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MASTER'S THESIS

# Corporate Social Responsibility and tax haven use: Evidence from the Central and Eastern Europe

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Prague, June 29, 2022 Veronika Sovičová

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# Abstract

The notion that businesses have certain responsibilities towards the society beyond the profit maximizing principle known as the Corporate Social Responsibility (CSR) has been devoted increasing attention in the academic field. Prior literature has found a link between firms´ CSR engagement and the use of tax havens, which are generally known for offering some form of preferential tax treatment. The aim of this thesis is to examine this relationship in the context of the Central and Eastern European countries. To perform the analysis, we collected data on 79 unique Central and Eastern European firms from 11 countries for the year 2020. Employing the ordered logistic regression methodology with CSR performance as categorical response variable and a tax haven user dummy as the main dependent variable of interest, we discovered that there is a significant relationship between CSR and tax haven use. It can be thus claimed that CSR has already developed sufficiently for such relationship to emerge in the post-communist region. Moreover, we find that this relationship is negative. This would suggest that the probability of being socially responsible is lower in tax haven using firms. Specifically, we provide evidence that tax haven using firms are more than 60% less likely to have higher CSR score. Our results are therefore in line with the corporate culture theory as opposed to the risk management theory. That is to say, our findings imply that in the context of CEE region, CSR is a reflection of firm´s shared beliefs rather than a reputation enhancing tool. Lastly, we show that the probability of a tax haven using firm being socially responsible increases after including the UK and the US into the list of tax havens.

**Keywords** Corporate Social Responsibility, tax havens, corporate culture theory, risk management theory, Central Europe, Eastern Europe, Ordered Logistic Regression

# Abstrakt

Teórií, že podniky by mali mať povinnosť voči spoločnosti presahujúcu vytváranie profitu, tiež známej ako podniková sociálna zodpovednosť (CSR), je v akademickej sfére venovaná čoraz väčšia pozornosť. Existujúca literatúra našla spojitosť medzi úrovňou podnikovej zodpovednosti firmy a jej využívaním daňových rajov, ktoré sú obecne známe pre ponúkanie nejakej formy daňových výhod. Účelom tejto práce je skúmať tento vzťah v kontexte krajín Strednej a Východnej Európy. Pre prevedenie analýzy sme zozbierali dáta zo 79 jedinečných východoeurópskych firiem z 11 krajín pre rok 2020. Využívajúc metodológiu ordinálnej logistickej regresie s CSR výkonom ako kategorickou závislou premennou a „dummy" premennou indikujúcou využívanie daňových rajov ako hlavnou nezávislou premennou nášho záujmu, sme odhalili významný vzťah medzi CSR a využívaním daňových rajov. Dá sa teda tvrdiť, že CSR je v danom regióne už dostatočne vyvinutá pre existenciu takéhoto vzťahu. Taktiež sme zistili, že je tento vzťah negatívny. To naznačuje nižšiu pravdepodobnosť vysokého CSR výkonu u firiem využívajúcich daňové raje. Konkrétne naše výsledky ukazujú, že firmy využívajúce daňové raje majú o viac ako 60% nižšiu pravdepodobnosť vysokého CSR výkonu. Na základe toho môžeme tvrdiť, že naše výsledky sú v súlade s teóriou podnikovej kultúry a odporujú teórií riadenia rizík. Inými slovami, z našich výsledkov vyplýva, že u firiem v Strednej a Východnej Európe CSR odráža zdieľané presvedčenie danej firmy a neslúži iba ako nástroj pre vylepšenie reputácie. Nakoniec sme ukázali, že u firmy využívajúcej daňové raje sa pravdepodobnosť sociálnej zodpovednosti zvýši po zahrnutí USA a Spojeného kráľovstva do zoznamu daňových rajov.

**Kľúčové slová** podniková sociálna zodpovednosť, daňové raje, teória podnikovej kultúry, teória riadenia rizík, Stredná Európe. Východná Európa, ordinárna logistická regresia

# Contents

**List of Tables** ........ 9

**List of Figures** ........ 10

**Acronyms** ........ 11

**Master's Thesis Proposal** ........ 12

**1. Introduction** ........ 17

**2. Literature review and hypotheses development** ........ 21

**3. Theoretical background** ........ 30

3.1. Defining a tax haven ........ 30

3.2. The concept of CSR ........ 31

3.3. Tax avoidance as a CSR issue ........ 33

**4. Data description** ........ 40

4.1. Description of collected data ........ 40

4.2. Compiling the tax haven list ........ 43

4.3. Description of variables ........ 43

**5. Methodology** ........ 50

5.1. Ordered logistic regression ........ 50

5.1.1. Ordered logit assumptions ........ 54

5.2. Model specification ........ 57

**6. Results** ........ 60

**7. Conclusion** ........ 65

**References** ........ 68

**Appendix** ........ 81

# List of Tables

Table 1: Base list of tax havens ........ 43
Table 2: Descriptive statistics ........ 48
Table 3: Correlation matrix for the model excluding UK and US ........ 54
Table 4: Correlation matrix for the model including UK and US ........ 55
Table 5: Regression results (excluding UK and US) ........ 61
Table 6: Marginal effects (excluding UK and US) ........ 62
Table 7: Regression results (including UK and US) ........ 63
Table 8: Marginal effects (including UK and US) ........ 63
Table 9: Results of the Brant test (excluding UK and US) ........ 81
Table 10: Results of the Brant test (including UK and US) ........ 81

# List of Figures

Figure 4-1: Country-wise distribution of firms ........................................................................ 42
Figure 4-2: Country-wise distribution of tax haven links ....................................................... 47
Figure 4-3: Country-wise distribution of firms ........................................................................ 49

# Acronyms

| | |
|---|---|
| **BG** | Belgium |
| **CEE** | Central and Eastern Europe |
| **CSR** | Corporate Social Responsibility |
| **CY** | Cyprus |
| **CZ** | Czech Republic (the) |
| **EE** | Estonia |
| **HR** | Croatia |
| **HU** | Hungary |
| **CH** | Switzerland |
| **IE** | Ireland |
| **JE** | Jersey |
| **LU** | Luxembourg |
| **LT** | Lithuania |
| **MT** | Malta |
| **MU** | Mauritius |
| **NL** | Netherlands (the) |
| **PL** | Poland |
| **RO** | Romania |
| **SI** | Slovenia |
| **SK** | Slovakia |
| **UA** | Ukraine |
| **UK** | United Kingdom (the) |
| **US** | United States (the) |
| **VG** | British Virgin Island (the) |

# Master's Thesis Proposal

| | |
|---|---|
| **Author:** | Bc. Veronika Sovičová |
| **Supervisor:** | doc. PhDr. Mgr. Ing. Antonie Doležalová, Ph.D. |
| **Defense Planned:** | June 2022 |

**Proposed Topic:**

Corporate social responsibility and Czech firms headquartered in tax havens

**Motivation:**

Although the importance of the influence of offshore finance on the global economy is ever-growing, the academic research on the link between the tax haven usage and Corporate Social Responsibility of firms is only limited. The main objective of the study is to address this link for Czech firms.

There are two principal theories to explain the linkage between firm´s CSR engagement and their use of tax haven services. The first theory, so called "corporate culture theory" suggests that if the firm pursues socially responsible actions, then they should not engage in tax avoiding operations as these are widely considered to be ethically dubious. That is to say, if the firm believes it is morally right to contribute to their employees, customers and the communities in which they operate, engaging in tax avoidance actions is in direct contrast with this view as the government tax revenue, which is in turn used to finance the community, will be diminished. (Hermalin 2001; Hoi et al., 2013). Thus, following this theory, one could expect a negative relationship between CSR and the tax havens use.

The second theory, "risk management theory", argues that the firm might want to improve its reputation by increasing their CSR ratings as using tax haven services is generally viewed as immoral (Godfrey 2005; Kang, Kim, & Lee, 2017). As in the past many multinational firms such as Apple, Google, Starbucks, Amazon have experienced negative media coverage for using the services of the offshore industry, the increased engagement in CSR actions might reduce the reputational risk and mitigate the customer backlash. (Col, Patel 2019). According to this reasoning, the relationship between CSR and tax havens use should be positive.

Existing studies in this area (such as Alsaadi 2020; Carroll and Joulfaian 2005; Col and Patel 2019; Davis et al. 2016; Fallan and Fallan (2019); Huseynov and Klamm 2012; Lanis and Richardson 2012; Lee, D. 2020; Hoi et al. 2013;

Watson 2015;) vary in results and thus there is a lack of consensus among scholars on which of these theories holds.

Moreover, it is questionable whether CSR can be even viewed as factor for Czech firms, given the fact that this concept arrived to our region with substantial delay compared to US.

In the thesis, I will examine the relation between CSR and tax havens use in Czech firms and analyse the firms´ incentives to engage in CSR activities in the Czech Republic.

**Hypotheses:**

1. Hypothesis #1: In the Czech Republic, there is no significant relationship between firm´s CSR engagement and the location of its headquarters in a tax haven
2. Hypothesis #2: A firm increases its CSR engagement in the Czech Republic after its move to a tax haven.
3. Hypothesis #3: Czech firms with CSR activities do not move their headquarters to a tax haven.

**Methodology:**

The thesis largely follows the methodology proposed in a recent study by Lee, D. (2020). In order to test the hypotheses, I will work with a probit model in which the response variable "CSR↑" equals to one if the firms CSR engagement increased from year t to year t+1 or zero otherwise. The main independent variable in this model will be a dummy variable „HAVEN_HQ", which equals to one if the firm has relocated their headquarter to a tax haven jurisdiction in year t or zero otherwise. The rest of the independent variables will control for factors commonly associated with the level of CSR engagement, such as the firm´s size, cash holdings, leverage, market-to-book ratio and return on assets.

I will construct an original dataset using two important databases: MSCI ESG KLD STATS, which will provide us on the firm´s CSR index. The second database that I will use is the Orbis database created by Bureau van Dijk. This database will provide important information on firms and will cover the rest of variables I will use in the empirical models including the addresses of the firms´ headquarters.

**Expected Contribution:**

Given that the existing research is largely focused on U.S. firms (Lee, D. (2020); Col, B. and Patel, S., (2019); Watson (2015)), our contribution lies mainly in its application to the Czech environment. Although there are certain studies that focus on the link between aggressive tax avoidance in countries outside of the U.S. – such as Su, W. and Tan, D. (2018), which covers Taiwanese business groups or Lanis and Richardson (2012), who examine the Australian-listed corporations, the majority of research studies the situation in the U.S.. To best of my knowledge, this is the first time such study is focused on Czech firms.

The link between tax avoidance and Corporate Social Responsibility scores is generally an under-researched area and a number of scholars (Christensen, Murphy (2004); Carroll, Joulfaian (2005); Hanlon, Heitzman (2010)) emphasizes the importance of exploring this relationship. My main objective will be to verify whether the conclusions obtained in the existing studies correspond with the Czech situation. This will help us understand whether the incentives for firms´ CSR engagement differ across regions. Moreover, the empirical results from the thesis might provide useful information for the Czech tax authorities.

**Outline:**

1. Content
2. Introduction
3. Literature review
4. Data
5. Methodology
6. Empirical models
7. Regression results
8. Conclusion

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# 1. Introduction

The idea that businesses should take part in upholding values such as sustainable development, promotion of human rights, pro-social business orientation or protection of the environment, commonly known as Corporate Social Responsibility (hereafter CSR), has been gaining increasingly more attention. This theory is widely based on the notion that companies have to take responsibility for the well-being of the society around them instead of solely focusing on profits and their behavior should further some social good (Khan et al., 2012). As the trend of CSR spreads, it also attracts more and more academic attention. The belief that companies have obligations towards society beyond their core business activities sparks controversy and thus polarizes scholars in their opinions. Some economists entertain this view. Others strictly reprobate it, claiming that the only corporate responsibility of a business is to generate profits for shareholders (Friedman, 1970). Nevertheless, increasingly more companies adopt some form of CSR initiatives. The customers, as well as the public in general, tend to react positively to such behavior of corporations and prefer the “ethical” product of a company with higher CSR performance. Therefore, it can be claimed that building a positive public image via CSR engagement can be beneficial to the company and even grant it with a competitive advantage. Moreover, a firm with a strongly positive reputation can not only be preferred by the customers, but may also be protected against public backlash in case of a corporate scandal. Such public backlash may include negative media coverage, decrease in the value of stocks but also consumer boycott. Thus, the CSR initiatives may as well be perceived as a form of insurance against reputational loss which may subsequently prevent losses of financial nature. A logical question thus arises: Does CSR reflect genuine good intentions of a company or is it more of a public relations campaign?

To address this question, we examined the relationship between firms´ CSR score and a form of behavior, which is generally considered highly unethical – tax haven use. The term tax haven is commonly associated with a jurisdiction that offers some form of preferential tax treatment. Therefore, these jurisdictions are usually sought-after by entities that have the intention to diminish their domestic tax liability. We examine this relationship in context of the Central and Eastern Europe (hereafter CEE). Firstly, as the notion of CSR awareness is not that widely spread in our area of interest as compared to the Western world, it is thus reasonable to ask whether any significant relationship between these two factors has already emerged at all. Then the rationale is the following: A negative relationship between CSR engagement and tax

haven use would indicate that tax haven using firms are less likely to be socially responsible. Such scenario would imply consistency in their behavior and suggest that CSR reflects company´s shared beliefs. This would be in line with the corporate culture theory. On the other hand, a positive relationship would imply a greater probability of being socially responsible in tax haven using firms. Having a high CSR index while engaging in such morally dubious action as tax avoidance might indicate that the firm perceives CSR rather as a reputation enhancing tool. This would support the risk management theory. In addition, since tax haven use often triggers public outcry when it comes to light, the insurance-like properties of CSR may also be a driver here. Moreover, as we conduct the analysis first without the inclusion of the UK and the US in the list of tax havens and then once again including both of these countries, we speculate that in the latter case the probability of a tax haven using firm being socially responsible might increase. This is due to a possibility that the firms with links to the UK and the US might be influenced by relatively more intense CSR culture in these countries.

