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Is Social Transparency Associated with Tax Avoidance?

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Abstract

Tax avoidance has been considered as an act of minimizing the amount of taxes to be paid through appropriate methods by recent tax evasion research. The study aims to examine the effect of social transparency on tax avoidance among firms listed Kenyan. The study is grounded in stakeholders' theory together with the Agency theory. The study employed Generalized Methods of Moments (GMM) estimation method and a panel data set drawn from a sample of 31 listed firms in the Nairobi Securities Exchange (NSE) over the period 2009 - 2018. Overall, the empirical results show a positive and statistically significant association between social transparency and corporate tax avoidance ($\beta = 0.027$, $p < 0.05$); thus, firms that are more social transparent are less likely to engage in tax avoidance. Based on these findings, the study has important implications for policy makers, managers and stakeholders

Keywords: *Social transparency, Corporate Social Responsibility (CSR), Tax avoidance, listed firms*

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1. Introduction

Corporate tax is considered an important agent for socio-economic development and maintenance of physical infrastructure. Hutton (2002) claims that private and public corporate entities engage with the society through payment of taxes. Moreover, government's chief sources of revenue include taxes, borrowing and donations (Ghimire, 2019). However, the extent of tax-avoidance and tax planning arrangements has grown so enormous that researchers described it as a shadow economy (Neck, *et. al.*, 2012). Specifically, this phenomenon is widely spread in globalized sectors such as banking, aviation, shipping, telecommunications pharmaceuticals, media, and weapons industry owing to the secretive nature of their activities; thus making it difficult to accurately quantify the scale of this shadow economy (Christensen, & Murphy, 2004).

Among all other taxes, corporate tax is a major and most reliable source of revenue for states (Bradshaw, Liao, & Ma, 2019). Despite the importance of this tax to a country's economic growth, studies have reported an upsurge in its avoidance. This has contributed to tax uncertainty and fiscal deficit in the governments' budgets (Henry, Massel, & Towery, 2016; Guenther, Wilson, & Wu, 2018). Thus, alongside statutory interventions, policymakers and academia continue to explore the determinants of corporate tax avoidance. Those cited in literature include lack of corporate transparency, profitability, firm size and industry type (Christian & Imagbe, 2019; Oats & Tuck, 2019). Corporate transparency is considered as a major contributor of tax avoidance since it covers a range of organizational dimensions; financial transparency, governance transparency, social transparency and operational transparency (Kim, *et. al.*, 2013). While financial transparency connotes the provision of timely and accurate financial disclosures, their interpretation and dissemination by analysts and the media, governance transparency captures disclosures on an organization's management (Habib, 2008). On the other hand, operational transparency centers on offering clear and detailed explanations of a firm's products and services from an internal perspective, whereas social transparency emphasizes on disclosure of a firm's corporate mission, code of ethics and whistle blowing policies as well as its willingness to contribute best to the shareholders, customer welfare, local communities, and the public at large (Lanis, *et. al.*, 2019; Kim, *et. al.*, 2013).

With the growing emphasis on a socio-economic business model, (the stakeholders' approach to management), companies are now tasked to create value for society as a whole; which entails not only on improving the quality of stakeholders' life's but also contributing to economic development (Huseynov & Klamm (2012). Thus, studies on corporate transparency are now centered on social transparency, that is, disclosure of information regarding companies' socially responsible behaviours (Baraibar-Diez & Luna-Sotorrío, 2012). Social transparency also emphasizes on disclosure of corporate mission, code of ethics and whistle blowing policies (Lanis, Richardson & Taylor, 2019). Gonzalez-Rodriguez, DiazFernandez, & Simonetti (2015) mentioned that social responsibility covers the capability of organization in creating more job opportunities, respecting and protecting human right, helping developing countries, developing staff skills, enhancing quality of life of host countries, practicing non-discrimination behavior, making contributions to the needy as well as ensuring the quality and safety of their product.

