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Tax Risk, Corporate Governance, and the Valuation of Tax Avoidance Across Philippine Firms: How Do Investors Value Corporate Tax Avoidance?

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Introduction

Tax avoidance has traditionally been thought to enhance firm value because it generates cash savings for reinvestment or distribution to shareholders. More recent literature, however, suggests that tax avoidance valuation may not be so simple. Desai and Dharmapala (2009) introduced the "agency perspective" on tax avoidance, arguing that investors consider the risk of tax avoidance as opening opportunities for managers to extract rents from their firms. Positive tax avoidance value would therefore be conditional on good corporate governance quality. Drake et al. (2017) introduced yet another dimension—tax risk—to the valuation of tax avoidance, arguing that tax avoidance that comes with less variability in tax outcomes (i.e., comes with lower tax risk) should be preferred to those that come with more because investors prefer stable earnings over risky earnings. This policy brief discusses our findings on how public investors in the Philippines value corporate tax avoidance in the contexts of tax risk and corporate governance quality, and policies that can be implemented to enhance firm transparency, increase tax revenues, and raise firm valuations.

Policy Recommendations

1. **Strengthen corporate governance standards** – Corporate governance quality has become an increasingly important dimension under which firms are valued by investors. When it comes to tax avoidance, corporate governance quality significantly mediates whether investors see tax avoidance as a value-accruing activity to shareholders or a rent-extracting opportunity for managers (as reflected in firm values measured by Tobin's Q.) We found that, on average, public investors in the Philippines value tax avoidance negatively, assigning a firm value discount to tax-avoidant firms. However, we likewise found that this firm value discount decreases in magnitude as corporate governance quality increases. Mandating stronger corporate governance standards may enhance the information available to investors attempting to arrive

at this determination, allowing for greater efficiency in the public markets. One way to strengthen corporate governance standards is to strengthen audit standards and increase audit disclosure requirements. Previous studies by Fan and Wong (2004) and Huang et al. (2019), for example, found that higher quality audits play an important role in monitoring managerial entrenchment and cash misappropriation, respectively.

2. **Reduce avenues for tax avoidance** – Firms often engage in tax avoidance to reduce tax expenses and increase profitability. However, tax avoidance is not costless—for the public, it is a transfer of wealth from the government to private firms, and for investors, it is a potential source of agency costs (which, as negative tax avoidance valuation shows, is a significant concern for investors.) Our study found that the average Philippine Stock Exchange (PSE)-listed firm's cash and GAAP effective tax rates (ETRs) from 2012 to 2019 stood at 15.4% and 18.1%, respectively—far below the prevailing 30% statutory corporate tax rate. This large gap signals a potentially significant level of tax avoidance across the board—a problem for the government from a revenue collection perspective and a problem for investors from an agency cost perspective. An effort to reduce avenues for tax avoidance would therefore likely not only accrue to the benefit of the government through higher tax revenues, but also to public investors through higher firm valuations.

Methodology

Our study examined the relationship between tax avoidance, tax risk, corporate governance quality, and firm value on a final sample of 1432–1438 firm-year observations for non-utility, non-financial, and non-Philippine Economic Zone Authority (PEZA) firms listed on the PSE from 2012 to 2019 using a two-step generalized method of moments (GMM) estimation technique. We used three-year industry-size mean-adjusted cash and GAAP ETRs (using the industry-size demeaning procedure implemented by Balakrishnan et al. (2019) and Shi et al. (2020) to proxy for tax avoidance, the three-year standard deviation of our tax avoidance measures to proxy for task risk, and a nine-point corporate governance quality index proposed by Sawicki (2009) and Prommin et al. (2014) to proxy for corporate governance quality. We also used a series of control variables to control the effects of firm performance, firm size, leverage, and growth on firm value. These control variables are as follows: the pretax return on assets and its standard deviation, total assets, leverage, capital expenditure, advertising expense, net intangible assets, depreciation and amortization expense, and net loss.

Empirical Findings

1. **Evidence to support the agency perspective on tax avoidance** – Our results showed that, on average, tax avoidance negatively affects firm value for both the cash and GAAP ETR measures. This supports the agency perspective on tax avoidance, which argues that tax avoidance provides opportunities for self-interested managers to divert corporate profits away from shareholders to themselves (Desai & Dharmapala, 2009). Investors, therefore, assign an overall negative value to tax avoidance in expressing their concerns about the agency costs it may produce. Support for the agency perspective is further strengthened by our finding that a strong positive relationship exists between firm value and corporate governance quality interacting with tax avoidance. This means that although tax avoidance negatively influences firm value, this negative effect decreases in magnitude as the corporate governance quality increases. Consistent with the agency perspective, this shows that fears of agency costs (as reflected in firm value discounts) are allayed to some degree in firms with strong corporate governance structures as opposed to those with weak corporate governance structures.

2. **Evidence against the tax risk hypothesis** – Our results showed no significant relationship between firm value and tax risk, as well as firm value and tax risk interacting with tax avoidance, regardless of whether the cash or GAAP ETR is used. This result contrasts with the results of Drake et al. (2017) on two counts. First, the absence of a significant relationship between firm value and tax risk suggests that investors do not consider the potentially unfavorable outcomes resulting from greater tax risk. Second, the lack of a significant relationship between firm value and the tax risk-tax avoidance interaction implies that tax risk does not moderate investor valuation of tax avoidance. These two results suggest that tax risk exerts neither a direct nor indirect effect on firm value.

3. **Other notable findings** – In addition to our main findings, we found statistically significant (individual) relationships between firm value and pretax return on assets, firm size (as measured by the natural logarithm of assets), and one-year lagged firm value. First, we found a negative relationship between firm value and pretax return on assets. We attributed this counterintuitive to loss years, which, although they have negative returns on assets (by definition), had an average firm value three times greater than that of non-loss years. When we eliminated loss years in our robustness tests, this issue was addressed, and the relationship between firm value and pretax return on assets turned positive as expected. Second, we found a positive relationship between firm value and firm size, indicating that firms holding a smaller scale of assets are given higher valuations by investors, consistent with the "small-firm effect" described by Cheung et al. (1994) and the fact that small and medium-sized enterprises (SMEs) are a dominant force in the Philippine economy (OECD, 2018). Finally, we found a positive relationship between contemporaneous and past firm values, indicating that investors retain a portion of the previous year's firm valuations in their present valuations.

Conclusion

Overall, we found that PSE-listed firms that engage in a greater degree of tax avoidance tend to be valued lower than their peers. In other words, investors negatively value tax avoidance. When it came to the risk and governance dimensions, we found only corporate governance quality as a significant positive moderator of tax avoidance valuation. These results suggest that for investors in the Philippines, negative concerns about agency costs arising from tax avoidance overpower positive expectations about their benefits. Adding nuance to this, we found that higher corporate governance quality allays these negative concerns to some degree. Although tax avoidance negatively influences firm value, this negative effect decreases in magnitude as corporate governance quality increases. Our findings provide evidence supporting the strengthening of corporate governance standards and the reduction of avenues for tax avoidance in the Philippines; the former to increase the availability of information to investors and to develop the efficiency of the stock market, and the latter to increase tax collections while raising public firm valuations.

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