Social Trust, Big-4 Auditors, and Tax Evasion:
Evidence from Contemporary China

Brian M. LAM
BNU-HKBU United International College
brianmolam@uic.edu.cn

Morris Ming LIU*
University of Macau
morrisliu@um.edu.mo

Gladie LUI
ESCP Business School
glui@escp.eu

Ding Xuan ZHOU
University of Sydney
dingxuan.zhou@sydney.edu.au

* corresponding author

Social Trust, Big-4 Auditors, and Tax Evasion:
Evidence from Contemporary China

ABSTRACT: Firms pay taxes to appear socially responsible, but managers may evade taxes if it maximizes firm value. This study examines the link between social trust and corporate tax evasion in China, particularly focusing on firms audited by Big-4 vs. non-Big-4 auditors. Findings indicate that higher regional social trust reduces tax evasion, yet paradoxically, Big-4-audited firms in high trust areas are more prone to evasion. To combat significant revenue losses from corporate tax evasion, Chinese tax authorities should employ forensic accountants to detect such practices.

Keywords: tax evasion; social trust; Big-4 auditors.

I. INTRODUCTION

Why do firms engage in tax evasion activities? Tax evasion refers to the situation in which taxpayers still obtain illegal income through various illegal means when they know that they should pay. The most likely reason is to reduce tax payments and increase after-tax earnings. However, why do some companies practice tax evasion but others do not? Researchers (e.g., Davis, Guenther, Krull, and Williams 2013; Watson 2011) have found evidence that firms pay their fair share of taxes because they want to be perceived as good corporate citizens. However, managers might be tempted to practice tax evasion because it leads to higher earnings. However, there are risk costs associated with tax evasion. Before managers decide to engage in tax evasion activities, they must weigh expected benefits against expected costs. The costs would at some point outweigh the benefits. Managers will not engage in tax evasion activities unless such activities are value-maximizing and well-hidden.

Penalty costs are often considered an important factor that deters corporate tax evasion activities. Hanlon and Slemrod (2009) examine stock price responses for companies accused of engaging in tax evasion. They find that those firms' stock prices decline following public revelation about their use of tax evasion. However, other studies have found contradictory results. Gallemore, Maydew, and Thornock (2014) find that although the immediate stock price response is negative around the revelation of firms' use of tax evasion, stock prices bounce back to their pre-revelation levels in the days that follow. On January 5, 2021, the Ministry of Finance of India issued a fine to Xiaomi Technology India for tax evasion between April 2017 and June 2020. The penalty amounted to Rs 6.53 crore, or about US $88 crore, for import taxes related to royalties. The news sent Xiaomi's share price down 3.45 percent on the day, knocking HK $14.5 billion off its market value. However, Xiaomi India's share price returned to its pre-disclosure level over the next three days. In addition, those firms do not face increased scrutiny from Internal Revenue Service (IRS), suggesting that they do not suffer significant reputational costs. Similarly, Blaufus, Mohlmann, and Schwabe (2019) find that news of corporate tax evasion does not have any effect on stock prices. Since the findings of these studies are contradictory, there is no conclusive evidence that reputational costs act as a deterrent in corporate tax evasion.

Tax evasion has a significant effect on economies. The Tax Justice Network estimates that governments lose $199 billion a year from $21 to $32 trillion in offshore private wealth accounts, while the International Monetary Fund estimates that global tax evasion is about $12 trillion a year. A 2007 survey conducted by the National Bureau of Statistics claimed that almost two-thirds of foreign firms in China that incurred losses had deliberately made false reports and used transfer pricing to avoid paying approximately RMB30 billion (USD4.39 billion) in corporate taxes (*Global Times* 2009). To deter tax evasion, in August 2017, China introduced the Opinions of The General Office of the State Council on improving the

supervisory system and mechanism of anti-money laundering, anti-terrorist Financing and anti-tax evasion. This proposal discusses the interaction situation of anti-money laundering and anti-tax evasion in identity recognition, monitoring early warning and coordination mechanisms, and puts forward policy suggestions to further improve the integration of anti-money laundering and anti-tax evasion mechanisms in China. The opinions seem to be effective since there was a reduction in tax evasion following its implementation (Leung et al. 2019). In the U.K., to campaign against tax avoidance and evasion, U.K.'s tax authority Her Majesty's Revenue and Customs (HMRC) set up hundreds of task forces in the past decade to target undeclared earnings. The task forces brought together different HMRC compliance and enforcement teams to conduct intensive forensic activity and have proven effective, with more than £2 billion brought in since 2011 (Agyemang 2020).

The Luckin Coffee scandal is a good example of forensic accounting at work. Luckin Coffee is a Chinese start-up that aims to displace Starbucks in China. With the U.S. stock market soared in 2019, shares in Luckin Coffee reached a record high in January 2020. However, questions over its accounting surfaced when an anonymous report was made public. The report stated that an anonymous research group had a team of more than 1,500 people monitoring the number of customers going to some of its outlets and found that the company overstated its business. Luckin denied the allegations at the time. However, in May 2020, the CEO and seven other employees were terminated after an internal investigation had uncovered hundreds of millions of dollars' worth of sham transactions. Although the Luckin case might be the opposite of tax avoidance (higher revenue means higher tax, not lower), it shows that corporations cannot hide behind their numbers. Through their investigative work, forensic accountants will uncover any manipulation of financial statements.

