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How Firms' Tax Incentives Affect Their Corporate Social Responsibility Activities: Evidence From Thailand's Tax Cut in 2012

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Abstract

This study aims to examine whether and to what extent tax incentives given to firms affect their corporate social responsibility activities. We use a corporate tax cut which took place in Thailand during 2012 and 2013 to explore the corporate tax allowance on corporate social responsibility activities. Such a tax cut constitutes a nature experiment that allows us to study precisely the behaviors of firms before and after the policy shift. Our analysis reveals the importance of tax incentives in explaining the corporate social responsibility activities. That is, we find that corporate income taxes and the CSR activities are negatively correlated. A large-scale tax cut led to potential higher profitability, which makes firms becoming financial more capable of investing in larger CSR projects which they would not, be able to consider under the tougher tax scheme. This result provides important implications to policymakers, not only in Thailand but also elsewhere, on whether benefits of tax-shielding serve as a key motivation to the firms' corporate social responsibility activities.

Keywords: Corporate social responsibility; Tax incentives; Financial performance; Tax cut.

1. Introduction

In Thailand, there were no official evidences on how and when the concept of Corporate Social Responsibility had been introduced. Most of the scholars, including Prayukvong and Olsen (2009), agreed that the initiative for Thailand to join the World Trade Organization in late 1990s served as the triggering event for CSR in the country. However, two decades had passed since Thailand became a member of WTO, Thai firms remained passive on both CSR knowledge and practice. Yodprudtikan (2010), conducted field survey on 4,350 business respondents and discovered that approximately 35% of the private business managers were not aware of the concept of CSR and only 11% of firms had practiced in CSR.

Since mid-2000s, leaders of the country began their attempts to increase the awareness of CSR in Thailand, a series of Royal Decree were issued in order to motivate Thai firms to practice in CSR activities[1]. Those Royal Decree provide various tax allowance - from 100% to 200% tax deductions - to the firms' CSR investments, aiming to boost Thai CSR practices. Naturally, those decree fueled curious debates over whether Thai firms saw CSR as an effective tax-shielding tool. However, the obvious obstacle for studying the linkage between tax-shielding and CSR activities is the lack of variation in the taxation rules.

On 14 December 2011, the Thai government enacted in two steps a country-wide corporate income tax cut of 10% in aggregate: first, a reduction from 30% to 23% for the tax year beginning on or after January 1, 2012, and second, a further reduction to 20% for tax years beginning on or after 1 January 2013 and onwards. Although the tax cut was mainly aimed for increasing the country's ability in attracting foreign direct investment and in anticipation of the launch of the ASEAN Economic Community (Sreesing, 2017), it does provide us a unique chance to examine and unveil whether Thai firms indeed adopt CSR practice as a tax-shield: the structural changes in the corporate tax serves as a natural experiment to explore the firms' changes in CSR activities during a significant change in corporate tax structure. We hope that by examine the shifts in Thai firms' CSR participations, we could elicit the hidden tax incentives for Thai firms to participate in CSR activities and contribute to the "missing-link" between taxation and CSR.

This research aims to explore how a change in the overall corporate tax rate and the tax allowance over CSR activities affect the firms' CSR participation level and their choice of CSR activities. We seek empirical evidences for the above-mentioned two contradiction claims: if the economic benefits from tax allowance is the dominant motivation for firms to invest in CSR activities, they should have higher CSR engagement during the period of higher corporate tax rates; if the external benefits such as public favor indeed over-weights the economic gains, firms

[1] Details of all Royal Decree on Corporate Social Responsibility can be found at www.sherrings.com/CSR-Tax-Allowance-Thailand/

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should invest more in CSR activities when their financial performance is better – that is, during the period of lower tax rates.

2. Theoretical Background

Corporate social responsibility (CSR) refers to the strategies or activities which were conducted by firms aiming to cater the interests of society including their customers, employees, shareholders, neighborhood communities and other stakeholders (Halkos and Skouloudis, 2017; Hsu, 2018). The concept of CSR has been gaining more attentions in both business and academic practice, and it has become a crucial part of the corporate decisions.

