Tax Avoidance Governance Effects of Financial Justice System Innovations -- Empirical Evidence Based on the Pilot Establishment of Financial Courts

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Abstract. In this paper, we study the governance effects of financial courts, an innovative investor judicial protection system, on firms using a sample of listed firms in Shanghai, Shenzhen, and North China from 2013 to 2023. We find that the establishment of financial courts can effectively curb corporate tax avoidance behavior, and the conclusion still holds after a series of robustness tests. The results of this paper confirm the positive significance of financial courts in building the cornerstone of sound capital market development.

Keywords: Financial Court; Tax Avoidance; Progressive Double Differential.

1. Introduction

Since the inauguration of the SSE on December 19, 1990, China's capital market has undergone a period of significant reform and development, spanning over three decades, and has achieved notable advancements. Nevertheless, the extant financial legal regulatory system in China remains imperfect and unsound, thereby gradually exposing the ‘dark side’ [1] of the voracious growth of capital. In response to the growing number of financial cases and their increasing complexity, the financial court was established. On August 20, 2018, China's inaugural financial court was inaugurated on a pilot basis in Shanghai. This was followed by the establishment of a financial court on a pilot basis in Beijing and the Chengdu-Chongqing area in 2021 and 2022, respectively.

The financial court is one of the professional courts delineated in the Organic Law of the People's Courts of the People's Republic of China. It is situated alongside military courts, maritime courts, and intellectual property courts. The financial court has centralized jurisdiction over financial commercial cases and financial-related administrative cases that were previously within the purview of intermediate people's courts.

In conclusion, the establishment of financial courts represents a significant milestone in China's pursuit of a novel financial regulatory system. It is regrettable that there is a paucity of empirical research literature on the policy events related to the pilot establishment of financial courts in China. This paper takes the perspective of governance of tax avoidance as its point of departure and examines the impact of financial courts on corporate tax avoidance behavior. The findings indicate that the establishment of financial courts has a significant inhibitory effect on corporate tax avoidance activities. This finding not only corroborates the positive significance of the establishment of financial courts and provides an empirical basis for further accelerating the promotion of the establishment of financial courts in China, but also improves the relevant theories of corporate taxation.

The remainder of the paper is structured as follows: the second part presents the hypothesis, the third part provides the empirical evidence, and the final part offers conclusions and policy recommendations.

2. Hypothesis Development

The theory of deterrent effect [2] posits that rational economic agents will refrain from engaging in a given behavior if the potential penalty for doing so outweighs the potential benefit. The Financial Court, as an innovative financial regulatory mechanism, employs a high degree of severity in penalizing listed companies for financial irregularities, thereby motivating the penalized companies to cease their irregular practices. For firms that have not yet been punished, social learning theory [3] posits that observing the consequences of others engaging in similar behavior can lead to increased awareness of the associated costs, which may then result in a reduction in the likelihood of repeating that behavior. Therefore, financial courts can serve as a demonstration effect, prompting businesses to engage in activities with positive externalizations and deterring corporate tax avoidance. In conclusion, this paper proposes the following hypothesis:

H: Other things being equal, firms in the pilot financial court districts are less likely to avoid taxes compared to non-pilot districts.

3. Data Collection and Research Methodology

This paper constructs the following multi-period double difference model (1) to examine the impact of financial courts on corporate tax avoidance behavior as follows:

$$RATE\_DIFF = \alpha 0 + \alpha 1COURT + CONTROLS + YEAR\ FE + FIRM\ FE + \varepsilon \qquad (1)$$

The explanatory variable COURT is a dummy variable, as referenced by Liu Jinyang and Ye Kangtao [4], which is assigned a value of 1 if the listed company is situated within the region and year where the financial court has been established, and onwards, and a value of 0 otherwise. The explanatory variable RATE_DIFF is employed to quantify the extent of corporate tax avoidance, as delineated by the practice of Wu Liansheng [5]. The coefficient α 1 of the COURT gauges the impact of the financial court on corporate tax avoidance conduct. This coefficient is the focal point of this investigation. In the event that the hypothesis proposed herein is validated, the coefficient α 1 will exhibit a markedly negative value. The set of control variables, designated as CONTROLS, encompasses variables pertaining to the financial status of firms, corporate governance, and the prefecture level at which they are situated. The variables YEAR FE and FIRM FE serve to control for temporal and firm-specific fixed effects, respectively. Furthermore, this study employs a firm-level clustering approach. For a detailed explanation of the specific variable definitions, please refer to Table 1.

