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# Corporate Legitimacy Practices and Corporate Tax Avoidance: A Study of Quoted Consumer Goods Firms in Nigeria

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## Abstract

The primary objective of the current study is to explore the nexus of corporate legitimacy practices (CLP) and corporate tax avoidance of quoted consumer goods manufacturing firms on the Nigerian Stock Exchange (NSE). The study adopted the ex post facto research design. The study sample was purposively delimited to twenty-one firms in the consumer goods manufacturing sector. The study relied on secondary sources of data retrieved from the annual reports of the selected companies from 2011 to 2018. The data were analyzed using descriptive and multiple regression techniques. The results showed a negative significant relationship between CLP and effective tax rate. Based on this the study recommends that CLP should form an integrated aspect of corporate activity for its inhibiting role in tax avoidance. The disclosure of CSR activities and further enforcement by the government that organisations implement environmental remediation activities. These include funding of activities which are related to costs incurred to prevent or compensate for injuries from corporate activities.

## 1.1 Introduction

There is growing pressure from stakeholders for managers to adopt corporate legitimacy practices (Abbas, 2020; Abbas & Sagsan, 2019). The move has been primarily driven by public pressure groups (Wijethilake, 2017), climate change caused by air, water and soil pollution (Li, Zhao, Zhang, Chen, & Cao, 2018), and growing consumer awareness, local and international regulations (Abbas, 2020). Such legitimacy practices are driven by corporate social responsibility principles based on the fact that businesses are an integral part of the society they operate (Crane, McWilliams, Matten, Moon, & Siegel, 2008). This negated the view by classical economists that the sole objective of a business is to create value for its shareholders (Sung-Kim & Oh, 2019). According to critics, spearheaded by Milton Friedman, the only social responsibility of business "is to use its resources and engage in activities designed to increase its profits . . ." (*cf* Friedman, 1970).

Much recently arguments have arisen in the literature that the survival and sustainability of a business do not wholly depend on a monolithic focus on profit maximization (Shafai, Amran, & Ganesan, 2018). Corporate legitimacy is intended as a pathway to address claims of various stakeholders fairly and rationally (Sung-Kim & Oh, 2019) and enables managers to drive their organisation's adaptation to external demands (Orlitzky, Schmidt, & Rynes, 2003). The view is that it enables firms to better manage their stakeholder relationship (Barnett & Salomon, 2012) and a sine qua non for protecting the bottom line, business survival and boosting shareholder value in the long-term (Epstein & Rejc-Buhovac, 2014). These can be achieved from a positive CSR engagement. The benefits of CSR include improves firm reputation and brand name (Benito-Hernández, Platero-Jaime, & Esteban-Sánchez, 2016).

Corporate tax avoidance is a managerial practice to reduce the taxable income through tax planning activities, whether these are legal, questionable, or even illegal (Chen, Chen, Cheng, & Shevlin, 2010). Tax avoidance causes corporations to reduce the income available to the government (Bird & Davis-Nozemack, 2018). Therefore, corporate tax avoidance has multifarious implications for businesses and society. it can damage the corporate reputation from detection. This would have the effect of lowering the firm value (Chang, Hsiao, & Tsai, 2013). Prior studies have documented an association between CSR and tax aggressiveness (Abdelfattah & Aboud, 2020). According to Lin, Liu, So, and Yuen (2019), "socially irresponsible firms undertake aggressive tax planning; whereas, socially responsible firms maintain tax savings".

Research suggests that the direction and empirical link between CLP and tax avoidance are bidirectional (Hajawiyah, Kiswanto, Suryarini, Yanto, & Harjanto, 2022). The bidirectional evidence was substantiated using the Indonesian dataset. This paper focuses on the nexus of corporate legitimacy practices and corporate tax avoidance of manufacturing firms in Nigeria. The empirical literature posits a negative relationship between corporate legitimacy practices and tax avoidance (Goerke, 2018; Lin, Liu, So, & Yuen, 2019). Few studies such as Mgbame, Chijoke-Mgbame, Yekini, and Yekini (2017), and Umobong and Agburuga (2018) have explored the link between CLP and corporate tax avoidance among non-financial firms. The current paper is intended to

fill the gap from a developing country context. The study focused on manufacturing firms, which according to Ingle, Seabra, Duran, and Rai (2014), are among the major polluters in industrial areas.