However, the motivations of why the firms engage in the CSR practices remain to be under heavy debates. Large number of researches have been carried out, attempting to unveil the missing links behind corporate social responsibility activities. Friedman (1970) saw CSR practices as additional costs of running business and hence claimed that aggressively carrying out the CSR activities would lead to reductions in the profitability; however, Freeman (1984) and Porter (1991) both argued that the CSR activities were not necessarily mutually exclusive and contradiction to the profit maximization objectives: many research works afterwards were trying to examine the impact of CSR over the firms' finance performance (Mir and Shah, 2018; Platonova *et al.*, 2018), their finding were similar that the firms who engage intensely in the CSR activities received favors from public investors and shareholders and therefore their financial performances were generally better than those who did poorly in CSR, and the positive impact from the CSR activities normally out-weighted their costs, thus CSR activities would lead to better finance performance as the "net return" from CSR activities were more likely to be positive than negative.

However, those findings were limited to the constraints that: 1. They were all based on the data in the developed countries, where public policies over CSR was already well established and exercised; 2. They concluded that CSR will enhance the firms' financial performance, but they did not indicate whether better financial performance is the motivation for firms to do CSR: in other word, their findings failed to explain "why firms do CSR".

Two contradiction points of views had hence been developed. Friedman (1970), argued that firms would be willing to engage in CSR activities if and only if the financial benefits from CSR activities were greater than their costs. Since most of the CSR activities did not provide direct financial benefits to the firms, the gains of CSR activities are indirect and in form of positive firm images, Friedman (1970) indicated that CSR activities were not different from any conventional marketing efforts that aimed to increase public awareness of brand image. However, in many developing countries, including Thailand, the administration allowed additional tax allowance for most of the CSR investment. For example, any firms invested in public health sectors would receive 200% tax deduction over the amount of investment, hence the CSR investment could be treated as tax-shield for firms and be considered as the "direct economic benefits" and the tax allowance received on CSR could be one of the essential motivations that determines the firms' CSR activities: it was a rational decision for firms to exercise more CSR activities that generate larger tax shield if the tax rates are high, whereas such motivation would mean less to the firms when tax rates are lower.

Friedman's view was largely debated and challenged, for instance, Ambec and Lanoie (2008) concluded that firms' participation in CSR requires both external and internal moderators while they have not concluded whether economic benefit and financial performance was an important moderator for the firms to participate in CSR; Kreps (1990), Hermalin (2001), Fleischer (2007), Cui *et al.* (2018) and others uncovers that under the context of corporate social theories, CSR is the "right action that generates leads to external gains such as social perceptions more than economic benefits..". If the "external gains" or indirect benefits from CSR activities indeed out-weights the economic benefits in the decision process, the firms should be more motivated to invest in CSR activities when their pressure of financial performance is low: when corporate tax rate is lower, firms generally perform better financially and hence become more motivated to engage in CSR activities that generate "indirect benefits".

Such ambiguity calls for a more intensive examination, especially in the developing countries, as CSR remains to be relative a new concept to firms in the private sector: unlike in most of the western countries, where CSR is integrated into the Corporate Act and the public views CSR as "a must" (Hoi *et al.*, 2013), private firms in developing countries are not "required" to engage in aggressive CSR activities, and CSR is consider by many firms as being a "social investment project" and the returns from the projects, no matter economically or socially, plays a predominant role in the corporate financial decisions.

3. Research Methodology

In order to examine the main hypothesis, how corporate tax rates affect the CSR activities, we exploit the sizeable drop in corporate income tax rates in Thailand from the long-standing rate of 30% to 23% in 2012, and another reduction to 20% in 2013 onward. Thus, the cut was a considerably large external shock to the firms, and therefore can be presented as a natural experiment for testing the association between corporate taxes and CSR activities.

This study investigates the effects of taxes on CSR activities from listed companies in Thailand (from SET and MAI) that contributed to the CSR activities reported by the Stock Exchange of Thailand (SET) during the period between 1 January 2009 until 31 December 2015. Our CSR index is obtained from a company's annual reports, and the Disclosure report concerning additional information (Form 56-1) from SET. Other information regarding data from a firm's financial statement will be collected from the Thomson Reuters Datastream. In the final sample, we examine 40 unique listed companies with 207 firm-year observations.