To perform the analysis, we originally planned to use a binary logit model with a dummy response variable, which would equal to one if the company´s CSR rating has increased after establishing a tax haven entity or zero otherwise. Nevertheless, as we later found out, the Orbis database does not provide information on firm´s subsidiaries retrospectively. That is to say, we could only obtain data on firm´s current subsidiaries and thus we were only able to examine this relationship at one point of time. As the latest input for most companies in our dataset was in 2020, we chose to conduct the analysis for this year. Therefore, we propose an ordered logit model with the firm´s CSR rating as the categorical response variable and a dummy indicating a tax haven user status as the main dependent variable of interest. This methodology is then applied on a sample of 79 unique firms from 11 Central and Eastern European countries. We find that there is a significant relationship between the CSR engagement and tax haven use, which rejects the proposition of non-existence of any such relationship in the context of the Central and Eastern Europe. Moreover, our findings suggest that tax haven using firms are less likely to be socially responsible and thus we provide evidence in favor of the corporate culture theory. Also, after including the UK and the US in the list of tax havens, the probability of a tax haven using firm being socially responsible slightly increased.

We chose to focus our analysis on the CEE region as we believe that this area is particularly interesting for the purposes of our research. Our original intention was to study this relationship in context of the Czech Republic. Unfortunately, there was not enough firms with available CSR statistics to conduct an econometric analysis. Therefore, we decided to extend our focus on all the Central and Eastern European countries for which the data was available.

Since these countries started a process of undergoing a transition from centralized economy to market-oriented economy in relatively recent past, they are believed to be a fascinating research laboratory for testing existing theories (Rašković et al., 2020). The former socialist regime and the subsequent adoption of capitalism associated with gradual integration into the Western economy make this region particularly intriguing and unique (Meyer and Peng, 2016). The processes of integration and globalization have substantially transformed the CEE region in the recent decades. Majority of these countries has already become members of the European Union, while other – mostly Western Balkan states – are currently at differing stages of accession. Also, their participation in international markets has sharply increased (Ipsmiller and Dikova, 2021). As a result, rapid GDP growth can be observed and overall economic climate has been improved (Horváth et al., 2017). Nevertheless, the questions whether the post-communist countries will ever recover from the drawbacks of the old regime and be able to catch up with the Western world still persist. Therefore, focusing research on this geographical area is of extreme importance as it may help us understand the opportunities and challenges associated with such transformation (Ipsmiller and Dikova, 2021). Moreover, since CSR can evolve differently is various social, economic and legal settings (Albu et al., 2016), we think that it deserves particular attention in such specific environment as the post-communist Europe. The socialist heritage is believed to be an important shaping factor of the notion of CSR in this region. In addition, to effectively spread CSR in a given country, it is crucial to understand where the country stands in terms of CSR (Paliwoda-Matiolańska, 2015). Further researching this area may thus help policymakers address the limitations of their economies or institutional environment which may impede successful implementation of CSR (Albu et al., 2016).

We believe that addressing the relationship between CSR and tax avoidance is important as the previous research is largely inconclusive. In addition, this relationship is a generally under-researched area outside of the developed world (Yoon et al., 2021). To the best of our knowledge, this is the first study addressing the link between CSR and tax avoidance devoted to the CEE region. Our main contribution lies in proposing an ordered logistic model which addresses tax avoidance in form of tax haven use and applying it to a sample of Central and Eastern European firms. The empirical findings from the thesis may help with deeper understanding of CSR, tax haven use and their mutual relationship in the CEE region. Moreover, we add to the body of literature on corporate culture versus risk management theory. Our research may thus provide useful information not only for tax authorities and policy makers, but also for customers.

The rest of the thesis is structured in the following manner. Section 2 provides an overview of existing research on the topic and formulation of hypotheses to be tested further in the thesis. Section 3 contains the necessary theoretical background with focus on shedding some light on the concept of CSR, defining a tax haven and illustrating tax avoidance as a CSR issue. Section 4 describes the data used for the analysis, the process of composition of an original dataset and the nature of the data sources. Moreover, it specifies the rationale behind the tax haven list used for the purposes of the analysis and explains the manner in which a tax haven using firm is identified. Also, it describes the variables included in the model as well as the way in which they were calculated from the collected data. Section 5 if focused on description of the employed methodology. Specifically, it describes the rationale behind the choice of an ordered logistic model, illustrates its specifications and verifies the underlying assumptions. Additionally, the empirical model used for the analysis is presented in this section along with the rationale for inclusion of individual independent variables. Section 6 summarizes and interprets the regression results. Finally, Section 7 concludes on the most important parts of the thesis, points to the limitations of our study and provides suggestions for future research.

# 2. Literature review and hypotheses development

Academic literature studying the connection between CSR practices and tax haven use is limited and largely inconclusive. A number of scholars ((Christensen, Murphy (2004); Carroll, Joulfaian (2005); Hanlon, Heitzman (2010); Sikka (2010)) have emphasized the necessity to further examine the relationship between aggressive tax avoidance and CSR. In this section, we would like to summarize relevant studies and illustrate the logic behind the development of our hypotheses. Our first hypothesis takes into account the specificities of the CEE region. This geographical area is particularly interesting for its communist past and the subsequent economic, political and societal conditions. As this part of the world is composed of countries that were subject to a transition from centralized economies to market-oriented economies in relatively recent past, the implementation, perception and general nature of CSR may be quite different here as opposed to other regions. Moreover, it appears that the former socialist regime substantially contributed to the fact that CSR is relatively underdeveloped in this region (Horváth et al., 2017).

It has been claimed in the literature that during the socialist period, the social contract which existed in these countries promoted socially responsible behavior of these companies. The social contract to which we refer is the very functioning of the socialist economies. In this economic setting, the public was granted basic life securities - particularly a job guarantee, inexpensive products, social benefits or housing - in exchange for restrictions in other areas, such as the availability of goods or their quality (Koleva et al., 2010). Nevertheless, in this political environment, the firms´ primary objective was not the profit maximization but the general well-being of the employees and the surrounding communities (Kopp, 2015). Since the firms were state-owned entities rather than private businesses, they were subject to the agenda of the socialist government. Thus, they were inclined towards socially responsible behavior (Koleva et al., 2010). We believe that this is a particularly important point, as the trade-off between socially responsible behavior and the profit maximizing principle is often the center of the CSR debate (e.g. Friedman 1970). For this reason, it has been claimed that the behavior of these firms, even if not specifically labelled as such, was in line with the CSR doctrine (Johnson and Brady, 2004).

However, it needs to be pointed out that it was not entirely so. The concept of ethical behavior of firms during the communist era differed from the Western understanding of CSR in a number of aspects. Specifically, the Western CSR doctrine is often perceived as "going beyond the requirements of the law" based on the idea of "voluntariness" (European Commission, 2002). On the contrary, the ethical behavior of firms during the communist era mainly took form as being compliant with the law (Lewicka-Strzalecka, 2006). Moreover, in the modern concept of CSR, the customers and the civil society are seen as an important stakeholder group holding great influential power. Activism in form of public backlash, consumer boycott or active criticism are tools that can be used as a response of the public to questionable behavior of the firms, which might as well impact company´s value. In the socialist environment, however, the power of civil society was rather weak (Stoian and Zaharia, 2012). Simply put, the concept of ethical behavior in the socialist setting deviates from the modern CSR notion. CSR as such has spread in the CEE region only after the financial crisis in 2008, perhaps because it was necessary to regain the public´s trust (Fijałkowska et al., 2017).

Nevertheless, after privatization in the 1990s, the economic and social role of the companies were divided. As the firms were no longer held by socialist government, the profit maximizing motive overrode the principle of contributing to the well-being of the society. Increasing profit by practices which can be perceived as questionable through the CSR lens, such as finding legislation loopholes, has become pervasive (King, 2001). As Kooskora (2006) puts it, these newly privately-held firms usually were not particularly concerned with the influence their business had on the environment or community and this factor was completely unimportant to them.

Thus, it can be claimed that the firms were socially ethical during the socialist era because they were an enlarged hand of the socialist government. It was the government who promoted the socially responsible behavior in firms, not the private sector itself as the modern CSR doctrine dictates. This could be an essential reason why CSR is fairly underdeveloped in the Central and Eastern Europe as compared to the Western capitalist states. The notion that promoting social well-being is a responsibility of the government, and not of the private corporations, might be still deep-rooted in the population – the business community as well as the society at large (UNDP, 2007). Paradoxically, it has been shown that governments in the post-communist countries do not facilitate the implementation of CSR into the society. Quite the opposite. As Steurer et al. (2012) demonstrate, there are considerably less CSR government initiatives in comparison to Western countries. Moreover, the authors suggest that the post-

communist governments create barriers for the companies to adopt CSR and that the public policies in these countries fortify rather than mitigate the already existing CSR gap.

Moreover, Vynoslavska et al. (2005) maintain that less developed and more unstable regulatory and legal systems of Central and Eastern European countries result in an environment in which the financial aspects are far superior to those ethical or ecological in terms of importance. Lewicka-Strzalecka (2006) claims that the Central and Eastern European business and political situation has a number of adverse features which impede the spread of CSR, such as negative image of business, impaired legal system, corruption, unfavorable economic situation of firms, absence of ethical standards or unemployment issues. Corruption has been highlighted as a factor for low CSR implementation also in Demirbag et al. (2017). According to the authors, this is because in setting with high levels of corruption, companies are enabled to solve the problems stemming from incompliance or unethical behavior with bribery and thus may not be motivated to follow CSR standards. As the Corruption Perception Index (Transparency International, 2021) suggests, the corruption is significantly more present in the Central and Eastern Europe in comparison to the Western world.

Since CSR is a component of American capitalism (Preuss et al., 2006) and the tradition of capitalism in this region is relatively short, it might be the case that the notion of CSR has not been sufficiently spread yet – as the studies suggest. Koszewska (2010) points out that customers in the Western countries are more inclined towards considering ethical aspects of product in their buying patterns. Specifically, the author shows that among Austrian consumers, more than 50% of those surveyed are willing to pay more for an ethical product. On the other hand, in the Polish setting, only 16% of respondents affirmed that ethical aspects of a product were important to them. This suggests poor CSR awareness among consumers. If consumers are uninterested in CSR, socially responsible practices of companies are as a result not rewarded (Fijałkowska et al., 2017). For instance, Strouhal et al. (2015) empirically shown that there is no relationship between disclosure of CSR reports and profitability of a firm in the context of Estonia and the Czech Republic. Since CSR engagement is unlikely to translate into tangible benefits to firms, the firms may not be as motivated to be socially responsible. As Csafor (2008) claims, successful implementation of CSR is virtually unachievable without the pressure of customers. Welzel and Inglehart (2005) propose that this relatively low interest of Central and Eastern European customers in CSR standards might be attributable to the fact that in comparatively wealthier Western countries, consumers are accustomed to their current material level and thus may pay greater attention to ethical aspects of their consumption.

Furthermore, insufficient CSR consciousness has been pointed out in Central and Eastern European firms as well. Preuss et al. (2006) claim that CSR has been marked as "absurd" by many Polish companies, assuming they were even familiar with the concept. It has been emphasized that profit generation is of central focus here and CSR is rather irrelevant. The authors described a similar trend in Bulgaria, where majority of consumers and companies were not acquainted with the concept. Fifka (2013) emphasizes that CSR reporting in Central and Eastern European firms is considerably weaker in comparison to the West. Berber et al. (2014) also illustrate low level of firms´ participation in the CSR in the post-communist region, specifically in the countries of Slovakia, Hungary, Bulgaria and Serbia. The authors claim that the number of companies with existing written CSR statements is as low as 14% to 28%.

Considering all of the above-mentioned factors, it seems logical to speculate that there might be no significant relationship between CSR engagement and tax haven use in the CEE region, simply because (as demonstrated above) the notion of CSR has not been sufficiently implemented in the business culture here yet, and thus no perceptible link has emerged so far. Clearly, the demand for CSR activities is gradually growing in spite of its short past in the Central and Eastern Europe (Csafor, 2008). Nevertheless, considering the tendencies described above, we believe it is reasonable to formulate the following hypothesis:

***Hypothesis 1***: For Central and Eastern European firms, there is no significant relationship between CSR scores and tax haven use.