Dahlsrud (2008) has suggested five key dimensions of corporate social transparency. First, the environmental dimension, as a discourse of the environmental impact of the company's activities. Second, the social dimension, which gathers the relationship between the company and society. Third, the economic dimension, which comprehends socio-economic or financial activities of the business operations. Fourth, the stakeholder dimension, which includes the activities where stakeholders get involved, and how the company interacts with employees, clients, vendors, community and competitors. Fifth, the voluntariness dimension, which includes the ethical values, actions beyond legal obligations, or voluntary actions

Furthermore, the emergence of social reporting (social accounting) has also prompted companies to provide non-financial information to satisfy the goals of stakeholders concerned and to obtain legitimacy. Greater involvement in CSR activities may prompt a firm to engage in tax planning which is associated with tax avoidance (Knuutinen, 2014; Hoi *et al.,* 2013). Though a firm's strategic scheme to reduce or avoid taxes may be beneficial to shareholders, it is detrimental to the society due to the reduced government revenue, which ultimately affects their social welfare. Therefore, it is from this background that researchers, policymakers and the public are paying more attention to the impact of social transparency on tax avoidance. Although these studies have made a significant contribution to the empirical literature, the findings are inconsistent (Lanis & Richardson, 2012; *Hoi et al.,* 2013). Therefore, this paper seeks to investigate further the link between social transparency and tax avoidance among listed firms in Kenya. The results of this paper will shed more light on the social transparency and tax avoidance relationship from an emerging economy perspective, that is characterized by acute tax deficits and weak disclosures framework. This paper is organized as follows: the following section presents the literature review, while the methodology is explained in the third section. The findings and discussion are presented in fourth section. The conclusion and recommendation are made in the final section.

2. Literature Review

In this section, we review the empirical literature on the social transparency on tax avoidance relationship. Over the last three decades, there has been a significant growth in firms' investment in corporate social responsibility which has raised concerns on their implementation on tax planning and tax avoidance (Fatma, Rahman, & Khan, 2015). CSR activities are grounded on two motives. First, is the firm's desire to improve on its corporate image and profitability (Garst, *et al*., (2017). Second, a firm's activities affect the health, culture, economic, and social life of the communities within which they operate; thus, firms are expected to be responsible corporate citizens (Samet, & Jarboui 2017; Watson, 2015; Lanis, & Richardson, 2012). On the other hand, CSR activities involve huge financial investment, which conflicts with the main objective of the firm, maximization of shareholders' wealth (Manchiraju, & Rajgopal, 2017). Thus, to meet the two conflicting objectives, firm managers are likely to engage in tax avoidance. Although a firm's disclosure of its corporate social responsibility is the main indicator of its corporate social transparency, just a few studies have examinedthe social transparency and tax avoidance nexus, and their findings are debatable.

Liu and Lee (2019) examined the effect of corporate social responsibility on earnings management and tax avoidance among Chinese listed companies, (both states owned, and non-state owned). Specifically, the authors investigated whether government guided CSR implementation indeed drives firms to behave in a responsible manner by constraining earnings management and tax avoidance. They used a sample of 1,374 firm-year observations covering the period 2010-2014. The study found that state owned enterprises with better CSR performance were less likely to engage in tax avoidance while non- state-owned enterprises avoided tax more. Using a sample of 5,588 firm-year observations of US firms during the 2006-2011 period, Davis *et al.,* (2016), concluded that firms who engage CSR activities are more likely to avoid taxes. More recently, a study by Watson (2015) sought to examine the link between CSR, tax avoidance and earnings performance. The study used panel data drawn from US firms over the period 2003-2009 and it found a positive and significant relationship between CSR and tax avoidance. In addition, the study reported that tax avoidance was more pronounced in firms experiencing low profitability. Similarly, Hoi *et al.,* (2013) sought to examine whether irresponsible CSR activities are associated with aggressive tax avoidance. The authors considered a sample of US firms and used a sample covering the period 2003-2009. The findings of the study show that excessively irresponsible CSR activities are associated with more aggressiveness in tax avoiding practices.

