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TÍTULO: Influencias políticas y tasas de impuestos efectivas: evidencia de Pakistán.

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RESUMEN. El propósito de este documento es examinar la relación entre las influencias políticas y las tasas de impuestos efectivas. Este estudio examina si las empresas con influencia política pagan impuestos efectivos significativamente más bajos que las empresas pakistaníes. El estudio utilizó una muestra de empresas que no cotizan en bolsa en Pakistán durante el período 2009-2013. Los resultados previeron que las empresas con influencia política pagan impuestos efectivos significativamente más bajos en comparación con las empresas sin influencia política. Este estudio contribuye al campo de la teoría de la economía política en el que brinda una perspectiva profunda a los responsables políticos interesados en mejorar la transparencia en las economías transnacionales.

PALABRAS CLAVES: influencias políticas, tasas impositivas efectivas, teoría de la economía política, Pakistán.

TITLE: Political influences and effective tax rates: Evidence from Pakistan.

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ABSTRACT: The purpose of this document is to examine the relationship between political influences and effective tax rates. This study examines whether companies with political influence pay significantly lower effective taxes than Pakistani companies. The study used a sample of companies that are not listed on the stock exchange in Pakistan during the 2009-2013 period. The results predicted that companies with political influence pay significantly lower effective taxes compared to companies without political influence. This study contributes to the field of political economy theory in which it provides a deep perspective to policy makers interested in improving transparency in transnational economies.

KEY WORDS: political influences, effective tax rates, political economy theory, Pakistan.

INTRODUCTION.

Prior research shows that politically influenced firms are associated with multiple problems such as corruption (Saeed et al., 2015), poor governance (Gul, 2006), lack of transparency and investor protection (Chaney et al., 2011), poor organizational performance (Cheema et al., 2016), lower earnings quality (Sadiq and Othman, 2017), and operational inefficiencies (Saeed et al., 2017). Firms develop political influences through links between firms and politicians. Some researchers (Faccio, 2010; Fisman, 2001) argue that political links are developed through buying shares in a firm or when a politician becomes a board member in the firm. While other researchers (Aggarwal et al., 2012) opine that political links arise when a firm gives political donations to a political party. However, in

the context of Pakistan, political influences develop through significant shareholdings in firms, which is subsequently translated into board memberships.

Prior studies have linked political influences with multiple problems in Pakistan such as poor organizational performance (Cheema et al., 2016), high earnings management (Sadiq and Othman, 2017), operational inefficiencies (Saeed et al., 2017; Samerkhanova et al., 2016), high leverages (Saeed et al., 2015). This is evidence of a strong nexus between politics and business in Pakistan. In addition, numerous well-known Pakistani politicians are named against the allegation that their assets do not match their earnings and that they are involved in tax evasion. However, little attention was given in prior studies to investigate the relationship between political influences and effective tax rates (ETR). Therefore, the prime motivation of this study is to investigate empirically the relationship between political influences and ETR in Pakistan.

However, the underlying mechanisms through which politically influenced firms are connected to lower ETR is beyond the scope of the current study. This is because politically influenced firms obtain privileges from the government such as tax subsidies, which may result in lower ETR. However, the disclosure of such tax subsidies are limited and quite discretionary. Prior research (Adhikari et al., 2006) is of the view that there are various discretionary tax shields such as special deductions, non-taxable income and allowances, which may lead to lower ETR for politically, influenced firms. In keeping with prior research, this study also finds empirically that politically influenced firms pay significantly lower effective tax rates when compared to non-politically influenced firms.

The current study makes the following contributions: Firstly, prior studies have looked at politically influenced firms from a narrow perspective, where a firm is assumed to be politically influenced if it is affiliated with a single powerful politician (examples of which are, Dr. Mahathir and Mr. Anwar Ibrahim in Malaysia, and the late President Suharto in Indonesia). This is unlike the situation in Pakistan, where there is a high presence of politicians and their close relatives in firms. In fact, the

political system in Pakistan is controlled by influential families and business conglomerates (Saeed, et al., 2015), which is unlikely to be the case in previous studies. Secondly, there is a strong nexus between politics and business in Pakistan, and numerous well-known politicians are alleged to be involved in tax evasion. However, there is limited empirical evidence available on this issue.

The remainder of the paper is structured as follows; firstly, there is a brief write up reviewing all the prior related literature, followed by the hypotheses development. Then the theoretical framework is developed to investigate whether there is a nexus between politically influenced firms and lower effective tax rates. This is followed by the literature review, research methodology, results, and conclusion.

