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A Theoretical Review on Corporate Tax Avoidance: Shareholder Approach versus Stakeholder Approach

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ABSTRACT

Objective – Although corporate tax avoidance is a widely discussed topic in the literature, conflicts do emerge when it is analyzed through the context of primary corporate duty. Should companies, in managing their taxes, solely honor their obligation to increase shareholders' wealth or should they cater to the interests of all their stakeholders? Such conflicts are especially evident in the inconsistent empirical observations on how corporate tax avoidance relate to corporate social responsibility (CSR), which makes the dearth of theoretical analysis on this issue even more conspicuous. Taking into account the socio-political nature and human elements in corporate tax avoidance, theoretical analyses from social sciences' perspectives are becoming markedly crucial.
Methodology/Technique – This paper critically reviews the extant literature for discussions on how corporate tax avoidance is influenced by the dissenting approaches towards primary corporate duty.
Findings – By allowing an insight into how people act and the world they live in, these analyses form a constructive tool to rationalize and foretell managerial actions towards shareholders and stakeholders alike.
Novelty – It focuses particularly on the theories that are widely used to lend supports for such approaches. These theories are the agency theory, stakeholder theory, and legitimacy theory.
Type of Paper: Review

Keywords: Corporate Tax Avoidance; Corporate Social Responsibility (CSR); Theoretical Analysis; Shareholder Approach; Stakeholder Approach; Agency Theory; Stakeholder Theory; Legitimacy Theory.

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1. Introduction

Tax constitutes one of the most substantial costs that companies have to bear each year. By eroding a large portion of corporate income, tax causes visible reduction in the companies' distributable profit (Annuar et al., 2014).

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In response, tax avoidance measures have become a universal norm for companies due to their effectiveness in improving cash flow position and financial accounting performance (Hanlon & Heitzman, 2010; Graham et al., 2014). In contrast, countries worldwide treasure their tax revenues as the lifeblood of their financial sustainability and independence. Tax revenues fund the countries' provisions of public utilities and welfare services as well as their operational expenditures and debt repayments (OECD, 2010). An unchecked epidemic of corporate tax avoidance will ultimately burden the society iniquitously by restricting government-driven social advancements (Bracking, 2012).

Numerous literatures have scrutinized corporate tax avoidance. In particular, it is being frequently analyzed under the lens of CSR as the boundaries between corporate tax laws and behaviors become further distorted (Sikka, 2010; Lanis & Richardson, 2015; Hillenbrand et al., 2019). The theoretical arguments and inconsistent empirical observations on the relationship between corporate tax avoidance and CSR accentuate an inherent conflict on the issue of fundamental corporate responsibility (Hanlon & Heitzman, 2010; Watson, 2015; Davis et al., 2016); do companies owe their primary duty to the shareholders or stakeholders? If companies owe their primary duty to the shareholders, then their sole objective is to maximize the shareholders' wealth. In contrast, if companies owe their primary duty to the stakeholders, they are obligated to act in the stakeholders' best interests. This polarity makes the dearth of further theoretical analysis on this issue all the more palpable.

As social sciences' theories allow a grasp on how people act and the world they live in, they form a constructive tool in rationalizing and foretelling managerial actions towards shareholders and stakeholders. These theories are thus relevant for examining the socio-political nature and human elements in corporate tax avoidance (Whait et al., 2018). Indeed, both shareholder and stakeholder approaches form part of the normative theories of business ethics even though they are polar opposite (Smith, 2003). Accordingly, this paper critically reviews the extant literature with focus on the theories used to explain how corporate tax avoidance is or may be influenced by the dissenting approaches on primary corporate duty. These theories are the agency theory, stakeholder theory, and legitimacy theory.

The rest of this paper is organized as follows. The next section outlines how primary duties of companies influence corporate tax avoidance in general. The subsequent sections pick up the discussions in detail by focusing first on shareholder approach and followed by stakeholder approach. The last section concludes the discussions and proposes a way to reconcile the diverging approaches.

2. Corporate Tax Avoidance and Primary Duties of Companies

Spurred by globalization, corporate tax avoidance practices have been experiencing a rapid proliferation around the world. They are now so rampant that they have become part of acceptable and sound business practices (Barford & Holt, 2013; Whait et al., 2018). Indeed, present-day businesses are being structured in such ways to exploit loopholes in tax laws (Christensen & Murphy, 2004).

The popularity of corporate tax avoidance practices is fueled by managers who inherently do not regard such measures as erroneous or even iniquitous (Sikka, 2010). They are adamant that companies possess the rights and freedom like any other taxpayers to manage their taxes so long they abide by the letters of laws (Hasseldine & Morris, 2013; Gribnau, 2015; Lanis et al., 2018; Whait et al., 2018; Hillenbrand et al., 2019). It should be borne in mind that companies are essentially created as investment vessels and managers are contractually bound to serve the shareholders' interests. It results in the managers tenaciously embracing the maxim of shareholders' wealth maximization and predominantly focusing on generating profit. Thus, agency theory occupies a significant role in explaining corporate tax avoidance.