HM Revenue & Customs had conservatively estimated a £36bn tax gap in 2014-15, excluding controversial multinational tax payments, with the difference between what is

payable and what is actually received accounting for 6.5 percent of the tax actually collected; As one of the countries with a relatively high success rate of income tax collection in the world, Australia loses 8.7 billion Australian dollars in income tax revenue every year. The National Research Plan had projected a net tax revenue deficit of $406 billion in 2016, equivalent to 2.20% of GDP. According to the statistics of (the 2016 China Tax Inspection Yearbook), the amount of tax checked and repaired in 2015 was 191.6 billion yuan, accounting for 1.7 percent of the annual tax revenue. From the above data, we can see that most countries in the world, including China, have serious problems of tax evasion.

At its core, society is based on trust. A society without trust will incur a tremendous amount of social cost, an example of which is agency cost. If managers are trustworthy, they act for the benefit of shareholders and societies. Consequently, there will be a reduction in monitoring costs incurred by shareholders and regulatory authorities. In recent years, researchers have shown more interest in the impact of social trust on corporate tax evasion. Pickhardt and Prinz (2014) believe that the relationship between taxpayers and the government is dominated by three aspects: coercivity (probability of examination and penalty rate for tax evasion), service (information and help provided to taxpayers), and trust level (for the government, trust refers to the taxpayer's honesty in paying taxes; The government is fair to the taxpayer). In a broad sense, the level of service and trust can be combined as "trust" that will lead to voluntary compliance by the taxpayer. Feld and Frey (2007) regarded the relationship between taxpayers and the government as a "psychological contract" relationship and used the survey data provided by 26 Swiss state governments to show that the greater the political participation of taxpayers, the higher their willingness to pay taxes. This also suggests that if taxpayers trust the authorities, they are more likely to pay taxes than avoid them. Another U.S. study by Boone, Khurana, and Raman (2013) investigates the relation between tax avoidance and the religiosity of the county where a firm’s headquarter is located.

The results of these studies revealed that firms with headquarters in counties that have higher levels of social capital or that are more religious are less likely to avoid taxes.

This paper focuses on the relation between social trust and the practice of corporate tax evasion in firms in China during the period from 2012 to 2021. It investigates whether firms with headquarters in societies with a higher level of social trust are less likely to engage in tax evasion activities. This paper also investigates whether this negative relation is more pronounced for firms in industries that are less competitive. Financial data for all listed Chinese firms is obtained from the China Stock Market and Accounting Research (CSMAR) database, and the firms' tax preference status is obtained from the *Wind* database. A regression model is applied to tax evasion (*TaxEvasion*). Independent variables in the models are *Trust* and control variables. The results show that firms located in provinces with higher social trust engage less in tax-evasion activities. In addition, this study finds that this negative relation is more pronounced for firms in industries that are less competitive.

China is the second-largest economy in the world. Its economic significance is well recognized. It is chosen for this study because of its unique institutional environment, which is characterized by strong government control and involvement but poor protection of intellectual property rights, favorable treatment of state-owned enterprises (SOEs), ineffective law enforcement (inconsistent interpretations of the law), and questionable business ethics. Some features in China's tax environment are conducive to corporate tax evasion. For instance, China implemented two sets of income tax systems of domestic capital enterprise, and foreign capital enterprise. Because the two sets of tax systems are highly irregular, there are more ways for enterprises to avoid tax and loopholes for tax revenue loss, which increases the difficulty of tax collection and management, and is not conducive to strengthening tax collection and management and blocking revenue loss, and to attract foreign investment, China implemented tax holidays for certain businesses and provided

other incentives in specific areas. However, identifying all entities in a multinational group that are involved in tax evasion is a very complex endeavor. China might not have the capability to counter such tax avoidance and tax evasion. In addition, the numerous distinctive local dialects and cultures in China lead to very different local practices and levels of social trust. Different from developed countries, social trust in China is likely to be abused. China not only has the problem of unbalanced regional development but also serious social inequity caused by the difference between rich and poor in the same region, which will affect the public's perception of social trust. Together with the fact that China's public firms are all in one country, eliminating any country-level effect, China is an ideal candidate for this study.