Our next two hypotheses are formulated largely following the approach in Col, Patel (2019) and Hoi et al. (2013). In existing research, there are two major theories illustrating the link between tax avoidance and CSR engagement, each of which suggests a different direction of the relationship. The first one, known as the ***corporate culture theory***, argues that a firm which engages in CSR practices and thus advocates for socially responsible behavior of the businesses will not take advantage of tax haven services. It is because tax avoidance is considered highly unethical (Sikka, 2010) and therefore it would be in direct conflict with this view. In other words, if a corporation considers the social responsibility to be a vital part of their agenda, then all of their actions should be consistent with this vision - whether it regards CSR or tax avoidance (Kreps, 1990). The theory further explains that the company should act in the best interest of its stakeholders, the list of which can be quite extensive. It may include company´s shareholders and owners, employees, customers or suppliers, but as well its surrounding community or creditors. Most importantly, however, it also includes government

institutions involved in taxation. As the company´s corporate culture dictates maximizing the benefit of all of its stakeholders, tax avoidance would not be aligned with this principle (Col, Patel; 2019). In summation, since the corporate culture determines the company´s shared belief on its direction, it cannot promote socially responsible behavior while engaging in a practice as costly to society as tax avoidance (Weisbach, 2002). This reasoning therefore implies a negative correlation between the firm´s participation in CSR practices and its engagement in offshore finance.

A number of studies provide evidence consistent with this theory. Hoi et al. (2013) propose that there is a lower probability of tax avoidance in firms with high CSR engagement using tax shelters, book-tax differences, and FIN48 to evaluate this tendency. Huseynov and Klamm (2012) employ tax management fees in their analysis and arrive at a similar conclusion. Likewise, Lanis and Richardson (2012) study the relationship in publicly listed Australian firms by analyzing effective tax rates. Even if the above-mentioned studies do not employ tax haven residence as such in their research, they imply a negative link between corporate social responsibility and aggressive tax avoidance.

There is also a number of studies which use tax haven use as a measure of tax avoidance in their research. Lee (2020) applies difference-in-differences methodology to analyze a sample of 46 U.S. listed companies with an offshore headquarter. The data covers the period between 2004 and 2013 and based on the evidence, it appears that after relocating to a low-tax region, the firms´ CSR ratings decrease. As suggested by the findings, the firms engaging in offshore financial practices are less likely to be socially responsible and their actions reflect their overall approach, which is in accordance with corporate culture theory.

Likewise, Su and Tan (2018) examine this link also finding a negative correlation. The authors conclude that highly internationalized Taiwanese business groups with high CSR ratings, and thus higher prosocial orientation towards secondary stakeholders, are less likely to establish offshore affiliates. To convey the analysis, the authors employ Heckman two-stage models to analyze a dataset consisting of 100 largest Taiwanese business groups and covering the period from 2008 to 2012. The Heckman two-stage model is used in order to resolve a potential endogeneity of the choice to relocate the headquarters offshore. The study is specific in that it shifts attention from U.S. companies and explores the Taiwanese business environment.

Evidence provided by Meng (2017) is also in line with the corporate culture theory. The author examines the relationship for top 100 largest publicly listed Chinese firms by their assets size. The data, constructed by 704 firm-year observations for the period from 2006 to 2013,

show a strong and statistically significant negative link between tax haven use and the extent of firms´ CSR activities. The period was specifically chosen due to Chinese new tax law implementation in 2008. To conduct the analysis, a model with a dummy dependent variable indicating an existence of an offshore affiliate has been employed and the outcome has been confirmed by various robustness checks, such as GMM regression or firm fixed effect regression.

Similar results have been obtained by Awad (2021), who provides evidence from Egypt. The author uses Egyptian Corporate Responsibility Index and companies´ financial reports to obtain a dataset covering 179 firm-years which spans period from 2009 to 2018. The outcome of the analysis reflects the idea that fair participation in the tax collection can be viewed as vital part of a company´s CSR policy as it shows lower tendency to establish offshore affiliates in firms with high CSR engagement. The author admits that the specificity of the Egyptian environment and thus its culture may as well play a role in the company´s reasoning, which can also be applied to the two preceding studies.

Interesting approach has been proposed by Temouri et al. (2021), who studied the propensity to use tax haven services in family-owned business versus non-family-owned firms. As family-owned companies have been shown to exhibit greater CSR ratings (Labm, Butler; 2018) and also be less likely to take advantage of offshore finance (Temouri et al., 2021), it can be claimed that the study suggests a negative relationship between the pro-socially oriented behavior and tax haven use. The authors argue that this might be ascribable to the fact that internalization into tax havens may pose a reputational risk that family-owned firms are generally unwilling to gamble. To analyze the data of 1,024 publicly listed US family and non-family firms, the authors propose model with a dummy dependent variable, which indicates whether or not the firm has an offshore located affiliate, along with a number of control variable, among which the most distinctive one is the dummy variable signaling the family-ran nature of the firm.

The negative link between CSR rating and tax haven use has also been shown by Huang et al. (2017) in a study focused on U.S throughout the period of 1991 – 2014 using a logistic regression. It has been demonstrated that firms with higher overall CSR performance are less likely to expatriate. However, when the CSR ratings were broken down to individual components (specifically: corporate governance, diversity, employee relations and environment) all of them were negatively linked to the likelihood of expatriation except for the last one, for which the link was positive. A possible explanation of this rather interesting finding suggested by the author is that as many firms in the sample conduct their business in a strongly

environment-related industry – e.g. oil, gas or chemicals - according to the risk- management theory, the companies may use positive environment ratings to protect themselves in case of negative event, such as environmental catastrophes.

The other theory, called the ***risk management theory***, suggests that CSR participation serves primarily as a firm´s measure to improve its public reputation. This can provide the firms with a sort of insurance and subsequently protect it in case of negative corporate event (Minor, Morgan; 2011). Engaging in tax haven operations and the related tax avoidance can lead to such negative corporate event as it may result in a severe public backlash once it comes to light. This can take form of intensified political pressure, negative media coverage, fines and might even escalate to customer boycott (Wilson, 2009). In the recent past, a number of global companies have suffered adverse reaction from the public in relation to tax haven use. These companies, such as Apple, Google, Starbucks, Amazon, eBay or Ikea, have been under close media scrutiny and have experienced customer boycott as well. The reason for this is allegedly the loss of reputation and strong association of the tax haven scandal with the brand (Nankole Mukaya, Karvounis (2018); Riedel (2018); Sikka (2018); Brin, Nehme (2021); Bender, Broekhuijsen (2015); Chouaibi, Rossi, Abdessamed (2021)). This claim is also supported by YouGov BrandIndex, which measures the strength of the companies´ brand name. According to the index, several of these corporations suffered significant reputational damage as a result of the tax haven-related scandals (Gribnau, Jallai; 2016). Therefore, the risk management theory claims that firms aim to minimize the risk associated with such events by undertaking CSR practices to build strong public image and thus prevent the potential loss in their brand identity (Godfrey, 2005).

Moreover, according to the risk management theory, the firm´s primary focus is to maximize the benefit of its owners and shareholders, not all stakeholders. That is to say, the engagement in CSR may serve purely for the brand name purposes, which should in turn benefit the shareholders and provide them with protection against reputational damage (Godfrey, 2005). After all, the reputational risk associated with tax avoidance can be the root of a long-term harm to the company and its shareholders in terms of financial profits (Fisher, 2014). Therefore, this theory implies a positive correlation between the company´s CSR engagement and tax avoidance practices. There are various studies to support this theory. Gulzar et al. (2018) investigate this relationship in Chinese listed firms by using the current cash effective tax rate as a measure of tax avoidance. Sikka (2010) studies tax avoidance examining the corporations´ transfer prices practices. Mao (2019) uses permanent and discretionary book-tax differences as a tax avoidance proxy. Likewise, Watson (2015), and Davis et al. (2016) derive similar outcome

by analyzing effective tax rates. These studies employ various tax avoidance measures other than the firm´s tax haven links. Nonetheless, the results suffice to illustrate the positive relationship between CSR engagement and tax avoidance.

The first research papers to employ tax haven use as a measure of tax aggressiveness were published by Preuss (2010, 2012). The methodology of both studies lies in analysis of a sample of 27 corporations headquartered in Bermuda and the Cayman Islands, and 20 corporations with a U.S. domicile. All the companies included in the sample were large corporations, since these are allegedly more likely to establish offshore entities (Desai, Foley, Hines; 2006) and to engage in CSR practices (Kaptein, 2004) as well. For illustration, the smallest included company still has an annual turnover of US$ 1.45 billion as of 2008. In both studies, the author finds that firms headquartered in the U.S. tend to be less active in terms of CSR in comparison to those with offshore domicile. Moreover, the studies also find that firms with tax haven domicile display considerable efforts to declare a code of conduct to strictly define their mission in the society and thus enhance its public image. Specifically, 96% of the sampled haven-based firms published one.

A study conducted by Col and Patel (2019) also brings results consistent with risk-management theory. The research is focused on U.S. firms and the sample covers the period from 1995 to 2012 with 341 firms with and 1630 without a tax haven headquarter. The authors use the CFC look-through rule instituted by the Congress in 2006, which aids the offshore profit shifting, to provide evidence. The ratification of this rule serves as an exogenous event in the difference-in-differences research approach, which is applied in the study. Authors find that for the companies affected by the CFC rule, there is a significant positive relationship between the CSR ratings and having an offshore headquarters.

Building upon these empirical findings and considering that our research will examine the relationship for the CEE region, we formulate our second hypothesis:

***Hypothesis 2***: In the Central and Eastern European region, tax haven using firms are less likely to be socially responsible.

Our third and the last hypothesis takes into account the specificities of our sample and the related need to work with a tax haven list that would be well-suited for the purposes of our analysis. For motives described in detail in section 4.2., we find it reasonable to conduct two separate analysis - one with and one without the inclusion of the UK and the US in the list of tax havens. We believe there are reasons to speculate that the two analyses may bring different

outcomes. As we described in the section devoted to *Hypothesis 1*, the concept of CSR is significantly more present in Western countries with longer tradition of capitalism as opposed to the Central and Eastern European region (Arraiano and Hategan, 2019). The US and the UK are certainly one of these countries. The formation of CSR in the post-communist countries is heavily influenced by the impact of the Western world as the Western countries constitute the main reference for their transition from centralized economy to the market-oriented economy and thus are also the main reference for their current economic development (Koleva et al., 2010). With this in mind, we may hypothesize that the company with links to the US and the UK might be more affected by the western trends and thus have a higher tendency to engage in CSR. If a company is identified as being "linked" to the UK or the US, it means that at least one of their subsidiaries or their owner are located in these countries. Thus, there is a possibility that these companies might be more influenced by the relatively more intense CSR culture present in the UK and the US. Therefore, it is possible that after accounting for the UK and the US in the list of tax havens, the probability of a tax haven using firm being socially responsible could be higher. For this reason, we include the following hypothesis:

***Hypothesis 3***: After inclusion of the UK and the US in the list of tax havens, the probability of a tax haven using firm being socially responsible will increase.

# 3. Theoretical background

In this part of the thesis, we intend to provide the necessary theoretical background. We will focus on explaining important concepts, illustrating CSR as a notion and presenting tax avoidance as a CSR issue.

## 3.1. Defining a tax haven

Tax haven as a term is quite ambiguous. There are many different definitions proposed by academicians as well as regulatory institutions. In broad terms, tax havens are generally understood as the jurisdictions offering some form of a tax privilege. Nevertheless, when it comes to narrowing down the term, there might be less consensus among individual publications. Perhaps the most well-known definition has been issued by OECD (1998). It encompasses 4 key characteristics of a tax haven, specifically:

"1. No or only nominal taxes (and offering, or being perceived as offering, a place for non-residents to escape tax in their country of residence);
2. Lack of transparency (such as the absence of beneficial ownership information and bank secrecy);
3. Unwillingness to exchange information with the tax administrations of OECD member countries;
4. Absence of a requirement that activity be substantial (transactions may be "booked" in the country with no or little real economic activity)." (OECD, 1998, p. 23)

This definition is believed to well reflect the general nature of tax havens (Tobin, Walsh; 2013). US Government Accountability Office (2008) adds more characteristics such as self-promotion to the tax haven definition. Other definitions of tax havens may include an artificial specification of the tax base, access to a wide network of tax treaties or foreign source income exempt from residence country tax (Van Dijk et al., 2006). An interesting approach to identifying a tax haven has been suggested by Gordon (1981), who proposes a so-called smell and reputation test. In essence, according to the author a country is a tax haven "if it looks like one and if it is considered to be one by those who care". Even if this definition is highly subjective, it may be understood as a reaction to the lack of consensus on what constitutes a tax

haven and suggests that the debate and definition-related confusion has been present for a long time. Nevertheless, for the purposes of the thesis, we will work with the general understanding of a tax haven as a jurisdiction offering some form of preferential tax treatment.

## 3.2. The concept of CSR

Corporate Social Responsibility is a topic that attracts increasingly more attention in the academic field. Nevertheless, up until now it has not been clearly defined. The subject is quite ambiguous as it not only varies regarding to cultural setting but also with respect to individual institutions (Höllerer, 2012). As there is a great number of factors shaping the concept of CSR, the its definition might be puzzling and burdensome to strictly delineate (Hiss, 2009). It is difficult to define descriptively as well as normatively (McWilliams et al., 2006). In effect, the concept is not easily definable as it is both complex and complicated. Complex since the areas it addresses, such as environmental, societal and economic issues are inherently complex in nature. Complicated as it is challenging to precisely calculate the extent to which corporations should be involved in tackling societal concerns or concerns beyond their core business in general (Sheehy, 2015).

