Multinationals' tax evasion: A financial and governance perspective

Shumi Akhtar a,⁎, Farida Akhtar b, Kose John c, Su-Wen Wong a

a University of Sydney, Finance Discipline, Business School, Building H69, Sydney, NSW 2006, Australia
b Macquarie University, Department of Applied Finance and Actuarial Studies, Faculty of Business and Economics, Building E4A, Room 226, Balaclava Road, North Ryde, NSW, 2109, Australia
c New York University, Stern School of Business, 44 West Fourth Street, Suite 9-190, NY 10012-1126, United States

ABSTRACT

This paper examines corporate tax evasion from both a financial and governance perspective: one, the impact of tax evasion on a multinational (MNC)'s financial performance and secondly, whether corporate governance levels affect the probability of the multinational committing tax evasion. We specifically address: (i) whether MNCs suffer any adverse short and long-term effects on their financial performance following news that the firm in question has committed, or is suspected of committing, tax evasion and (ii) whether firm and country level governance has any influence on the likelihood of MNCs evading tax. In the short-term, we find that share prices drop in the event window around the announcement date. Further, we find evidence that multinationals do not suffer long-term reputational damage from tax evasion (unless there is repeated media follow-up); leaving no impact on firm profitability or value. We also find that a small number of firm level governance, tax-efficiency based governance and country governance measures have a significant relationship with an MNC's likelihood to commit tax evasion.

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1. Introduction

Contrary to the perfect world envisioned in Modigliani and Miller (1958), Finance research over the last half century demonstrates that tax considerations form an increasingly relevant part of financial decision-making (Graham, 2003). The primary intention of engaging in tax planning strategies is to reduce a firm's tax liability and accordingly increase pre-tax cash flow, which ceteris paribus will result in maximising a firm's value (Graham and Tucker, 2006; Hanlon and Slemrod, 2009). Tax avoidance and by extension, tax evasion, have always been an omnipresent reality arising from the implementation of any tax system. While tax evasion manifests itself in a variety of ways (only limited by an individuals' ingenuity and the structure of the tax system itself), the typical offences that tax evaders would usually be found guilty of in the past were under-reporting of income or over-claiming of deductible expenditure (Tanzi and Shome, 1993).

However, the dawn of the 21st century has arguably resulted in a changing international tax landscape that has become increasingly favourable to multinational corporations (“MNCs”) and their tax strategies. Rising labour and capital mobility in tandem with globalisation has provided modern MNCs with the ammunition to take advantage of sophisticated strategies such as transfer pricing, hybrid entities and shell companies to lower their tax bills (Christensen and Kapoor, 2004; Lymer and Hasseldine, 2012; Needham, 2013). Our current international tax systems are increasingly exposed as being unable to cope with the challenges...
brought about by today's reality (Desai and Hines, 2004). In response, countries from China to the European Union have proposed new laws and penalties as part of the global crackdown on MNCs (Colchester and Winning, 2015; Toh, 2015), aiming tax authorities with growing power as well as purpose to cross that grey area from what was formerly "legal tax avoidance" into "illegal tax evasion". While critics have argued that international bodies such as the Organisation for Economic Co-operation and Development (OECD) are intentionally "criminalising tax avoidance" in their pursuit against harmful tax competition, scandals such as the recent Panama Paper leaks showing thousands of offshore accounts being used by corporations (and individuals) to conceal assets or dodge taxes is proof that tax evasion is an issue that runs deep and serious at all levels of society (The New York Times, 2016). Yet surprisingly, very little research has been made in the area of MNC tax evasion despite the current spate of international tax reforms being proposed by governments and the OECD.