This study makes several contributions to the literature. First, although there have been studies on social trust and tax avoidance, this study is the first to investigate the impact of social trust on tax evasion. Second, this study uses data obtained from surveys conducted by the Chinese General Social Survey (CGSS) to construct a measure of social trust. To the authors' knowledge, no other research has constructed a proxy for trust based on CGSS data. Third, this study employs a two-stage least square (2SLS) test to mitigate the concern of potential endogeneity. For the 2SLS test, an instrumental variable that is highly correlated to social trust but not directly to tax evasion is adopted. The instrumental variables adopted are the distance between a firm's location and the hometown of Confucius (Qufu in Jinan in Shandong Province) and ethnic homogeneity. Fourth, this study expands the current literature by focusing on firms in China. The findings add to the social trust literature by documenting that social trust does correlate to firms' tax-evasion practices. Fifth, this study contributes to the literature by demonstrating that noneconomic factors and cultural norms affect corporate tax practices. Social trust is identified in this study as a factor that can help explain variations in corporate tax evasion across provinces. The findings of this study imply that corporate tax strategy is impacted by culture and, more specifically, social trust. In other words, social trust

affects micro- and firm-level behavior. This finding complements the literature on how social trust affects various macro-level economic activities.

II. RELATED LITERATURE

Tax Evasion

Prior research has examined determinants of tax evasion in non-Chinese firms. At the present stage, the research on the causes of taxpayer tax evasion has been comprehensive, and the determinative factors can be corporate governance, corporate characteristics, tax issues including tax rate, examination rate, penalty intensity, individual characteristics of taxpayers, the relationship between taxpayers and the government, and the tax atmosphere of the whole society, etc.

Corporate governance issues are associated with corporate tax evasion practices. Corporate governance mechanisms include board independence and financial sophistication of the board (Armstrong, Blouin, Jagolinzer, and Larcker 2015; ownership structure (Chen, Chen, Cheng, and Shevlin 2010; McGuire, Omer, and Sharp 2012); Chief Executive Officers' (CEO) risk-taking equity incentives, compensation paid to Chief Financial Officers (CFO) and CEOs, annual bonuses, and tax director incentives (Armstrong et al. 2015; Gaertner 2014; Hanlon, Mills, and Slemrod 2007; Phillips 2003; Rego and Wilson 2012; Robinson, Sikes, and Weaver 2010); and level of ownership by institutional shareholders with a long-term horizon (Chen et al. 2010).

Firm characteristics are also correlated with a firm's participation in tax-evasion activities. These characteristics include corporate attributes such as profitability, intangible assets, research and development (R&D) spending, the extent of foreign operations, leverage, pretax income, and subsidiaries in foreign tax havens (Dyreng and Lindsey 2009; Joulfaian 2012; Lisowsky 2010; Wilson 2009); effect of individual executives' and managers'

characteristics (Dyreng, Hanlon, and Maydew 2010); corporate diversification (Zheng 2017); a firm's life cycle (Hasan, Al-Hadi, Taylor, and Richardson 2017); a firm's dividend imputation (McClure, Lanis, Wells, and Govendir 2018); customer–supplier relationship (Cen, Maydew, Zhang, and Zuo 2017); customer concentration (Huang, Lobo, Wang, and Xie 2016); corporate social responsibility (Hoi, Wu, and Zhang 2013); and quality of a firm's internal information environment (Gallemore and Labro 2015).

Allingham and Sandmo (1972) established the expected utility model (A-S model), analyzed the correlation of changes in tax rate, actual income, declaration amount, tax authority inspection rate, and penalty rate, studied the impact of different factors on tax evasion, and obtained A series of static results.

In addition, some tax issues have been found to affect whether a firm will engage in tax-evasion activities. These issues include whether a firm prepares its own tax returns, hires a nonauditor or has its own internal tax department, and the amount of tax paid (Klassen, Lisowsky, and Mescall 2016). a firm hires a tax expert from an external audit firm (McGuire, Omer, and Wang 2012); whether or not tax enforcement is strict (i.e., IRS audits) (Hanlon and Slemrod 2009; Hoopes, Mescall, and Pittman 2012; Wilson 2009); characteristics of information-sharing systems and financial sector outreach of the country where a firm is located (Beck, Lin, and Ma 2014); and characteristics of the home country tax system (Atwood, Drake, Myers, and Myers 2012).

The subjects in the aforementioned studies are all non-Chinese firms. Other recent studies include only firms in China. Based on the analysis of the A-S model, Liu and Chen (2004) used the cost-benefit comparison model to analyze the influence of tax rate, tax inspection probability, penalty rate, operating cost of tax evasion, psychological cost and social cost of tax evasion and other factors on tax evasion. Chow, Ke, Yuan, and Zhang (2022) investigate Chinese companies that are involved with tax evasion. They find that state-owned

enterprises (SOEs) are more likely to evade taxes than nonstate-owned enterprises (NSOEs). Bradshaw, Liao, and Ma (2016) find that tax rates paid by SOEs are higher than those paid by NSOEs, suggesting that SOEs are less involved in tax evasion. The results are more pronounced for local SOEs than for central SOEs and in the year when SOE managers are evaluated for their performance. Yang (2009) believes that voluntary tax compliance is positively correlated with taxpayers' trust in government integrity and economic level. Richardson, Wang, and Zhang (2016) examine the relation between ownership structure and tax compliance in publicly listed private firms in China. One of the characteristics of publicly listed private firms in China is the dominance of one primary owner who also participates in firm management. Richardson et al. find that at a lower ownership concentration level, any increased ownership concentration leads to more tax evasion. However, beyond the minimum level necessary for effective control, a concentrated ownership structure leads to less tax evasion.