### 1.2 Objective of the Study

The main objective of the study is to explore the nexus of corporate legitimacy practices and corporate tax avoidance of quoted manufacturing firms in Nigeria. The specific objective of the study is:

1. To ascertain the effect of corporate legitimacy practices on the effective tax rate of quoted manufacturing firms in Nigeria.

## 2.0 Literature Review

### 2.1 Concept of Corporate Legitimacy Practices (CLP)

Corporate legitimacy practices are activities undertaken by corporations to address the cultural, social, environmental and economic aspects of the business's operational environment (Raimi, 2017). According to Parsons (1960, p. 175) legitimacy can be defined as "the appraisal of action in terms of shared or common values in the context of the involvement of the action in the social system". Therefore any actual or potential disparity between social values associated with the activities of the organisation and the norms of acceptable behaviour in the wider society can constitute a threat to organisational legitimacy (Dowling & Pfeffer, 1975). Therefore, organisations to seek legitimacy may engage in CSR activities. As such companies "disclose environmental information in annual reports as a strategy of obtaining society's acceptance and approval of their activities" (Mabonesho & Ngole, 2019).

According to Bansal and Roth (2000), one reason firms pay attention to social and environmental externalities is the desire to build organisational legitimacy.

CSR is linked to the issue of organisational legitimacy. The European Commission defines CSR as "a concept whereby companies integrate social and environmental concerns in their business operations and their interaction with their stakeholders voluntarily" (European Commission, 2011). The World Business Council for Sustainable Development (2000, p. 8) defines CSR as "the continuing commitment by business to contribute to economic development while improving the quality of life of the workforce and their families as well as of the community and society at large". According to the tenet of CSR, "business and society are interwoven rather than distinct entities; therefore, society has certain expectations for appropriate business behaviour and outcomes" (Wood, 1991, p. 695).

Barnett and Salomon (2006) summarised the following benefits for a company of being socially responsible: (1) it is easier to attract resources; (2) it can obtain quality employees; (3) it is easier to market products and services; (4) it can create unforeseen opportunities; and (5) it can be an important source of competitive advantage. Weber (2008) also identified five potential benefits of CSR for companies: (1) the positive effects on a company's image and reputation; (2) a positive effect on employees' motivation, retention and recruitment; (3) cost savings; (4) increased revenue from higher sales and market share; and (5) a reduction of CSR-related risk.

### 2.1.2 Concept of Tax Avoidance

Tax is the allocation of "scarce resources to a non-shareholder stakeholder" (Watson, 2015, p. 2). Tax avoidance is distinct from tax evasion (Bird & Davis-Nozemack, 2018). Tax avoidance is "where a firm can either explicitly or implicitly reduce its tax burden without incurring additional expenses from tax investigations, in both short-and long-term" (Kim & Im, 2017, p.1). Corporate tax avoidance is, therefore "the downward management of taxable income through tax planning activities" (Lanis & Richardson, 2012, p. 86). It is perpetrated using mechanisms such as inversions, transfer pricing, and tax havens (Bird & Davis-Nozemack, 2018; Chen, Chen, Cheng, & Shevlin, 2010). Tax avoidance is therefore an opportunistic behaviour; whereby, a firm exploits the implicit contract between the firm and society at the expense of the latter (Laguir, Staglianò, & Elbaz, 2015).

