



Public policy, political connections, and effective tax rates: Longitudinal evidence from Malaysia

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Abstract

This study examines the link between effective tax rates (ETR) and political connections in developing economies. The *political connections* explanation is informed by the observation that developing economies tend to be “relationship-based” rather than “market-based” capitalisms. Two proxies of political patronage are developed and applied to a group of Malaysian firms over a 10-year period. We find firms with political connections pay tax at significantly lower effective rates than other firms. Our results suggest that political connections are an important determinant of ETR in relationship-based economies.

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1. Introduction

The finding that some firms pay lower actual or effective tax than others has been a source of concern in the US (Citizens for Tax Justice, 1984, 1985, 1986; Wilkie and Limberg, 1990; Kern and Morris, 1992; McIntyre and Nguyen, 2000). The main reason for this is that the difference in effective tax rates (ETR hereafter) between firms runs contrary to the notion of tax equity in Western capitalisms (Hagan and Larkins, 1992).² This notion of tax equity is also responsible for the *firm size* explanation adopted in current ETR research.³ However, there are reasons to suggest that *firm size* alone may not be sufficiently useful as an explanation in understanding the largely unexplored issue of ETR determinants of non-western firms.⁴

A major difference between developed capitalisms in the West (e.g., in North America) and non-western developing capitalisms (e.g., in East Asia) is that the latter tend to be “relationship-based” or “crony” rather than “market-based” capitalisms (Rajan and Zingales, 1998, 2003). The multi-faceted relation between business and politics in East Asia attests to this notion of “relationship-based” capitalism (Gomez and Jomo, 1997, 1998; Gomez, 2002). The Malaysian government, for example, plays the role of political patron to selected firms, which have been referred to as firms with *political connections* (Perkins and Woo, 2000; Fisman, 2001; Johnson and Mitton, 2003).

Some researchers (Rajan and Zingales, 1998, 2003) argue that capitalism in its initial developing stage tends to be “relationship-based” (with political connections being an important form of relationship) and that, as the economy develops, it transforms itself from “relationship-based” to “market-based.” The notion of “relationship-based” capitalism suggests that the *political connections* explanation may complement the *firm size* explanation in understanding ETR in developing economies.

Research concerning the importance of political connections as a determinant of ETR is important for several reasons. Very little is currently known about the determinants of ETR in relationship-based economies. Yet the economic importance of countries with relationship-based economies has increased substantially and their significance is likely to grow even more in coming decades. It is, therefore, important that current research be expanded to capture the complexities of ETR and its determinants in relationship-based economies. Such research, while certainly worthwhile by itself, may also provide insights into the forces that shape ETR in Western countries. Moreover,

² Tax equity requires that all firms pay the same amount of effective tax.

³ Large firms pay more effective tax due to higher “political cost” (e.g., Zimmerman, 1983) or large firms pay less effective tax due to stronger “political clout” (e.g., Porcano, 1986).

⁴ With the exception of Kim and Limpaphayom (1998) and Derashid and Zhang (2003), there are no studies examining ETR of non-western firms.

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