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Research on Corporate Transparency - Unit 6

Tax transparency

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Concerns about *corporate* tax avoidance – What did policymakers do?

- Multiple approaches to combat tax avoidance
  - OECD BEPS initiative: Introduction of harmonized, cross-country effort
  - Even without BEPS: Trends towards stricter anti-tax avoidance rules (Dharmapala 2014, Brühne et al. 2021)
  - One element of BEPS: More tax-related disclosures and reporting (“tax transparency”)
  - More coordinated tax enforcement efforts (e.g., the European Commission’s state aid investigations)
- What do we know about current anti-tax avoidance rules:
  - Generally, these rules substantially limited profit shifting (Alexander et al. 2019).
  - Thin-cap rules (Buettner et al. 2012), transfer pricing regimes (Lohse and Riedel 2014), etc. are effective in curbing tax avoidance
  - Next step: tax transparency and, e.g., country-by-country reporting (see Joachim’s great summary)

Let‘s take a step back – what do we want to achieve

- Objective of the governments
  - Maximize tax revenues
  - Ensure a fair and equitable tax system
  - Incentivize investment and growth
  - ….
- Objective of firms
  - Pay the tax they owe (i.e., comply with the law) → This implies tax planning, of course
  - Avoid double taxation
  - Consider after-tax profits
  - ….
- What we see here is a potential trade off. Why?
  - Tax transparency efforts can have adverse investment effects:
    - *Country-by-Country Reporting*: De Simone and Olbert (2020): Investments are shifted to low tax countries
    - Public tax disclosure *FIN 48*: reduced investment and R&D (e.g., Goldman 2019, Williams and Williams 2020)
    - Private tax disclosure *Schedule UTP*: delay of large investments (Jacob et al. 2021)

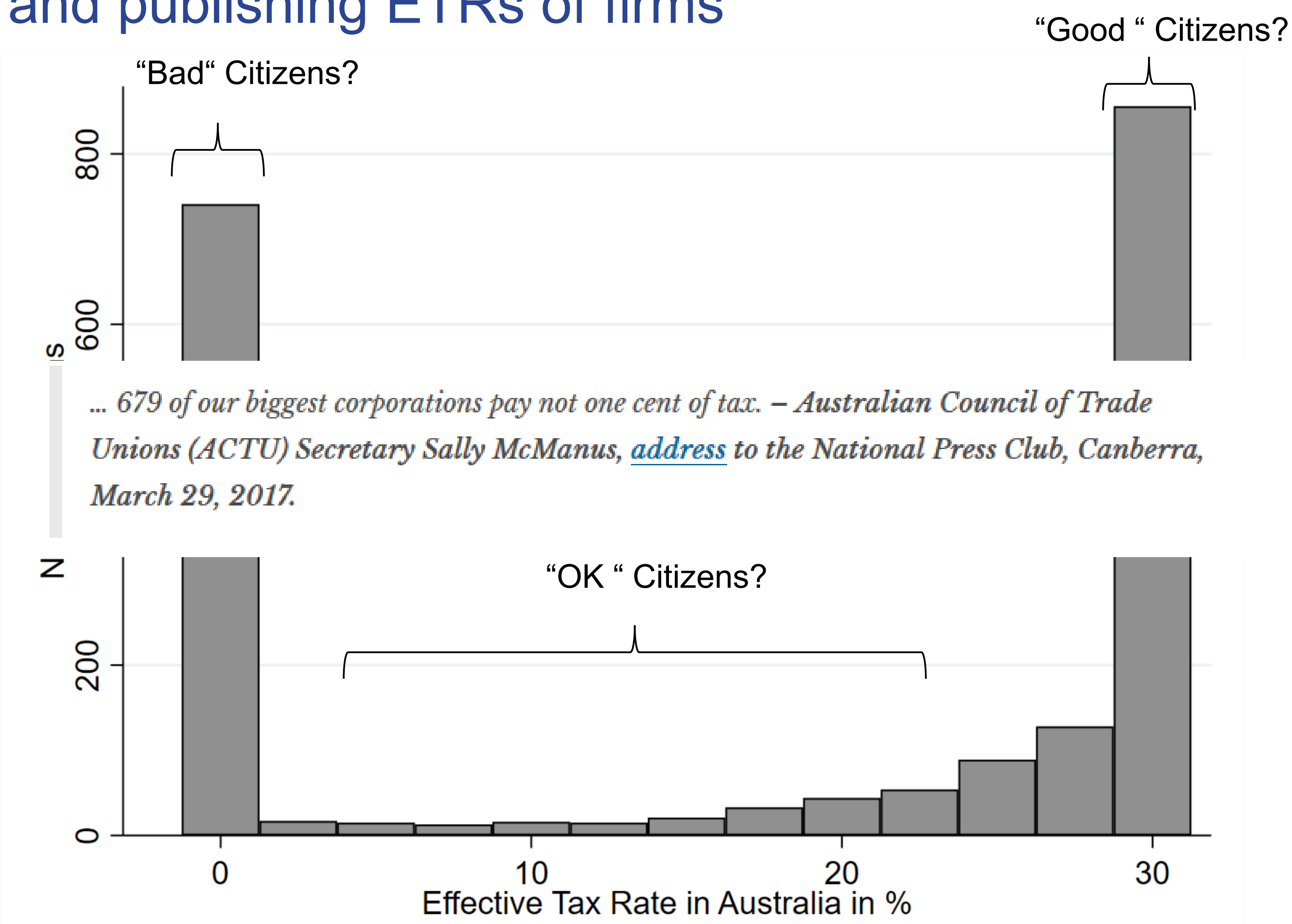
Let‘s think about costs and benefits of tax disclosures and tax transparency