### 2.1.3 Corporate Legitimacy Practices (CLP) and Corporate Tax Avoidance

The link between corporate legitimacy practices (CLP) and corporate tax avoidance is well documented in the literature. The proponents argue that it centres on the stakeholder primacy perspective rather than shareholder primacy. According to Marta, Barros, and Sarmento (2019), CSR is a mechanism to mitigate the risk of being scrutinized and consequently getting regulatory actions, as well as to control for negative reputational events. Prior studies, such as Revsine, Collins, Johnson, and Mittelstaedt (2005) and Pratt (2005) found that the ratio of pre-tax book income to taxable income is a useful indicator for assessing the degree of conservatism in a firm's accounting choices. Using empirical data from the U.S., Lanis and Richardson (2015) find that socially responsible firms are less likely to engage in a tax dispute over their tax obligations. However, using empirical data from U.S., Hoi, Wu, and Zhang (2013) finds that companies that engage in irresponsible activities are prone to greater tax aggressiveness. Landry, Deslandes, and Fortin (2013) found a positive relationship between CSR activities and tax avoidance in the Canadian context. In contrast, Laguir, Staglianò, and Elbaz (2015) in France found that CSR is negatively associated with the level of corporate tax aggressiveness. From a global perspective using a dataset from 30 countries, Ortas and Álvarez (2020) and the multiple regression techniques find a negative relationship between CSR components (social performance, environmental performance and governance performance) with tax aggressiveness.

## 2.2 Theoretical Framework

The study is anchored on the stakeholder theory. The theory was postulated by Edward Freeman (Freeman, 2010). It is a broad conceptualisation of the strategic management literature. And it focuses on stakeholders rather than shareholders for organisational survival. Stakeholders include 'groups or individuals who benefit from or are harmed by corporate action' (Melé, 2008). Stakeholders encompass shareholders, employees, customers, suppliers, creditors, government, as well as the community in which companies operate (Smith, 2003). In a much broader classification, Figar and Figar (2011) identified eight categories of stakeholders which are investors, suppliers, employees, customers, governments, communities, politicians and trade associations. Stakeholder theory explicates a company's responsibility beyond economic or financial performance (Guthrie, Petty, & Ricceri, 2006). According to Shafai, Amran, and Ganesan (2018), the management of a company is expected to

execute its accountability towards its stakeholders by undertaking activities that are deemed salient by the stakeholders.

### 2.3 Empirical Review

Vacca, Iazzi, Vrontis, and Fait (2020) examined the role of gender diversity on tax aggressiveness and corporate social responsibility in Italy. The sample consisted of 168 firms listed on Milano Stock Exchange between 2011 and 2018. The study relied on secondary data obtained from AIDA Bureau Van Dijk database. The data were analysed using the logit regression model. The results showed a non-significant positive effect of tax aggressiveness on CSR reporting.

Similarly, Alsaadi (2020) using empirical data from Europe examined the nexus of tax avoidance and corporate social responsibility. The data which spanned from 2008 to 2016 were analysed using regression analysis and showed a positive association between CSR and tax avoidance.

In contrast, Abdelfattah and Aboud (2020) using a sample of 735 firm-year observations from EGX 100 Egyptian firms explored the interaction of tax avoidance, corporate governance, and corporate social responsibility from 2007 to 2016. The OLS results showed a significant negative effect of ETR on CSR disclosure. This is somewhat consistent with the study by Kristiadi, Kurniawati, and Naufa (2020) in Indonesia using a sample of 67 manufacturing firms from 2008 to 2019 found that ETR had a significant negative effect on CSR. They employed the Generalized Method of Moments (GMM) in the analysis.

Another study in Indonesia, by Mashuri and Ermaya (2019) using a sample of 80 firms listed on the Indonesia Stock Exchange (IDX) and data spanned from 2014 to 2018 found that ETR has a significant positive effect on CSR disclosure.

Using empirical data from the European Union, Makni, Affes, and Trigui (2019) employed a sample of 64 firms from 15 E.U. countries to analyse the nexus of CSR and tax avoidance. They obtained data obtained from the Thomson Reuters DataStream database and Thomson Reuters ASSET4 from 2002 to 2015. They employed the Tobit and GLS regression models which showed that CSR had a negative effect on ETR.

The study by Rahmat and Kustiawan (2018) in Indonesia analysed a sample of 11 firms listed in LQ45 Indonesia. The data spanned from 2013 to 2015. The results showed a non-significant negative effect of CSR on ETR. Umobong and Agburuga (2018) in Nigeria obtained a sample of 154 firm-year observations from manufacturing firms from 2004 to 2015. The data were analysed using multiple regression techniques. They found that ETR positively related to CSR for environmental CSR activities.

