Journal of Contemporary Accounting & Economics 11 (2015) 138–147

Contents lists available at ScienceDirect

Journal of Contemporary Accounting & Economics

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

Foreign investors' interests and corporate tax avoidance: Evidence from an emerging economy

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ARTICLE INFO

Article history:
Received 20 September 2013
Received in revised form 23 February 2015
Accepted 3 March 2015
Available online 12 March 2015

JEL:
F23
H26
G32
O10

Keywords:
Foreign direct investments
Tax avoidance
System GMM estimator
Developing economies

ABSTRACT

Foreign investment inflows into developing countries has become a cause for concern, as the opportunity for profit shifting across their various operating outlets has made multinational companies tax avoidant in host countries. Thus, this study examines the tax impact of foreign investors' interests within a host developing economy. The sample data were extracted from annual reports of the FTSE Bursa Malaysia Top 100 firms for the financial periods of 2009, 2010 and 2011. Using four similar measures of tax avoidance and three related measures of foreign investors' interest, our analysis of the dynamic panel data with a system GMM estimator shows significant positive relationships between foreign investors' interests and the measures of corporate tax avoidance among large Malaysian companies. This result suggests the possibility of multinational companies exploiting their international scales of operations to avoid taxes in both host and parent countries. Thus, emerging economies need to consider the residual benefits of foreign direct investment in the presence of such tax avoidance in their pursuit of economic development.

1. Introduction

Foreign ownership – through direct investments, joint ventures, mergers and acquisitions, or equity ownership (Dahiya and Gupta, 2004) – represents the interests of foreign investors (Ohori, 2011). These foreign owned/linked firms are desirable for most developing economies looking for rapid economic growth and development because of their superior performance (Mohd Ghazali, 2010), higher productivity (Khawar, 2003), higher level of voluntary disclosure (Haniffa and Cooke, 2002), robust stock values (Huang and Shiu, 2009) and efficiency within the host countries. On the part of the firms, reasons such as access to new markets, opportunities to exploit resources, lower cost of labour, technological progress, policy liberalization, and most importantly, tax incentives, have served as motivating factors for them to go abroad.

Given these reasons, emerging markets have become battlefields wherein multinational companies compete among themselves (Luo, 2002). In Asia, for instance, the amount of foreign direct investment (FDI) inflows into South, East and Southeast Asia increased from US$24.5 billion in 2009 to US$299.7 billion in 2010 (UNCTAD, 2011, p. 45). In Southeast Asia alone, a 26% increase in the amount of FDI to US$117 billion was recorded in the same year. Similarly, the Malaysian economy witnessed an increase of 30% from US$9.1 billion in 2010 to US$11.9 billion in 2011 (MIDA, 2012, p. 15). While these might be admirable inputs for the growth of developing economies in Asia, it has been argued that multinational firms have structured their business in a way to avoid taxes in every jurisdiction where they operate (Christensen and Murphy, 2004). Furthermore, empirical studies have also shown that multinational US firms pay low taxes in the host countries despite their high

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http://dx.doi.org/10.1016/j.jcae.2015.03.001
1815-5669/

levels of profitability (Grubert and Mutti, 1991; Hines and Rice, 1994; Kinney and Lawrence, 2000). This may be due to opportunities for international shifting of corporate income (Shackelford and Shevlin, 2001) and possible tax incentives granted by host countries.

Theoretically, this is surprising, as these firms are expected to seek organizational legitimacy given the express social contract between them and the society where they operate. Any act of tax avoidance would be tantamount to breaching the social contract and constitutes "a crime against the nation" (Landolf, 2006, p. 6). Thus, for an organization to be legitimate, it needs to fulfil its social responsibility to the host community economically by paying taxes (Preuss, 2010; Williams, 2007a). Because multinational companies are generally believed to operate within international best practices, they are perceived as socially responsible firms. It would be worthwhile therefore to investigate whether these firms consider the issue of organizational legitimacy. If they are actually tax avoidant, as claimed by Christensen and Murphy (2004), the benefits from their tax management strategies outweigh the costs and less emphasis is given to organizational legitimacy.