Social Trust

Social trust can be defined as "generalized trust that is equal to a subjective belief about the likelihood that a potential trading partner will act honestly" (Xia et al. 2017, p. 375). It is a deep-seated indicator of the health of societies and economies (Halpern 2015). Social trust is essential to a cohesive society (Reid 2011) and plays a pervasive role in social affairs (Cook 2001). Welch et al. (2001) explore the concept of trust, particularly its relation to social capital, and how trust is conceived from diverse social scientific perspectives. They argue that social capital is a byproduct of trust. Putnam (2000) suggests that social trust benefits individuals, communities, workplaces, institutions, and even nations.

Various other authors have studied social trust and have found that social trust is determined by many different factors. Knight (2001) finds that the greater the level of social diversity within a society, the lower the level of trust. Similarly, the higher the level of ethnic

diversity within a community, the lower the level of trust (Rice and Steele 2001), and the greater the similarity between an individual and another on specific attributes, the more likely the individual is to trust the other (Nee and Sanders 2001). It is more likely that an individual will trust another person or it is easier for that individual to trust another if that individual is more likely to take risks (Hardin 2001), has a higher level of social intelligence (Yamagashi 2001), is more familiar with the other (Macy and Skvoretz 1998), joins a greater number of civic organizations (Stolle 2001), interacts more repetitively with the other (Sorrentino, Hanna, Holmes, and Sharp 1995), or is more certain or confident about the other (Kee and Knox 1970). In addition, Molm et al. (1999) find that the more exchanges there are between individuals who are not explicitly contract-based, the more likely they are to trust each other, and the more an individual can adopt a long-range perspective, the more likely he/she is to trust the other person in an exchange relationship. However, Putnam (2000) finds that it is easier for individuals to develop trust in small-scale social organizations such as families and small communities. However, if an individual believes his/her trust will be betrayed, he/she will become more distrustful (Deutsch 1958).

One instrument available for measuring social trust can be found in the Chinese College Student Survey (CCSS), which includes questions that measure standard generalized trust, trust with respect to the property or finances of others, and willingness to interact with strangers. Li, Lien, and Peng (2014) analyze the CCSS to examine students' levels of trust when they are in their final year of study at universities in China. They find that students in different provinces in China vary significantly in terms of their trust scores on the three indicators covered in the CCSS. Even within a province, trust scores on the three indicators differ. On the one hand, the study reveals that coastal and northern provinces display the highest trust regarding respect for property and finances of others but relatively low trust regarding willingness to interact with strangers. Inland provinces, on the other hand, display

significantly higher trust regarding the willingness to interact with strangers than coastal provinces. However, generalized trust does not seem to differ among the different provinces.

III. HYPOTHESES DEVELOPMENT

Social Trust and Tax Evasion

Social environments affect individual beliefs and behavior. Hasan et al. (2017) examine whether social capital affects corporate decisions regarding taxes. The authors present two opposite scenarios. Decision makers in a firm are vulnerable to the influences of social peers and the people they associate with. Since it is widely believed that all individuals and corporations have a civic duty to pay taxes, tax evasion is regarded as divergent from the legal requirement and the civic norm. Decision makers try to refrain from tax evasion to conform to the expectations of their social peers. Therefore, one would expect a negative relation between social capital and tax evasion. On the other hand, some constituents in the corporate sector want to reduce a firm's tax burden. To them, any practice that leads to tax minimization is acceptable. If decision makers are influenced by these corporate peers, they engage in tax-evasion activities. At the same time, the higher the corporate power of the actual controller of the company, the more inhibited the social capital of the actual controller of the company and the lower the degree of corporate tax evasion. The higher the corporate power, the more likely it is to maximize the interests of shareholders and corporate value, that is, the social capital of the actual controller of the company is more likely to become the means and tools for the actual controller to benefit the company. Hasan et al. find that U.S. corporations' corporate tax evasion practices are negatively and significantly associated with the social capital levels of the counties in which the firms have their headquarters. They also find that firms that relocate to counties with higher social capital display significantly lower changes in tax evasion over time after relocation than firms that relocate to counties with

lower social capital. As any economic organization or individual has certain "social relations" and "social connections" to the outside world, social capital, as an informal system, can also have a wide and profound impact on the behavior of enterprises. Social trust is the extension and mechanism of social capital.

In another study, Lam et al. (2020) examine the impact of social trust on corporate tax compliance. Using firms in China for their study, they find that there are variations in social trust among different provinces and that areas with high trust have a strong integrity and moral atmosphere. Under the influence of high trust and pressure from social groups, managers show a lower tendency toward tax evasion.

