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Social trust environment and firm tax avoidance: Evidence from China

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ABSTRACT

We examine the impact of the social trust environment in which a firm is located on its tax avoidance in China and paying attention to the moderating effect of corporate governance and state-ownership. Drawing from theoretical and empirical work on firm tax avoidance and manager–shareholder agency conflict, we hypothesize that social trust can lower firm tax avoidance. It is because a high social trust environment can reduce agency conflict so that tax avoidance is less. Our findings are consistent with our hypothesis, and robust to a battery of robustness tests. Furthermore, we document that the association between social trust and firm tax avoidance is more pronounced for firms with weak corporate governance and state-owned. Moreover, we find that firms in more trustworthy provinces present less general and administrative expenses and higher asset turnover, corroborating our theoretical foundations with respect to agency cost in our hypothesis. Our findings suggest that social trust and its interactions with corporate governance and state ownership are important internal and external determinants on the variations in tax avoidance.

1. Introduction

The extent of a firm's tax avoidance[1] is an important element in its tax planning strategy. Dyreng et al. (2008) report that about one-fourth of US public firms have effective tax rate below 20% while the stated corporate tax rate is 35%. Similarly, in China, one-fourth of its firms pay an effective tax rate below 10% (from our summary statistics) with the official Chinese corporate tax rate is 33% (before 2008) and 25% (after 2008). Firms, in general, engage in tax avoidance and it becomes part of a firm's overall operation. Hence, it is not surprising that a large body of literature examines the contributing factors behind a firm's tax avoidance and its economic consequences (Hanlon & Heitzman, 2010; Shackelford & Shevlin, 2001).

The focus of the literature is primarily on the internal contributing factors of tax avoidance, such as agency conflicts between manager and shareholder (Desai & Dharmapala, 2006; Desai, Dyck, & Zingales, 2007), ownership structure (Chen, Chen, Cheng, & Shevlin, 2010; Desai & Dharmapala, 2008), corporate governance (Armstrong, Blouin, Jagolinzer, & Larcker, 2015; Minnick & Noga, 2010), and manager political connections (Chan, Mo, & Zhou, 2013; Kim & Zhang, 2015).

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[1] There is no universally accepted definition of tax avoidance (or tax aggressiveness), we follow the literature by defining tax avoidance broadly as the reduction of explicit taxes (Dyreng, Hanlon, & Maydew, 2008 and Hanlon & Heitzman, 2010).

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The impact of external factors on tax avoidance is gaining notice. Atwood, Drake, Myers, and Myers (2012) show that a firm located in a legally sound and a high investor protection country, on average, engages in less tax avoidance. Boone, Khurana, and Raman (2012) examine religiosity as a determinant of tax avoidance by corporate and individual taxpayers by considering the role of religiosity in restraining individual unethical or opportunistic behavior. Dyreng, Hoopes, and Wide (2016) and Kubick, Lynch, Mayberry, and Omer (2015), who study how activists and market competition in the market change a firm's tax avoidance behavior but they do not focus on the informal institutional environment in which a firm is located. Many studies examine internal factors on tax avoidance with several studies investigate solely how external factors affect tax avoidance. Few studies investigate the interplay of internal factor and external factor on tax avoidance. We fill this gap.