Gulzar et al. (2018) in china, using a sample of 3,481 firm-year observations and data from the China stock market and accounting research (CSMAR) database for the period 2009 to 2015 showed that CSR was negatively related to current and cash effective tax rate. However, in contrast to this, Shafai, Amran, and Ganesan (2018) in Malaysia from a sample of 270 companies listed in Bursa Malaysia showed that earnings tax avoidance positively correlates with corporate social responsibility.

In Nigeria, Mgbame, Chijoke-Mgbame, Yekini, and Yekini (2017), using a sample of 50 companies listed on the Nigerian Stock Exchange revealed a negative relationship between CSR performance and tax aggressiveness.

## 3.0 Methodology

The study follows a quantitative approach and adopts the *ex-post facto* research design as the most appropriate design. An ex-post-facto research design observes events (activities of companies as reduced to figures) after they have occurred (reporting year) (Onwumere, 2009; Salkind, 2010). The population comprised listed manufacturing firms on the Nigerian Stock Exchange (NSE). The study employed a purposive sampling technique and selected the twenty-one consumer goods manufacturing firms. The study relied on secondary data extracted from the annual reports and accounts of the selected companies. Annual reports and accounts are widely used documents in secondary data analysis and are the only publicly available source for estimating the needed information.

## 3.1 Methods of Data Analysis

The study employs multiple regression techniques to validate the hypotheses. Multiple regression is a statistical procedure to analyse the relationship between a singular dependent variable and several independent variables by estimating coefficients for the equation on a straight line (Hair, Black, Babin, Anderson, & Tatham, 2006). All the analyses were performed using the E-Views version 9 statistical software.

### 3.2.1 Model Specification

$$ETR_{it} = \beta_0 + \beta_1 CLP_{it} + \beta_2 SIZE_{it} + \beta_3 LEV_{it} + \beta_4 CFO_{it} + \beta_5 GROWTH_{it} + \varepsilon_t \quad \ldots\ldots\ldots\ldots 1$$

The model shows some firm-specific factors identified in literature which affect the relationship between CSR and tax aggressiveness (Gulzar *et al.*, 2018; Kim & Im, 2017). The study employs firm size, leverage, CFO, and sales growth to control for firm-specific factors affecting tax aggressiveness. The variable firm size was included because the size of a firm largely determines its level of commitment to CSR; leverage is vital because the debt-equity combination is a prime determinant of financial risk and sustainability of a business. For instance, Rahmat and Kustiawan (2018) showed that firm size had a significant negative effect on ETR. Prior studies of a similar nature also utilise leverage as a control variable because it could affect both CSR and tax aggressiveness (Ortas & Alvarez, 2020; Vacca *et al.*, 2020). As explicated by Ortas and Álvarez (2020) companies with high leverage may employ tax-deductible interest payments to develop aggressive tax initiatives. Operating cash flow measures the actual cash movement in and out of the organisation as an indicator of financial viability; and, sales growth implies the annual change in the current level of sales over the prior year which is an indicator of the market performance of the company's products.