In the experiments of Wahl, Kastlunger, and Kirchler (2010), they found that trust has different effects on voluntary and compulsory tax payment: for voluntary tax payment, trust increases tax compliance. However, the trust-building effort of authorities is assumed to have a diminishing marginal return on voluntary compliance. As for compulsory tax payment, the higher the trust in the government, the lower the compulsory tax compliance, again with a diminishing marginal return. And in the study of Kogler et al. (2013), they found that social trust can reduce the level of information asymmetry, increase the degree of information openness, effectively limit the economic behaviors of social members, enhance the voluntary compliance of members, form "normative constraints", and thus reduce the level of tax evasion.

From the above arguments, we put forward the first hypothesis as follows:

H1: Firms that have their headquarters in provinces with high social trust engage less in tax evasion practices.

Moderating Effect of Big-4 Auditors

The auditing industry is bifurcated into two distinct sectors: the large, globally recognized firms (often referred to as Big-4) and their smaller domestic counterparts. The distinguishing feature of these international giants lies in their ability to deliver superior audit services across a worldwide network, ensuring consistent quality through standardized controls and procedures. With access to advanced audit technologies, extensive knowledge bases, deep comprehension of diverse accounting norms, and a wealth of experienced personnel, Big-4 firms are better equipped to scrutinize financial statements, thereby enhancing audit quality (Becker et al., 1998).

Despite this general perception, it remains uncertain if the correlation between client significance and auditor independence is more pronounced for Big-4 firms compared to others. Research indicates that Big-4 firms have substantial motivations to uphold their international reputation by acting independently with key clients. DeAngelo (1981), for instance, argues that larger auditors maintain high standards due to the severe consequences of audit failures on their extensive client portfolios.

Nevertheless, PwC China (2024) reports on its website that on September 13, 2024, the regulatory authority in China, the Ministry of Finance and the China Securities Regulatory Commission, released official sanctions concerning the audits conducted by PricewaterhouseCoopers Zhong Tian LLP, a part of the PwC network responsible for auditing services in mainland China, for their past client Hengda Real Estate Group Company Limited.

In light of the considerations from these non-consistent results on the qualities of audit services by Big-4 auditors, the null hypothesis H2 posits that in regions with high social trust, firms audited by Big-4 auditors are not more or less prone than those audited by non-Big-4 auditors to engage in tax evasion practices.

H2: Firms that have their headquarters in provinces with high social trust and have been audited by big-4 auditors do not engage more or less in tax evasion practices than those audited by non-big-4 auditors.

IV. DATA AND METHODOLOGY

Sample Selection

The period for this study is 2012 to 2021. Financial data for all listed Chinese firms for the study period are obtained from the China Stock Market and Accounting Research (CSMAR) database and the firms' tax preference status is obtained from the Wind database. As shown in Table 1, the initial sample contains 35,485 observations. Since the characteristics of firms in financial sectors differ from those of other manufacturing firms included in the CSMAR database, observations of financial firms are excluded. Observations with missing required values are also excluded from this study. The final sample contains 29,696 observations. Effective tax rates are then winsorized at 0 and 1, and other continuous variables are winsorized at 1 and 99 percent.

Insert Table 1

Empirical Model

To test the hypothesis, we construct an empirical model. The dependent variable is tax evasion and the independent variable of interest is social trust. Control variables come from prior tax research, such as Bradshaw et al. (2016) and Lam et al. (2020).

Following Lam et al. (2020), we construct social trust (Trust) using data obtained from the surveys conducted by the Chinese General Social Survey (CGSS) in 2012, 2013, and 2015. The 2015 survey results were first released online by the Chinese National Survey

Data Archive (CNSDA) on January 1, 2018. Trust is constructed from the principal component analysis based on responses to four of the questions presented in the surveys:

1. Generally speaking, would you say that most people can be trusted?

2. Generally speaking, would you say that you need to be careful in dealing with people, otherwise they will try to take advantage of you?

3. Generally speaking, do you consider contemporary society to be fair?

4. Generally speaking, do you have a feeling of well-being in your daily life?

Tax evasion data comes from the manual collection on the CSMAR database. We code *TaxEvasion* to be one if there is tax evasion and zero otherwise.

Firm-level control variables include *SOE*, *ROA*, *Size*, *MB*, *Lev*, *CAPEX*, *NOL*, *M&A*, *EquOffer*, *CrossList*, *OwnConcen*, *MgmtOwn*, and *DualCEO* (see Appendix A for definitions of these variables). Provincial-level control variables include *TaxPreference* and *GDPGrow*. In addition to fixed effects of industry and year, we also include fixed effects of province, in which the firm is located, to control for potential omission of variables. The final tax evasion models are functions of trust and control variables as shown below:

TaxEvasion = f (*Trust*, firm-level Control Variables, Provincial-level Control Variables, Provincial Fixed Effects, Industry Fixed Effects, Year Fixed Effects).