To calculate the CSR index, we utilize the unweighted disclosure index approach technique that have been widely used in the literature (Rouf, 2011; Saleh *et al.*, 2010). This approach has been also adopted in the empirical study that examined Thai companies (Jitaree, 2015). The CSR index measures the firms' CSR activities by constructing the activities into a dichotomous variable. Whenever a company discloses its CSR activities in the annual financial report, a scored of "1" will be assigned, while scored "0" indicates total absence of CSR-related activities in the report. Each company will then receive a total score aggregated from all sub-scores of different CSR activities, including 11 sub-items under environment category, 6 under energy category, 16 from employee-care category, 7 of the community involvement category, and 5 more for the product quality assurance category. The unweight indexes are calculated by the equation below and hence after summed in to the final CSR Index (CSRI) as follows:

$$CSRI_i = \frac{\sum_{j=1}^{n} x_{i,j}}{n_i}.$$

The effect of corporate taxes on the CSR activities and also for the potential influence CSR determinants, therefor, will be examined from the following regression framework:

$$CSRI_{i,t} = \alpha + \beta Tax_{i,t} + \sum_{j=1}^{k} \delta X_{i,t,j} + \eta_i + \gamma_t + \epsilon_{i,t}, \qquad (1)$$

where $CSRI_{i,t}$ is corporate social responsibility index for firm *i* in year *t*, and $Tax_{i,t}$ is the corporate income tax rates for firm *i* in year *t*. *X* is a *j*-dimensional vector of control variables: which include firm size measured as the firm's total assets, leverage as the ratio of total book debt and the market value of assets, market-to-book equity ratio, sales as the company annual net sales, η_i is a firm fixed effect, and γ_t a year fixed effect.

3.1. Empirical Results

Table 1 reports the descriptive statistics of the final sample. As shown in Table 1, the $CSRI$ index significantly increases after the tax cut policy became effective. Also, the results indicate the significant post-cut changes in firm characteristics known to influence CSR activities.

Table-1. Descriptive Statistic

	Entire	Pre-cut (2009-2011)	Post-cut (2012-2015)	Post - Pre
CSRI_Index (%)	69.91	62.17	74.59	10.53
Tax (%)	24.16	30.00	20.75	−9.25
Assets (Baht mil)	16,889	13,350	19,030	5,680
Leverage (%)	27.09	24.13	28.88	4.75
Market-to-book ratio	1.81	1.60	1.93	0.33
Sales (Baht mil)	22,251	21,034	22,987	1,953
N. of observations	207	78	129	

Note: ***, **, and * denote the means being significantly different between before and after the tax cut, at the 1%, 5% and 10% levels, respectively.

The regression analysis based on equation (1) are reported in Table 2. In Table 2, the coefficients of *Tax* are negative and significant in all models. By controlling for the year and firm fixed effects, model 3 shows that corporate taxes and CSR disclosure are negatively and significantly correlated with the coefficient of -1.161 at 1% level of significance. This suggests that, on average, the 1% increase in corporate tax rates would reduce the CSR disclosure index by approximately 1.16%.

As for the control variables, the coefficients of firm size (ln (asset)) are positive and significant in all models (at least at 10% level), implying that larger firms are likely to participate more with the CSR activities. This result is consistent with the majority of studies on the CSR disclosure index, which suggest that lager firms potentially have better ability and recourses to undertake the CSR activities (Nelling and Cooper, 2008). Moreover, consistent with Nelling and Cooper (2008), the coefficients of leverage in all models are negative although only significant in model (1), suggesting that firms with high leverage (high debt usage) tend to have less CSR disclosure. This low level of CSR disclosure could be due to the less of available funding to support the CSR activities from the higher bankruptcy risk that firms are encountered with.

To further confirm the result found in Table 2, we also employ the following regression framework to examine the impact of the new tax policy on CSR activities:

$$CSRI_{i,t} = \alpha + \beta Post_{i,t} + \sum_{j=1}^{k} \delta X_{i,t,j} + \eta_i + \gamma_t + \epsilon_{i,t}, \qquad (2)$$

where $Post_{i,t}$ takes the value of 1 for the observations after (2012-2015), and 0 before (2009-2011) the tax cut. All other variables are defined as in the previous section.

Table-2. Regression analysis of CSR and Tax

CSR Index	1	2	3
Tax	-1.159***	-0.717**	-1.161***
	(0.000)	(0.032)	(0.004)
ln (Assets)	5.865**	20.590**	17.770*
	(0.041)	(0.022)	(0.051)
Leverage	-40.702***	-20.214	-19.769
	(0.004)	(0.142)	(0.163)
Market-to-book equity	-2.894**	0.693	0.190
	(0.241)	(0.204)	(0.761)
ln (Sales)	1.644	-1.213	0.383
	(0.417)	(0.846)	(0.957)
Constant	-4.734	-237.453*	-205.323*
	(0.802)	(0.075)	(0.091)
Firm fixed effects	No	Yes	Yes
Year fixed effects	No	No	Yes
Adjusted R^2 (%)	41.234	37.932	37.334
N. of observations	207	207	207

Note: In parentheses is *p*-value based on the White standard errors. ***, **, and * denote significance at the 1%, 5% and 10% levels, respectively.