- Benefits
  - Less tax avoidance? (*questioned by current research*)
  - Identification of tax avoiders
  - Public pressure on firms
  - ….
- Costs
  - Proprietary costs: Revealing where companies operate
  - Real responses: reduced investment activity, shifting of investments to low tax countries
  - …

- Let’s look at some evidence from Australia and their public tax disclosures…

What public tax disclosure can do

The case of Australia and publishing ETRs of firms



… 679 of our biggest corporations pay not one cent of tax. – Australian Council of Trade Unions (ACTU) Secretary Sally McManus, address to the National Press Club, Canberra, March 29, 2017.

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What public tax disclosure can do

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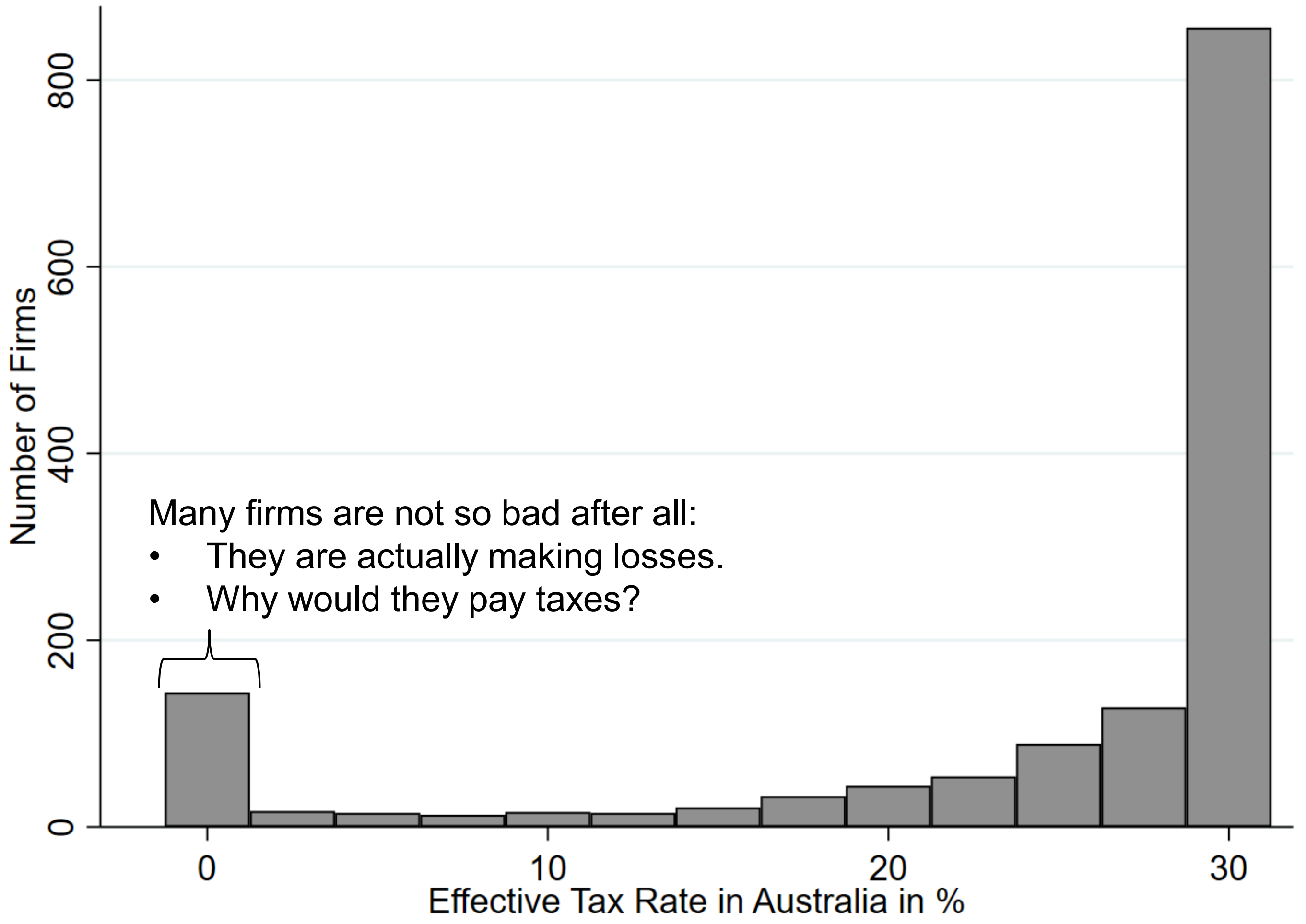

