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## Analysis of the Relationship between CSR and Tax Avoidance: An Evidence from Pakistan

**Majid Khan**

Research Scholar, Department of Management Sciences, Hazara University, Mansehra

**Zahid Yousaf**

Research Scholar, Department of Management Sciences, Hazara University, Mansehra

**Zubair Alam Khan**

Research Scholar, Department of Management Sciences, Hazara University, Mansehra

**Dr. Muhammad Yasir**

Assistant Professor, Department of Management Sciences, Hazara University, Mansehra

### **Abstract:**

*Business organizations are engaging in socially responsible practices in order to manage their business activities through the lens of tax avoiding practices. The current research paper reviews literature in order to check whether businesses in Pakistan are at the same time embarking on CSR and indulged in tax avoidance practices as well. There is a scarcity of literature concerning the relationship between CSR and tax avoidance practices. The current situation of Pakistan demands the corporate sector to play its role in the development of the country. Firstly, the current study tried to accomplish whether business organizations which are engaged in tax avoidance practices consider themselves as socially responsible businesses. Secondly, the research assess whether businesses in Pakistan embark on attending the goals of stakeholders. The purpose of this material is to identify and to spot clearly the relations and the influences of the tax practices of corporations related to their undertaken social responsibility actions.*

**Keywords:** Corporate Social Responsibility, Tax Avoidance, Tax Evasion

### **1. Introduction**

Corporate social responsibility and tax avoidance are important topics of research in both management and accounting literatures (Hoi, Wu, & Zhang, 2013). Upto now, there has been a little attention paid to the relationship between CSR and tax avoidance, though there is a large research independently available on each of these issues. Similarly, according to Sikka (2010) academicians and practitioners have called for in depth investigation onto the relationship. The current study looks at the corporate social responsibility conduct of business organizations in the context of Pakistan by examining their tax practices.

Moser and Martin (2012) argued that CSR activities are comprised of all the actions taken by business organizations affection all the stakeholders of the business, such as employees, environment, community, suppliers, customers, government etc. in line with this, activities which are damaging, employees, corporate governance, human rights, communities, employees relations, diversity, environment and public health etc. are considered as irresponsible CSR activities.

The disparities between corporate claims of corporate social responsibility and their practice of avoiding tax are increasingly highlighted by pressure groups and non-governmental organizations, which enable the capacity of governments to provide security, healthcare, education, redistribute wealth to eradicate poverty, clean water, and provide an equitable and peaceful society (Action-Aid, 2009). Nevertheless, Christensen & Murphy, (2004) argued that payment of democratically agreed taxes has received a very little attention from academicians; despite the fact that payment of taxes is central to any notion of corporate social responsibility. Sikka (2010) argued that the link between corporate social responsibility and tax avoidance because businesses quite often do not provide any information other than standardized accounting information. Business organizations provide very little information regarding tax issues on a voluntary basis and it is rare for businesses to look at tax payment as social responsibility.

Business organizations nowadays are taking big about corporate social responsibility by producing brochures and reports, however the businesses are accompanying this with large scale tax evasions and tax avoidance. This leads to loss in revenues which can make a difference in quality of life of millions. According to Majid et, al. (2013) in Pakistan CSR and its associated practices are relatively new to the socio-economic development scene. However, individuals and businesses have been indulging in philanthropy and voluntary giving since long. In line with this, Yawar, (2009) argued that most of the business organizations in Pakistan are contributing towards humanity, charity, religious purposes and community development.

From another point of view, business organizations can treat CSR as a risk minimization strategy a business can use to enhance its CSR reputation, which can protect the business from the risk of adverse regulatory, political and social penalties in case of negative corporate actions (Minor & Morgan 2011). Wilson (2009) argued that tax avoidance practices can lead to negative penalties such as increased political/media pressures, loss of firm reputation, consumers boycotts and potential fines and penalties. According to Godfrey (2005) businesses can lessen the expected costs associated with tax avoidance practices by managing their CSR reputation. According to Hoi, Wu, & Zhang, (2013) if embarking on corporate social responsibility is a risk management strategy, then there should be a negative correlation between tax avoidance and irresponsible CSR activities.

While referring to corporate social responsibility, one of the most important elements is the notion of legitimacy of actions. Business organizations should pay taxes based on domestic or multi-national legislation, because it is a very important part of corporate activity. Therefore, in Pakistan the concept of tax avoidance is a very controversial issue in relation to corporate social responsibility.