Table 3 reports the results based on equation (2), where Tax is replaced by a dummy variable indicating pre- or post- tax cut.

Table-3. Regression analysis of CSR and the Tax cut policy

CSR_Index	1	2	3
Post	13.242***	5.685*	11.612***
	(0.000)	(0.060)	(0.004)
ln (Assets)	5.876**	22.103**	17.772*
	(0.046)	(0.020)	(0.051)
Leverage	-38.928***	-18.542	-19.763
	(0.007)	(0.216)	(0.163)
Market-to-book equity	-2.781**	0.798	0.190
	(0.041)	(0.189)	(0.761)
ln (Sales)	1.542	-1.750	0.383
	(0.453)	(0.793)	(0.957)
Constant	-48.923**	-275.631**	-240.415**
	(0.010)	(0.037)	(0.044)
Firm fixed effects	No	Yes	Yes
Year fixed effects	No	No	Yes
Adjusted R^2 (%)	40.112	35.231	37.334
N. of observations	207	207	207

Note: In parentheses is *p*-value based on the White standard errors.
***, **, and * denote significance at the 1%, 5% and 10% levels, respectively.

The *Post* has significantly positive coefficients in all models, implying that the CSR disclosure index decrease following a new tax cut policy. As reported in model (3), with the firm year and fixed effects, the coefficient of *Post* is positive and significant (11.612) at 1% level, indicating that on average the CSR activities in firms with the SET CSR awards rise by approximately 11% after the tax cut. In sum, our results reveal the evidence of the negative relation between corporate taxes and CSR activities.

In both models, it appears that the tax cut in 2012 – 2013 has led to a significant increase in Thai firms' Corporate Social Responsibility activities. Such findings fail to confirm with initial argument that the aggressive tax benefit provided by Thai Royal Decree indeed serves as a strong motivation to Thai firms to engage in CSR activities; however, the result was not unexpected, as the scale of the tax cut in Thailand is magnificent and could potentially alter the profitability of the firms completely, leading to an overhaul of their financial and CSR decisions. The findings are aligned with the point of view by Kreps (1990), Hermalin (2001) Fleischer (2007), Cui *et al.* (2018) that Thai firms see CSR investments more as public relation spending than tax-shielding. One most important note is that, a large-scale tax cut led to potential higher profitability, which makes firms becoming financially more capable of investing in larger CSR projects which they would not be able to consider under the tougher tax scheme.

The empirical result also partially explains the slow development of CSR in Thailand and why the Royal Decree was not an effective motive for the firms. The significantly positive correlation between tax cuts and CSR activities indicates that most of the Thai firms treat CSR investment as a financial expenditure that generates only indirect benefit, and they do not view CSR investments as an effective tax shield regardless of the various royal decree; in other words, the firms never aim to utilize the benefit from the royal decrees as means to reduce tax payments and increase profitability. Instead they treated CSR spending as investment: a mean to potentially generate indirect benefits in future.

The findings could also indicate that policies which enhance the profitability of firms directly, such as corporate tax cuts not only affect the competitiveness of the country but potentially also affect firms' CSR activities. This implication, in sum, suggests that government may also promote and encourage firms to participate more with the CSR activities through improvements in the business environments.

4. Conclusion

After the first introduction of corporate social responsibility concept in Thailand, we found that most of Thai firms remains inactive in practicing the CSR. Even though the policy makers attempted to promote CSR activities through a series of Royal Decrees, the effectiveness of such policy was doubtful - only larger public listed companies intensively engage in CSR activities. Our study examined the impact of corporate income tax cut on the firms' CSR investment, and found that the tax cut seemed to have a positive correlation with firms' CSR activities.

Although it is not conclusive whether the tax cut is the most important factor that leads to higher CSR engagement due to the lack of theoretical support on control variables, we could still observe that the shifting taxation policy indeed has significant impact over firms CSR activities. We will try to dive into more depth of the intriguing linkage between tax policy and CSR activities in future by altering the model to control for more external factors as well as to examine the mediation effects of profitability more closely.

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