DEVELOPMENT.

Literature review.

Politics in the context of Pakistan.

Pakistan is a commonwealth country, located in South Asia (Cheema et al., 2016). Administratively, it is a federal republic comprising of a capital territory, namely Islamabad, and four provinces, namely Sindh, Punjab, Baluchistan, and Khyber Pakhtunkhwa. By virtue of the Constitution of Pakistan (1973), the provincial governments have provincial assemblies, which are headed by the elected Chief Ministers, whereas the Federal Government has a parliament which is led by the elected Prime Minister. Since the independence of Pakistan in 1947, except for outright military dictators and elected governments backed by military dictators, only two elected governments have been able to complete their tenure. Elected governments were either toppled by the military dictators or dismissed by the President on charges and conviction of corruption, political abuse of power, and mismanagement (Saeed et al., 2015).

The listed firms in Pakistan are governed by the Securities and Exchange Commission of Pakistan (SECP), which is required to abide by and comply with the Code of Corporate Governance (CCG) of Pakistan, which is an essential part of the listing requirements on the Pakistan Stock Exchange (PSE). Therefore, the PSE, SECP, and CCG Pakistan make up the main regulatory mechanisms for listed firms in Pakistan. The regulatory mechanisms although theoretically strong in Pakistan, have not been implemented practically (Cheema et al., 2016). In addition, legislation relating to conflicts of interest are weak in Pakistan, which allows civil servants and politicians to get political benefits (Cheema et al., 2016). Furthermore, the presence of government owned banks provide opportunities for politically connected firms to default on bank loans (Khwaja & Mian, 2005). Therefore, weak regulatory bodies, institutes, and legal system, result in the lax exercise of corporate governance in Pakistan**.**

Furthermore, the tax collection authority namely, the Federal Board of Revenue (FBR) is always blamed for issuing Statutory Regulatory Orders to facilitate the shenanigans of politically influential people (Cheema et al., 2016). The authors further claim that the discretionary powers in tax assessment allow corrupt practices in the FBR. In addition to the weakness of FBR, National Accountability Bureau (NAB), which is the authority to curb financial corruption, is always accused of being highly politicized (Cheema et al., 2016), because NAB has rarely probed politically influential people whose assets do not match their earnings. Therefore, given the presence of weak institutions, it is high likely that politically influenced firms may get involved in earnings management activities in order to report poor organizational performance and therefore report less taxable income.

Political Influences and Effective Tax Rates (ETR).

There is an array of definitions for the meaning of the term politically influenced firms. For the purpose of this study prima facie, a firm is considered to be politically influenced if it has the presence

of any; politician(s) or close relative(s) of a politician(s) (Sadiq & Othman, 2017; Cheema et al., 2016; Faccio, 2006). The premise of this study is based on the argument that the politicians influence managerial decisions due to their significant shareholdings and presence on the board of directors. For this purpose, they may appoint politically influential people as their representatives on the board of directors and senior management.

Hillman (2005) postulates that politically influenced firms obtain benefits in the form of reduction of the impact of government policies, enforcements and regulations over the firm which in turn protects them from external threats and fluctuations. Politically influenced firms may enjoy benefits such as loans with lower interest rates (Saeed et al., 2015), government contracts (Faccio, 2006), and government support (Adhikari et al., 2006). Government support results in implicit and explicit subsidies. These subsidies may include tax-free government bailouts and special tax deductions (Adhikari et al., 2006), which may consequently result in a lower effective tax rate. Therefore, the impact of political influences on effective tax rates is an important aspect to be investigated, because government subsidies may result in a different effective tax rates for politically influenced firms. Thus, the current study hypothesizes that politically connected firms' pay tax at lower effective rates:

Hypothesis: politically influenced firms are related to lower effective tax rates (i.e. effective tax rates in Pakistan are negatively associated with political influences).

Data collection and sampling.

In keeping with the above paradigm, this paper collected data from 160 firms listed on the Pakistan Stock Exchange (PSE), which consisted of 80 politically influenced and 80 non-politically influenced firms. The data used in this study was a balanced panel and gathered manually over the period 2009–2013 from Annual Reports published by firms listed on the Pakistan Stock Exchange (PSE). After using the filter on non-financial listed firms, the final sample included 80 politically influenced firms, and therefore, 80 similar non-politically influenced firms were chosen.