Table 1. Variable Definition Table

Variable Category	Variable	Definition
Dependent Variables	RATE_DIFF	Difference between nominal corporate income tax less effective income tax,and the larger it is, the higher the degree of corporate tax avoidance is.
Independent Variables	COURT	Dummy variable, 1 if the enterprise is in a region and year where a financial court has been established and later, 0 otherwise.
Control Variables	SIZE	Logarithmic total assets of the enterprise.
	LEV	Total liabilities / total assets.
	GROWTH	(Current year's sales - previous year's sales) / Previous year's sales.
	ROA	Net Profit / Total Assets.
	CASHFLOW	Net cash flows from operating activities / total assets.
	TOP10	Total number of shares held by the top ten largest shareholders / Total share capital of the enterprise.

	BOARD	Logarithmic total number of board members.
	DUAL	Dummy variable, 1 if the chairman of the board of directors and the general manager are the same person, otherwise 0.
	INDEP	Number of independent directors / Total number of board members.
	WAGE	Logarithmic total remuneration of directors and supervisors.
	AGE	Logarithmic number of years since listing.
	AO	Assigns a value of 1 when the enterprise is issued a standard audit opinion, otherwise assigns a value of 0.
	TOP4	Assigned a value of 1 if audited by a top 4 accounting firm, otherwise assigned a value of 0.
	GDP_AREA	Logarithm of the annual nominal GDP of the prefecture level city where the enterprise is registered.

This paper examines the financial performance of Chinese companies listed on the Shanghai and Shenzhen stock exchanges between 2013 and 2023. The research data were sourced from CSMAR and CNRDS and processed in accordance with the following methodology: (1) Financial and ST listed companies are excluded; (2) insolvency samples are excluded; (3) samples with missing main variables are excluded; and (4) all continuous variables are subjected to a shrinking treatment of 1% on either side to control the influence of extreme values. Following the aforementioned treatments, this paper ultimately obtains data for a total of 27,713 firm-year samples from 2013 to 2023. Table 2 presents the descriptive statistics of the main variables in this paper.

Table 2. Descriptive Statistics

VARIABLES	N	MEAN	SD	MIN	MEDIAN	MAX
RATE_DIFF	27713	0.008	0.103	-0.512	0.016	0.233
DID	27713	0.112	0.315	0.000	0.000	1.000
SIZE	27713	22.299	1.322	19.893	22.094	26.653
LEV	27713	0.393	0.194	0.046	0.380	0.864
GROWTH	27713	0.174	0.348	-0.511	0.112	3.273
ROA	27713	0.055	0.041	0.001	0.046	0.238
4	27713	0.058	0.065	-0.173	0.056	0.267
TOP10	27713	0.603	0.149	0.227	0.614	0.913
BOARD	27713	2.111	0.195	1.609	2.197	2.708
DUAL	27713	0.306	0.461	0.000	0.000	1.000
INDEP	27713	0.377	0.053	0.286	0.364	0.571
WAGE	27713	15.606	0.677	13.743	15.571	17.689
AGE	27713	2.013	0.960	0.000	2.197	3.434
AO	27713	0.990	0.099	0.000	1.000	1.000
BIG4	27713	0.063	0.242	0.000	0.000	1.000
DIQU_AREA	27713	9.130	1.073	5.902	9.259	10.763

4. Empirical Results and Analysis

4.1 Multiple Regression

Table 3 presents the primary regression results of this study. The estimated coefficients of the explanatory variable DID in columns (1) and (2) of the regression results are -0.012 and -0.010, respectively. Both are significantly negative at the 1% level, indicating that the establishment of a financial court significantly reduces the extent of tax avoidance by firms. This finding is robust to the inclusion or exclusion of the control variables and the application of firm-specific and vintage fixed effects. Therefore, the hypotheses presented in this paper are supported by the empirical evidence.