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What public tax disclosure can do

The case of Australia and publishing ETRs of firms: Misguiding Stakeholders

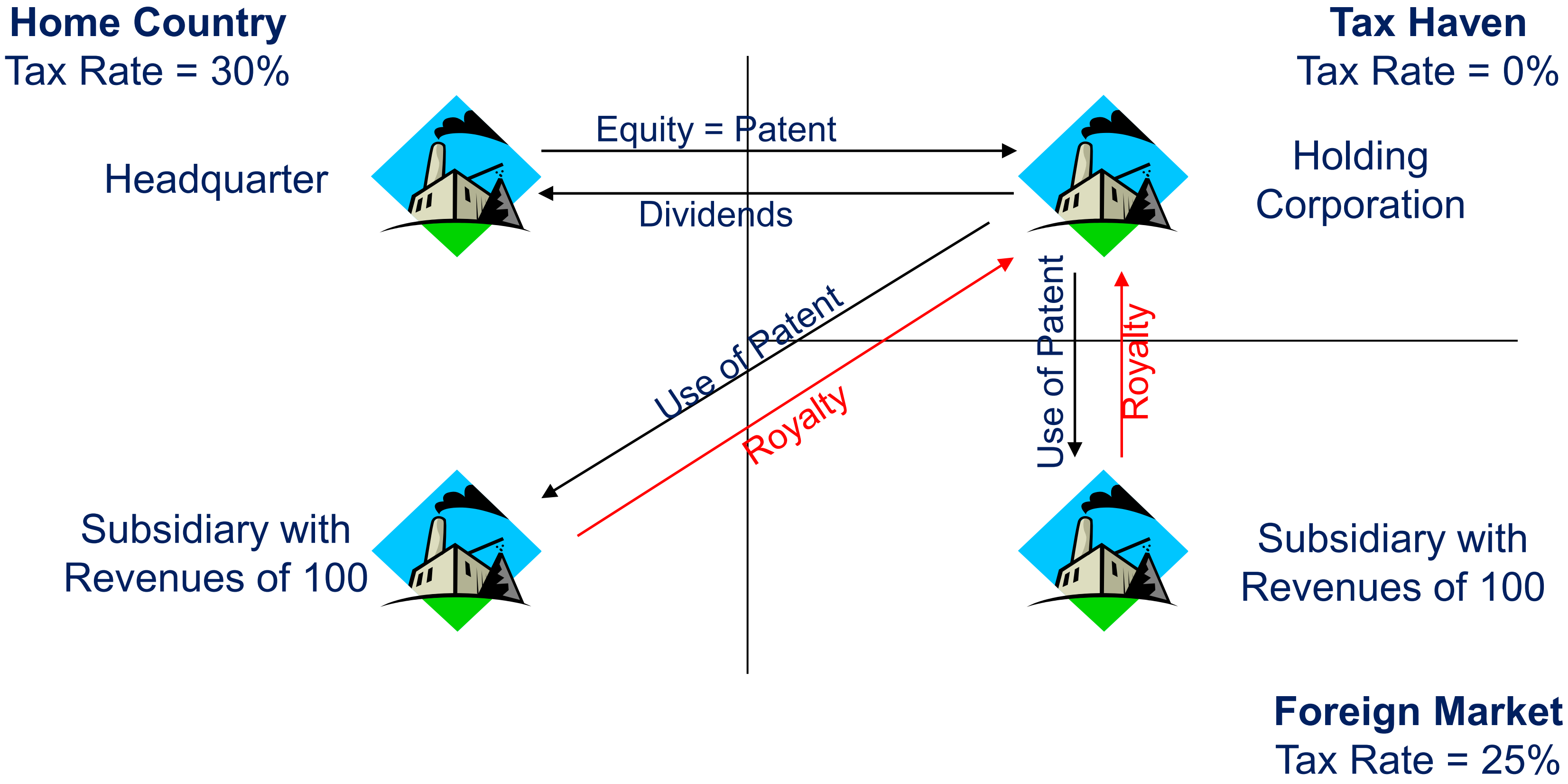
- **Paying 30% ETR does not necessarily mean that you are a "good citizen"**
- Example: Apple is within the group of firms with an ETR of 30%
- However, Apple reports a profit margin of 5% in Australia; its global profit margin is over 50%.
  - The key metric is not the ETR, but the margin that is left in Australia
  - Apple is fine with paying 30% on the 5% margin because the profits have been diverted from Australia to another country

- **Paying less than 30% ETR does not necessarily mean that you are avoiding taxes**
- Example: If you are using R&D Tax Credits, you will pay a lower ETR
- R&D tax credits are designed by policymakers to foster innovation but using them can lead to "public shaming"

Let‘s think about costs and benefits of tax disclosures

- Benefits
  - Less tax avoidance? (*questioned by current research*)
  - **Identification of tax avoiders** Let’s look at these benefits!
  - Public pressure on firms
  - ….
- Costs
  - Proprietary costs: Revealing where companies operate
  - Real responses: reduced investment activity, shifting of investments to low tax countries
  - …

Motivation:
Is this aggressive tax avoidance?



Motivation:
Is this aggressive tax avoidance?