Nevertheless, even if we lack a specific definition of CSR, generally it can be claimed to encompass such behavior of corporations which reflects commonly approved social values, such as sustainability, accountability and fairness (Lu et al., 2019). While there are numerous theories under the wide CSR umbrella, their essence is based on the notion that corporations should take responsibility for their actions and the potential consequences arising for the society (de Bakker, den Hond; 2016). The general CSR belief states that the role of corporations exceeds the classical profit maximizing principle and it suggests that the corporations also have certain commitment towards the society as a whole (Crane et al., 2008). Such view is in direct contrast to the beliefs of Nobel prize winning economist Milton Friedman, who is also perhaps the most well-known opponent of CSR as a concept. This is due to the author´s famous quote in which he firmly maintains that "the only social responsibility of a business is to generate profit for shareholders" (Friedman, 1970).

Sometimes, literature understands CSR as corporate philanthropy (e.g. Liket, Simaens (2015); Sasse, Trahan (2007)). However, it has been pointed out that this view is deeply flawed as corporate philanthropy, which usually takes form of corporate giving in form of donations, can be combined with other forms of behavior - even socially irresponsible (e.g. polluting the

environment). Therefore, it has been suggested that a firm cannot claim to be socially responsible based merely on their corporate philanthropy actions (e.g. Sheehy, 2015; von Schnurbein et al., 2016). Also, D'Aprile and Mannarini (2012) maintain that such multidimensional concept as CSR cannot be reduced to mere philanthropy. Moreover, philanthropy is sometimes seen as a completely separate concept, not even being a component of CSR (Crane, Matten; 2004).

The most striking difference among the various definitions of CSR, which also implies far-reaching consequences in terms of understanding the concept, is the element of voluntariness. The debate whether or not it should be an essential component of CSR definition has been quite heated. Some scholars (e.g. Windsor (2006); Carroll (2004); Marsden (2001); Woodward (1999); Federick et al. (1992); Jackson, Hawker (2001)) see CSR as a non-optional guideline on how corporate executives should administrate public agenda and social concerns, whereas others (e.g. McWilliams, Siegel (2001); Lea (2002); Van Marrewijk (2003); Jones (1980); Piacentini et al. (2000)) explain it as a set of actions which surpass the requirements of the law and provide benefits to the society besides company´s direct interests. The former perspective has far more imperative character, while the latter emphasizes the element of going beyond the necessary. However, the statements defining CSR as actions exceeding legal obligations can be tricky as in such case the notion of CSR largely depends on a given legal framework. In other words, what qualifies as CSR action in one country might not be viewed as such in another, as the regulatory system varies and so does its content. If an action is required by the law, it is no longer evaluated as CSR, even if we refer to the same action. From a more philosophical standpoint, it can be claimed that since CSR refers to the social responsibility of corporations, defining it on a basis of voluntariness can be somewhat contradictory. Indeed, describing something as a “responsibility” and a “voluntary act” at the same time might be at least paradoxical. In other words, a “responsibility” bears an inherently imperative meaning of obligatory action and the term itself by no means carries any essence of voluntariness. Furthermore, it might be rather difficult to determine what is above the compulsory legal requirements and what is not. Naturally, the distinction can be quite straightforward in case of hard law, where the line between compliance and infringement is more definite and less prone to misinterpretation. However, in terms of soft law, the differentiation of the mandatory and the additional might not be that crystal clear (Höllerer, 2012). Moreover, Campbell (2007) points out that a definition narrowing CSR as actions going further than the law requires might indicate that engagement in CSR must be inherently an active deed, whereas oftentimes the opposite is true. To follow CSR may frequently mean more of a passive approach in which a company

refrains from a certain socially harmful action and thus it can be more about "not doing" something as opposed to actually "doing" something.

In summation, it can be claimed that there is a great variety in possible understanding of the term CSR. For this reason, the concept exhibits considerable opacity which might at times lead to confusion. Therefore, it may be difficult to draw a clear line to define the concept. Many scholars (Höllerer (2012); Matten, Moon (2008); Van Marrewijk (2003); Genasci, Pray (2008); Basu, Palazzo (2008)) thus decide to think of CSR as an all-encompassing umbrella term for the purposes of their research. In effect, CSR has been claimed to be a dynamic and multilayered term with respect to which meticulous attention to context has to be paid (Höllerer, 2012). For the purposes of the thesis, it thus seems that perhaps the best approach to define CSR is to retain this perception of it. Additionally, even if CSR is a somewhat chameleon concept, it deserves more academic attention as it is believed to be the key corporate contribution to sustainable development (Kolk, Van Tulder; 2010)

## 3.3. Tax avoidance as a CSR issue

For the purposes of the thesis, it is crucial to define the distinction between tax evasion and tax avoidance, although the terms are oftentimes used interchangeably (Montenegro, 2021). In fact, some scholars even propose to refrain from separating these two concepts and to analyze them in combination due to their similar economic effects (e.g. Cross. Shaw; 1981). Nevertheless, the conceptual difference lies in the legality of these practices (Feetham, 2011). Whereas by tax evasion we usually refer to such tax-related activities that violate the law, tax avoidance takes advantage of the ambiguity of the tax code and operates within the legal bounds. That is to say, a tax avoidant individual searches for loopholes in the tax rules and thus has nothing to hide from the tax authorities (Bittker, 1995) as all their practices are in line with the legal framework. Freedman (2006) defines tax avoidance as the grey area between tax compliance and tax evasion. In essence, tax avoidance usually takes form of the following three practices: minimization of an individual´s tax burden; settlement of tax on profits that were not gained in the country in which they are declared and a settlement of a tax on profits that were gained earlier. To provide a specific example, one can convert labor income into capital income, as this one is taxed at lower rate (Sandmo, 2005). On the other hand, tax evasion as a rule includes a certain type of concealment, fraud or destruction of records. It is a criminal offence that is punishable by fine or, in a worse case, imprisonment (Slemrod, 2007).

Even if the line between tax evasion and tax avoidance is quite blurry and both can be characterized by a willful attempt to reduce one´s tax liability, the difference in public perception of the concepts is significant. In a study proposed by Kirchler et al. (2003), it has been shown that there is substantial gap in individuals´ views on these practices in spite of their identical economic consequences. To conduct the experiment, 252 fiscal officers, business students, business lawyers, and small business owners were questioned to label scenarios describing tax evasion or tax avoidance as negative, neutral or positive. As could be expected, the tax evasion examples were mostly associated with the label "negative". Surprisingly however, the scenarios describing tax avoidance were perceived rather positively. This result is even more shocking given that the option "neutral" was available.

Similar difference in perceiving these two concepts can also be detected in multinational corporations. Whereas there has never been a corporation to publicly disclose their openness to tax evasion, a number of them has admitted an interest in tax avoidance. For instance, in 2011, the chairman of Google, Eric Schmidt, defended Google´s tax avoidance practices, declaring that their tax-related decisions are only a reflection of the incentives that the government created for them (Herson, 2013). Similarly, the company General Electric reacted to the criticism aimed towards its tax avoidance operations stating that all their actions are in line with the tax framework while suggesting the tax avoidance may not only be acceptable, but it can be also viewed as a company´s duty towards its shareholders to reduce the tax base as much as the legal system permits (Davis et al., 2016)

Therefore, the following question arises – why should we be aggravated by tax avoidance, if it does not include any law infringement? Naturally, it is not debatable whether or not tax evasion is ethical. Once it is against the law, it is crystal clear that a socially responsible firm would refrain from it. The answer is however not that straightforward regarding (even if lawful) tax avoidance. On one hand, there is the traditional business management theory as proposed by Milton Friedman (1970), according to which there is no other responsibility of a company as to maximize profit for its shareholders. This notion is perfectly in line with the reaction of the General Electronics company. Indeed, Friedman (1970) suggests that the company is bound to maximize the benefit of the shareholders, as they confided their wealth to the company and thus provided the company with trust. In other words, the company is responsible to manage the wealth with meticulous care, since the wealth does not belong to the company and thus it should operate with other people´s wealth accordingly. The effort to seek legal ways to diminish the company´s tax base and thus be able to reward the shareholders with more generous dividends would only reflect this view. Moreover, the author

believes that any normative questions should be left to the government and thus the companies should only be concerned with following their own pursuits within the legal bounds.

On the other hand, the CSR doctrine suggests that the company should go beyond cold-hearted profit making and take into account the needs of other stakeholders, which may be indirectly affected by its tax avoidance practices (Payne, Raiborn; 2018). From this perspective, the major problem seems to be the issue of shrinking contribution to the national budget. Since the tax collections are used as a source for financing a wide range of public goods, such as schooling, infrastructure, law enforcement or military defense – all of which help the company conduct their business, it may appear that in case of tax avoidance the company takes from the society but does not pay back. Undoubtedly, companies benefit from educated workers, stable environment ensured by functioning legal system, or even national protection that promotes safety (Scheffer, 2013). Thus, it becomes a matter of fairness to pay their respective share of taxes. Otherwise, the communities in which they operate cannot enjoy the same level of public goods as if the companies contributed properly and thus the stakeholders are indirectly and negatively affected by the companies´ choice to avoid taxes (Sikka, Willmott; 2010). Moreover, it can be claimed that corporations in effect bite their own hand through tax avoidance. In other words, lessening the national budget leads to general downgrade in public goods (e.g. educational system, roads), that in turn deteriorates the economic climate and the markets in which they aspire to flourish themselves.

The portions by which the tax avoidant companies manage to diminish their tax liabilities are no neglectable amounts. For instance, throughout the period of 1998-2012, Starbucks paid only £8,6 million in taxes despite of earning approximately £3 billion in UK sales. That constitutes less than 1% of the profit as the corporate tax payment. Furthermore, in 2011 the company paid no corporate tax even if the sales for that year were as high as £398 million (Scheffer, 2013). The national budget unarguably suffers when such behavior of firms occurs repeatedly and the losses accumulate. Overall, the yearly tax collection loss resulting from tax avoidance as a whole is estimated to be as high as $100 billion (Fisher, 2014).

Nonetheless, the companies attempt to outplay this argument and somehow defend their tax avoidant behavior by claiming that in case a government is corrupt, no one can ensure that their fair tax contribution will be re-invested in the society (Contractor, 2016). In addition, it is often argued that the US corporate tax rate, which can be as high as 35%, is already one of the highest among advanced economies. The latter point is, however, well invalidated by the fact that the 35% percent corporate tax rate is only a marginal tax rate, applicable solely on the very topmost part of the income. Once the average rate is applied, the US falls to the middle of the

OECD developed countries in terms of corporate tax liabilities. In effect, it is estimated to range between 19,4% (PwC, 2014) to 27% (McIntyre et al.; 2014). Therefore, in any case, the decrease is substantial. Furthermore, as the reciprocity theory suggests, company´s tax directors can have a tendency to engage in tax aggressiveness if they believe that the rest of the companies tends to act dishonestly as well. In other words, they may be discouraged from playing fair while there is a great number of free-riders benefiting from their honest contributions (Lederman, 2003).

Companies also tend to oppose criticism by arguing that with less after-tax income, they will subsequently have less funds available to re-invest the profits into research and development, improve their product and thus their chances to succeed in the global highly-competitive market are likely to dwindle. In other words, the competitive firms may have an unfair comparative advantage if located in a jurisdiction with relatively lower tax rate. The critics of this argument, however, maintain that the proceeds may instead be translated into more lucrative stock options and bonuses for the highest-ranking corporate officials and not necessarily will they be reflected in the quality of the product (Contractor, 2016).

Another case in point is the job creation process. Even if the companies may declare that the expatriation to a low tax region is solely intended for tax purposes, an inherent by-product of such action is a greater likelihood of an emergence of further job positions, that may otherwise be located in the home country and thus enrich the home job market (Behuria, 2022).

Some scholars believe that tax avoidance may be a stepping stone to other forms of dishonest corporate behavior. Desai and Dharmapala (2006) claim that since tax avoidance demands a certain level of befuddlement, it can serve as a conceal for activities that are far from the best interest of shareholders. For this reason, the tax avoidance is frequently associated with corporate misconduct. Moreover, the evidence from cases of distorting the numbers at Enron, Tyco or Xerox shows, that there is a bidirectional relationship between the urge to enhance the accounting profits and tax avoidance. In other words, a management with higher tendency to alter reported numbers is more likely to engage in tax avoidance, but the link also holds the other way round (Desai., 2005). Therefore, as engagement in tax avoidance may serve as an indicator of corporate misconduct from the part of the management, investors at the stock market may be quite averse to tax avoidance in firms (Desai, Dharmapala; 2006). In addition, from the shareholders´ perspective it may raise doubts whether it is reasonable to expect a company inclined to deceive the tax authority to refrain from deceiving the shareholders themselves (Huseynov, Klamm; 2012).

Since tax avoidance is such a controversial practice, the public usually reacts to it with a serious backlash. Once such information comes to light, it can be highly pernicious to the company´s image and result in serious reputational loss. Oftentimes, a leak of company´s information disclosing an engagement in such activities is accompanied by customer boycott, by which the consumers demonstrate their power and express contempt towards the company´s methods (Rahiminejad et al., 2018). By these means, the customers attack the company´s most painful spot and thus it is believed that the corporations may have more to be scared of from the public than from the government itself (Valencia, 2013). Therefore, the companies may severely harm themselves and their shareholders by risking public outcry, especially considering that consumers are far more likely to react to negative media coverage than to the positive one (Sen, Bhattacharya; 2001). Interestingly, it appears that some companies are more vulnerable to public scrutiny than others. Research suggests (Hanlon, Slemrod (2009); Gallemore et al. (2014)) that for companies that do not heavily rely on their reputation, the impact from negative publicity might be limited. Therefore, it can be claimed that likelihood of tax avoidance practices is higher in less visible firms, as the potential gain offsets the possible sacrifice. This idea can be demonstrated by the Starbuck´s reaction to public scrutiny in 2012, when they attempted to calm the outraged population by paying 10 million in an additional tax as the company is quite prominent and thus the reputational loss posed a great risk (Fisher, 2014). Additionally, intense public criticism does not appear to harm the tax havens themselves. Quite the opposite – under such extreme critique, they seem to bloom (Rosenzweig, 2010). Moreover, certain type of investors, especially the short-term hedge funds or private equity ones, may find the company´s willingness to undergo a risk to minimize its tax base quite alluring (Blank, 2008). This unfortunately indicates a restricted power of customers´ initiatives.