However, critics have been quick to reproach corporate tax avoidance practices. Public tax shaming against multinational corporations have seen Apple, Google, and Starbucks becoming the global poster children of corporate tax avoidance through their manipulation of transfer pricing system to "move" their substantial profits to more tax-friendly locales (Barford & Holt, 2013; Hillenbrand et al., 2019). Using reputational loss as a threat, the public shaming of tax-avoidant companies has been seen as an effective way to make them honor their fair share of taxes (Barford & Holt, 2013).

Such public censures stem from the view that companies are primarily responsible to fulfill their fair share of taxes as part of their social contributions for the stakeholders' betterment (Sikka, 2010; Lanis et al., 2018). Considering that taxes provide for public goods and services, companies that are not honoring their fair share of taxes unequivocally cause significant fiscal problems and perhaps irreparable loss to the society (Sikka, 2010; Lanis et al., 2018). As a result, these companies are deemed to be disinclined in discharging their ultimate social obligation (Christensen & Murphy, 2004; Avi-Yonah, 2008). This stakeholder approach is commonly discussed in corporate tax avoidance literature using stakeholder theory and legitimacy theory.

The following sections discuss the respective approaches in detail by focusing on the theories that are most commonly used by the literature to represent them.

3. Shareholder Approach toward Corporate Tax Avoidance

Even though being the rightful owners, shareholders in general relinquish the corporate control to managers who act as agents and run the business on their stead. The resultant agency relationship brought by the separation of ownership and control forms the very basis of agency theory (Jensen & Meckling, 1976).

The logic of capitalism asserts that the ultimate corporate responsibility is to generate profit for the shareholders' economic benefit (Friedman, 1970; Sikka, 2010; Elbra & Miller, 2017; Whait et al., 2018). Consequently, managers are often subject to intense pressures by especially risk-indifferent shareholders to produce higher corporate profit and firm value (Hanlon & Heitzman, 2010; Whait et al., 2018). It includes expecting the managers to pursue opportunities to reduce expenses such as taxes, as long as the benefits of doing so exceed the costs. This view is supported by empirical findings. In their respective studies, Desai and Dharmapala (2006) as well as Graham and Tucker (2006) agree that shareholders do appreciate corporate tax avoidance as a value-enhancing activity. In a similar vein, Wilson (2009) observes that well-governed companies participating in tax shelter activities generate significant wealth for their shareholders. Chyz and Gaertner (2018) meanwhile find that CEO turnover is significantly greater in companies paying relatively higher taxes as compared to their peers.

On the other hand, the separation of ownership and control very much expose corporate tax decisions to the managers' private interest (Desai & Dharmapala, 2006; Hanlon & Heitzman, 2010). The control they possess on business operations allow them to filter and even misrepresent the information they share with the shareholders (Hill & Jones, 1992). The resulting information asymmetry, vis-à-vis those related to tax avoidance activities, gives managers a viable opportunity to engage in rent extraction without openly exhibiting their self-interested behaviors (Desai & Dharmapala, 2006). Frank et al. (2009) likewise highlight the shareholders' concern that managers who aggressively plan and avoid corporate taxes may be similarly aggressive in making financial reporting decisions.

Managers' engagements in tax avoidance activities therefore may be an indication of agency problem (Hanlon & Heitzman, 2010; Chen et al., 2014). This necessitates corrective measures to align the interests of shareholders and managers in order to reduce managerial opportunistic behaviors and in the long run, to evade the managers' total subversion of shareholders. Among such corrective measures involve managerial remuneration and compensation policies. It is not uncommon for shareholders to reward managers for their efforts to minimize corporate taxes (Crocker & Slemrod, 2005; Seidman & Stomberg, 2017). Studies have found that managerial incentives are directly correlated with corporate tax avoidance (Robinson et al., 2010; Rego & Wilson, 2012; Gaertner, 2014; Powers et al., 2016). Besides compensation, corporate tax avoidance significantly boosts the professional reputations of CEOs and directors, which later advances their future career progressions (Lanis et al., 2018).

4. Stakeholder Approach toward Corporate Tax Avoidance

Corporate stakeholders generally encompass shareholders, employees, customers, suppliers, creditors, government, as well as the community in which companies operate (Smith, 2003). According to stakeholder theory, the stakeholders' rightful interests on companies stem from the essential corporate contributions they make (Hills & Jones, 1992). As this quid pro quo relationship represents "nexus(es) of contracts" between companies and their stakeholders, companies are thus deemed to have no ultimate owner since a nexus cannot be possessed by any specific party (Fontrodona & Sison, 2006; Lanis & Richardson, 2012). This effectively turns the managers into agents for all corporate stakeholders. Therefore, managers are not exclusively responsible to fulfill the shareholders' interests. Instead, they are obligated to safeguard the stakeholders' moral rights and best interests while executing their corporate duties (Freeman et al., 2004).