Table 3. Descriptive Statistics

VARIABLES	(1)	(2)
	RATE_DIFF	RATE_DIFF
DID	-0.012***	-0.010***
	(0.004)	(0.003)
CONTROLS	NO	YES
N	27713	27713
ADJ. R^2	0.329	0.371
FIRM	NO	YES
YEAR	NO	YES

4.2 Parallel Trend Test

In this paper, we refer to the findings of Li P et al. [6] and group the samples four years and more from the implementation of the policy before conducting the parallel trend test. We use the year before the first implementation of the policy (2017) as the benchmark for comparison. As illustrated in Figure 1, the ex ante trend is found to be insignificant, whereas the ex post trend is significantly negative. Furthermore, the negative inhibition of corporate tax avoidance by the establishment of financial courts is observed to intensify with the prolongation of the policy implementation period. These findings substantiate the robustness of the conclusions drawn in this paper.

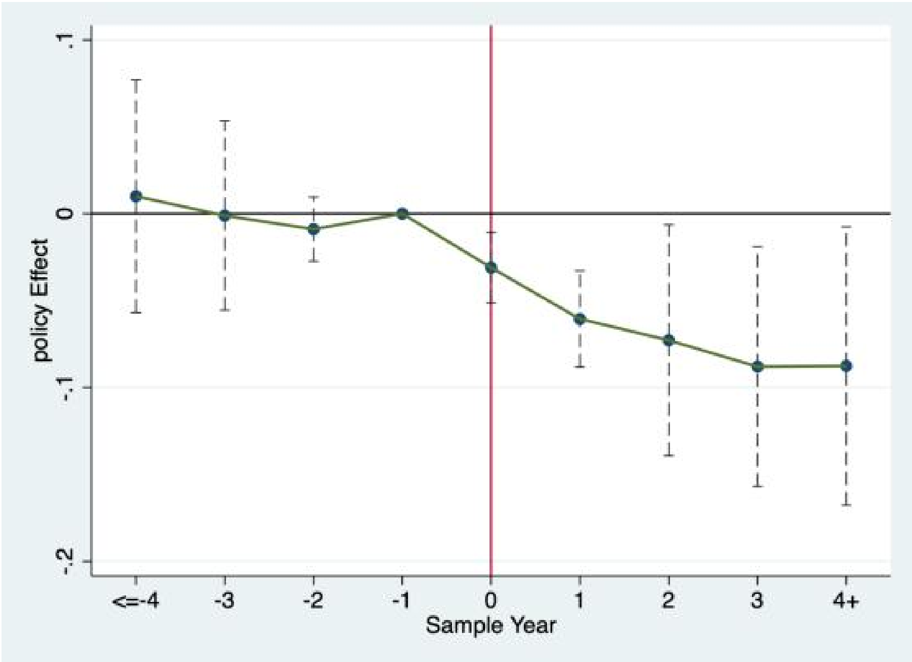

Fig. 1 Parallel trend test results

4.3 Placebo Testing

In this paper, we construct a fictitious treatment group by randomly assigning the sample of enterprises affected by the establishment of financial courts and the policy year to conduct 500 randomized tests. This process allows us to obtain the fictitious P-value and fictitious coefficients, which are presented in the following figures. The results are presented in Figures 2 and 3. The true estimated coefficients of the fictitious treatment group are markedly to the left, and the majority of the fictitious treatment group has a P-value of 0.1 or more. These findings demonstrate that the core conclusions of the previous paper remain robust.