Where to set up your new business? (simplifying assumption: all else is equal)

Ludwigsfelde: 28.3%

Zossen: 22.0%

Motivation:
Is this aggressive tax avoidance?

Where to set up your new business? (simplifying assumption: all else is equal)

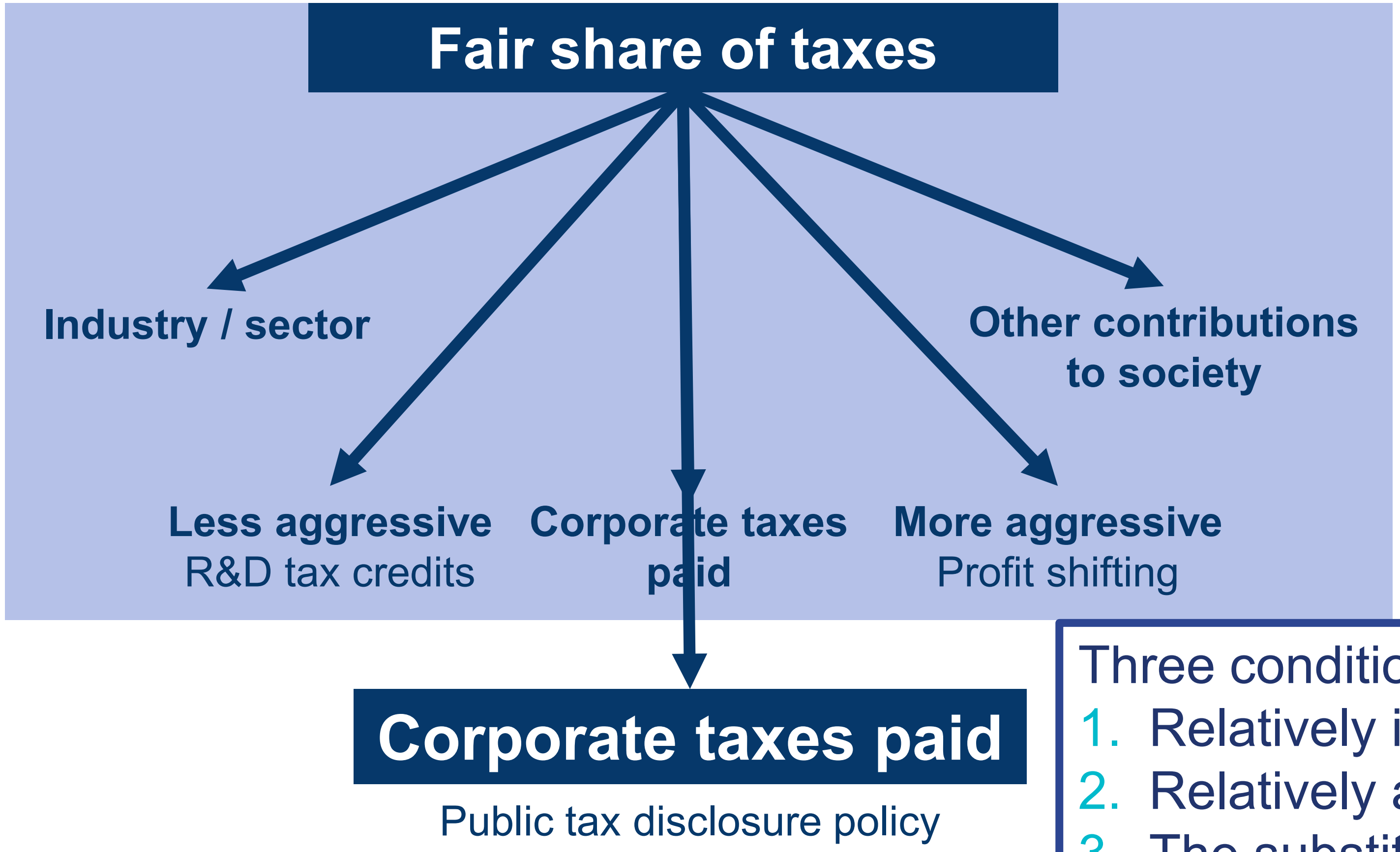
Germany: 30% 

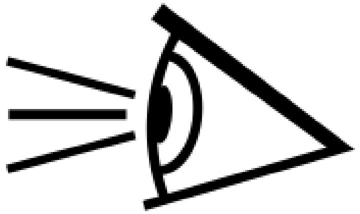
 Ireland: 12.5%

Now, the Paper: Research Question

How does public tax disclosure influence investor perceptions about whether firms are paying their fair share of taxes and their investment decisions?