In contrast, a stream of literature shows that firms engaging in corporate social responsibility activities are more transparent and unlikely to engage in tax avoidance. Lanis and Richardson (2012) studied the relationship between corporate social responsibility and corporate tax aggressiveness (an indicator of tax avoidance). The study considered a sample of 408 Australian listed corporations a panel data set from 2008 to 2009. The results of their study showeda negative and statistically significant association between CSR disclosure and tax aggressiveness. Thus, the higher the level of CSR disclosure the lower the level of corporate tax aggressiveness. The study concluded that more socially transparent corporations are likely to avoid less taxes. Also, Ki (2012) who used a sample of 2,002 Korean firmsand data for the 2002-2009 period, found that firms with higher CSR performance are less likely to engage in tax avoidance. The study by Lanis & Richardson (2015) also shows that there is a negative association between CSR and tax avoidance. They used a matched sample of 434 firm-year observations (217 tax avoidance and 217 non-tax avoidance firm year observations) and found that firms with superior CSR performance are less likely to engage in tax avoidance.

CSR disclosure is a key dimension of a firm's corporate social transparency and going by the aforementioned empirical literature, there seems to be no consensus on the impact of corporate social transparency and tax avoidance relationship. Thus, this study hypothesizes the following;

H1. Corporate social transparency has no significant impacton tax avoidance among listed firms in Kenya

3. Methodology

Data and sample

The target population consists of all 67 listed firms at the Nairobi Securities Exchange, Kenya as at 2018 (NSE, 2018). However, owing to the unique characteristics of financial institutions and the nature of the key variables, the study excluded all firms engaged in the provision of financial services to reduce data distortion. Again, a firm ought to have traded in the entire period under study that is 2009 - 2018. Thus, the final sample comprised of 31 firms which yielded 310 firm year observations.

Measurement of variables

Dependent Variable - Tax avoidance

To measure tax avoidance, the study employs the effective tax rate (ETR) methodology. This method compares the applicable statutory tax rate (STR) of the firms with the ETR. The unexplained excess of the STR over the ETR is considered as tax planning outcome. All things being equal, the wider the gap between the ETR and the STR (that is, STR> ETR), the higher the tax avoidance from tax planning. The ETR approach has been adopted by previous researchers, (Gupta & Newberry 1997; Rohaya *et al.*, 2008). The strength of the ETR approach lies in the fact that the data required can be accessed without direct correspondence with the firm and the tax authorities

Independent Variable - Social transparency

A broadly referenced measure of corporate transparency is the Transparency and Disclosure (T&D) index compiled by Standard and Poor (S&P). The T&D index consists of 98 items for the evaluation of corporate transparency classified in three major sections: ownership structure and investor rights, board structure and process, and financial transparency and information disclosure (Patel *et al.*, 2002). Previous empirical studies, on corporate transparency at the firm level, used the intact T&D index as an evaluation instrument while other researchers have modified the basic T&D index to reflect the national context (Aksu & Kosedag, 2006).

This study adopted a corporate transparency index that was devised by Kim *et al*., (2013) after investigating items from transparency indices of various previous studies. This index had 19 items social transparency ranging from public relations, business ethics to social contribution. However, the index was modified in order to fit the Kenyan firms and had eight (8) items that cut across from firm's public relations through business ethics to social contribution practices. The items were binary in nature. Where a company provided the information, it got one (1) otherwise it was awarded zero (0). The final index is a ratio of the score attained divided by the maximum number of scores.