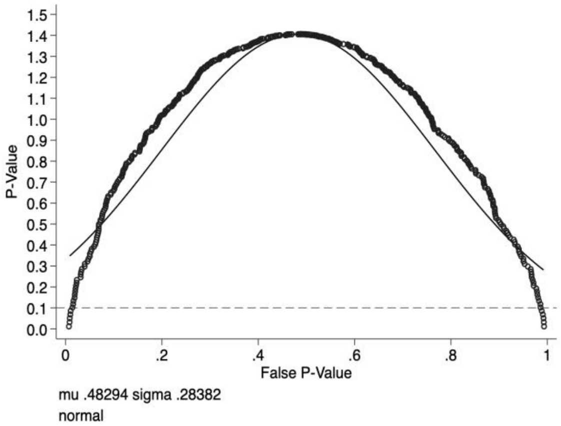

Fig. 2 Spurious P-value results

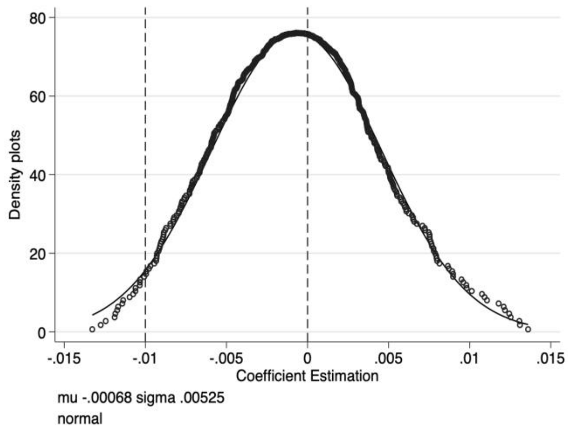

Fig. 3 Coefficient Estimation

4.4 Other Robustness Tests

Furthermore, this paper performs the following robustness tests: (1) replacement of explanatory variables, based on the methodology proposed by Dyreng et al [7]. To gauge the extent of corporate tax avoidance, this study employs a five-year average of the difference between the nominal income tax rate and the effective tax rate (year t-4 to year t), LRATE_diff. Additionally, this paper utilizes PSM to select all the control variables in Model (1) as matching variables through Probit regression. The samples are then matched with no-return 1:1 intra-caliper nearest neighbor matching, with the caliper set at 0. (1) The samples from 2013 to 2017 are analyzed on an annual basis prior to the implementation of the treatment effect. (2) To isolate the impact of the new securities law, this study excludes the samples from 2020 and beyond and re-runs the regression. The results are presented in columns 1 to 3 of Table 4, and the primary findings remain consistent.

Table 4. Other robustness tests

VARIABLES	(1)	(2)	(3)
	LRATE_DIFF	RATE_DIFF	RATE_DIFF
DID	-0.005**	-0.009***	-0.011**
	(0.002)	(0.003)	(0.005)
CONTROLS	YES	YES	YES
N	27713	25524	15425
ADJ. R^2	0.602	0.370	0.422
FIRM	YES	YES	YES
YEAR	YES	YES	YES

5. Conclusion

This study assesses the influence of the introduction of financial courts on the prevalence of corporate tax avoidance practices. To this end, the research encompasses a sample of listed enterprises in Shanghai and Shenzhen, China, spanning the period from 2013 to 2023. The findings indicate that the establishment of financial courts has a considerable deterrent impact on corporate tax avoidance practices. The conclusion remains consistent following a series of robustness tests.

The findings of this paper provide a theoretical basis and practical insights into the impact of financial regulatory system innovation on corporate taxation. From the perspective of enterprises, it is of paramount importance to establish a sound business philosophy, cultivate a sense of social responsibility, and ensure the active fulfillment of tax obligations. Conversely, the establishment of financial courts represents a constructive response to the accelerated development of the contemporary financial industry, while also functioning as a deterrent and supervisory mechanism.

Such actions compel those who have violated the law to face the consequences of their actions. This, in turn, fosters the growth of a culture of legal compliance, deters tax avoidance, and motivates businesses to adhere to the principle of paying taxes in good faith. This results in a virtuous cycle that combats corporate tax avoidance and regulates the order of the capital market. The findings of this study offer significant insights into the establishment of financial courts at the national level.

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