The Relation Between Firm Value, Business Strategy, Ownership Structure and Tax Avoidance In Pakistan: Mini-Review

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Abstract

Most of the time companies tend to indulge in tax avoidance activities to refrain from paying taxes and escalate their after-tax income. Tax avoidance has become a hot topic in the media as well as for academic discussion because taxes are extremely important for budgeting and revenue generation for developing countries like Pakistan. Hence the goal of this review is to compile and analyze corporate governance strategies in relation to tax avoidance in order to provide policymakers, organizations, and governments with data to help eliminate such activities. Based on previous researches conducted and further analysis it has been found that having a higher number of independent directors on the board will bring a reduction in tax avoidance. Firm value and tax avoidance have a negative relationship that can be mitigated by corporate governance. Furthermore, tax payment and business strategy have a negative relationship too, suggesting that prospectors-type strategies are more prone to be indulged in tax avoidance.

Introduction

Taxation plays an important role not only in the development of a country but also in the strategic decisions of a company. Therefore, companies often choose to adopt a dynamic or active method for tax management (Anouar, 2017). Some companies even choose to hire tax experts that are well aware of the tax codes to find loopholes in them to avoid taxes. However, the term, tax avoidance can be interchangeably used with other terms such as tax management, tax sheltering, tax planning, and tax aggressiveness (S. Chen et al., 2010; Minnick & Noga, 2010; T. Tang & Firth, 2011). How the term is perceived depends on different people and their understanding (Hanlon & Heitzman, 2010).

The strategies used to avoid tax not only increase the cash flow but also accelerates the accounting earnings, in particular, situations (Husnain et al., 2021). These strategies are perceived as value enhancement methods by the companies (S. Y. Chen et al., 2018; Higgins et al., 2014). An argument presented suggests that companies need to develop an optimum level of tax avoidance so that firms can develop a balance between follow-on benefits and costs in order to maximize the value to shareholders (Slemrod, 2016). It was also further elaborated that for evading a reduction in distributable wealth, the company needs to develop tax avoidance strategies that are most commonly practiced (Annuar et al., 2014).

It has been found that decisions related to tax avoidance can also affect shareholder's returns which are further linked to investment decisions and consequently affect the managers who earn benefits from tax savings

(Phillips, 2003; T. Y. H. Tang, 2017; Wilde & Wilson, 2018). Hence tax avoidance can raise much concern for the government, society, authorities, and policymakers (S. Chen et al., 2010). It has been found that public-private firms use tax avoidance rather aggressively (Martinez, 2017). However, there are multiple factors affecting tax avoidance such as the size of the company, its capital investment, the economies of scale through foreign operation, and leverage (D.Dyreng et al., 2010; Rohaya et al., 2009).

In this review, we will be analyzing tax avoidance in relation to various aspects of a company to understand its effects. The goal here is to reduce and eventually eliminate tax avoidance. It has become a hot topic in recent years for political and academic discussion (Huseynov et al., 2017). The media has also shed a lot of light on international firms involved in tax avoidance (Kanagaretnam et al., 2016). There has been evidence found of the impact of tax avoidance on firm value (Khan et al., 2020). It has been evaluated that if the profits earned from tax avoidance are used for personal uses, then the firm value will drop. Whereas in the case of transparent processing, tax avoidance can actually enhance firm value. Therefore, corporate governance attenuates any negative impact tax avoidance can have on firm value (X. Chen et al., 2014). In terms of firm value, we will be reviewing how corporate governance mitigates conflicts caused by tax avoidance to enhance firm value in developing countries like Pakistan.

In addition to this business strategy and tax avoidance are of major interest because corporate governance plays a vital role in regulating various factors and planning processes. Studies show that larger and relatively independent boards are related to low levels of risk-taking hence resulting in reduced tax avoidance (Husnain et al., 2021). Many studies have related tax evasion with family firm status, executive compensation, and ownership structure (S. Chen et al., 2010; Desai & Dharmapala, 2008; Hanlon & Slemrod, 2009; Richardson & Lanis, 2011). Multiple aspects are enveloped with the term corporate governance or business strategies. These aspects are entrenchment, board composition, board compensation, and executive compensation used (Minnick & Noga, 2010).