Consistent with the fundamental belief of stakeholder approach, tax compliance represents a sensible and natural means for companies to foster and reinforce positive stakeholder relationships. As a result, managers' treatment of tax as a cost to be minimized should correspondingly diminish as they recognize their duties in satisfying the needs of all stakeholder groups (Godos-Díez et al., 2011).

This theoretical view is supported by several empirical findings. Lanis and Richardson (2012, 2015) conclude that positive relationships with stakeholder groups make Australian listed companies significantly less tax avoidant. Hoi et al. (2013) meanwhile surmise that CSR-inhibiting corporate culture results in large American public firms becoming significantly more tax avoidant as they are nescient of how their tax avoidance practices impact the society's well-beings. Similarly, Watson (2015) finds that American firms with low social responsibility become significantly more tax avoidant when their profits fall due to their explicable preference in saving their limited financial resources for themselves. However, Huseynov and Klamm (2012) along with Davis et al. (2016) demonstrate a circuitous link between corporate tax avoidance and CSR. They respectively suggest that although certain companies are indeed socially responsible, they purposely avoid taxes to use the generated savings for more CSR activities. In view of this, Davis et al. (2016) conclude that CSR activities and taxes are indeed proxies to one another.

Besides stakeholder theory, another theory normally cited in stakeholder approach is legitimacy theory. Under legitimacy theory, corporate values are to be harmonious with those of the society so as to preserve the companies' legitimacy to continue operating as their existence and well-beings are profoundly at the mercy of societal perceptions (Lindblom, 1994; Gray et al., 1996). When stakeholders regard tax avoidance as contradictory to their expectations of proper firm behaviors, the long-term viability and survival of tax-avoidant companies are put at risk (Woods, 1991; Jones, 1995; Lanis & Richardson, 2013, 2015; Hillenbrand et al., 2019). In consequence, companies hardly ever publicize their tax avoidance practices (Sikka, 2010). This reveals their innate perception that tax avoidance contravenes the expected social standards. Thus, companies seeking to uphold their legitimacy are expected to be less tax avoidant (Lanis & Richardson, 2011).

However, legitimacy theory can be more of a double-edged sword in explaining corporate tax avoidance. Cognizant on corporate ability to exploit the media, there are concerns that companies have been successfully exploiting their CSR performance as a whitewash tool to placate or distract the stakeholders from their tax avoidance practices (Sikka, 2010). In researching this, Lanis and Richardson (2013) subsequently conclude that Australian listed companies accused as being tax-avoidant have significantly disclosed more CSR information to show their commitment to stakeholders as well as to appease and improve the public's perceptions of them.

5. Conclusion

By their very nature, shareholder and stakeholder approaches present rather contradictory stands on corporate tax avoidance. Shareholder approach is more shareholder-centric and materialistic, making it being universally conjectured as single-minded and promoting selfishness (Fontrodona & Sison, 2006; Cuevas-

Rodríguez et al., 2012). Stakeholder approach, au contraire, promotes more generous and altruistic corporate attitude through delicate balancing acts by companies to preserve their symbiotic connections with the stakeholders (Cuevas-Rodríguez et al., 2012).

Nevertheless, these contradictions offer opportunities for greater theoretical developments that may allow corporate tax avoidance to be better understood and explained. New theories, such as bounded self-interest theory, that are capable of addressing the best interests of both shareholders and stakeholders simultaneously may be very useful indeed in finding a common ground between the companies' right to manage their taxes and their social responsibilities.

Bounded self-interest theory, which is an offshoot of the much-known agency theory, does emphasize on individual self-interest. Yet, it insists, under the principle of reciprocity, that a person strives to maximize his own self-interest so long that his own perceived forms of fairness are not defiled (Bosse & Phillips, 2016). Accordingly, managers may avoid tax and fairly distribute the resultant savings to the shareholders and stakeholders alike. Likewise, bounded self-interested shareholders will reciprocate by rewarding the managers appropriately when their tax avoidance measures successfully increase the shareholders' returns. Other bounded self-interested stakeholders will similarly give more of their supports to the companies in return when the companies use the tax savings generated for their direct improvements. This study therefore finds it compelling for future studies to analyze corporate tax avoidance by means of bounded self-interest theory, and how it may benefit the shareholders and stakeholders mutually.

In conclusion, the theoretical aspect of corporate tax avoidance ought not to be disregarded while empirical investigations on this discipline are rapidly progressing. Ultimately, the application of new theories to analyze corporate tax avoidance will lead to potential source of constructive and universal findings. This will be of immense use for policy developments and efficient tax enforcement strategies especially for countries that are more dependent on their corporate income tax revenue.

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