### 3.2.2 Description of Variables

Table 1: Operationalization of variables used to test the hypotheses

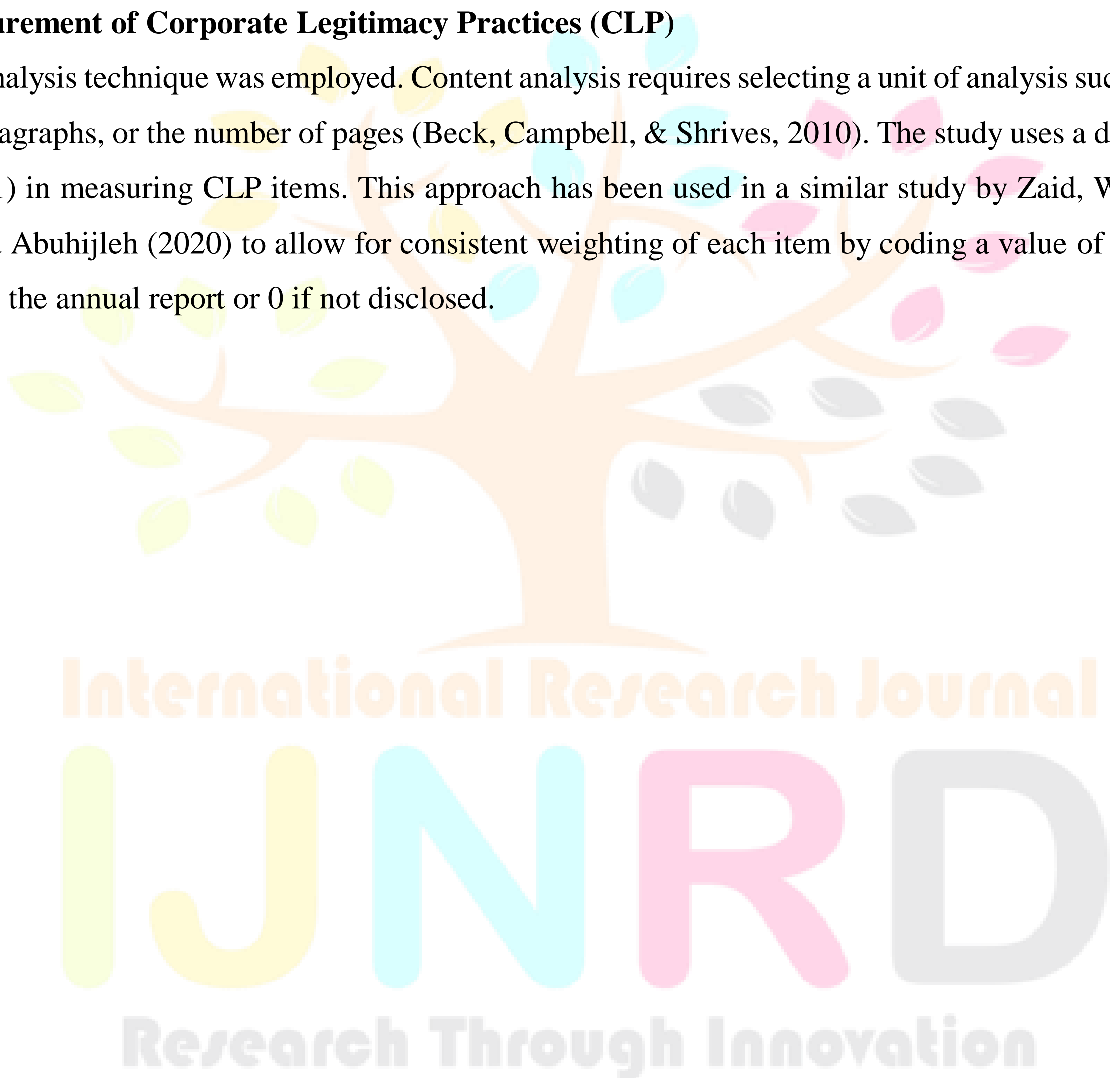
| Variable | Measurement | Source |
|---|---|---|
| ETR | This is a measure of the proportion of profit before tax paid as tax. It is computed as tax paid divided by profit before tax. | Kristiadi, Kurniawati, and Naufa (2020) |

| SIZE | Natural logarithm of closing assets | Abdelfattah and Aboud (2020) |
|---|---|---|
| LEV | Total debt over total assets | Abdelfattah and Aboud, (2020) |
| Operating cash flow | Net cash from operating activities | Gulzar et al. (2018) |
| Sales Growth | (Current term sales-Previous term sales)/Previous term sales | Gulzar et al. (2018) |

Source: Author’s compilation (2020)

### 3.2.3 Measurement of Corporate Legitimacy Practices (CLP)

The content analysis technique was employed. Content analysis requires selecting a unit of analysis such as words, sentences, paragraphs, or the number of pages (Beck, Campbell, & Shrives, 2010). The study uses a dichotomous approach (0, 1) in measuring CLP items. This approach has been used in a similar study by Zaid, Wang, Adib, Sahyouni, and Abuhijleh (2020) to allow for consistent weighting of each item by coding a value of 1 if an item is disclosed in the annual report or 0 if not disclosed.