Corporate governance in terms of ownership structure is one of the key features of a company because they assist in the smooth running of the company in the market (Zhang & Kyaw, 2016). Studies have revealed that the ownership structure is very concentrated in Pakistan companies. Statistics show that companies in developing countries tend to have 55.20%, concentrated owners. This also insinuates that families are directly or indirectly owners of these companies (Afgan et al., 2016). A similar situation was observed in Turkish firms so studies were conducted to evaluate the performance and impact of ownership concentration on tax avoidance, Spanish companies underwent similar research (Mandacı & Gumus, 2010). Pakistan is a developing country so it is essential that this key factor of a company is well understood in relation to tax avoidance (Fernández-Rodríguez et al., 2019).

So, our main focus for this review is to broaden the horizon of factors linked with tax avoidance in Pakistani companies and study them well. We have compiled and analyzed data from all recently conducted studies on tax avoidance in relation to corporate governance.

Business Strategy and its relation with Tax Avoidance

A study conducted in Pakistan by Husain et al., in 2021 studied 125 non-financial companies listed on the Pakistan stock exchange from 2013 to 2017 and analyzed the nexus between board structure, business strategy, and tax avoidance. They examined the moderating role of an independent board and board size with respect to tax avoidance and business strategies focusing on developing countries such as Pakistan. They utilized dynamic panel data estimation techniques which is a generalized method of the moment that showed elevation in board size will consequently increase tax avoidance. It was also found in this study that an increase in the number of independent directors will actually reduce the trends of tax avoidance. (Husnain et al., 2021)

Apart from this, the results obtained indicate a negative relationship between tax payment and business strategy hence suggesting a positive relationship between tax avoidance and business strategy. It can be deduced that firms that tend to adopt a prospector strategy tend to be more involved in tax avoidance, which is consistent with similar previous studies (Higgins et al., 2014; Hsu et al., 2018; Lopo Martinez & Ferreira, 2019). This can be owed to the fact that the cost of tax avoidance is borne by the prospector-type firms and is not a hindrance for them. Since the prospectors are the ones who get high income from a broad market share and sale of their diverse products which match the consumer needs and tastes hence, they have fewer competitors and better market share (Higgins et al., 2014; Sadjiarto et al., 2020). This confirms that business strategy influences tax avoidance.

Ownership Structure and its relation with tax avoidance

A study conducted in 2021 by Younus et al., investigated the relationship between concentrated ownership structure and moderation of tax avoidance. Their sample included 50 nonfinancial companies listed on Pakistan Stock Exchange and their data from 2015 to 2020. The results obtained were based on panel regression techniques: Fixed effect and random effect models along with other pre-estimation and post-estimation techniques. Part of their results showed that tax avoidance regulates the relationship of ownership with the performance of the firm. It was found that companies with concentrated ownership tend to display tax avoidance activities (Fig 1). The shareholders do so by developing incentives to increase the value of the firm. Similar results have been obtained from studies conducted in other countries.

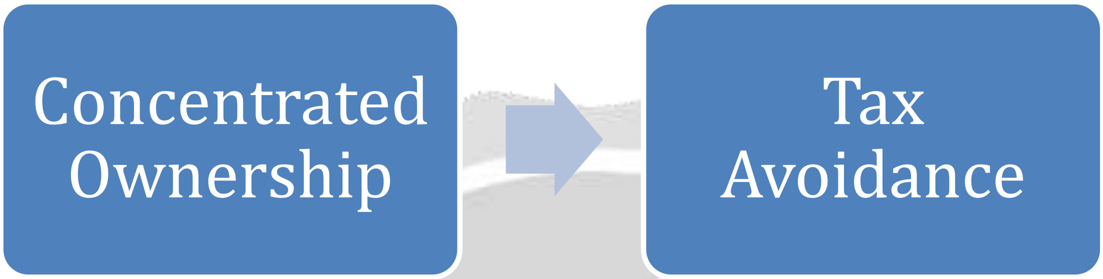

Figure 1: Companies with concentrated ownership tend to display tax avoidance activities

A research study conducted on six companies on the Indonesian stock exchange showed that tax avoidance has a significant influence on the financial performance of firms. Some research has also proposed that if tax avoidance is observed in firms, then the agency cost may go up leading to lower firm performance. In addition to this, a significant, indirect, however, positive relation has been found between tax avoidance and the market value of companies.