The paper manifest how the business organizations in Pakistan how businesses considered themselves as socially responsible still involved in tax avoidance practice. Furthermore, the relationship between corporate social responsibility and tax avoidance is the scope of this paper. In line with those of the decisions of managers were influencing the objectives of shareholders and stakeholders to be offshore and apply to various tax avoidance practices. Using a sample of Karachi Stock Exchange listed Textiles companies we found that companies which are reporting more on CSR have a less probability of engaging in tax avoiding practices after controlling a variety of factors that can affect tax avoidance practices such as earnings quality, company's earning, corporate governance, year effect, etc.

## 2. Literature Review

Long before the development of any definition of corporate social responsibility, discussion regarding the impact business organization has on community, society and the environment were initiated. CSR has been meeting the merging needs of the society and it has a long history, which evolved with the development of businesses. CSR was in practice in developed countries in one way or another. The role of ethics in business, has historical surrounded by dominant ideology derived from the assertion of Adam Smith (1776) that the free market economy is self-regulating by means of the "invisible hand", whereby an individual's self-interested goals will inevitably result in a democratic capitalist system. One of the strong proponents of Smith's argument and a stern critic of the emerging concept of CSR was Milton Friedman, who famously argued that "the only responsibility of the business is to maximize the profit" (Friedman, 1970). In line with this he argued that business organizations should not conduct CSR because of the reasons that only humans can have a moral responsibility for their actions, it was this reason that Milton Friedman hold that the only obligation of business is to drive profit and social issues are the responsibility of the state. Frederick, (2006) argued that as a matter of fact the emphasize on the social and ethical business conduct was initially originated by the businessmen themselves, in the form of social give back policies, corporate philanthropy and codes of conduct that most of the business organizations established in 1920s. According to Blowfield and Murray, (2008) corporations like Carnegie, Lever and Cadbury were the pioneers companies to use their assets for the improvement of working conditions and also for improvement of society. In line with this business organizations begin to be recognized as "social enterprise" under the umbrella of social contract theory, if the business is serving the interest of the employees, customers, environment and society at large.

There is a considerable increase in the volume and variety of literature regarding CSR in recent years (Banerjee, 2007). Mainly, the literature focused on theoretical perspectives and seeks to address issues about accountability, economics, governance, the future of capitalism, sustainability, ethics, and ultimately the survival of the planet and the human race. As a consequence there is a wide range appreciation of the possibilities and limitations of addressing environmental, investment, employment, gender, ethics, politics, power and a variety of social problems. The scope of CSR is increasingly being broadened and is and is frequently associated with promises of ethical and socially responsible conduct.

Snider and colleagues (2003) argued that corporate social responsibility denotes the obligation of business organization to use its resources in a way that can benefit the society and all other stakeholders. According to European Commission (2002) corporate social responsibility is a concept whereby business organizations incorporate social and environmental concerns in operations of their business and their fundamental interaction with all the constituencies on a voluntary basis. Kotler and Lee (2005) defined corporate social responsibility as it the commitment by businesses to improve well-being of community through contribution of corporate resources and through voluntary business practices. This is why CSR is considered as a strong discretionary component beyond what is required by law and beyond the interest of the business. In line with this UK Institute of Directors (2002) hold that CSR is about going beyond the legal requirements in order to manage the impacts their business has on society, community and environment.

In developing countries like Pakistan CSR is increasingly recognized to have some peculiarities and distinctive features. According to Visser, (2008) recently in developing countries corporate social responsibility is more extensive than commonly believed, less politically rooted and less embedded in corporate strategy than in most of the developed countries. Jamali et al., (2009) argued that research on corporate social responsibility on SMEs of developing countries have shown a mixture of religious and personal motivation CSR initiatives which result in altruistic, philanthropic CSR orientation. This is the reason why discussions of CSR at an international level often involve consideration of environment, society and sustainability issues.

CSR has become much more prominent in today's age of globalization. Business organizations seek to minimize cost have strong opportunities and incentives to look for legal obligation that which is less stringently regulate, for example, environmental abuses and human rights. There have been numerous attempts by non government organizations (NGOs) to fill the void where an international legally binding framework did not exist, whereby business organizations are encouraged by civil regulation to address human rights and environmental violations. There have been guidelines and other forms of soft law by intergovernmental

an international organizations such as World Bank and United Nations to minimize various types of business organization's abuses. However, there is a lack of enforcement mechanism of external regulation. Still there are a lot of business organizations which have voluntarily started to embark on CSR mainly targeting the traditional CSR issues of environmental sustainability and human rights. Therefore, a self regulatory approach to corporate social responsibility could reduce the harms caused by tax avoidance practices, if notions of socially responsible behavior expand beyond environmental and human rights issues.