## 4.0 Data Analysis

Table 2: Descriptive statistics of regression model variables

| | ETR | SIZE | LEV | GROWTH | CFO |
|---|---|---|---|---|---|
| Mean | 0.629520 | 1.27E+11 | 0.410464 | 391.6885 | 4.96E+10 |
| Median | 0.215845 | 6.59E+10 | 0.106977 | 6.399746 | 7.98E+09 |
| Maximum | 7.624883 | 6.87E+11 | 12.95956 | 29329.08 | 1.06E+12 |
| Minimum | 0.000000 | 1.04E+08 | 0.000000 | -100.0000 | -4.27E+10 |
| Std. Dev. | 1.044168 | 1.57E+11 | 1.409647 | 2715.669 | 1.07E+11 |
| Observations | 168 | 168 | 168 | 168 | 168 |

Source: E-Views 9

The table above shows the mean value of the selected proxies for corporate tax aggressiveness the average value of effective tax rate is approximately 0.63; the mean value of the average asset for the firms in the sample to approximate ₦127billion and that of cash flow from operation to approximate ₦50billion. The standard deviations of SIZE and GROWTH both exceeded the mean, indicating high deviations from the mean value respectively. The average value of LEV was 0.410; indicating that the capital structure of the firms in the sample was approximately 41% financed by Debt. The average value of GROWTH was approximately 391.7% for firms in the sample.

The Table below shows the Pearson's correlation results of the regression model variables. The magnitude of the relationship is determined by the absolute value while the sign indicates the direction of the relationship.

Table 3: Correlation matrix of variables

| | ETR | SIZE | LEV | CFO | GROWTH |
|---|---|---|---|---|---|
| **ETR** | 1.000000 | | | | |
| **SIZE** | -0.009820 | 1.000000 | | | |
| **LEV** | -0.114104 | -0.145523 | 1.000000 | | |
| **CFO** | 0.033711 | 0.273360 | 0.002659 | 1.000000 | |
| **GROWTH** | -0.001016 | 0.009718 | 0.018138 | 0.175517 | 1.000000 |

Source: E-Views 9

ETR negatively correlated to the following control variables; SIZE, LEV, and GROWTH but positively correlated with CFO.

### 4.2 Test of Hypotheses

#### 4.2.1 Hypothesis One

$Ho_1$: There is no significant relationship between corporate legitimacy practice and effective tax rate.

Table 4: Analysis output for hypothesis (Panel EGLS (Cross-section weights))

| Variable | Coefficient | Std. Error | t-Statistic | Prob. |
|---|---|---|---|---|
| C | -2.237149 | 0.446882 | -5.006127 | 0.0000 |
| CLP | -0.175060 | 0.066135 | -2.647017 | 0.0089 |
| SIZE | 0.123125 | 0.023788 | 5.175987 | 0.0000 |
| LEV | 0.012501 | 0.008777 | 1.424306 | 0.1563 |
| CFO | 5.74E-13 | 3.44E-13 | 1.670541 | 0.0967 |

| GROWTH | 6.09E-06 | 3.27E-06 | 1.862880 | 0.0643 |
|---|---|---|---|---|

| Weighted Statistics | | | |
|---|---|---|---|
| R-squared | 0.259961 | Mean dependent var | 0.816377 |
| Adjusted R-squared | 0.237120 | S.D. dependent var | 0.951016 |
| S.E. of regression | 0.915854 | Sum squared resid | 135.8836 |
| F-statistic | 11.38146 | Durbin-Watson stat | 1.256944 |
| Prob(F-statistic) | 0.000000 | | |

| Unweighted Statistics | | | |
|---|---|---|---|
| R-squared | 0.019734 | Mean dependent var | 0.629520 |
| Sum squared resid | 178.4849 | Durbin-Watson stat | 1.031721 |

