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Importing corruption culture from overseas: Evidence from corporate tax evasion in the United States[☆]

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ABSTRACT

We study how cultural norms and enforcement policies influence illicit corporate activities. Using confidential Internal Revenue Service (IRS) audit data, we show that corporations with owners from countries with higher corruption norms evade more tax in the U.S. This effect is strong for small corporations and decreases as the size of the corporation increases. In the mid-2000s, the United States implemented several enforcement measures to increase tax compliance. We find that these enforcement efforts were less effective in reducing tax evasion by corporations whose owners are from corrupt countries. This suggests that cultural norms can be a challenge to legal enforcement.

1. Introduction

A substantial fraction of foreign-controlled corporations operating in the United States pay little or no income tax (U.S. Government Accountability Office (GAO), 2008), but the reasons behind the low effective tax rates of these corporations remain largely unexplained. The existing literature has tended to focus on legal tax avoidance as a possible cause,[3] but tax noncompliance may also play a role. Our study proposes a link between this corporate illicit activity among foreign-controlled corporations in the U.S. and corruption culture from overseas.

Specifically, we ask whether foreign-controlled corporations from more corrupt countries are more likely to evade U.S. taxes. We answer this question by linking the results of over 25,000 IRS corporate tax audits from 1996 to 2007 with corruption measures from the foreign owner's country of residence. This setting puts foreign corporations with different norms from overseas in the same enforcement context

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[3] Grubert, Goodspeed, and Swenson (1993) and Grubert (2000) suggest that foreign firms have more aggressive tax planning, but Blouin, Collins, and Shackelford (2005) debate this. There has not been any conclusive evidence on why and how foreign corporations evade and avoid tax.

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in the U.S. and allows us to separate out the impact of culture on corporate behavior.

The economics literature on tax evasion is small but expanding. Its basic framework for analysis dates back to Allingham and Sandmo (1972), which was built on a seminal model of crime by Becker (1968). In this framework, taxpayers choose an optimal of tax evasion given the level of penalty, probability of getting caught, and their own level of risk aversion.[4] To analyze the role of corporate governance in tax evasion, this framework has been embedded in a principal-agent structure. Using this approach, Slemrod (2004) argues that small firms tend to behave more like individuals than do large firms. This is because an owner of a small firm may make tax reporting decisions directly. In large firms the tax planning and reporting decisions are often delegated. In this case, owners must provide incentives for their tax directors to evade. Crocker and Slemrod (2005) demonstrate that a firm's principal could alter compensation contracts with his agents to induce tax evasion on his behalf, though such arrangements might not always be the case. Further, Desai and Dharmapala (2006) point out that high-powered incentives for agents may not lead to higher tax evasion for the principal if tax evasion and diversion of rents are complementary activities.

While the economics literature focuses on the economic and financial motivations for tax evasion, there is an emerging literature on the role of culture in illegal activities. In an interesting study of illegal parking by United Nations' diplomats in New York City, Fisman and Miguel (2007) find that the corruption norms in the diplomats' home countries strongly influence their propensity to engage in illegal parking in NYC. The stationing of United Nations' diplomats in NYC provides a natural experiment for testing the role of cultural norms because diplomats from different countries (with different norms) face the same set of economic incentives regarding illegal parking in one city.

Although there is not yet similar research relating to tax evasion, cultural factors have been argued to be important in shaping behavior in this illicit activity. Frey (1997) proposes that taxpayers pay taxes because of both extrinsic motivation (*e.g.*, worries about penalties for tax evasion) and intrinsic motivation (*e.g.*, the willingness to contribute to a public good). The latter is shaped by cultural parameters such as personal values and social norms, and there is some evidence for this influence from survey data. Slemrod (2003) finds that survey respondents who said they trust the government tend also to report paying higher taxes (see also Torgler (2003) and Hanousek and Palda, (2004)). shows that executives who underreport their personal taxable income also tend to run firms that have higher incidences of tax noncompliance. Dyreng, Hanlon, and Maydew (2010) find that individual executives are important determinants of firms' tax avoidance behavior. It is, however, unclear whether this relation is driven by cultural norms or personal risk preferences.

We utilize a new data set of 25,541 IRS audits of foreign-owned corporations for the 12 years from 1996 to 2007. Corporate tax evasion by foreign-owned corporations in the U.S. provides a natural experiment because it subjects firms with different home-country norms to the same legal enforcement setting in the United States. This design allows us to estimate the influence of home-country corruption norms of a firm on its tax evasion behavior. We measure a firm's tax evasion using the ratio of IRS-determined tax deficiency over total income. The IRS-determined tax deficiency is the amount of positive adjustment to the firm's tax liability following audit.[5] Corruption norms in home countries are measured using the well-known Corruption Perception Index by Transparency International. Given the important role of firms' size (pointed out by Hanlon, Mills, and Slemrod (2007)), we examine the effect of corruption norms on tax evasion for firms of different sizes. Although the selection of firms for auditing is not random, we are able to address this selection issue by using the Discriminant Information Function (DIF) score, which the IRS computes to determine the likelihood of auditing change in tax liability following audit. The IRS then uses the DIF score in its audit selection decisions.

The results are straightforward. High corruption norms are strongly associated with increased tax evasion among small and medium-sized firms. As the firms' size increases, this effect diminishes gradually. As an illustration, we find that a firm with annual revenue and total assets equal to the sample mean ($20 million and $50 million, respectively) and with an owner from a country with Nigeria-level corruption, on average, exceeds a similar firm from Sweden in tax noncompliance by about $64,371 (equivalent to about 8% of mean total corporation income tax for firms who evade). However, as firm assets become very large (above $102 million), the difference in their tax evasion behavior becomes negligible. The association between corruption norms and tax deficiencies is quite robust to controlling for a number of possibly confounding covariates, including a country's Gross Domestic Product (GDP) per capita, trade relations, distance from the United States, the firm's net income, and even country fixed effects. These results provide evidence supporting the view that cultural norms can shape behavior of small corporations where the owners may handle the tax decisions directly or influence their tax staff more strongly. However, our results also support the view that large corporations (which are likely to have more delegated tax reporting) attenuate the influence of individual norms.

We also find that corruption norms have a stronger effect on tax evasion when the firm is a multinational or

[4] This framework has been extended to incorporate different issues for individual tax evasion. For a review of this literature, see Andreoni, Erard, and Feinstein (1998) or Sandmo (2005).

[5] Note that this is the IRS recommended adjustment and not the actual amount the tax payer remits after any appeals and/or legal proceedings. The line between tax evasion and tax avoidance is often ambiguous. We do not argue that the tax adjustment we use in this paper is strictly tax evasion, but it is perhaps the best measure for tax evasion available to date. Throughout the paper, we will use the terms tax adjustment, deficiency, and evasion interchangeably.