We use Firth-type logistic regression in our empirical tests. Firth-type logistic regression has become a standard approach for the analysis of binary outcomes when samples are small (Puhr et al., 2017). Firth-type logistic regression is a kind of penalized logistic regression which reduces the bias in maximum likelihood estimates of coefficients (Puhr et al., 2017). Firth-type logistic regression is used for two main reasons. First, tax evasion is a small sample when we compare it with the whole sample of firm-year observations. Second, since we need to control for fixed effects of country, industry, and year, the perfect prediction will result in ordinary logistic regressions for including those fixed effects.

Endogeneity Issue

The authors of this study conjecture that social trust affects the corporate practice of tax evasion. However, the practice of tax evasion could also affect social trust. It is possible that if people in a society observe that most firms do not engage in tax evasion activities, they might generalize that the society as a whole is trustworthy. A two-stage least-squares (2SLS) regression is employed to address concerns about this potential endogeneity issue. An instrumental variable needs to be adopted in order to implement the 2SLS regression. This set of instrumental variables has to be highly correlated to social trust but not correlated directly to tax evasion.

Following Lam et al. (2020), we use the distance (*Dist*) between a firm and Qufu, the hometown of Confucius in Shandong Province, as a measure that fits these two criteria. As shown in Panel A of Table 3, the correlation coefficient between *Dist* and *Trust* is -0.529 and significant at the 1 percent level, indicating that the shorter the distance between a location and the birthplace of Confucius, the higher the levels of social trust in that location Confucius (551 B.C. to 479 B.C.) is the founder of Confucianism.

Meanwhile, we note that China is a country with ethnic diversity. We collect the ethnic proportion information for each province from China's population census conducted in year 2000. Prior research indicates that ethnic heterogeneity has a negative impact on social capital (Alesina and La Ferrara, 2000). As social trust is a core ingredient of social capital, it is expected that ethnic heterogeneity (ethnic homogeneity) social trust has a negative (positive) impact on social trust. We measure the ethnic homogeneity (*RaceHII*) by the Herfindahl-Hirschman Index of ethnicity as below.

$$RaceHHI = \sum R_{ij}^2$$

where R_{ij}^2 is the square of the percentage of the i-th province of the j-th race.

V. EMPIRICAL RESULTS

Primary Results

Descriptive statistics of the final sample are presented in Table 2. The mean, median, and standard deviation of *Trust* are 0.037, 0.043, and 0.155, respectively, whereas the mean, median, and standard deviation of *TaxEvasion* are 0.007, 0.000, and 0.084, respectively. Table 3 presents Pearson correlations among regression variables. The correlation between *Trust* and *TaxEvasion* is -0.020, which is significant at the 1 percent level before controlling for covariates.

Insert Table 2

Insert Table 3

Baseline Analysis

Hypothesis H1 predicts that firms located in provinces with high social trust are less likely to commit tax evasion than those located in provinces with low social trust. If firms in regions with high social trust engage less in tax-evading activities than those located in provinces with low social trust, the coefficient for *Trust* is expected to be negative. Regression results are presented in Table 4. *TaxEvasion* is the dependent variable. The results show that the coefficient for *Trust* is negative and significant. Thus, H1 cannot be rejected, suggesting that firms that have their headquarters in provinces with high social trust engage less in tax-evading activities than firms with their headquarters in provinces with low social trust.

Insert Table 4

Endogeneity Issue

To address a potential endogeneity issue, an instrumental variable approach is employed in the 2SLS method. In the first stage, Trust is regressed on the natural logarithm of the distance between a firm's location and Qufu, the hometown of Confucius (*Dist*), and all exogenous variables. Column (1) in Table 5 presents the results for the first stage of the 2SLS test. The coefficient for *Dist* is significant at the 1 percent level, indicating that the proximity of a firm's location to Qufu is positively associated with *Trust*.

We perform the endogeneity test on *SK* (Ho: *SK* is exogenous) and find that Durbin (score) $chi^2(1) = 0.657$ ($p = 0.42$) and Wu-Hausman $F = 0.656$ ($p = 0.42$), indicating that *SK* is exogenous. Meanwhile, we also performed the instrument weakness test (Ho: *SK* is weak) and find that the minimum eigenvalue statistic = 3811.22, which is higher than the 2SLS (LIML) Size of nominal 5% Wald test statistics of 19.93 (8.68), indicating that *SK* is not a weak instrument. Since we use two instrument variables for *SK* in the model, we conduct an over-identification test. Under the null hypothesis that the instruments are valid and correctly excluded from the investment function, the statistics of Sargan (score) $chi^2(1) = 0.901$ ($p = 0.343$) and Basmann $chi2(1) = 0.900$ ($p = 0.343$) show that insignificant p-values, we do not reject the null hypothesis and conclude that the instruments are valid.

In the second stage of the 2SLS test, *TaxEvasion* is regressed on the fitted value of social trust ($\widehat{Trust}$). Column (2) presents the results of the second stage of the 2SLS test. The coefficient for ($\widehat{Trust}$) is -1.491 (z-statistic = -2.73), and is statistically significant. The 2SLS test reveals that controlling for potential endogeneity produces results that are consistent with those in the baseline analysis.