Nevertheless, as the societal pressures from the consumers´ part persist, renouncing tax avoidance may become the new CSR standard (Segerlund, 2016). The tax avoidance opponents use diverse means to spread the message of the necessity to compel the companies to pay their fair share of taxes and instigate the initiatives to close the loopholes in the tax framework. Once the contempt for corporate tax avoidance in the society grows sufficiently severe to make a difference, the firms refraining from these practices – and displaying doing so – may improve their market position compared to the rest of the companies. Subsequently, if the company´s market position is considered better relatively to other companies, it is more likely to be chosen by the customer and thus a vicious circle emerges (Sen, Bhattacharya; 2001). Therefore, as all the companies naturally want to improve their market position and gain a competitive

advantage, it can be claimed that even if a small number of firms break under the consumers´ pressure, the rest will likely join.

Likewise, the positive impact can also be made by investors´ influence. If the tax-obedient companies become widely preferred from the shareholders´ perspective, the pressure to adopt responsible tax policies is likely to grow. There is a number of indices that provide the shareholders with guidance for ethical investment, specifically the Dow Jones Sustainability index, FTSE4GOOD index, Calvert Social Index or Domini 400 Social Index. The indices gradually broaden the range of ethical criteria they cover to keep up with the evolution of ethical issues and investors´ heterogeneity. However, attempting to pressure the companies into ethical behavior can be riskier from the investors´ standpoint, as it may curb dividends or possible prospective growth. As consumer are exposed to lesser direct loss, they may have a superior position to incite company´s social responsibility (Fisher, 2014).

Last crucial agent in repressing corporate tax avoidance are corporations themselves - especially the big and prominent ones, which can do so by setting an example. In the past, we can observe examples of corporations that managed to increase their worth by also simultaneously benefiting the society - Cisco´s Academies or Nestle´s milk districts can be used as examples. As these companies are outstanding players in their business areas and thus are closely observed by the public eye, the investment into reputation improvement brings even greater benefit. For smaller companies, the adoption of CSR doctrines may be unreasonable, as their reputation may not hold so much power and thus the investment is unlikely to sufficiently contribute to their private value. In addition, the smaller companies may even be discouraged by the threat of the business giants taking advantage of their public investment (Fisher, 2014). Moreover, apart from generating greater private benefit for the firm, it is also more sensible for a bigger company to adopt a CSR program as they are better equipped in terms of resources and thus may operate various CSR initiatives concurrently to broaden their CSR portfolio (Rangan et al., 2012). Also, to carry a long-term project or a project which generates lower returns than the industry average is believed to be less risky for a relatively bigger company (Fisher, 2014).

The same reasoning can be applied to adoption of anti-avoidance doctrine. Considered a specific type of socially responsible behavior, anti-avoidance programs are likely to be beneficial for the highly eminent firms (Haufler, 2009). Because bigger corporations are capable of promoting the awareness due to their visibility and capital, they are believed to be very powerful as advocates of anti-avoidance since they might endorse it and popularize it (Utting, 2005). An incorporation of an anti-avoidance program would be processed in

equivalent fashion as any other form of CSR – it would be necessary to weight the possible costs and benefits and thus decide whether such policy can be expected to generate worth for the company (Li, 2006). Also, once the decision to adopt anti-avoidance approach is made, the companies may design their specific policy in order to exploit the CSR´s reputation-enhancing power to maximal extent so it best corresponds with their particular situation (Fisher, 2014). Likewise, it is advisable to construct the CSR policy in a way that adds to firm´s overall endeavors, as in such case it is more likely to be successful (Sen, Bhattacharya, 2001). For instance, the anti-avoidance doctrine can be presented as a firm´s initiative to pay the fair share of tax collections for proper development of hospitals which can complement the firm´s primary business, such as distribution of pharmaceuticals.

Tax avoidance is relatively new in the CSR framework (Desai, Dharmapala; 2006). Nevertheless, it is often believed to be an ethically dubious corporate method even if it is, as opposed to tax evasion, in line with the law. The seldom inclusion of tax avoidance in the context of CSR may be attributable to the fact that it does not possess the staggering nature of human rights infringement or pollution issues and thus less attention is devoted to it. Nevertheless, with growing media coverage of debatable tax patterns of prominent corporations such as Starbucks, Apple, Google or Amazon, the public appears to be more concerned with tax avoidant practices and enforcing fair tax contributions. This subsequently also raises concerns for the corporations, as such coverage may result in reputational damage and severely diminish the company´s profits. On the other hand, the companies that incorporate the anti-avoidance doctrine into their corporate philosophy may boost their public image and attract investors as well as customers (Sen, Bhattacharya; 2001).

Advocates of CSR have two ways of defending its validity. Some claim that even if ethically dubious behavior may bring certain benefits in the short-run, they are sure to be offset by far greater costs in the future and thus it is not an advisable approach (Cornell, Shapiro; 2021). In case of tax avoidance, this can be illustrated by not contributing the fair share to the tax collection at first and subsequently facing the public backlash accompanied by a drop in profits. Others believe that despite following the CSR doctrine may decrease profits without their future recovery, there is a moral imperative to prefer it above the lure of dishonest earnings (Cornell, Shapiro; 2021). In the tax avoidance context, contributing properly to the national budget from which hospitals and schools are financed is a good depiction of this idea. In either way, we believe that tax avoidance is a valid CSR issue which should be tackled as such, even if it may sometimes require to occasionally forgo possible additional earnings in order not to do disservice to the society as a whole.

# 4. Data description

## 4.1. Description of data sources and collected data

To perform the analysis, we created an original dataset using two major data sources. First important data source was the MSCI ESG database (formerly known as KLD STATS), which provided us with the information on the level of a firm´s CSR engagement. It reflects the environmental, social, and governance performance of companies as rated by MSCI ESG Research LLC and provides CSR ratings to investors who aim to incorporate social values into their investment decisions. For the independence of its information sources, it is widely considered a research standard in measuring CSR engagement (Benlemlih, Bitar; 2018) and is frequently used in CSR literature to determine a firm´s CSR performance (see e.g. Attig et al., 2013; Jeffrey et al., 2018; Harjoto, 2017; Attig et al., 2016). It is believed to be the most reliable source of CSR scores for the purposes of our thesis due to the following reasons. Firstly, as opposed to most CSR rating sources, such as Fortune Magazine and Financial Times, it covers also companies other than U.S. firms or big international corporations (Toyota, for instance), which is crucial to our analysis. Secondly, it can be claimed that this data source is, contrary to other sources, substantially more comprehensive. Therefore, it can give the investors and researchers more understanding of a firm´s CSR score (Kim, Chung, Park; 2013). From this data source, we managed to collect information on 101 unique Central and Eastern European firms from 11 countries. These are specifically Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Lithuania, Poland, Romania, Slovakia, Slovenia and Ukraine. Unfortunately, the database did not cover information for some other post-communist countries, such as Moldova, Serbia or Kosovo. Nevertheless, we believe that our sample well represents the CSR-related behavior of firms in Central and Eastern Europe as compared to other regions of the world.

To assign a CSR score to a firm, MSCI ESG considers seven qualitative and six exclusionary evaluation categories. The qualitative categories cover community, corporate governance, diversity, employee relations, environment, human rights, and products. In each of these categories, MSCI ESG summarizes a firm´s strengths and concerns according to specific standards. Subsequently, a firm is awarded certain number of positive and negative points from which the final score is calculated as their sum. The exclusionary categories represent the so called “sin industries”. These are specifically alcohol, gambling, firearms, military, nuclear power and tobacco. Based on these categories, a company can only be assigned a negative

number of points (and thus be penalized with a point deduction from overall score) if they operate in any of these industries (Kim et al., 2014). Finally, once the final number of points is determined, a company is assigned one out of seven CSR ratings, which can take form as "AAA", "AA", "A", "BBB", "BB", "B", and "CCC". Here, "AAA" is the best rating, while "CCC" is the worst. Firms are then labelled as laggard (ratings "CCC" to "B"), average ("BB" to "A") or leader ("AA" to "AAA") within their industry in terms of CSR performance.[1]

The second data source is a subset of the Orbis database compiled by commercial data provider Bureau van Dijk – Orbis Europe. The complete Orbis database holds information on approximately 400 million companies across more than 100 countries all over the globe as of January 2022 (Kalemli-Ozcan et al., 2022). However, since our analysis is centered on the CEE region, Orbis Europe more than suffices our needs. The information is collected from myriad of sources - usually the national and local institutions, which gather the data to meet legal and administrative obligations. Subsequently, the data is re-arranged into a specific form, which has been designed based on European Union guidelines and stems from the most commonly-used formats of recording business account data in Europe. As a result, it considerably simplifies cross-country firm comparisons, where the original formats may differ substantially (Ribeiro et al., 2010)

It contains information on companies´ financial statements as well as its ownership structure, which are both vital for our analysis. Therefore, this database enabled us to cover not only whether or not a firm is a tax haven user, but it also provided us with the information necessary to compute the rest of the independent variables. Specifically, the data we extracted from the Orbis database to perform these calculations were the following firm characteristics: book value of total assets, cash and cash equivalents, long term debt and net income. Unfortunately, the Orbis database does not allow the possibility to search a firm´s subsidiaries historically and it only displays its current subsidiaries. Therefore, it solely made us able to assess whether a firm is a tax haven user at the moment of the most recent data entry. For Orbis in general, the latest available information on firms is as of 2021. However, for most firms in our dataset, the latest update was for the year 2020. For this reason, we decided to execute our analysis based on the information from 2020.

In addition, we had to exclude 22 companies from our initial sample due to data unavailability. In these cases, Orbis did not cover all the necessary information of a firm (e.g.

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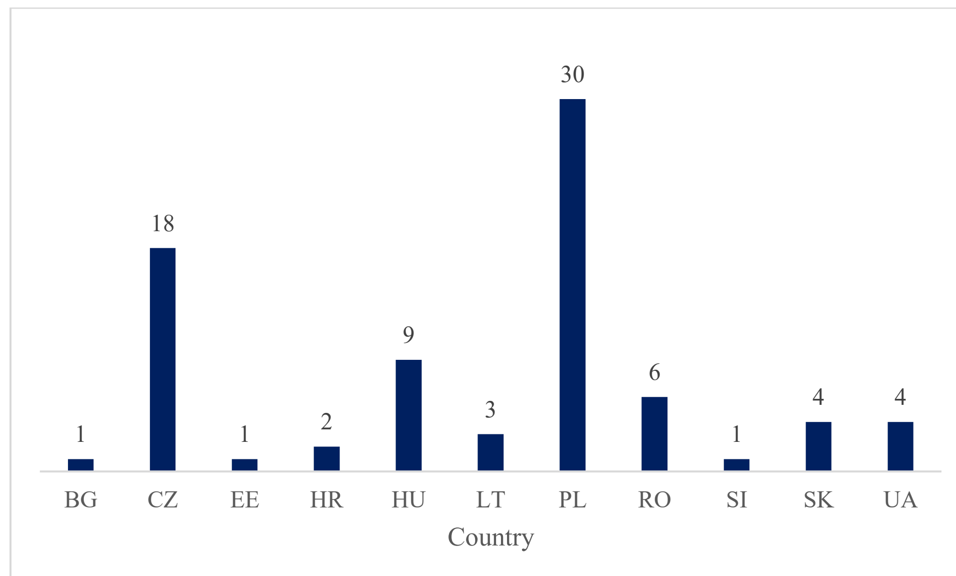
it only contained the very basic information, such as total assets and number of employees) or the data was already outdated (e.g. the last available accounting information was for the year 2015). Nevertheless, after combining the information in both datasets, we compiled a sample of 79 unique Central and Eastern European firms. The country-wise distribution is illustrated in the chart below.

**Figure 4-1: Country-wise distribution of firms**




*Source: author´s computations*

As the graph indicates, the most numerous subgroup in our sample are Polish firms, for which there is a total of 30 observations in our sample. Czech companies rank second, with total number of 18 firms. The least represented countries in our sample are Bulgaria, Estonia and Slovenia, with only one company each.