Theoretical Framework





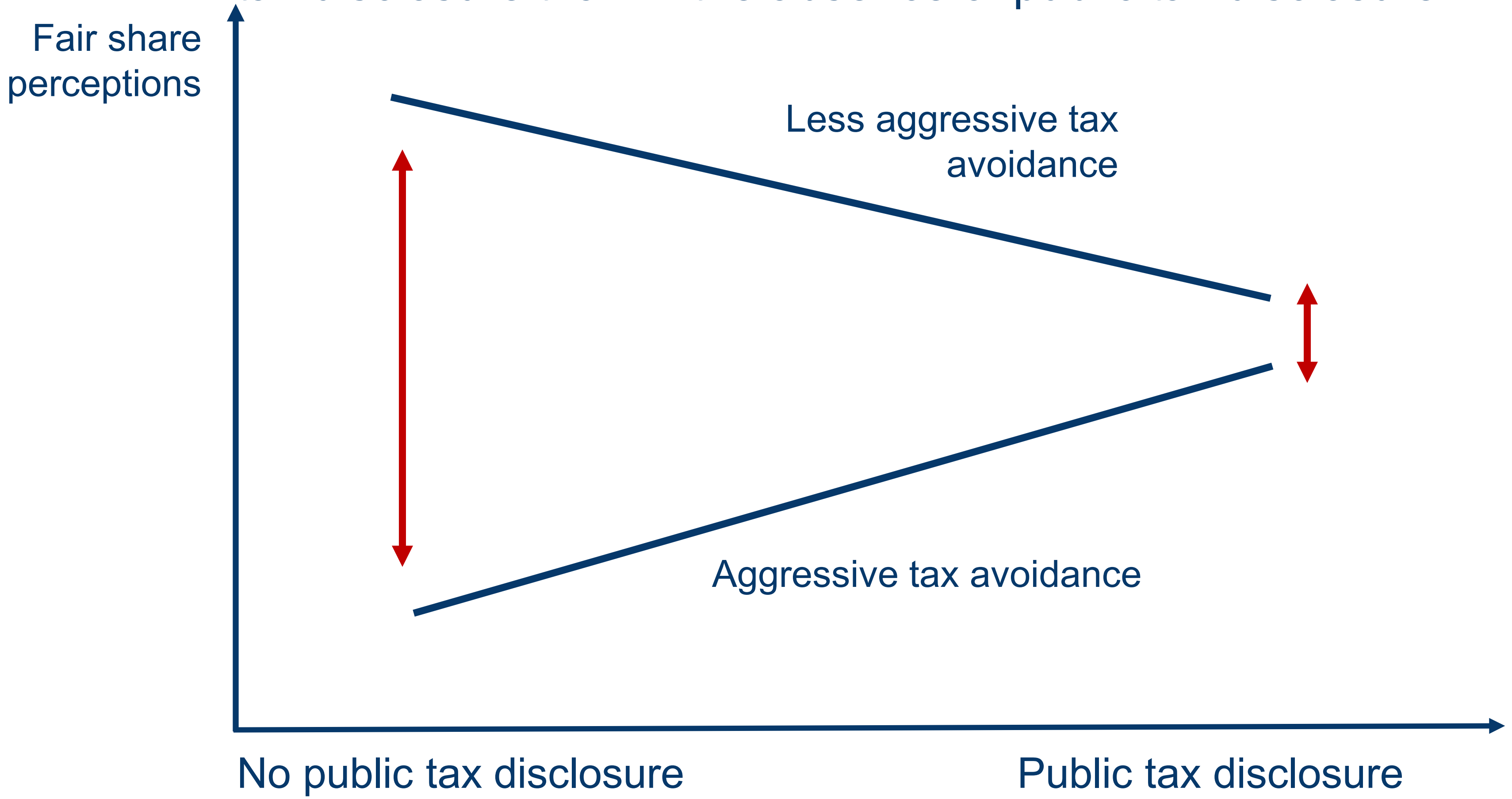
Fairness perceptions

Three conditions:

1. Relatively inaccessible "target attribute" ✓
2. Relatively accessible "heuristic attribute" ✓
3. The substitution must not be consciously rejected ✓

Hypothesis

The difference in retail investors' fairness perceptions between a firm that uses aggressive tax avoidance methods and a firm that uses non-aggressive tax avoidance methods is smaller in the presence of public tax disclosure than in the absence of public tax disclosure.



Experimental Design

- We chose an experimental setting to allow for:
  - Exogenous variation in *public tax disclosure*
  - Observation of investor fairness perceptions and their willingness to invest
- Three M-Turk experiments
- Independent variables: Tax avoidance method (*tax credit / profit shifter*) and public tax disclosure (*yes / no*)

2 × 2 between-subjects

Keep pressing to show financial report

Telecom Co.	
Telecom Co. discloses the following consolidated financial information for all its operations across the world in millions of USD:	
Revenues	710
Profit before taxes	199
Corporate taxes	22
Telecom Co. discloses the following in the reconciliation to the financial report in millions of USD:	
Corporate taxes at Country A's tax rate (24%)	48
Tax differences due to foreign profits	
Investment tax credits	
Corporate taxes	22

Tax credit	Profit shifting
0	(26)
(26)	0

To inform the public about companies' tax policies, the tax authorities in Country A publicly disclose the following information about Telecom Co.'s operations in Country A. All numbers are in millions of USD.