The objective of this paper is to examine the impact of social trust as an external determinant of tax avoidance while accounting for the corporate governance and state-ownership factors. We also study the economic mechanism behind the relation using a sample of Chinese firms. We focus on social trust because it is a critical informal institution that shapes the social environment in which a firm operates (Dong, Han, Ke, & Chan, 2016; Wu, Firth, & Rui, 2014). Specifically, following the social capital literature, we define social trust as generalized trust which equal to a subjective belief about the likelihood that a potential trading partner will act honestly (Bottazzi, Da Rin, & Hellmann, 2016). Generalized trust does not necessarily pertain to the specific company whom an investor interacts with, but it may pertain to the company's countrymen and country's institutions, which can influence the investment outcome. China offers three advantages for our analysis. First, China has a weak formal institution environment. Consistent with Allen, Qian, and Qian (2005) and Ayyagari, Demirgüç-Kunt, and Maksimovic (2010), it is expected that Chinese managers are easy to extract private benefits through a firm's tax avoidance. Essentially, as an emerging market, China has typical characteristics of ineffective law enforcement and a questionable business ethical environment. Therefore, we expect that there are large variations of corporate governance across firms. It is important to incorporate governance factors because they play a role in monitoring managers relating to agency conflicts embedded in tax avoiding behavior. In addition, China has a wide-spread state-ownership among its public firms. The public ownership takes away the equity-based compensation (Xu, Li, Yuan, & Chan, 2014). Thus, the incentive structure in state-owned firms (SOEs) is different from the traditional shareholder-manager relation. We expect that state-ownership affects a firm's tax avoidance behavior.

Second, China has 5000 years of history, with vastly differing local languages and culture, which shapes local practices and social trust (Wu et al., 2014). Because social trust is shaped by local culture, we expect that social trust across different Chinese provinces is heterogeneous, which offers a good environment to examine the relation of social trust and tax avoidance in a single country environment.

Third, using a one-country study, such as China, there is no need to account for the impact of some country-level characteristics. For instance, all firms in a country, regardless of their locations, are subject to the same regulations of their government (Fan, Wang, & Zhu, 2011). Thus, we can explore in depth the moderating effect of corporate governance and state-ownership and study the underlying economic mechanism between social trust and tax avoidance. In sum, China provides a powerful setting to examine the relation between social trust and tax avoidance with variations of corporate governance and state ownership among its public firms.

We hypothesize that the level of social trust in a region in which a firm is located is negatively correlated with the firm's tax avoidance. When there is a separation of ownership and control, managers can use tax avoidance to extract private benefits (Desai et al., 2007). Hence, tax avoidance is result of management opportunistic behavior. A low agency conflict means less such behavior (Desai & Dharmapala, 2006). Trust is an agent's subjective assessment of the probability that certain actions will be performed by another party (Gambetta, 1988). It means that a high social trust environment promotes trustworthiness among firm stakeholders. Therefore, agency conflicts and manager opportunism are low in regions with high social trust (Desai & Dharmapala, 2006; Desai et al., 2007; Slemrod, 2004). Essentially, a high social trust environment creates a positive social norm and promotes ethical behavior to discourage agency problems among corporate stakeholders (Cialdini & Goldstein, 2004; Sunstein, 1996). Garrett, Hoitash, and Prawitt (2014) and Pevzner, Xie, and Xin (2015) offer evidence suggesting that social trust is negatively correlated with agency conflicts and manager opportunism. Hence, we expect a high social trust environment to be associated with lower tax avoidance and vice versa. In addition, a strong corporate governance of a firm can mitigate its agency conflicts. we contend that corporate governance plays a moderating role in the relation between social trust and tax avoidance. Moreover, if there is any impact of social trust on managerial opportunistic behavior and thereby reduce corporate tax avoidance, then the impact should most likely be affected by the ownership structure. Thus, with both governance and state-ownership internal factors, we can explicitly link internal and external factors in the determination of tax avoidance.

Using a sample of Chinese A-share firms over a 15 years period (2000–2014), we find that social trust environment and tax avoidance are negatively correlated. The results are economically significant. For example, the results suggest a one standard deviation increase in social trust is associated with ¥19.14 million increased in effective income tax payable. Our findings are robust to different measures of tax avoidance, social trust, and a battery of different research methods. Moreover, we find that the negative effect of social trust on corporate tax avoidance is more salient for a firm with weak corporate governance, corroborating our theoretical foundations with respect to agency theory in our hypothesis and the conclusions from the related literature. With respect to state-ownership, we find that the negative association between social trust and corporate tax avoidance is less pronounced for SOEs.

Finally, we examine the economic mechanism under the negative association between social trust and corporate tax avoidance. Specifically, we provide evidence that firms located in more trustworthy provinces, on average, have less general