firm's degree of compliance with reporting requirements while facing competition from informal firms will accordingly depend on the costs and benefits of operating within the formal sector.

This paper endeavors to make three contributions to IB research. First, we contribute to the understanding of an important corporate strategic (although illegal) decision in various countries around the world. Despite its ubiquity, corporate tax evasion has received scarce attention in the IB literature. In a comparative lens, we explore the perceived challenges with respect to informal competition and costs and benefits of staying formal in various countries to understand the dynamics of competition between formal and informal firms. Second, there is a growing literature about the dark side of competition and the requisite institutions, showing that in more competitive environments firms are more likely to behave in illicit ways (Acemoglu & Robinson, 2012). We contribute to that stream by showing the impact of informal competition above and beyond the formal competition on firm misconduct. We believe this is important since managers dealing with dysfunctional competition from "unfair" (i.e. informal) sources may perceive their illicit behavior less of an issue than firms that are dealing with formal competitive pressures. Finally, we contribute to the institution-based view of business strategy (Peng et al., 2008) by studying both informal and formal institutions with respect to their impact on firms' tax evasion decisions. This implies that with their liability of foreignness multinational enterprises (MNEs) may be in a difficult position if they naively expect just formal market competition in some countries where informal competitive pressures are strong.

2. Theory and hypotheses

2.1. Effects of competitive pressures on firm misconduct

Firms operate under varying degrees of competitive pressure within their markets. On the one hand, competition is associated with greater internal efficiency in organizations, increased incentives for innovation, and higher market efficiency by selecting out inefficient firms (Ahlstrom, 2010). On the other hand, the consequence of increased competition within a market is reduction of profits (at least in the short run). This competitive pressure leads firms to find ways to improve the bottom line and enhance chances of survival (Porter, 1990).

While the positive effects of competition such as improvements in productivity, quality, and efficiency in process designs have been amply documented, scholars have recently pointed to the negative effects of competition on firms' decision to engage in tactics that may not be market-based, and sometimes may not even be legal (Bennett, Pierce, Snyder, & Toffel, 2013; Bliss & Di Tella, 1997; Emerson, 2006; Sethi & Sama, 1998). While some firms may choose to lobby and influence regulatory agencies in order to manipulate policies for competitive advantage (Hillman, Keim, & Schuler, 2004), others may opt for illegal practices such as bribery or other forms of corrupt behavior (Lee & Weng, 2013), or they may choose to escape from regulatory oversight by hiding from the government to reduce their liabilities and costs (Cai & Liu, 2009; Fisman & Wei, 2004; Witt & Lewin, 2007). The latter is of specific concern, because unlike other strategies, tax evasion is not only illegal, but it also has direct negative consequences in terms of a potential loss in tax base that in turn impedes the healthy regulation of the very market within which firms compete.

In one of the earliest studies that focused on the antecedents of firm misconduct, Staw and Szwajkowski (1975) found that resource limitations in market environments are associated with an increased likelihood of illegal and unfair trade activities by firms. Campbell (2007) theorized that the relationship between competition and socially responsible acts may be curvilinear where too much competition can give firms incentive "to cut corners and save money wherever possible" in order to survive; and too little competition (such as a monopoly) would cause a similar result due to reduced incentives to be socially responsible (2007, p. 953).[2] Looking at the dark side of competition, Bennett et al. (2013) showed that when vehicle inspection facilities faced increased competition, they passed vehicles in emission tests fraudulently.

Scholars have recently examined the effects of competition on tax evasion as well. Cai and Liu (2009) found that increased competition in product markets leads firms to conceal greater amounts of their business from government. Goerke and Runkel (2011) argued that increased competition (with reduced market entry costs) leads to increased tax evasion by firms. Yet these studies have exclusively focused on the effects of competition from the formal economy. What they have not considered is the

[2] Meng, Zeng, Xie and Qi (2016) empirically showed this case with a sample of Chinese listed firms.

Please cite this article in press as: O.N. Gokalp, et al., Competition and corporate tax evasion: An institution-based view, Journal of World Business (2017), http://dx.doi.org/10.1016/j.jwb.2016.12.006