Telecom Co.	Country A
Revenues:	$710
Profit before taxes:	$199
Corporate taxes:	$22

Keep pressing to show financial report

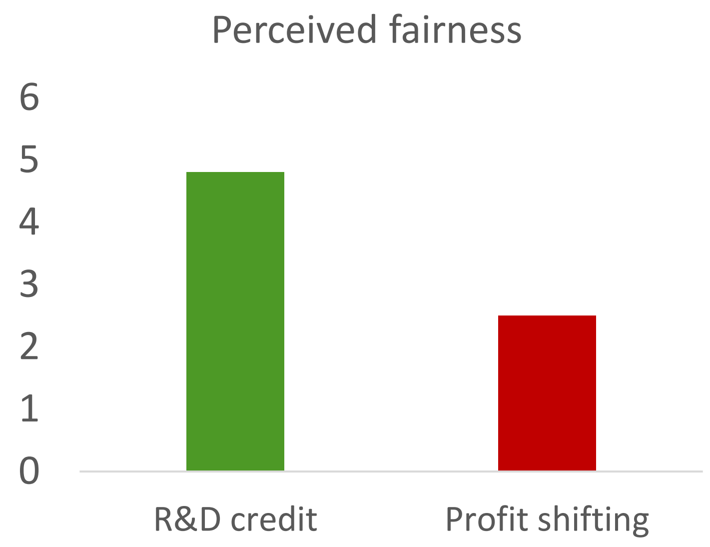
Tax credits versus profit shifting

Tax avoidance → − → **Retail investors' fair share**

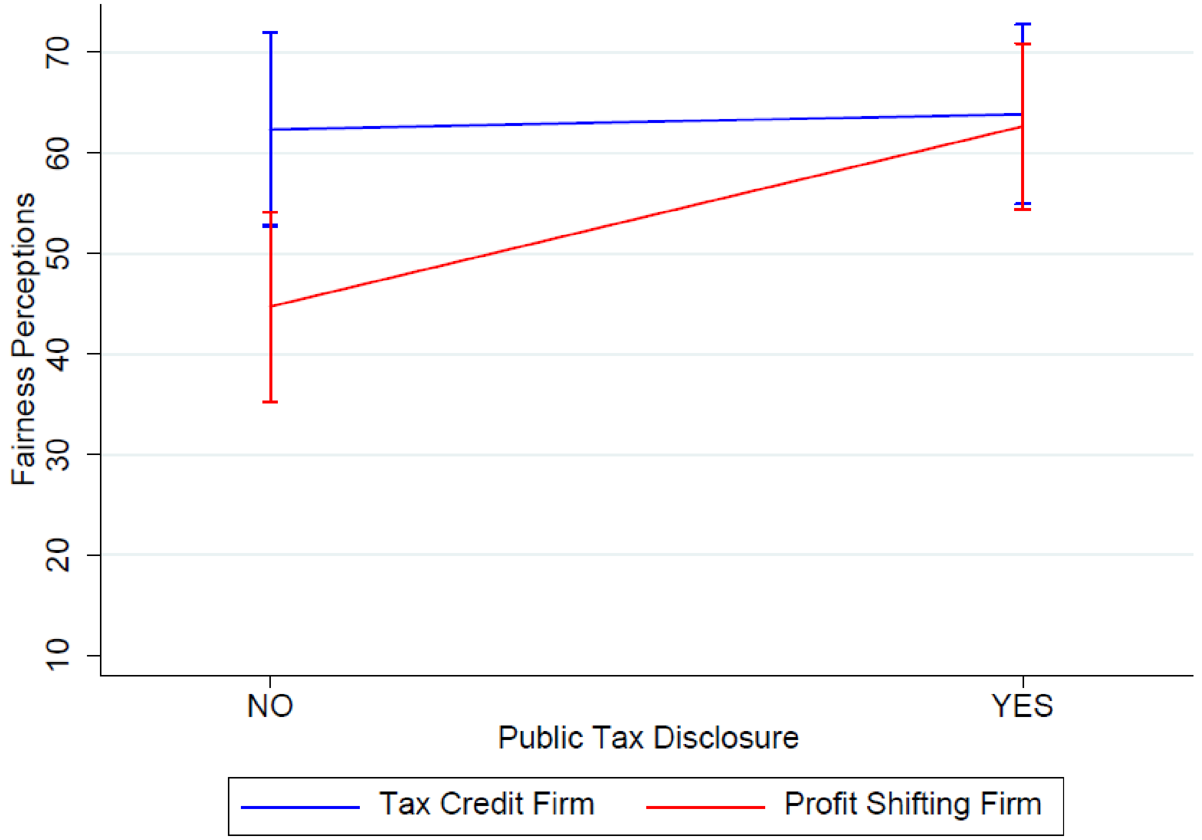
R&D tax credits

Profit shifting

Our sample



Fair Share Perceptions



To what extent do you think that Telecom Co. is paying its fair share of taxes? Please rate this on the slider below. The slider ranges from 0 (completely unfair) to 100 (completely fair).