Thus, the primary research question in this paper is concerned with whether a firm's engagement in corporate tax evasion negatively affects its short-term as well as long-term financial performance. A higher degree of scrutiny on MNCs' international tax strategies coupled with an increasingly stringent regulatory environment could have potentially adverse consequences for MNCs and their shareholders, necessitating an investigation of the effects of the above. We also seek to examine whether firm level corporate governance play any role on tax evading MNCs' performance and also investigate whether firm and country level corporate governance explain MNC's likelihood to evade taxes. We envisage that this would shed some light as to why MNCs continue to engage in harmful tax practices despite the risks of being penalised in an increasingly regulated climate, and allow shareholders of these MNCs to better understand the risks at hand for firms undertaking aggressive tax planning. We find that in the short-term, share prices drop in the event window around the announcement date of firm committing tax evasion. However, while generally we find no evidence that multinationals suffer long-term reputational damage from tax evasion, a sub-sample of firms having repeated follow up media coverage on their tax evasion demonstrate a negative impact on their performance due to incurring a 'reputational cost'. Further, we find that certain aspects of firm level governance demonstrate some level of ad-hoc relationship with MNCs' performance. We also find that a small selection of firm and country level governance measures have a significant relationship with an MNC's likelihood to commit tax evasion.

2. Advancements on existing work

It is important to understand the fine distinction between tax avoidance and tax evasion. Tax avoidance is a mechanism to reduce the amount of tax that a taxpayer is required to pay while staying within the limits defined by the law and by fully disclosing material information to the tax authorities. On the other hand, tax evasion, while somewhat related, is the exact opposite to tax avoidance - it is the non-payment of tax through illegal means. Tax evasion usually involves the deliberate misrepresentation or concealment of the true nature of the affairs to reduce the overall tax liability. Much of the existing literature focuses on corporate tax avoidance (Minnick and Noga, 2010; Huseynov and Klamm, 2012). The little research on tax evasion available centres on the socio-economic impact of tax evasion from a public finance perspective (Otusanya, 2011; Slemrod, 2007), or from an individual's ethical and behavioral perspective (Allingham and Sandmo, 1972; Clotfelter, 1983; Feld and Frey, 2007; Kaplanoglu and Rapanos, 2015; Slemrod, 1992). The practical difficulty of obtaining data on non-compliance is a driving factor behind why empirical testing of tax evasion has remained scant (Chan and Lan Mo, 2000; Slemrod and Yitzhaki, 2002; Tedds, 2010).

We observe several glaring gaps in the tax evasion literature. Firstly, not only are the studies named above very sporadic and use mainly out-dated data (none use data beyond 2002), they largely only focus on firms within a single country (with the exception of Tedds, 2010). With multinational tax becoming such an area of international economic importance, our study would provide a much-needed update and holistic insight into how tax non-compliance behaviour may have changed in the decade following globalisation. There is only a handful of studies that are within the peripheral of our study. The main contribution of our study lies by drawing a number of distinctions relative to some key research in this area.

Taxation plays a vital role in the literature of corporate finance (Graham, 2003) and yet, there are only a very small number of studies that analyze how tax evasion affects firms' performance. Also, there is no research thus far that investigates how MNCs, country level corporate governance and tax evasion interplay with firm performance and the likelihood of committing tax evasion. Further, the public finance literature typically ignores any effects of governance on the functioning of the corporate tax system (Auerbach, 2002; Hassett and Hubbard, 1997). Therefore, our paper is the first to examine the implications of tax evasion on performance and how corporate governance plays a role in both MNCs' performance and their likelihood of committing tax evasion. We are the first to show whether tax evasion has an impact on MNCs' short-run and long run performance.

From a theoretical perspective, the effect of tax evasion on firm value is unclear. On one hand, tax evasion is a transfer of money from the government to a firm, in which case it should increase firm value. On the other hand, because tax evasion fosters agency problems, it should decrease firm value. Only a few recent studies provide empirical evidence on this topic (Baucus and Baucus, 1997; Minnick and Noga, 2010 and Hanlon and Slemrod, 2009).

Our paper differs from Baucus and Baucus (1997) to the extent that they investigate a whole range of illegal activities without specifically investigating the criminal act of tax evasion. It is paramount to isolate the impact of tax evasion separately on performance because unlike most other illegal activities, companies have a tendency to repeatedly engage in tax evasion for years until they are legally prosecuted. This has far more intense and continuous implications on the economy than any other illegal activities conducted by corporations. Tax evasion is a rather unique illegal activity in the sense that managers of the companies in question

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1 For a more detailed explanation on the differences between 'tax avoidance' and 'tax evasion', please refer to Appendix 1.
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