Tax is obligation levy upon a taxpayer by government. Pakistan has the lowest tax-to-GDP ratio worldwide and its taxation scheme are unjust and discriminatory. Tax-to-GDP has been decreased 9.8% (Fiscal Year) 2007-2008 to 9.1% (Fiscal Year) 2011-2012. The taxation systems itself offers an easy way to escape so that affluent evade taxes whereas governments suffers that why NAB (National Accountability Bureau) reported tax evasion is almost Rs 7 billion per day. Another reason may be people's perception as they feel that taxpayer money is being used for reasons other than social welfare and uplift (Business Recorder, 2013).

Tax evasion and tax avoidance are erroneously used interchangeably but there is major difference between both. Tax evasion classically refers to unlawfully reducing tax payments Palan et al (2013) it refers to conduct involving some level of "dishonesty, camouflage, [or] destruction of records, whereas "tax avoidance" normally refers to lawfully reducing tax -payments (Feetham, 2011). There are three major motives for tax avoidance: Firstly, Payment of less tax than the requirement of the country's law. Secondly tax payments on profit declared in country instead of original profit earned from elsewhere. Thirdly, tax payment levies somewhat later than the profits were earned.

Organization for Economic Development and Cooperation (OECD, 1998) defined tax havens as: no or low taxes, be short of effective exchange of information, lack of intelligibility, and no need of substantial activity.

### 3. Relationship between CSR and Tax Avoidance

Fisher (2014) argued that tax avoidance harms not only to shareholders but also to government and companies should feel fear from the public than from governments. Consumers' perceptions of corporate performance are more sensitive to news of socially irresponsible activity than to news of socially responsible activity. Thus, as corporate tax avoidance becomes increasingly publicized and stigmatized, news of a corporation's engagement in tax avoidance practices likely will have an increasingly detrimental effect on its reputation. Some corporations are more susceptible to reputational harm than others.

Tax avoidance practices cost the U.S. government up to \$100 billion in lost revenue each year, in addition to causing financial harm to the government of the offshore locale, the corporation itself, and the corporation's shareholders (International Revenue Service, 2013)

Gravelle (2013) reported that international businesses can synthetically transfer profits from high-tax to low-tax jurisdictions using a variety of techniques, such as shifting debt to high-tax jurisdictions or shifting profits from a high-tax jurisdiction to a low-tax one is to borrow more in the high-tax jurisdiction and less in the low-tax one. This shifting of debt can be achieved without changing the overall debt exposure of the firm. Transfer pricing can shift profits from high-tax to low-tax jurisdictions i.e. pricing of products or services sold between affiliates. To show exact income, price of products sold by related companies must be the equal to the prices that would be paid by unrelated parties. By decreasing the price of products sold by parents and affiliates in high-tax jurisdictions and increasing the price of purchases, income can be shifted.

Christensen and Murphy (2004) analyzed that policy measures are required to redress the distortions that have arisen as globalizing companies have left nationally based tax regimes floundering. Furthermore, the corporate citizenship debate needs urgently to address the issue of how company directors should act on tax avoidance in the context of their CSR agendas.

Richard Miller et al, (2011) argued that businesses must view tax planning via corporate responsibility lens. The major factors include the increase in public analysis [or] scrutiny of corporate tax evasions [&] tax avoidance, and a rehabilitated attempt to tackle tax avoidance [&] tax evasions by dominant revenue authorities in developed and developing countries. The Oxford Centre for Business Taxation conducted survey in 2007 and reported that a mainstream of respondents thought that, "corporate taxations give the impression to be too multifarious or complex for both public and media to understand. Thus, the tax issues are not enclosed by the media [or] overlooked by public." Researcher reported that participants suggested, if public and media concentrate on tax planning and taxpaying as important social issues, tax would be the part of CSR. The emergent debate about corporate social responsibility on the domain of tax planning presents businesses with an opportunity to showcase their commitment to corporate responsibility, and their approaches to risk management. The challenge now is to translate this commitment into concrete steps that contribute to a positive vision of tax responsibility.

Hines and Rice (1994); OECD (1998); Sikka (2003) argued that CSR performance is highly influenced by tax havens or Offshore Finance Centers (OFCs). OFCs catch the attention of bank deposits and described business activities through small or zero tax rates and often do not require extensive corporate actions within the terrain.

Preuss (2010) concluded that companies enjoying tax havens also claims that they are socially responsible and practicing under the shelter of CSR norms. Furthermore, it is found that Offshore Finance Centers based companies have made significant efforts to design codes of conduct. In the light of the fact that tax avoidance is based on "complicated transactions promoted to provide tax benefits unintended by the tax code" (Levin, 2007; Hines & Rice, 1994; Hampton & Christensen, 2002), it is particularly surprising to find that 38 per cent of the OFC sample firms claimed to obey both the letter and the spirit of legislation.

