Financial sophistication, review of the financial reporting and the probability of fiscal control

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Outline

Empirical facts (U.S.)

- Increasing tax aggresiveness

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- "*Corporate tax revenues* as a share of GDP have fallen to near historic lows. At 1.7% of GDP in 2009, the U.S. has the third-lowest effective corporate burden in the world based on corporate taxes as percentage of GDP." (Dave Johnson, April 23, 2013)

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- Official reports focus on their use of sophisticated tax planning techniques to lower their US tax liabilities and shift profits to low tax countries
- Corporate lobbyists and CEOs argue that companies are paying all applicable taxes in every jurisdiction they operate. However, recent turmoil over tax avoidance practices of large corporations (such as Google, Starbucks, Microsoft and HP)

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- Audit rates for the group of companies with assets greater than \$100 million, but below \$250 million: 17.6% in 2001, 16.6% in 2011

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- Evidence of increasing role and review rate of the Securities and Exchange Comission

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- IRS providing a monitoring mechanism can generate a spillover benefit of higher financial reporting quality (Desai et al., 2007; Hanlon et al., 2012)

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- Drawing from the idea that high-quality financial reports allow for easier detection of tax evasion (Wysocki, 2011). We provide simple scenarios in which, once considering the SEC's review in the game between IRS and agents, there can be proved some degree of substitution between the intensity of SEC's activity and that of the IRS.

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- Practically we replicate the empirical observation (including for periods of no changes in the IRS penalties) showing the fiscal audit rates decreasing, while the fiscal discipline weakens.
- (Different from the view in the **generally used explanations**: lower budget with respect to the size of the economy $\rightarrow$ rates of IRS audit $\rightarrow$ lower perceived risk of being audited $\rightarrow$ firms break the law more often)

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    - it should not be understood that the companies with $T = 0$ do not pay taxes, just that from technical point of view we choose not to carry forward the symbol of low taxes; what actually matters is the difference between high and low tax liabilities, so we did a normalization to $T = 0$ for low tax liabilities and $T = 1$ for high tax liabilities.

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  - the expanding financial sophistication may have as effect a change in the distribution of these liabilities, in the sense that more and more firms with large amounts of income, are assimilated to the firms with low liabilities.

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- assume $B_1 < B_2 - 1$ (large firms do not have incentives to report lower profits in order to pay less taxes) (Erickson et al 2002).

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  - if both audit $\pi = B - T - F \cdot 1_{\{T>y\}}$.

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- $c : [0, \infty) \to [0, \infty)$ satisfies $c'(0) = 0;\ c'(\rho) > 0, \rho > 0;\ c''(\rho) > 0, \rho \geq 0.$

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  4. The IRS sees (x, y), whether the SEC has reviewed and the result of the review. It decides the probability of audit ρ (at each information class).

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Measure of fiscal authority's response:

- The total probability of fiscal audit is ρ^*, the weighted average of the probabilities of audit at each information set.

Results

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3. Simultaneous increase in p and σ

There are ranges of the parameters for which an increase in p and in σ produces an increase in α^* and β^*, and a decrease in ρ^*.

Conclusions

- We show a magnifying effect of the financial sophistication on the tax compliance. That is, even if the size of the group of firms

  susceptible of tax evasion is decreasing because of an increase in p (i.e., $q \cdot (1-p)$ is decreasing in p), the rate of individual evasion α^* increases so much that even the total rate of evasion $\beta^* = q \cdot (1-p) \cdot \alpha^*$ will increase.

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- We show a "substitution effect" between the probability of audit of IRS and SEC.

- We describe an alternative mechanism where the IRS audit activity decreases and the tax aggressiveness increases endogenously.