## 4.2. Compilation of the tax haven list

For our analysis, it is essential to identify Central and Eastern European firms with links to tax havens. Prior to that, however, we must choose a tax haven list that we will use for the purposes of the thesis. As a result of little consensus on the definition of a tax haven, even the available tax havens lists tend to vary. Moreover, tax haven lists may differ also in context of individual countries or regions, as pointed out by Markle and Robinson (2012). Likewise, tax haven lists may evolve over time, as countries develop and so their taxation policies may change. For these reasons, we focused on using a tax haven list which would be both region-specific and relatively recent. As a base, we chose a list created by Nerudová et al. (2020). In this study, the authors analyze profit shifting to tax havens in context of Visegrad countries. Even if their study does not cover all countries in our sample, we believe that it well reflects the specificities of the post-communist region. Also, the study was published in 2020 and thus it is unlikely that the created list would be outdated. Specifically, it includes the following countries:

**Table 1: Base list of tax havens**

| | |
|---|---|
| Andorra | Luxembourg |
| Anguilla | Macau |
| Antigua and Barbuda | Maldives (the) |
| Aruba | Malta |
| Bahamas (the) | Marshall Islands (the) |
| Bahrain | Mauritius |
| Barbados | Monaco |
| Belize | Montserrat |
| Bermuda | Nauru |
| British Virgin Islands (the) | Netherlands Antilles |
| Cayman Islands (the) | Niue |
| Channel Islands (Guernsey and Jersey) | Panama |

| | |
|---|---|
| Cook Islands (the) | Samoa |
| Costa Rica | San Marino |
| Cyprus | Seychelles (the) |
| Dominica | Singapore |
| Gibraltar | St. Kitts and Nevis |
| Grenada | St. Lucia |
| Hong Kong | St. Vincent and Grenadines |
| Isle of Ireland (the) | Switzerland |
| Jordan | Tonga |
| Lebanon | Turks and Caicos |
| Liberia | US Virgin Islands (the) |
| Liechtenstein | Vanuatu |

*Source: Nerudová et al., (2020).*

After taking a close look at the tax haven list of Nerudová et al. (2020) and comparing it to tax havens frequently used by firms in our sample, we notice absence of two important jurisdictions – the UK and the US. There is, again, little consensus on whether these countries should be labelled as tax havens. Nevertheless, a number of scholars point out that they exhibit tax haven characteristics (e.g. Gravelle, 2022; Drucker, 2016; Palan et al., 2013; Zoromé, 2007). Recently published Pandora Papers indicate that US is the second largest tax haven after the Cayman Islands, especially the states of Delaware, Nevada, South Dakota and Wyoming (Minter, 2021). They share tax haven attributes like the absence of reporting requirements, zero tax on interest paid to foreign entities or the possibilities of establishing a flexible corporate vehicle exempt from taxation. Moreover, they also involve in practices which encourage international tax evasion, such as providing identity secrecy to the depositors (Gravelle, 2022). Also, according to Financial Secrecy Index, the US holds approximately 20% of financial services for non-residents (Knobel, 2016). States of Delaware, Nevada and Wyoming along with the UK have also been referred to as the greatest perpetrators of tax fraud (Gnaedinger, 2009). Likewise, the UK is often considered a tax haven as it offers a wide range of international

financial services (Zucman, 2017) and is especially interesting for large businesses (Brooks, 2014). Furthermore, it offers stronger financial secrecy for non-resident investors than many other tax havens (Cockfield, 2015) and policies enabling to avoid most taxes on capital income as well as foreign-source income (Mitchell, 2007).

We understand that not all regions of the UK and the US may have tax haven characteristics. However, it is important to note that the Orbis database, from which we obtain information on firms´ links to tax haven, has one shortcoming that we believe should be considered in this matter. It codes all states of the United States as "US". That is to say, it is impossible to distinguish between individual states, as they are all assigned the same label. Thus, we cannot know if the firm is linked to a region with or without tax haven characteristics. The same goes for the UK. As Orbis codes regions with tax haven characteristics, such as the Channel Islands (expect for Jersey) and the Isle of Man, simply as "UK" as well, it is impossible to tell which part of the UK the firm is connected to. Some of the regions coded as "UK" are also included in our base list. Therefore, we find it reasonable to account for "UK" in our final list even if we did not consider it a tax haven as a whole.

Moreover, incorporating the UK and the US into our list of tax havens changes the number of identified tax haven using firms from 21 to 26. At first the increase by 5 firms may not seem like a big change. Nevertheless, as it represents an increase by almost one quarter, we believe it is worth our attention. For these reasons, we decided to conduct two separate analyses – one excluding the UK and the US and one including both of these countries. We believe that such approach best suits the specificities of our sample while also avoiding unnecessary confusion.

## 4.3. Description of variables and summary statistics

This section of the thesis is devoted to the description of variables used in the analysis, both dependent and independent. We will show how we derived them from the collected data and provide descriptive statistics.

***CSR_rating***, is our dependent variable. It equals to "1" if the respective company has been assigned the score "laggard" in the MSCI dataset, "2" if it has been classified as "average" and "3" if it has been marked as a "leader". Our sample contains 11 laggards, 51 average-performing companies and 17 leaders.[2]

***Haven_user*** is the main independent variable of our interest. This dummy variable indicates whether a company has been classified as a tax haven user or not. According to Janský and Kokeš (2015), a company can be considered a tax haven user if it has either direct or indirect links to a tax haven country. As the authors claim, direct link to a tax haven can be described as having at least one subsidiary in a tax haven jurisdiction. On the other hand, a company can be indirectly linked to a tax haven through its parent ownership structure. Orbis database contains information on a company´s list of subsidiaries as well as the parent companies. Therefore, we consider the location of both - the firm´s subsidiaries and its owner. If either any of the subsidiaries or the owner are located in a tax haven country, we classify the company as a tax haven user. Similar approach has also been used in Afrasinei et al. (2016). In this manner, we identified 21 (about 27% of the sample) tax haven users if we do not include UK and US in the list of tax havens and 26 (about 33% of the sample) if we do. Interestingly, we can observe that countries in our dataset are predominantly linked to tax haven in a direct way. That is to say, the connection to a haven mostly takes form of having established a subsidiary in such jurisdiction. In case we do not consider UK and US as tax havens, out of 21 identified tax haven users, 17 are linked to a tax haven country through a subsidiary. Only 6 companies are connected to a haven by an indirect link through their ownership structure. In other words, there are almost three times as many direct links as there are the indirect ones. Naturally, some companies have both. If we do include the UK and the US in the list of tax haven jurisdictions,

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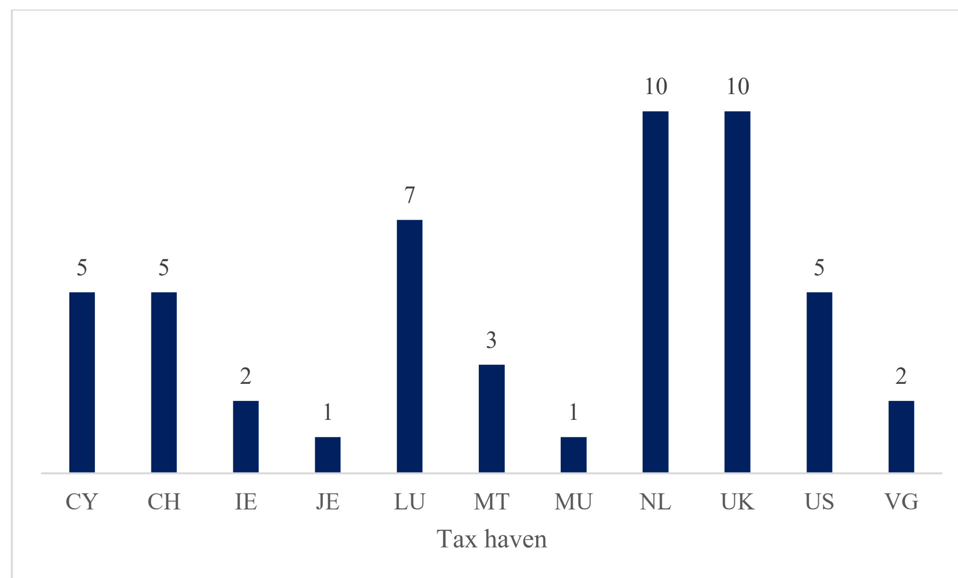
the figures slightly change, but the overall asymmetry persists. Total number of identified tax havens is 26, out of which 20 are linked to a tax haven directly and 8 indirectly.

In the table below, the numbers of country-wise links to individual tax havens are summarized.

**Figure 4-2: Country-wise distribution of tax haven links**




*Source: author´s computations*

As we can observe, the most tax haven links are formed with the Netherlands and the United States. The tax havens which account for the least connections are Mauritius and Jersey, with only one link each. It is important to note that only the countries from our tax haven list for which there was at least one link, whether direct or indirect, are depicted in the graph. Therefore, if a specific haven appears on our tax haven list but is excluded from the graph, no company in our dataset is linked to that tax haven in any way.

Moreover, not only there are more direct tax haven links then there are indirect ones, but it also appears that direct tax haven links span across more tax havens. For instance, there are no links based on the corporate ownership for the countries of Ireland, British Virgin Islands, Malta, Mauritius or the US. That is to say, the list of tax havens that are used by the firms in our dataset through the indirect links is relatively shorter as compared to the list of tax havens used through the direct links. On the other hand, there is no company to have a direct connection in the country of Jersey. Therefore, this country would be the only one with zero links if we only considered direct connections.

It is important to mention that a firm can have more than one tax haven link, as it can establish subsidiaries in more than one tax haven country or there can be a combination of a haven subsidiary and the owner located in a tax haven. Therefore, it is natural that the number of haven links exceeds the number of identified haven users.

To compute the rest of the independent variables, we largely followed the approach employed in Flammer and Kacperczyk (2019) or Flammer and Luo (2017). ***Size*** is the natural logarithm of the book value of company´s total assets. ***Leverage*** is computed as a ratio of long-term debt to the book value of total assets. ***Cash*** is expressed as the ratio of cash and cash equivalents to total assets. ***Return_on_assets*** (ROA), as the last of our independent variables, is calculated as a ratio of net income before depreciation to total assets.

The descriptive statistics are enclosed in Table 2. It contains the minimum, the maximum and the mean value for each independent variable along with the respective standard deviation values.

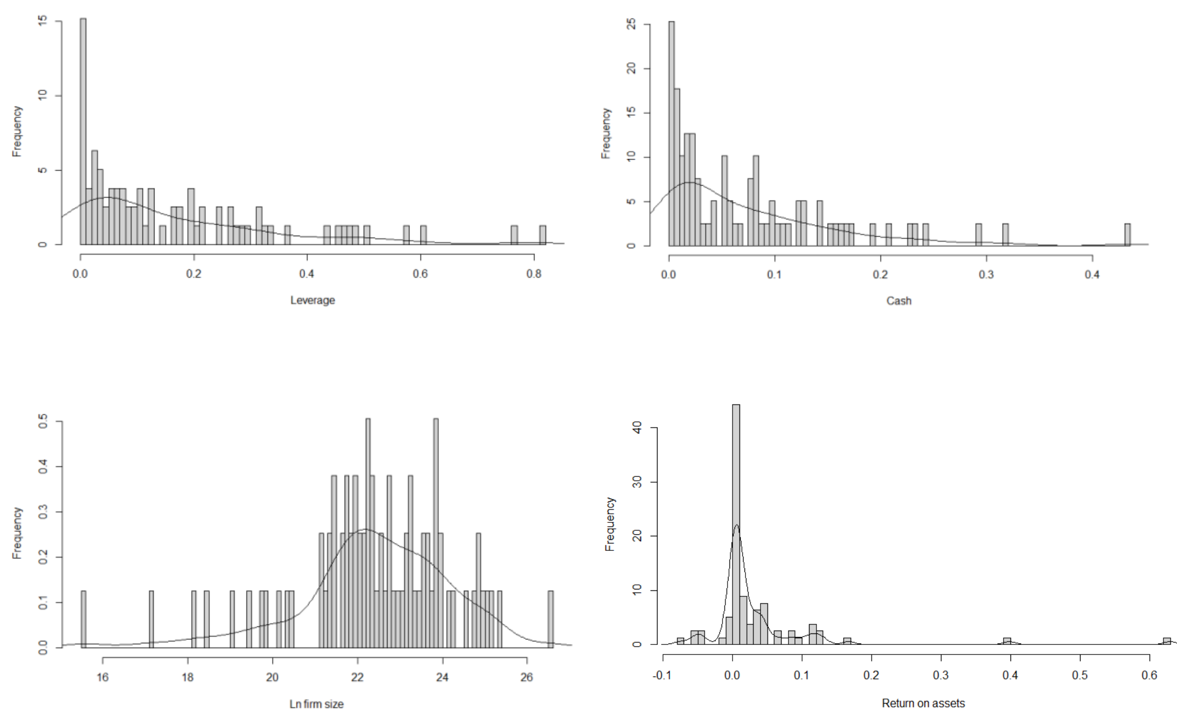
**Table 2: Descriptive statistics**

| | Minimum value | Maximum value | Mean value | Standard deviation |
|---|---|---|---|---|
| Haven_user (without UK or US) | 0.000 | 1.000 | 0.266 | 0.445 |
| Haven_user (with UK and US) | 0.000 | 1.000 | 0.329 | 0.473 |
| Size | 15.580 | 2.520 | 22.370 | 1.864 |
| Leverage | 0.000 | 0.817 | 0.168 | 0.184 |
| Cash | 0.0000017 | 0.435 | 0.076 | 0.084 |
| Return_on_assets | -0.075 | 0.630 | 0.034 | 0.090 |

*Source: Author´s computations*

In addition, we include the histograms of individual independent variables. They are depicted in Figure 4-3. The x-axis carries a label with the name of the depicted variable and the y-axis represents the frequency at which given value of the variable appears in our sample.

**Figure 4-3: Histograms of independent variables**



# 5. Methodology

## 5.1. Ordered logistic regression

This section of the thesis is devoted to describing the ordered logit methodology, which has been employed in our analysis. We describe the technical aspects of this approach, explain the rationale behind its choice and verify the underlying assumption.