Husain et al., in 2021 also viewed business strategy and tax avoidance in relation to the moderating effect of ownership structure and found that the results tend to change with respect to their characteristics (Husnain et al., 2021). It has been found that the size of the board tends to have a negative relation with tax payment which suggests that the larger the board, the higher the number of tax avoidance activities, which further supports the previously conducted studies (Abdul Wahab & Holland, 2012). Whereas the results for board independence show that there is a positive relation with tax payment. If there is an increase in independent directors, then there will also be a decrease in tax avoidance activities (Fig 2) (Aburajab et al., 2019; Chytis et al., 2018).

Figure 2: Board independence has a positive relation with tax payment

Firm Value and its relation with Tax Avoidance

Khan et al., in 2020 investigated the influence that tax avoidance has on firm value by using 10 non-financial first from the Pakistan stock exchange as a sample and studying their data from 2013 to 2017. They utilized proxy ETR (Effective Tax Rate) to measure tax avoidance. They found that tax avoidance has a negative impact on firm value which is consistent with previous similar studies. The results suggest that agency conflict becomes an integral part in the reduction of firm value and this conflict is mitigated by corporate governance (Fig 3). The takeaway from the study is that well-though governance, the money saved due to tax avoidance can actually be used for firm value otherwise it gets lost in the personal benefits of management. (Younus et al., 2021)

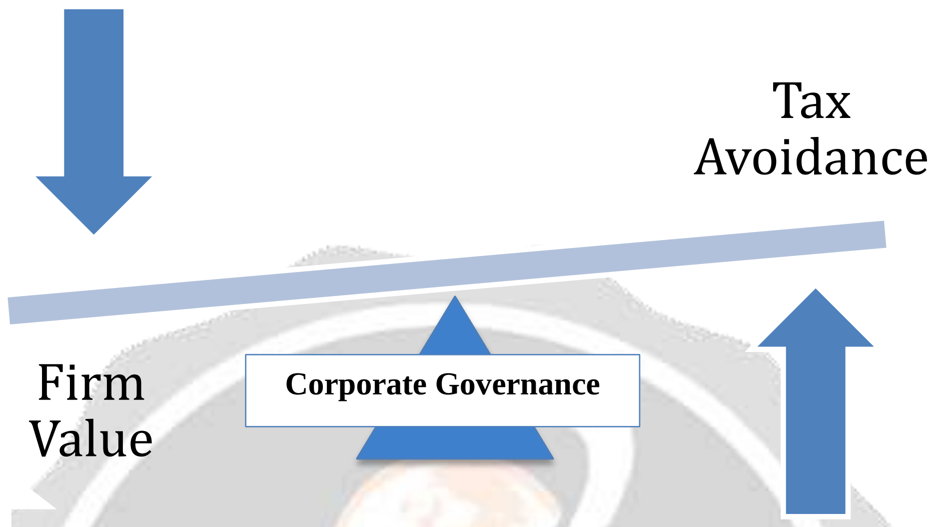

Figure 3: Negative relationship between tax avoidance and firm value can be mitigated by better corporate governance

Results:

These results are supported by previous studies (S. Y. Chen et al., 2018; Desai & Dharmapala, 2008). Desai and Dharmapala also suggested that tax avoidance activities lead to agency problems, paving a way for reduced firm value. However, it is not a given that the cash flow from tax avoidance will always result in personal benefits for the managers because the existence of agency conflicts can result in unpredictable outcomes. Chen et al. reported their findings which align with these results too hence it can be deduced that the relationship between tax avoidance and firm value is negative even in developed countries as well. (X. Chen et al., 2014).

Conclusion

Based on the above reported studies it can be observed that the tax avoidance trends faced by Pakistan are pretty similar to other developing countries and in the case of firm value, they coincided with developing countries as well. Tax avoidance is a heinous act. Taxes are needed for the development of the country. Moreover, tax avoidance can lead to agency conflict as well because the non-transparency of the first and weak corporate governance increases the conflict paving way for distrust between stakeholders and managers.

The goal of this review is to help policymakers in tax planning. Especially a developing country like Pakistan to understand means that can be used to reduce tax avoidance so that their economy can grow. Having a higher number of independent directors on the board will bring a reduction in tax avoidance. Firm value and tax avoidance have a negative relationship that can be mitigated by corporate governance. Furthermore, tax payment and business strategy have a negative relationship, suggesting that prospectors-type strategies are more prone to be indulged in tax avoidance.

In the future studies can be conducted on other types of corporate governance attributes in relation to tax avoidance such as compensation, gender equality on the board, CEO duality, and CEO mechanisms. Such studies can further help out Pakistan to better understand trends in tax avoidance.

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