Source: E-Views 9

**Interpretation:**

The R-squared value is 0.259 and, the adjusted R-squared value is .237 for the weighted statistic. These values describe the proportion of variance in the dependent variable explained by the independent and control variables. Thus, the model explains approximately 24% (i.e., adjusted R-squared value to account for sample size) variation of the dependent variable. The F-statistic (ratio of the mean regression sum of squares divided by the mean error sum of squares) was used to check the statistical significance of the model. The value of the statistic was 11.381 ($p < .05$); thus, the hypothesis that all the regression coefficients are zero is rejected. Both the F-statistics and adjusted $R^2$s for the regression suggest that the overall model is a good fit and explains most of the variations in the effective tax rates.

The *coefficient* and *t-statistic* of our variable of interest (CSR) are negative and statistically significant [*t-statistic* (-2.647017), *p* (0.0089, <.05)]; thus, the alternate hypothesis is accepted and null rejected. Therefore, “There is a significant relationship between social responsibility disclosure and effective tax rate.”

The table shows that the following control variables CFO and GROWTH were significant at 10% in the regression output. The variable firm size was significant at 5% in the regression output. The results from the table showed that SIZE (p = 0.0000), CFO (p = 0.0967) and GROWTH (p = 0.0643). The results from the analysis further showed that the *t statistics* of all the control variables were positive; however, the variable LEV was not significant because the p-value was greater than .05 (p=0.1563).

### 4.3 Discussion of Findings

The analysis showed a significant negative relationship between corporate legitimacy practice and effective tax rate. This is consistent with Ortas and Álvarez (2020) using cross-country data found evidence of a negative relationship between CSR (corporate social, environmental and governance performance) with tax aggressiveness; Abdelfattah and Aboud (2020) in Egypt showed a significant negative effect of the effective tax rate on CSR disclosure; while, Kristiadi, Kurniawati, and Naufa (2020) in Indonesia found a non-significant negative effect of CSR on ETR, but when reversed ETR had a significant negative effect on CSR. Karlberg (2020)

using a sample of industrial firms in the U.S.A. found a non-significant negative effect of CSR on cash ETR using the OLS. Makni, Affes, and Trigui (2019) on a sample of firms from the European Union reported a negative statistically significant effect of CSR on ETR at 1%. Specifically, the economic, environmental, social and corporate governance performance dimensions were negative and significantly related to ETR. van Renselaar (2016) found that the environmental dimensions of CSR had a significant negative effect on the effective tax rates. Rahmat and Kustiawan (2018) in Indonesia reported a non-significant negative effect of CSR on ETR.

However, contrary to this, Umobong and Agburuga (2018) in Nigeria reported that ETR was positively related to CSR for environmental CSR activities. Using a sample of firms in the U.S. Vacca, Iazzi, Vrontis, and Fait (2020) in Italy found a non-significant positive effect of tax aggressiveness on CSR reporting. Mashuri and Ermaya (2019) in Indonesia showed that ETR has a significant positive effect on CSR disclosure.

## 5.0 Conclusion and Recommendation

The study concludes that corporate legitimacy practices influence corporate tax avoidance in consumer goods manufacturing firms in Nigeria. The empirical results revealed that there is a significant relationship between corporate legitimacy practices and effective tax rate ($p<.05$). The study anchored the stakeholder to explore the nexus of corporate legitimacy practices and corporate tax avoidance. The sample was delimited to firms in the consumer goods sector of the Nigerian Stock Exchange (NSE) for the selected period of the study. Based on this the study recommends that corporate legitimacy practices should form an integrated aspect of corporate activity for its inhibiting role in tax avoidance. The disclosure of CSR activities and further enforcement by the government that organisations implement environmental remediation activities. These include funding of activities which are related to costs incurred to prevent or compensate for injuries from corporate activities. Corporate legitimacy practices can serve as a useful hedge Managers may hedge against potential negative consequences of tax aggressiveness.

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