For the time period ranging from 2009-2013, all non-financial listed firms were included in the original sample. There were 330 non-financial listed firms in the original sample, classified into different industries; Cement, Manufacturing, Services, Fuel and Energy, Sugar, Chemicals and Pharmaceutical, and Textiles. The original sample was then reduced by the following exclusions:

1) Firms which were suggested as politically connected firms by online sources, showed no unambiguous evidence of such claims upon reviewing the profiles of their management and board of directors. 39 firms fell into this category.

2) Firms with incomplete information were excluded. There were 21 such firms.

3) After selecting the sample of politically influenced firms, non-politically influenced firms of a similar nature were also chosen for the sample. Therefore, to match with 80 politically influenced firms, 80 non-politically influenced firms were similarly chosen.

Regression model and variable definition.

We use a regression model of the following general form:

$$ETR_{j,t} = \delta_0 + \delta_1 PI_{j,t} + \delta_2 CAPINV_{j,t} + \delta_3 BIG4_{j,t} + \delta_4 LEV_{j,t} + \delta_5 ROE_{j,t} + \delta_6 SIZE_{j,t} + \delta_7 INDUSTRY_{j,t} + \omega_{j,t}$$

The dependent variable, ETR, is the average effective tax rate for firm j in year t. The independent variables include political influences (PI), capital investment (CAPINV), big four auditors (BIG4), financial leverage (LEV), return on equity (ROE), total assets (SIZE), and industry dummies (Industry).

Effective tax rate measures.

In keeping with prior studies (Adhikari et al., 2006), this study measures ETR using the operating income method. Following Adhikari et al. (2006), this study adopted operating income method to measure ETR: (Tax expenses _ Deferred tax expenses)/ (Profit before interest and tax).

Measurement of Political Influences.

This study measures political influences (PI) as a dummy variable, which is equal to 1 if firm is politically influenced and 0 if non-politically influenced. PI refers to the connections of firm with politicians (direct connections) or presence of close relative (indirect connections) of politician(s) in senior management or board of directors. Thus, PI includes both direct and indirect political connections.

Measurement of Control Variables.

In addition to political influences, this study includes several control variables, which were used in previous studies (Sadiq & Othman, 2017; Adhikari et al., 2006). We have included capital investment (CAPINV), big four auditors (BIG4), financial leverage (LEV), return on equity (ROE), total assets (SIZE), and industry dummies (Industry). CAPINV equals to the ratio of net property, plant, and equipment to total assets. CAPINV is expected to be negatively associated with ETR because of accelerated depreciation to report less taxable income. BIG4 is a dummy variable which is coded 1 if a firm is audited by top big four audit firms, and 0 otherwise. It is expected to be positively related to ETR because firms audited by big four auditors are usually high profitable firms. LEV equals to the ratio of debt to total assets, consistent with previous studies (Cheema et al., 2016), is anticipated to be negatively linked to ETR because of tax-deductible interest payments. SIZE equals to natural log of total assets, which is used as a control for size effects. SIZE is expected to be negatively related to ETR, because large firms decrease their taxable income with the objective to reduce political costs (Sadiq & Othman, 2017). ROE is the return on equity. Firms with high return on equity tend to have higher profitability, and thus are estimated to be positively associated with ETR. Industry is a vector of dummy variables, which represents different sectors to which a sample firms belong.

Results.

Table 1 reports descriptive statistics for the dependent and independent variables over the period 2009–2013. ETR has a mean of 0.2078, PI has a mean of 0.50 suggesting that half of the sample firms are politically influenced firms.

Table 1. Summary Statistics of the variables used in analysis.

Variable	Observations	Mean	Std. Dev.
ETR	800	0.2078	0.2198
PI	800	0.5000	0.5003
ROE	800	15.9658	51.3474
BIG4	800	0.4398	0.4896
SIZE	800	6.8473	0.6682
CAPINV	800	0.2563	0.2823
LEV	800	0.6194	0.3068

Note: **ETR is the effective tax rate; PI is a dummy variable, coded 1 in presence of politician(s) or close relatives of a politician(s) on board of directors or senior management of firm and 0 otherwise; ROE is the percentage of net income/loss divided by equity; BIG4 is a measure of firms' audit quality, which is coded 1 for top big four auditors and 0 otherwise; SIZE is equal to log of total assets of the firm; CAPINV represents the ratio of net property, plant, and equipment to total assets; LEV is equal to the ratio of total debt/liabilities to total assets.**

Pearson correlation is presented in Table 2. The low correlation between independent variables indicates that there is no serious multi-collinearity problem in the data set.