### 4. Nature of Taxation in Pakistan

As to the number and rate of taxes, there is no comprehensive study available. But it is generally believed that everything is taxed and is taxed at a far higher rate. In 1990, Karachi Chamber of Commerce and Industry had established that the industry was subjected to 50 direct and indirect taxes but the President PFCCI (Pakistan Federation of Chambers of Commerce and Industry) at

the Businessmen Conference in Islamabad on March 25, 1997, that 37 government departments and agencies were collecting taxes gives a measure of the proliferation of taxes that has taken place in Pakistan (Rehman, 1997). According to Rehman, (1997) there are 70 major taxes to which consumers and producers are subjected. In addition there are host of specific taxes like a Research and Development Levy, Drug Manufacturing License and Drug Registration Fee. It can be said safely that there are at least 100 taxes in vogue in Pakistan.

Currently, it is understood in Pakistan that a nation or a society cannot do without a government; and, to run the business of a government, taxes are levied. It is said that the business of a government comprises two things: i) to provide services to the people such as maintaining law and order, and accomplish development works such as build and maintain roads, etc; and ii) (in case of a redistributive state) to provide welfare services such as 'food, clothing, shelter,' and education, health care, etc. For most of the people, it is quite natural a political philosophy!

Obviously, the more duties and responsibilities we assign to a state, the more machinery (bureaucracy, etc.) will it require, and the more expenditures will it incur. Thus, in addition to maintaining law and order, if a state is required to provide everything to its citizens, then its government won't remain limited. It will require more revenue, and will resort to high taxes. Conversely, if its duties are limited to the protection of life, liberty and property of its citizens, it will have no justification to have recourse to more and more taxes.

But all the governments tend to expand, and develop a big state-apparatus which it with the passage of time becomes difficult for them to sustain without imposing high taxes. As a result, they are caught in a net of clear disproportion: their non-development expenditures outweigh their development expenditures; and, in some cases, their development expenditures, too, can be termed as non-development expenditures as they are spent without producing any tangible results. Such a state because of its erratic policy of taxation turns into an unhappy burden on the shoulders of its citizens.

Pakistani state is such a high tax state. On the one hand, it is not providing the list of the essential services to its citizens; that is, maintaining law and order, and protecting life, liberty and property of its citizens. On the other, under the slogan of Welfarism, it is resorting to high taxes and control over the lives of the people, and thus it has to sustain an ever-increasing state-machinery. Moreover, it has instituted monopolies, and likes to take care of their interests. And, last but not least, it has gathered around a ring of rent-seekers in the shape of politicians, privileged groups, civil and military bureaucrats, etc. who cause to manipulate its policy of taxation to their own benefit or to the detriment of others.

Another important aspect of the nature of taxation in Pakistan is trade protectionism; or, in other words, another cornerstone of taxation is the protection of local industry. For this purpose, the interests of the consumers, the common citizens, are ignored and, rather sacrificed on the altar of that holy cow, local industry. High duties are imposed on all of the imports, except ones benefiting the privileged ones, to protect the local industry which is inefficient, uncompetitive, and dependent on the help from the government to sustain itself. As a result of this, consumers are forced to buy low quality and expensive goods.

## 5. Conclusion

The current research provides an examination of the relationship between CSR and tax avoidance in the context of Pakistan. Our results are based on examination of tax avoidance and CSR practices by business community in Pakistan. It was found that businesses which are not conducting CSR activities are more likely to avoid tax. Overall, our results suggest that businesses which are not conducting CSR activities are more aggressive than others in avoiding taxes, lending credence to the idea that CSR could be viewed as a facet of corporate culture that affects corporate tax avoidance.

Secondly, current study examines the businesses which are avoiding tax and still consider that of them as socially responsible. There are a lot of businesses in Pakistan which even though are indulge in tax avoiding practices but still consider to have a well-known CSR approach and not to mention anything about their profits movements.

Thirdly, the paper also examined the influence of stakeholder's goals for those companies which are involved in tax avoidance practices. There are socially responsible companies in Pakistan, but their actions have the result of moving capital outside the domestic countries. This result in lack of the taxes which each company pays to the country in which it is operating.

In addition the research provides a review of CSR practices of businesses in Pakistan. CSR is at it's initial stages in Pakistan and companies started to align their policy based on this criteria. Pakistan is considered as a tax burden country as a result a lot of companies moved their capital using tax avoidance practices. These types of companies are continuing to publish in their annual report the part of the CSR, without mentioning anything about the tax avoidance practices. Therefore, there is a dire need for companies in Pakistan to review their activities from a social point of view.

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