Insert Table 5

The moderating effect of big-4 auditors

In Table 6, the coefficient of *Trust* is -1.374 (z-statistic = -2.73), which is consistent with Table 4. The coefficient of *Big4* is -1.966 (z-statistic = -2.30), showing that firms audited by a Big-4 auditor are in general less likely to engage in tax evasion than those firms audited by a non-Big-4 auditor are. The coefficient of *Trust*Big4* is 2.520 (z-statistic = 2.20) providing evidence that firms audited by a Big-4 auditor are more likely to engage in tax evasion when those firms are situated in high social trust regions.

Insert Table 6

Robustness Tests

Dichotomous Social Trust for Hypothesis 1

To mitigate the measurement error on social trust, we use a dichotomous social trust instead of the continuous one in the robustness test for hypothesis 1. In Table 7, we code the variable *TrustHigh* the value of one if it is greater than the median and zero otherwise. The coefficient of *TrustHigh* is -0.449 (z-statistic = -3.16), showing consistent results as those in the baseline analysis as shown in Table 5.

Insert Table 7

Dichotomous Social Trust for Hypothesis 2

To mitigate the concern of measurement error on social trust, we use a dichotomous social trust instead of the continuous one in the robustness test for hypothesis 2. In Table 8, we code the variable *TrustHigh* the value of one if it is greater than the median and zero otherwise. The coefficient of *TrustHigh*Big4* is 2.416 (z-statistic = 2.25), which is consistent with the results in the analysis shown in Table 6.

Insert Table 8

Support Vector Machine

Since the dependent variable of this study is a binary variable, we are able to use the support vector machine (SVM) method to perform a classification prediction. We divide the sample into two subsamples, the one with a period from 2012 to 2016 being used for training data and the one with a period from 2017 to 2021 being used for testing data. After performing the training and prediction, the prediction error is found to be 0.1%.

VI. CONCLUSIONS

Using firms in China, we investigate the relation between social trust and the corporate practice of tax evasion. Consistent results show that firms located in provinces with higher social trust levels engage less in tax-evading activities. The results have implications for regulators and educators. Since corporate tax evasion leads to significant loss of tax revenues, tax authorities in China should engage the services of forensic accountants to identify those corporations that practice tax evasion. Furthermore, China needs to provide more forensic accounting training for accountants and auditors. Educational institutions need to offer more forensic accounting courses to fill the gap between forensic accounting practices and education.

REFERENCES

Agyemang, E. 2020. HMRC task forces crank up battle against tax evaders. *Financial Times* (April 15). Available at: https://www.ft.com/content/f3ef684b-6f77-47cd-98cb-7a244abfab01

Alesina, A., & La Ferrara, E. 2000. Participation in heterogeneous communities. *The quarterly journal of economics*, *115*(3), 847-904.

Allingham, M. G., and Sandmo, A. 1972. Income tax evasion: A theoretical analysis. *Journal of public economics*, *1*(3-4), 323-338.

Armstrong, C. S., J. Blouin, A. D. Jagolinzer, and D. F. Larcker. 2015. Corporate governance, incentives, and tax avoidance. *Journal of Accounting and Economics* 60 (1): 1-17.

Atwood, T. J., M. S. Drake, J. N. Myers, and L. A. Myers. 2012. Home country tax system characteristics and corporate tax avoidance: International evidence. *The Accounting Review* 87 (6): 1831-1860.

Beck, T., C. Lin, and Y. Ma. 2014. Why do firms evade taxes? The role of information sharing and financial sector outreach. *The Journal of Finance* 69 (2): 763-817.

Becker, C.L., DeFond, M.L., Jiambalvo, J. and Subramanyam, K.R. (1998), "The effect of audit quality on earnings management", *Contemporary Accounting Research*, Vol.15 No.1, pp.1-24.

Blaufus, A., A. Mohlmann, and N. Schwabe. 2019. Stock price reactions to news about corporate tax avoidance and evasion. *Journal of Economic Psychology* 72: 278-292.

Boone, J.P., I.K. Khurana, and K.K. Raman. 2013. Religiosity and tax avoidance. *Journal of American Taxation Association* 35 (1): 53-84.

Bradshaw, M., G. Liao, and M. S. Ma. 2016. Ownership structure and tax avoidance: Evidence from agency costs of state ownership in China. Working paper, Boston College, Central University of Finance and Economics, and American University.

Cen, L., E. L. Maydew, L. Zhang, and L. Zuo. 2017. Customer-supplier relationships and corporate tax avoidance. *Journal of Financial Economics* 123 (2): 377-394.

Chen, S., X. Chen, Q. Cheng, and T. Shevlin. 2010. Are family firms more aggressive than non-family firms? *Journal of Financial Economics* 95: 41-64.

Chow, T., Ke, B., Yuan, H., and Zhang, Y. 2022. Government ownership and corporate tax evasion: evidence from China. *Available at SSRN 3160421*.

Cook, K. 2001. Trust in society. In *Trust in Society*. K. S. Cook (ed.). New York: Russell Sage Foundation.