However, the tax status of these firms in developing host economies remains unclear despite increasing cross-border investments. Although some studies have examined the tax impacts of foreign investments in the US and UK, similar studies in developing host countries are virtually non-existent. Thus, this study examines the relationship between foreign investors' interests and corporate tax avoidance[1] among listed Malaysian companies. Three related measures are used to capture foreign investors' interests comprehensively: the proportion of shares owned by foreign investors to the firms' total shareholding, substantial foreign shareholding, and the proportion of foreign directors on the board. Corporate tax avoidance, on the other hand, is measured using four similar measures: accounting effective tax rate (ETR), long-term cash effective tax rate (ETR), the ratio of income tax expenses to operating cash flow, and the ratio of tax paid to operating cash flow.

Malaysia is chosen as the context of this study because of the emerging nature of its economy and its potential for foreign direct investments (FDIs), as stated in the vision 2020 (MIDA, 2012). In fact, recent efforts made by the country's present administration to attract foreign investments have been highly commended.[2] It is therefore imperative to conduct this type of study to properly evaluate the country's policies on FDIs, at least on tax related matters. This is especially important given recent findings concerning the outflows of illicit funds from the country through commercial tax non-compliance.[3]

The remaining part of this paper is organized as follows. Section 2 covers a review of the related literature and states the tested hypothesis. Section 3 provides details on the empirical method, which includes the sample source of data, model specification, variable measurements and model estimation method. Section 4 delineates the results of the parameters' estimations, and Section 5 sets out the conclusion to the paper.

2. Literature review and hypothesis development

Empirical studies on foreign investors' interests within developing host countries have focused on several issues in the corporate setting, such as performance (Mohd Ghazali, 2010), disclosure (Che Haat et al., 2008; Haniffa and Cooke, 2002, 2005), dividend policy (Jeon et al., 2011), corporate governance (Nga et al., 2012, February), technology transfer (Rasiah, 2003; Wignaraja, 2008), and stock values (Huang and Shiu, 2009; Sulong and Nor, 2008). However, studies on the tax impacts of foreign investors' interests within developing host countries are virtually non-existent. Studies in this respect have only been conducted in developed economies and are limited. The following review covers the available studies.

Using information provided by the Amadeus database, Huizinga and Nicodeme (2006) investigate the link between foreign ownership of shares and corporate income tax rates among several European countries. The study finds that countries with a higher level of foreign ownership do have higher tax rates. Hence, a complementary relationship is documented between foreign ownership and corporate income tax rates.

Similarly, Egger et al. (2010) find higher rates of tax avoidance to be related to high-tax host countries while examining the impacts of foreign plant ownership on corporate tax avoidance among 31 European countries. The use of international profit-shifting strategies is documented as one of the means through which such avoidance has been perpetrated. An earlier US study by Kinney and Lawrence (2000) also finds firms with substantial foreign ownership to be tax avoidant. The study investigates the influence of foreign ownership of shares on the tax burden of some US firms and documents profit shifting as the means for the lower tax burden after controlling for earnings management.

Demirguc-Kunt and Huizinza (2001) examine the relationship between foreign ownership and tax avoidance among several banks in 80 countries around the world. Covering an eight-year period, the global analysis shows that foreign linked banks pay fewer taxes compared to domestic banks within the host countries. It is also found that these banks use profit-shifting strategies to avoid tax payments. Although this study unveils the impact of foreign ownership on corporate

[1] The term corporate tax avoidance is defined as the reduction of explicit corporate tax liabilities (adapted from Dyreng et al., 2008; Hanlon and Heitzman, 2010). The term is used throughout this study, although it could be used interchangeably with tax management, tax planning or tax aggressiveness.

[2] The commendation was given in the 2012 Investment Climate Statement on Malaysia by the US Department of State, Bureau of Economic and Business Affairs report June 2012, available at http://www.state.gov/e/eb/rls/othr/ics/2012/191191.htm (accessed on 25 August 2013).

[3] This was unveiled in a report by Global Financial Integrity (GFI) in January 2011. The report ranks Malaysia fifth among the developing countries with the highest illicit outflow of funds. While the reasons for such flows out of the country were not stated in the report, GFI argues that 60 to 65 per cent of the global illegal fund flows could be due to commercial tax non-compliance.