Consistent with our hypothesis, PI is negatively and significantly correlated with ETR, suggesting that politically influenced firms pay lower effective tax rates as compared to non-politically influenced firms.

Table 2. Pearson Correlations of the effective tax rates and independent variables.

	ETR	PI	ROE	BIG4	SIZE	CAPINV	LEV
ETR	1						
PI	-0.035***	1					
ROE	0.098*	-0.011**	1				
BIG4	0.23**	-0.18*	0.21**	1			
SIZE	0.105	0.13*	0.11*	0.48***	1		
CAPINV	-0.24*	0.098	0.098*	0.168**	-0.148**	1	
LEV	-0.04*	0.27***	-0.17**	-0.31***	-0.12*	-0.081*	1

Note: **ETR is the effective tax rate; PI is a dummy variable, coded 1 in presence of politician(s) or close relatives of a politician(s) on board of directors or senior management of firm and 0 otherwise; ROE is the percentage of net income/loss divided by equity; BIG4 is a measure of firms' audit quality, which is coded 1 for top big four auditors and 0 otherwise; SIZE is equal to log of total assets of the firm; CAPINV represents the ratio of net property, plant, and equipment to total assets; LEV is equal to the ratio of total debt/liabilities to total assets.**

*** Correlation is significant at the 0.10 level.**

**** Correlation is significant at the 0.05 level.**

***** Correlation is significant at the 0.01 level.**

Regression results.

Table 3 shows the results of the relationships between political influences and effective tax rates. Consistent with our hypothesis, the result shows the negative and significant relationship between political influences and effective tax rates. The coefficients of PI is negative and significant with the coefficients being -20.6489 (z = -3.04). These findings suggest that politically influenced firms in Pakistan pay significantly lower effective tax as compared to non-politically influenced firms, which is consistent with the findings of Adhikari et al. (2006).

As predicted, CAPINV is significantly and negatively associated with ETR, suggesting that Pakistani firms with more capital investments pay significantly lower effective tax. The coefficient of BIG4 is positively and significantly related to ETR, suggesting that firms audited by BIG4 auditors pay significantly higher effective tax. LEV is negatively and significantly related to ETR, indicating that high debt firms pay lower effective tax as compared to lower debt firms in Pakistan. SIZE is positive, but not significantly related to ETR. Our findings suggest that firm size does not have any significant

impact on effective tax rate. The coefficient of ROE is positively and significantly related to ETR, suggesting that high profitable firms pay significantly higher effective tax.

Table 3. Linear results of the relationships between effective tax rate (ETR) and political influences (PI).

ETR	Coefficient	z	P>z
PI	-20.6489	-3.04	0.002
CAPINV	-20.1140	-2.66	0.008
BIG4	14.1586	2.05	0.040
LEV	13.9292	-2.59	0.010
SIZE	2.2872	0.44	0.657
ROE	0.1862	3.47	0.001
_cons	12.8956	0.40	0.691
Industry Effect		Yes	
R-Square		0.2069	
Observations		800	

Note: **ETR is the effective tax rate; PI is a dummy variable, coded 1 in presence of politician(s) or close relatives of a politician(s) on board of directors or senior management of firm and 0 otherwise; ROE is the percentage of net income/loss divided by equity; BIG4 is a measure of firms' audit quality, which is coded 1 for top big four auditors and 0 otherwise; SIZE is equal to log of total assets of the firm; CAPINV represents the ratio of net property, plant, and equipment to total assets; LEV is equal to the ratio of total debt/liabilities to total assets.**

CONCLUSIONS.

This study provides clear evidence that politically influenced firms in Pakistan are negatively and significantly associated with effective tax rates as compared to non-politically influenced firms. We have come to this conclusion after testing the relationship between political influences and effective tax rates. Furthermore, this result is consistent with the argument of Adhikari et al. (2016), who assert that governments by providing support to political influential firms in the form of tax-free government bailouts and special tax deductions, which may consequently result in lower effective tax rates.

This study contributes to the field of political economy theory and contributes to the ongoing debate about the role of political influences in emerging markets. We offer insights to tax authorities and policy makers who are interested in brining transparency in transitional economies such as Pakistan, where politics and businesses are closely linked to each other.

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