Control variables: - cash holding, size and leverage

To isolate the direct effect of social transparency and tax avoidance as suggested in the empirical literature, the study controlled for several variables (firm size, firm leverage and cash holding). First, the effect of firm size on tax avoidance is contentious. Large firms have more resources that enable them to engage more in CSR and hire experts who will disclose the firm's activities correctly. Therefore, such firms are less likely to engage in tax avoidance practices. They are likely to be more transparent in their operations and reporting. Further, large firms may also be able to outsource for tax planning and legal services (Irianto, Sudibyo, & Wafirli, 2017; Rusydi, 2014). These will lead to the firm exploiting the tax laws and end up avoiding more tax. Firm Size *(Fsize)*, is measured by the natural logarithm of total assets of firm. Secondly, based on Agency theory, firm leverage has been suggested as a relevant factor in explaining tax compliance level (Al- Shammari *et al.,* 2008; Demir & Bahadir, 2014; Yiadom & Atsunyo, 2014). Proponents of the Agency theory suggest that agency conflicts between the principals (for example debt holders) and their agents (for instance managers acting in the interests of the shareholders) give rise to agency costs which are expected to be higher for levered firms (Jensen & Meckling 1976 and Fama & Jensen 1983). Hence, firms with higher leverage can be expected to disclose more information to reduce agency costs by reassuring the debt holders that their interests are protected (Yosra & Hela, 2017). Firm Leverage *(Lev.),* is measured by the ratio of total debt (liabilities) to total assets (Arfan *et al.*, 2017; Atwood, Drake, Myers, & Myers, 2012). Although some researchers argue that the motive for holding cash is to maximize the wealth of shareholders (Dittmar, Mahrt-Smith, & Servaes, 2003), it has also been discussed elsewhere in the literature that tax avoidance is an opportunistic act of managers (Khuong, Ha, Minh, & Thu, 2019; Kurniawan & Nuryanah, 2017). Thus, the agency conflict is likely to contribute to tax avoidance. Cash holding is measured by total cash held by the firm, divided by net asset of the firm $_i$ in year $_t$ (Arfan *et al.*, 2017).

$$CH = \mathrm{TC_{it}}/\mathrm{NA_{it}}$$

Where: CH = Cash Holding of firm *i* at time *t*

$\mathrm{TC_{it}}$ =Total Cash held by firm *i* at time *t*

$\mathrm{NA_{it}}$ =Net Assets held by firm *i* at time *t*

Regression Model

The study sought to examine the effect of social transparency on tax avoidance. The hypothesis was testing using multiple regressions. The study used the dynamic panel, Generalized Method of Moments (**GMM**), with the lag of the dependent variable to control for possible endogeneity in tax avoidance, social transparency and the control variables.

$$TA_{it} = TA_{it-1} + \beta_1 ST_{it-1} + \beta_2 CH_{it-1} + \beta_3 FS_{it-1} + \beta_4 LEV_{it-1} + \varepsilon_{it}$$

Where:

TA_{it} = tax avoidance.

TA_{it-1} = lagged depended variable.

ST_{it-1}= social transparency of firm *i* at year *t*.

CH_{it-1}= cash holding of firm *i* at year *t*.

FS_{it-1}= size of firm *i* at year *t*.

Lev_{it-1}= leverage of firm *i* at year *t*.

$\beta_1 \ldots \beta_4$= Coefficients of the concerned explanatory variables.
β_{0i} = y-intercept of firm *i.*
ε_{it}= error term of firm *i* at year *t.* (random variation due to other unmeasured factors).

4. Results

Descriptive statistics

The descriptive statistics of the research variables are given in Table 1. The mean value of tax avoidance, the dependent variable, is about 22.5%, which is lower than the county's effective corporate tax rate of 30%. This implies that selected firms avoid taxes at 7.5%. Social transparency, the independent variable, has a mean score of 0.629 and a standard deviation of 0.18, inferring low variation in social transparency. The control variables (cash holding, leverage and firm size) had means of 0.077, 0.424 and 6.836 with corresponding standard deviations of 0.901, 0.153 and 0.850, respectively.

Table 1. Descriptive Statistics

Variable	Obs	Mean	Std. Dev.	Min	Max
TaxAvoidance	310	0.225	0.139	0.007	0.509
Social transparency	310	0.629	0.180	0.250	1.000
Cashholding	310	0.077	0.091	0.001	0.590
Leverage	310	0.424	0.153	0.132	0.806
Size	310	6.836	0.850	4.701	8.579

Correlation Results

In this study, Pearson's pairwise correlation analysis was conducted to examine the relationship between variables. The results displayed in Table 2 demonstrates that the relationship between social transparency significant and tax avoidance is positive and significant (r = 0.302, $p \leq 0.05$). Additionally, the association between cash holding, firm size and tax avoidance has a positive and significant (r = 0.161, p ≤ 0.05 and r = 0.665, $p \leq 0.05$) effect on tax avoidance. However, leverage is negatively and insignificantly (r = -0.049, $p \geq 0.05$) related to tax avoidance for listed firms in Kenya.