Results - Investment Perceptions

TABLE 2
OLS Regression of Willingness to Invest on Fairness Perceptions

Variables	Panel A: Full Sample (1)	Panel A: Full Sample (2)	Panel B: Tax Credit Firm (3)	Panel B: Tax Credit Firm (4)	Panel C: Profit Shifter (5)	Panel C: Profit Shifter (6)
Fairness Perceptions	0.726***	0.716***	0.803***	0.777***	0.647***	0.634***
	(0.088)	(0.090)	(0.127)	(0.127)	(0.125)	(0.131)
Controls	NO	YES	NO	YES	NO	YES
Observations	195	195	98	98	97	97
R-squared	0.304	0.364	0.348	0.414	0.251	0.333
F-Statistic	68.00***	9.48***	39.68***	7.31***	26.64***	5.94***

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Results – Additional Analysis

- Process evidence: Time spent analyzing financial statements.

Public tax disclosure	No public tax disclosure
20.80 seconds (s.d. = 2.00 seconds)	25.25 seconds (s.d. = 1.79 seconds)

- Significantly different (p = 0.10, two-tailed).
- Also works for dummy variable (p = 0.028, two-tailed).
- Process evidence in support of our theory.

Keep pressing to show financial report

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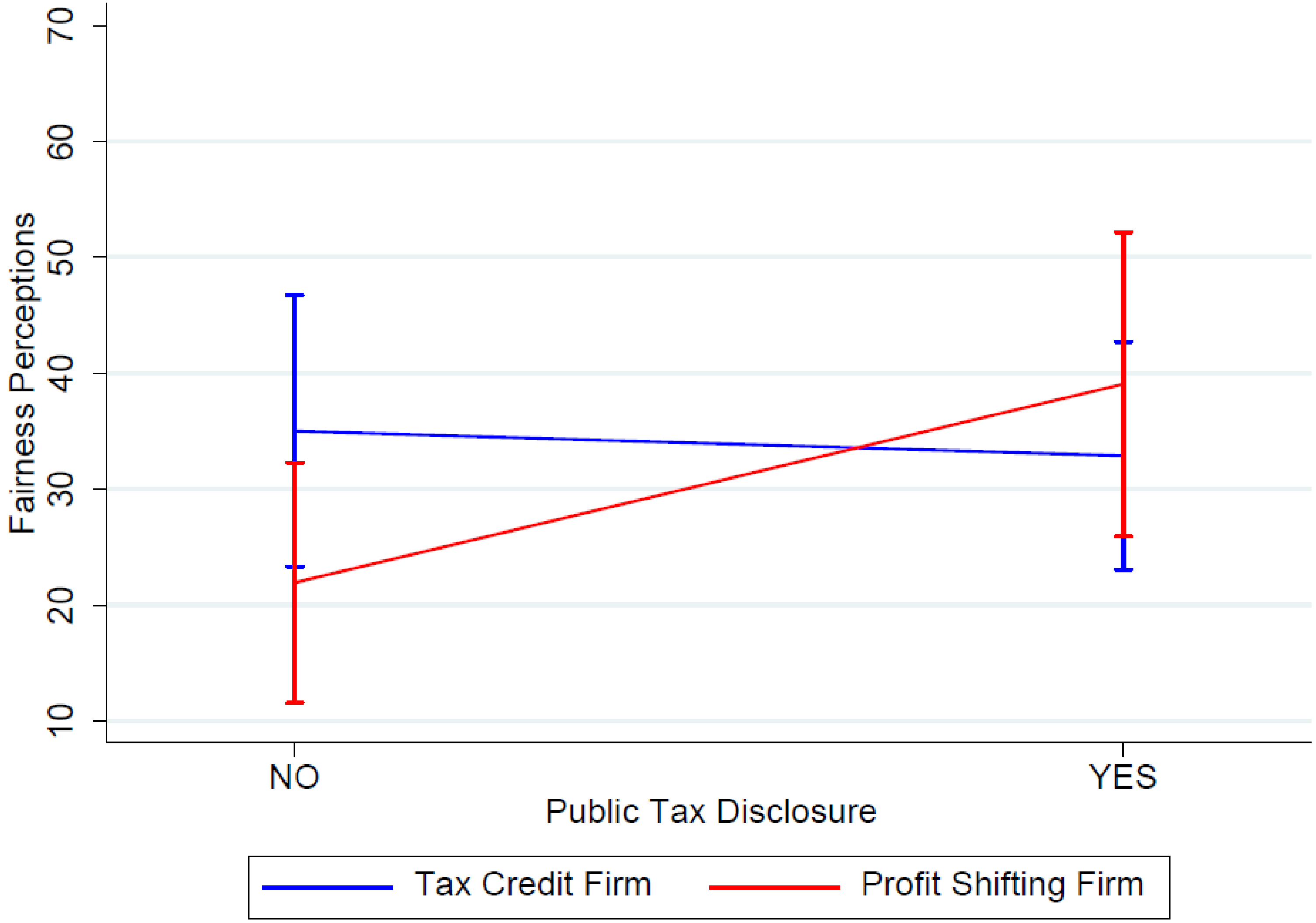
Telecom Co. discloses the following in the reconciliation to the financial report in millions of USD:

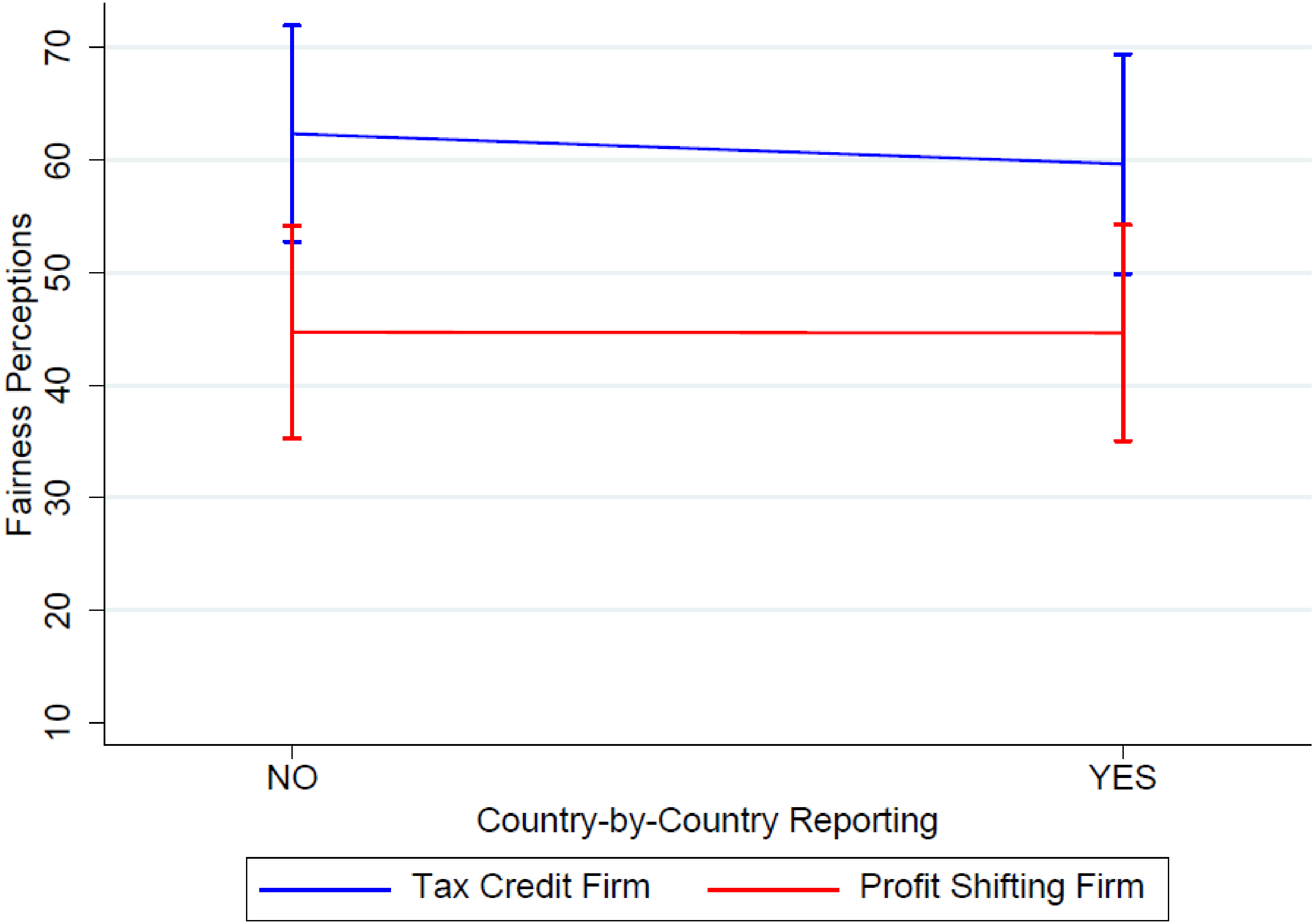
Corporate taxes at Country A’s tax rate (24%)	48
Tax differences due to foreign profits	(0)
Investment tax credits	(26)
Corporate taxes	22

Same effect when ETRs are really low?

Supplemental experiment (568 participants) with consolidated ETR of 1%



Does Country-by-Country Reporting help?



Is this just a private investor problem? Maybe NGOs will do a much better job…See Vodafone

Luxembourg

	Revenue (€m)	Profit before tax (€m)	Direct revenue contribution: Tax (€m)			c
			Total paid	Split between: Direct taxes	Corporate tax	
2018	133	1,448	9	5	4	
2017	187	1,450	8	4	5	

Look at the numbers:
- Revenues of 133m
- Profits of 1,448m
- Taxes paid: 9m
- Tax rate in LUX is 35%!

Conclusion

- Public tax disclosure causes retail investors to overly rely on the imperfect information being disclosed. Retail investors differentiate less between aggressive and non-aggressive tax avoiders when public tax disclosure is present compared to when it is absent.

- Our results thus suggest that public tax disclosure can have the opposite effect of what governments and regulators aim for (or they the benefits may not materialize).
  - Firm-level tax disclosures may thus do more harm than they do good

- Final question for thought: Would should be more *transparent*?
  - Companies (CbCR, tax reports, etc.)?
  - Countries (e.g., publicly disclose tax rulings and deals, income statistics)?
  - Both?
  - Is it a fair game? Countries may force firms to be more transparent without being more transparent on their own…