Ordered logit is generally used for models in which the dependent variable can take the form of multiple categorical outcomes, which can also be ranked. For instance, if we wanted to analyze which factors influence the choice of a consumer´s drink size in fast food restaurants – that is to say, whether they opt for “small”, “medium” or “large” - it would be suitable to choose ordered logit as we can clearly state that “medium” is more than “small” and “big” is more than “medium”. Another example might be a study focused on what causes sportsmen to win “bronze”, “silver” or “gold” medals (UCLA, 2022). This methodology is also widely used for ratings such as satisfaction questionnaires. In essence, it is crucial for the dependent variable to be capable of being ranked. In case we work with a categorical dependent variable that cannot be ranked, it is more suitable to use different methodology, such as multinomial logit. Since our dependent variable is a rating which takes form of three different categories with a meaningful sequential order, we believe ordered logistic model is a good choice for our analysis.

It would also be possible to use ordered probit as an alternative. These models are fairly similar and generally tend to produce comparable results. They differ in that the logit uses logistic distribution, whereas probit uses standard normal distribution. Nevertheless, we chose logit as a matter of preference.

The coefficients of the logistic regression are interpreted in terms of proportional odds ratios. This ratio represents the odds of an event occurring in one group versus the event occurring in another group. Specifically, the coefficients of ordinal logistic regression can be interpreted as the increase in probability (associated with one unit increase in the independent variable) of the dependent variable being in a higher category. This is to say, the coefficient represents the increase in probability of the dependent variable being equal to level 3 versus being equal to level 2 or level 1. At the same time, it also represents the increase in probability of the dependent variable being equal to level 3 or level 2 as opposed to being equal to level 1. This is because of the parallel regression assumption, which is described in section 5.1.1.. In essence, it means that none of the independent variables has a disproportionate effect on certain

level of the dependent variable and that the slope of the logistic function is the same for all of its categorical levels. For this reason, we can interpret the coefficients as simply representing the probability of the dependent variable being in a “higher” category and not representing a relationship between any specific pair of categories.

Ordinal logistic models are sometimes understood as lying between linear and multinomial regression. It resembles linear regression in that we can claim that our outcome increases (or decreases) depending on the inputs. However, as in the multinomial regression, these increments (or reductions) are stepwise rather than continuous. Nevertheless, it is important to note that the ranking has only an ordinal meaning and does not hold any information on the distance between individual levels. In other words, we cannot state that the difference between level 1 and level 2 to is the same as the difference between level 2 and level 3. For instance, in medical research, the distance between moving from “healthy” to “early stage of disease” may not be the same as the distance between moving from “early stage of disease” to “developed stage of disease” (McNulty, 2021).

Pursuing the approach from McNulty (2021), the ordered logit models can be derived using the latent dependent variable as follows:

For simplicity and the purposes of our specific example, we can assume an ordinal outcome variable *y* with three different categorical values (this approach can of course be easily generalized to *n* different categories). We will label these categories as 1, 2 and 3. Also, let us assume we have one independent variable called *x*. We can model an auxiliary linear continuous variable $y'$, which can be described as $y' = \alpha_0 + \alpha_1 x + E$, with $E$ being an error term with mean equal to zero. Then, let us have two increasing cutoff values labelled as $\tau_1$ and $\tau_2$. Using the auxiliary linear continuous variable and the cutoff values, we can construe y as $y = 1$ if $y' \leq \tau_1$, $y = 2$ if $\tau_1 < y' \leq \tau_2$ and $y = 3$ if $y' > \tau_2$. Also, it is important to assume that the error term $E$ follows logistic distribution based on the variance of $y'$ instead of normal distribution. Therefore, we can write it as $E = \sigma\varepsilon$, where σ is proportionate to the variance of $y'$ and ε reflects the shape of the logistic function, which is to say:

$$P(\varepsilon \leq z) = \frac{1}{1 + e^{-z}}$$

The probability of our ordinal dependent variable being in the lowest category can be written as:

$$P(y=1)=P(y'\le\tau_1)=\ P(\alpha_0+\alpha_1x+E\le\tau_1)=\ P(\alpha_0+\alpha_1x+\sigma\varepsilon\le\tau_1)$$
$$=\ P\left(\varepsilon\le\frac{\tau_1-\ \alpha_0-\alpha_1x}{\sigma}\right)=\ \ P(\varepsilon\le\nu_1-\beta x)=\ \frac{1}{1+e^{-(\nu_1-\beta x)}}$$

where $\nu_1=\frac{\tau_1-\alpha_0}{\sigma}$ and $\beta=\frac{\alpha_1}{\sigma}$

Since our dependent variable *y* cannot be lower than 1 and only attains values of 1, 2 and 3; we can calculate the probability of *y* being greater than 1 as a complementary probability to *y* being equal to 1.

$$P(y>1)=1-P(y=1)=1-\ \frac{1}{1+e^{-(\nu_1-\beta x)}}=\frac{1+e^{-(\nu_1-\beta x)}-1}{1+e^{-(\nu_1-\beta x)}}=\ \frac{e^{-(\nu_1-\beta x)}}{1+e^{-(\nu_1-\beta x)}}$$

Therefore, the probability of *y* being in the two higher categories (2 or 3) versus *y* being in category 1 can be expressed as:

$$\frac{P(y>1)}{P(y=1)}=\frac{\frac{e^{-(\nu_1-\beta x)}}{1+e^{-(\nu_1-\beta x)}}}{\frac{1}{1+e^{-(\nu_1-\beta x)}}}=e^{-(\nu_1-\beta x)}=e^{\beta x-\nu_1}$$

To obtain the log odds of this outcome, we apply the natural logarithm.

$$\ln\left(\frac{P(y>1)}{P(y=1)}\right)=\ \beta x-\nu_1$$

In a similar fashion, we can obtain the log odds of y being in our highest category (3) versus of it being in the lower categories (1 or 2) as:

$$P(y=3)=P(y'>\tau_2)=\ 1-P(y'\le\tau_2)=1-\ P(\alpha_0+\alpha_1x+E\ \le\tau_2)$$

$$= 1 - P(\alpha_0 + \alpha_1 x + \sigma\varepsilon \le \tau_2) = 1 - P\left(\varepsilon \le \frac{\tau_2 - \alpha_0 - \alpha_1 x}{\sigma}\right) = 1 - P(\varepsilon \le \nu_2 - \beta x)$$

$$= 1 - \frac{1}{1 + e^{-(\nu_2 - \beta x)}} = \frac{1 + e^{-(\nu_2 - \beta x)} - 1}{1 + e^{-(\nu_2 - \beta x)}} = \frac{e^{-(\nu_2 - \beta x)}}{1 + e^{-(\nu_2 - \beta x)}}$$

where $\nu_2 = \frac{\tau_2 - \alpha_0}{\sigma}$ and $\beta = \frac{\alpha_1}{\sigma}$

$$P(y \le 2) = 1 - P(y = 3) = 1 - \frac{e^{-(\nu_2 - \beta x)}}{1 + e^{-(\nu_2 - \beta x)}} = \frac{1 + e^{-(\nu_2 - \beta x)} - e^{-(\nu_2 - \beta x)}}{1 + e^{-(\nu_2 - \beta x)}}$$

$$= \frac{1}{1 + e^{-(\nu_2 - \beta x)}}$$

Therefore:

$$\frac{P(y = 3)}{P(y \le 2)} = e^{-(\nu_2 - \beta x)}$$

And thus

$$\ln\left(\frac{P(y = 3)}{P(y \le 2)}\right) = \beta x - \nu_2$$

We can generalize the formula for any natural number k:

$$\ln\left(\frac{P(y = k)}{P(y \le k)}\right) = \beta x - \nu_k$$

As we can see, the effect of a unit change in x on the probability of being y in a higher category is always represented by $\beta$, regardless on which category we examine. That enables us to only have one coefficient to describe the impact of $x$ on $y$ across the whole range of levels. What does differ though is the intercept coefficients $\nu_k$ that are unique for each individual level.

### 5.1.1. Ordered logit assumptions

There is a number of assumptions, that must be fulfilled in case of the ordered logistic model. These are specifically:

1. *No multicollinearity*

   No two independent variables are correlated. If so, only one of the variables between which there is high correlation should be included in the model. To verify this assumption, we used correlation matrices – one for the model with and one for the model without UK and US. In any of the matrices, no high correlation (we used a commonly applied threshold of 0.7) between independent variables has been spotted. Therefore, none of the independent variables needs to be excluded from the model.

**Table 3: Correlation matrix for the model excluding UK and US**

| | haven_user | log(firm_size) | cash | leverage | return_on_assets |
|---|---|---|---|---|---|
| haven_user | 1.000 | 0.204 | 0.157 | 0.011 | 0.183 |
| size | 0.204 | 1.000 | 0.123 | -0.045 | -0.209 |
| cash | 0.157 | 0.123 | 1.000 | -0.268 | 0.240 |
| leverage | 0.011 | -0.045 | -0.268 | 1.000 | -0.145 |
| return_on_assets | 0.183 | -0.209 | 0.240 | -0.145 | 1.000 |

*Source: Author´s computations*

**Table 4: Correlation matrix for the model including UK and US**

| | haven_user | log(firm_size) | cash | leverage | return_on_assets |
|---|---|---|---|---|---|
| haven_user | 1.000 | 0.135 | 0.213 | -0.003 | 0.307 |
| size | 0.135 | 1.000 | 0.123 | -0.045 | -0.209 |
| cash | 0.213 | 0.123 | 1.000 | -0.268 | 0.240 |
| leverage | -0.003 | -0.045 | -0.268 | 1.000 | -0.145 |
| return_on_assets | 0.307 | -0.209 | 0.240 | -0.145 | 1.000 |

*Source: Author´s computations*

2. *Ordered dependent variable*

Since our dependent variable is a categorical rating and thus meaningful sequential order can be assigned to it, we believe this assumption is fulfilled.

3. *At least one of the independent variables is either continuous, categorical or ordinal*

This assumption has been verified in section 4.3.. The main independent variable is a dummy, and thus a categorical (binary) variable. The remaining independent variables are continuous.

4. *The parallel regression assumption*

Also known as the proportional odds assumption or parallel slopes assumption, it states that the relationship between each pair of outcome groups is the same. That is to say, the coefficients that describe the relationship between the highest category as compared to all lower categories are identical to coefficients describing the relationship of the second highest category to all lower categories, etc. For this reason, it is possible to have only one set of coefficients. Otherwise, it would be necessary to calculate separate sets of coefficients to describe the relationship between each pair of outcome groups. There are more tests to verify this hypothesis, out of which we chose the Brant

test. The null hypothesis here is that the proportional odds assumption holds. Therefore, if the p-value on this test – especially on the omnibus and at least one of the independent variables – is lower than 0.05; we can reject the null hypothesis and thus the proportional odds assumption should be considered violated. In our case, the assumption holds as p-value on all of the variables as well as the omnibus is greater than 0.05. The results of the Brant test are included in Appendix.

## 5.2. Model specification

In this section of the thesis, we provide the description of the model used to conduct the analysis. In addition, we will specify the motivation behind the inclusion of each independent variable.

We constructed an ordered logistic model, that can be expressed by the following equation:

$$CSR_rating_i = \beta_0 + \beta_1 haven_user_i + \beta_2 size_i + \beta_3 leverage_i + \beta_4 cash_i + \beta_5 return_on_assets_i + e_i$$

In this model, $\beta_0$ is the intercept parameter, $\beta_1$ to $\beta_5$ are the coefficients representing the effects of individual independent variables on the response variable and $e_i$ is the residual term.

Our ***independent variable***, labelled as ***CSR_rating***, is a categorical variable which takes the value of “1”, “2” or “3” which stand for “laggard”, “average” and “leader” respectively. As the categories can be ranked and we can clearly state which of the categories is better and which is worse, it means that the variable is not only categorical but also ordinal. In our specific example, since CSR is perceived as good and desirable strategy, we can tell that “average” is better than “laggard” and “leader” is better than “average”. Therefore, we have to do with an ordered categorical variable. Naturally, this is usually the case for ratings.

Our most important ***dependent variable*** is a dummy labelled as ***haven_user***, which takes form of 1 if a company has been identified as a haven user and 0 otherwise. The rest of our independent variables are firm characteristics that are frequently associated with the level of a company´s CSR engagement (see e.g. Col, Patel (2019); Lee (2020); Flammer, Kacperczyk (2019); Flammer, Luo (2017)).

***Size*** is included in the model since it is often believed to strongly influence a firm´s CSR engagement (Solikhah, 2016). This is because the firms that are bigger in size are generally also more visible and might attract more public attention. For this reason, they may face more intense social pressures and thus are more likely to be socially responsible (Giannarakis; 2014). On the other hand, smaller companies may not only face less social pressure but also their potential gain from CSR initiatives may be limited due to their lower visibility (Udayasankar, 2008). Therefore, this variable should be positively correlated with the response variable. An alternative measure for size can be the number of employees. However, this information was

missing in the Orbis database for a considerable number of firms in our sample (15 out of 79). Another possible proxy for visibility could also be for instance the firm´s advertising expenses.

In addition to being a proxy for visibility, there are also other reason for which a bigger firm might be expected to be more socially responsible. For example, large economies of scale can substantially facilitate the effectiveness of CSR initiatives (Youn et al., 2015). Bigger firms tend to have more resources, both financial and human, which can contribute to the firm´s CSR activities. On the other hand, smaller firms might engage in CSR to lower extent since they may be more constrained in both of these areas. Moreover, successful implementation of CSR in large firms is more likely since their objectives are generally well-defined and they follow precise procedures to monitor their activities (D'Amato and Falivena, 2020).