Table 2. Pairwise correlation matrix

Variables	1	2	3	4	5
1. Tax Avoidance	1.000				
2. Social Transparency	0.302*	1.000			
3. Cash holding	0.161*	0.039	1.000		
4. Leverage	-0.049	-0113*	-0.044	1.000	
5. Firm size	0.665*	0.237*	0.029	-0138*	1.000

Notes: * Correlation is significant at the 0.05 level.

Regression Results

Table 3 present the results of the multiple regression analysis using tax avoidance as the dependent variable and social transparency as the predictor variable. The hypothesis is tested using the GMM estimates. The regression coefficients for the fixed effect and random effect estimation models are also presented. The result of the multiple regression revealed that the effect of social transparency on tax avoidance is positive and significant (β = 0.027, $p <0.05$). Therefore, the null hypothesis stating that social transparency had no significant effect on the tax avoidance for firms listed in the Nairobi Securities Exchange was not supported. The findings are supported by previous studies, for examples studies by Hoi *et al*. (2013) who found out that those firms with excessive irresponsible CSR activities are more aggressive in avoiding taxes. Lanis & Richardson (2013) found out that firms which provide more CSR disclosures actively violate the tax regulations in order to cover up their opportunistic acts and engage more in tax avoidance, Davis, (2016) and Watson (2015) also found a positive and significant relationship between CSR activities and tax avoidance. The results of the study by Amidu *et al.*, (2016) also show that the firms sampled engage in management of their tax as a result an increase in CSR activities. However, the findings of this study contradict those of Lanis & Richardson (2012), Lanis & Richardson (2015), and Ki (2012) who found that firms with higher CSR performance are less likely to engage in tax avoidance.

Firm leverage had a positive and insignificant effect (β = 0.113, $p > 0.05$) on tax avoidance, this could be attributed to judicious use of debt among the listed firms. However, cash holding had a positive and significant effect on tax avoidance (β = 0.273, $p <0.05$). This implies that high cash holding is a key indicator of tax planning and tax avoidance. Also, managers are likely to avoid taxes to improve firms' liquidity position. Additionally, firm size had a positive and significant impact on tax avoidance (β = 0.099, $p < 0.05$). Large firms are more likely to engage in tax planning than small ones. One possible explanation could that large firms have resources that enable them hire tax consultants.

Table 3. Analysis of the Effect of Social Transparency on Tax Avoidance

TaxAvoidance	GMM	Fixed Effect	Random Effect
Social transparency	0.027(0.005)**	0.031(0.005)**	0.027(0.004)**
Cashholding	0.273(0.085)**	0.187(0.058)**	0.193(0.057)**
Leverage	0.113(0.078)	0.101(0.056)	0.079(0.048)
Firm Size	0.099(0.017)**	0.092(0.013)**	0.110(0.012)**
_cons	0.083(0.051)**	0.079(0.037)**	0.124(0.036)**
Observations	248	310	310
R^2		0.4149	0.4529

Notes. The values in parentheses are standard errors of the coefficients. Significance levels: ** p<0.05.

5. Conclusion

Social transparency and tax avoidance have increasingly become of interest to policymakers, researchers and development practitioners. On this basis, the study set out to investigate the impact of social transparency on tax avoidance. The study concludes that firms that engage in CSR activities and disclose the same are less likely to engage in aggressive tax planning to avoid taxes. By way of policy implication, policymakers should apply mandatory disclosure to social transparency; voluntary disclosures are usually more of impression management than on providing any transparent account of activities, which can possibly minimize tax avoidance. Additionally, companies' directors should also realize that aggressive tax-planning strategies are not be compatible with long-term sustainability and corporate citizenship, and therefore may not be in the shareholder's broader interests. Therefore, managers should voluntarily embrace social transparency, by publishing all necessary accounting information on corporate social responsibility, and to refrain from the irresponsible use of profits on social activities that lack substantial economic purpose

This study is subject to a number of limitations which can be the basis for future studies. First, the sample is drawn from publicly listed Kenyan firms. Because of a lack of data, it was not possible to include unlisted firms in the sample. Second, the size of the sample is relatively small, although it appears to be adequate given the sampling time frame of ten years, which yielded 310 firm-year observations.

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