The rationale behind the inclusion of ***leverage*** is that highly levered companies might be less prone to pursue investments in CSR activities (e.g. Mishra, Modi (2013); Sheikh (2019)). This is because debt tends to discourage investments valuable for the company as well as those valuable for the society (Moussu, Ohana; 2016). Since high levels of debt imply that the firm has to pay high interest expense, the funds to finance CSR activities are limited (Swandari and Sadikin, 2016) Moreover, highly levered firms are more likely to focus on tackling the problems which result from borrowing than to invest in CSR initiatives (Tarek, 2019). Therefore, leverage should be negatively correlated with the level of CSR engagement.

We included the variable ***cash*** in the model because cash holdings are believed to be one of the main determinants of the CSR engagement (Col, Patel; 2019). CSR encompasses various commitments to stakeholders, such as promises of stable job for employees or steady service to customers. Under such promises, the employees are willing to work for lower wage and the customers are willing to accept higher price, which is beneficial to the company. These commitments, however, are not legally binding and thus the firm can default on them without facing any legal consequences. Adopting a conservative financial policy and maintaining higher levels of cash holdings may help persuade the stakeholders that the firm has sufficient liquidity for these promises to be met (Chang et al., 2019). Moreover, firms with more financial proceeds can afford to spend on CSR-related activities (Col, Patel; 2019). Thus, this variable should be positively linked to the firm´s CSR score.

The last of our independent variables is the ***return_on_assets*** (ROA). It is used as a proxy for firm´s profitability. We believe that this variable should be included in our model since research suggests a significant relationship between CSR and profitability (e.g. Ekatah et al. (2011; Nwaneri (2015)). Other alternative measures of profitability could also be return on equity (ROE) or net profit margin (NPM) (Mulyadi and Anwar, 2012). Nevertheless, the

direction of the relationship between CSR and profitability is speculative. On one hand, CSR initiatives require additional costs a thus may decrease profitability, at least in the short run (Zieliński and Jonek-Kowalska, 2021). This would indicate negative relationship between CSR and profitability. On the other hand, engaging in CSR enhances the company´s public image, which helps attract customers and in turn may increase firm´s profitability (Giannarakis et al., 2016). Moreover, firms with higher profitability have the fund flexibility to execute CSR programs (Swandari, Sadikin; 2016). By this logic, we may expect positive CSR-profitability relationship.

# 6. Results

In this section of the thesis, we would like to present our findings and interpret the results. First, we will comment on the outcomes of the analysis without the inclusion of the UK and the US. The results obtained from the regression are summarized in Table 5. Our main variable of interest, which indicates whether or not a given company has been classified as a tax haven user, appears to be statistically significant on the 90% confidence interval as the p-value is below 0.1 level. It thus appears that there is some form of significant relationship between the level of CSR engagement and tax haven use. Our first hypothesis, which suggests that no perceptible relationship exists between these two variables for potentially insufficient spread of CSR in the CEE region, is therefore not supported by the evidence. The negative sign associated with the variable implies that being a haven user decreases a probability of a firm being more socially responsible. This is consistent with the corporate culture theory, which suggests that CSR engagement should be understood as a reflection of company´s shared beliefs rather than a means of enhancing its public image. Therefore, in context of post-communist countries, the results support our second hypothesis. As the coefficients of the logistic regression are expressed in terms of log odds, we must take the exponential form of the coefficient to quantify the effect. Therefore, the effect associated with being a tax haven user is exp (-1.093) = 0.33521. In other words, the probability of a firm being more socially responsible decreases by approximately 66% (100% - 33,521%) if the firm is a tax haven user. It can be claimed that the effect is quite pronounced.

If we look at the marginal effects, which are summarized in Table 6, we can observe that a tax haven using firm (as compared to a firm without links to tax havens) is about 14,3% more likely to be classified as "laggard" in terms of CSR performance, but only 0,06% more likely to be labelled as "average" and almost 15% less likely to fall into the "leader" category. This is consistent with the claim that tax haven using firms are generally less likely to be more socially responsible, since the marginal effects gradually decline as we move to upper CSR score categories.

As for the rest of the independent variables, unfortunately none of the them seems to have a significant effect on the dependent variable. Nevertheless, the direction of the effect is in line with our expectations based on existing research for the variables ***size***, ***cash*** and ***leverage***. For the variable ***return_on_assets***, the research was inconclusive and thus we were unsure about the potential direction of the relationship. However, it appears than the relationship is

negative, suggesting the firms with high CSR engagement are generally less profitable. Taking this into account, it can be claimed that the results we obtained regarding the variables ***haven_user*** and ***return_on_asset*** are in line with each other. In other words, since the negative sign associated with the variable ***haven_user*** provides evidence against the risk management theory, according to which the firms engage in CSR to enhance their public image which in turn can help them generate higher profits, the finding that socially responsible firms are also less profitable is in accordance with the rejection of this theory.

**Table 5: Regression results (excluding UK and US)[3]**

| | Value (Standard Error) |
|---|---|
| haven_user | -1.092 * |
| | (0.577) |
| size | 0.082 |
| | (0.134) |
| cash | 2.107 |
| | (2.921) |
| leverage | -0.051 |
| | (1.300) |
| return_on_assets | -3.872 |
| | (2.985) |
| N | 79 |
| Nagelkerke's $R^2$ | 0.105 |
| *Note:* *p< 0.1; **p< 0.05; ***p< 0.01 | |

*Source: Author´s computations*

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**Table 6: Marginal effects (excluding UK and US)[4]**

| | effect 1 | effect 2 | effect 3 |
|---|---|---|---|
| haven_user | 0.143 | 0.006 | -0.149 |
| size | -0.009 | -0.004 | 0.013 |
| cash | -0.227 | -0.108 | 0.335 |
| leverage | 0.005 | 0.003 | -0.008 |
| return_on_assets | 0.417 | 0.199 | -0.616 |

*Source: Author´s computations*

The results after including UK and US into the list of tax havens are summarized in Table 7. The effect of the firm being a tax haven user remains negative and is still significant on the 10% level. However, we can observe that the p-value, even if still below the value of 0.1, slightly increases. Also, the magnitude of the effect changes to exp (-0.968) = 0.380 and thus the probability of a tax haven using firm being more socially responsible is now -62%. Regarding the marginal effects, as summarized in Table 8, the probability that a tax haven using firm will be classified as "leader" in terms of their CSR score remained fairly similar. It only changed from suggesting a 15% decrease to suggesting a 14% decrease. The marginal effect for the category "laggard" now implies 12% increase in probability for a tax haven using firm rather than 14%, which we can still consider a slight change. Nevertheless, the greatest shift can be observed for the marginal effect of the category "average". Here, the probability moved from 0,6% increase to 2,2% increase. This might be attributable to the fact that all 5 firms in our sample which become identified as tax haven users after accounting for the UK and the US fall into the "average" category, and thus notably increase the probability of a tax haven using firm having an "average" CSR score. The direction of the effects associated with the remaining independent variables is the same as in the previous regression, including the negative effect of the return on assets. Moreover, we can observe that after the inclusion of the UK and the US, the overall performance of the model, as measure by Nagelkerke´s $R^2$, slightly decreased.

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**Table 7: Regression results (including UK and US)[5]**

| | Value (Standard Error) |
|---|---|
| haven_user | -0.968 * |
| | (0.557) |
| size | 0.065 |
| | (0.131) |
| cash | 2.259 |
| | (2.912) |
| leverage | -0.040 |
| | (1.300) |
| return_on_assets | -3.252 |
| | (2.905) |
| N | 79 |
| Nagelkerke's $R^2$ | 0.097 |
| *Note:* *p< 0.1; **p< 0.05; ***p< 0.01 | |

*Source: Author´s computations*

**Table 8: Marginal effects (including UK and US)[5]**

| | effect 1 | effect 2 | effect 3 |
|---|---|---|---|
| haven_user | 0.119 | 0.022 | -0.141 |
| size | -0.007 | -0.003 | 0.010 |
| cash | -0.243 | -0.119 | 0.363 |
| leverage | 0.004 | 0.002 | -0.006 |
| return_on_assets | 0.350 | 0.172 | -0.522 |

*Source: Author´s computations*

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In summary, our first hypothesis which proposes that the relationship between CSR score and tax haven use will not be significant in CEE region, will be rejected since the tax haven user status proved to be significant on 90% confidence interval. As being a tax haven user appears to have quite strong negative effect on the firms CSR score in both cases (whether including the UK and the US in the list of tax havens or not), we can comprehensively conclude that we found evidence supporting our second hypothesis. In other words, we provide evidence in favor of the corporate culture theory in the context of Central and Eastern European firms. Our third hypothesis has been supported by the evidence, as after inclusion of the UK and the US in the list of tax havens, the probability of a tax haven using firm being more socially responsible changed from -66% to -62%. Therefore, since the new number is relatively less negative, it can be claimed that the probability indeed increased – even if only slightly.

# 7. Conclusion

The purpose of the thesis was to address the relationship between the level of CSR engagement and tax haven use in the context of the CEE region. To analyze this relationship, we formulated three principal hypotheses. Our first hypothesis is focused on the fact that we conduct the analysis for the Central and Eastern Europe. We suppose that, since the trend of CSR is not that widespread in our area of interest as compared to the Western world, it can be the case that no perceptible relationship between CSR and tax have use has emerged so far. In the second hypotheses, we suggest a potential negative relationship between a firm´s CSR score and their tax haven user status. In other words, we speculate that firms with higher CSR ratings generally tend to refrain from taking advantage of tax haven services. This scenario would be in line with the corporate culture theory. In practice, it would imply that CSR is a reflection of company´s shared beliefs rather than a tool for reputation enhancement. In the opposite case, that is to say, if relationship between a firm´s CSR performance and their tax haven user status was positive, the evidence would be in accordance with the risk management theory. In such scenario, firms with higher CSR ratings would have a higher tendency to use tax haven services. It would imply that firm´s CSR engagement reflects an effort to build public image which might serve as a form of insurance against reputational (and subsequent financial) loss in case a negative corporate event, such as a tax avoidance scandal, comes to light. In our third hypothesis, we propose that the probability of a firm with links to tax havens being socially responsible may increase after accounting for the links to the UK and the US, due to the potential influence of relatively more intense CSR culture in the Western world.

Our first hypothesis has not been supported by the evidence, since the relationship between the level of CSR engagement and tax haven use proved to be significant on the 10% level. As it appears, the extent to which CSR is spread in the CEE region is therefore sufficient for some form of relationship between CSR scores and tax haven use to emerge. On the other hand, we found evidence supporting the second hypothesis. Our results suggest that being a tax haven user is associated with 62% or 66% (if including UK and US in the list of tax havens or not, respectively) decrease in probability of being more socially responsible. It can be claimed that this effect is quite pronounced. This finding suggests that the firms in the Central and Eastern Europe use CSR as a tool to pursue their overall agenda rather than for mere reputational purposes. Based on our findings, we may draw a conclusion that firms´ CSR efforts and their tax avoidance practices are in congruence. In other words, it seems that more socially

responsible firms in the CEE region also avoid using tax haven services. Therefore, we may affirm that CSR is generally not used as a hedge against the risk stemming from tax avoidance scandal and the related public backlash. As for our third hypothesis, it is supported by the evidence since after the inclusion of the UK and the US in the list of tax havens, the probability of a tax haven using firm being socially responsible did increase.

The main limitation of the study lies in the limited data coverage. As CSR reporting is relatively less common in the Central and Eastern Europe, the number of corporations for which we managed to collect CSR performance data was also fairly limited. Likewise, the information on a firm´s subsidiaries, which was crucial to identifying tax haven using firms, was not available retrospectively. That is to say, we could only obtain information on a firm´s current subsidiaries and thus were able to only perform the analysis in a single point of time.

From the above-stated issues, we draw the suggestions for future research. As the number of CSR reporting firms grows, the research might as well become more extensive with a greater quantity of observations. This might happen over time with growing awareness of the CSR concerns. Similarly, with the possibility of obtaining historical data on corporate ownership structure and their individual subsidiaries, performing a time-series analysis might bring interesting results. For instance, it may be intriguing to observe time trends in the link between CSR scores and tax haven use. Specifically, a research design focused on examining the change in CSR engagement after establishing an offshore affiliate could be an interesting possibility.

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# Appendix

**Table 9: Results of the Brant test (excluding UK and US)**

| Test for | X2 | df | probability |
|---|---|---|---|
| Omnibus | 3.01 | 5 | 0.7 |
| haven_user | 0 | 1 | 0.98 |
| firm_size_log | 0.09 | 1 | 0.76 |
| cash | 2.54 | 1 | 0.11 |
| leverage | 0.03 | 1 | 0.87 |
| return_on_assets | 0.01 | 1 | 0.92 |

*Source: Author´s computations*

$H_0$: Parallel Regression Assumption holds

**Table 10: Results of the Brant test (including UK and US)**

| Test for | X2 | df | probability |
|---|---|---|---|
| Omnibus | 3.71 | 5 | 0.59 |
| haven_user | 0.46 | 1 | 0.5 |
| firm_size_log | 0.01 | 1 | 0.91 |
| cash | 2.57 | 1 | 0.11 |
| leverage | 0.01 | 1 | 0.91 |
| return_on_assets | 0.02 | 1 | 0.88 |

*Source: Author´s computations*

$H_0$: Parallel Regression Assumption holds