Davis, A., D. Guenther, L. Krull, and B. Williams. 2013. Taxes and corporate accountability reporting: Is paying taxes viewed as socially responsible? Working paper, University of Oregon.

DeAngelo, L. E. (1981), "Auditor size and audit quality" *Journal of Accounting and Economics,* Vol.3 No.3, pp.183–199.

Deutsch, M. 1958. Trust and suspicion. *Journal of Conflict Resolution* 2 (4): 265-279.

Dyreng, S. D., M. Hanlon, and E. L. Maydew. 2010. The effects of executives on corporate tax avoidance. *The Accounting Review* 85 (4): 1163-1189.

Dyreng, S., and B. P. Lindsey. 2009. Using financial accounting data to examine the effect of foreign operations located in tax havens and other countries on US multinational firms' tax rates. *Journal of Accounting Research* 47 (5): 1283-1316.

Feld, L. P., and Frey, B. S. 2007. Tax compliance as the result of a psychological tax contract: The role of incentives and responsive regulation. *Law & Policy*, *29*(1), 102-120.

Gaertner, F. B. 2014. CEO after-tax compensation incentives and corporate tax avoidance. *Contemporary Accounting Research* 31 (4): 1077-1102.

Gallemore, J., and E. Labro. 2015. The importance of the internal information environment for tax avoidance. *Journal of Accounting and Economics* 60 (1): 149-167.

Gallemore, J., E. L. Maydew, and J. R. Thornock. 2014. The reputational costs of tax avoidance. *Contemporary Accounting Research* 31 (4): 1103-1133.

Global Times. 2009. SAT steps up watch on transfer pricing by multinationals. (July 31). Available at: http://www.globaltimes.cn/business/china-economy/2009-07/453131.html

Halpern, D. 2015. Social trust is one of the most important measures that most people have never heard of – and it's moving. https://www.behaviouralinsights.co.uk/uncategorized/social-trust-is-one-of-the-most-important-measures-that-most-people-have-never-heard-of-and-its-moving

Hanlon, M., L. Mills, and J. Slemrod. 2007. An empirical examination of corporate noncompliance. In *Taxing Corporate Income in the 21st Century*, edited by A. J. Auerbach, J. R. Hines, Jr., and J. Slemrod, Chapter 5, 171-210. Cambridge, U.K.: Cambridge University Press.

Hanlon, M., and J. Slemrod. 2009. What does tax aggressiveness signal? Evidence from stock price reactions to news about tax shelter involvement. *Journal of Public Economics* 93 (1-2): 126-141.

Hardin, R. 2001. Conceptions and explanations of trust. In K. S. Cook (Series ed. and Vol. ed.), *Trust in Society*, Vol. 2. The Russell Sage Foundation Series on Trust (1st ed., pp. 3-39). New York: Russell Sage Foundation.

Hasan, I., C. K. S. Hoi, Q. Wu, and H. Zhang. 2017. Does social capital matter in corporate decision? Evidence from corporate tax avoidance. *Journal of Accounting Research* 55 (3): 629-668.

Hasan, M. M., A. Al-Hadi, G. Taylor, and G. Richardson. 2017. Does a firm's life cycle explain its propensity to engage in corporate tax avoidance? *European Accounting Review* 26 (3): 469-501.

Hoi, C. K., Q. Wu, and H. Zhang. 2013. Is corporate social responsibility (CSR) associated with tax avoidance? Evidence from irresponsible CSR activities. *The Accounting Review* 88 (6): 2025-2059.

Hoopes, J., D. Mescall, and J. Pittman. 2012. Do IRS audits deter corporate tax avoidance? *The Accounting Review* 87 (5): 1603-1639.

Huang, H. H., G. J. Lobo, C. Wang, and H. Xie. 2016. Customer concentration and corporate tax avoidance. *Journal of Banking and Finance* 72: 184-200.

Joulfaian, D. 2012. Debt and corporate tax evasion. Working Paper. Office of Tax Analysis, U.S. Department of Treasury.

Kee, H. W., and R. E. Knox. 1970. Conceptual and methodological considerations in the study of trust and suspicion. *Journal of Conflict Resolution* 14 (3): 357-366.

Klassen, K. J., P. Lisowsky, and D. Mescall. 2016. The role of auditors, non-auditors, and internal tax departments in corporate tax aggressiveness. *The Accounting Review* 91 (1): 179-205.

Knight, J. 2001. Social norms and the rule of law: Fostering trust in a socially diverse society. In K. S. Cook (Series ed. and Vol. ed.), *Trust in Society*, Vol. 2. The Russell Sage Foundation Series on Trust (1st ed., pp. 354-373). New York: Russell Sage Foundation.

Kogler, C., Batrancea, L., Nichita, A., Pantya, J., Belianin, A., and Kirchler, E. 2013. Trust and power as determinants of tax compliance: Testing the assumptions of the slippery slope framework in Austria, Hungary, Romania and Russia. *Journal of Economic Psychology*, *34*, 169-180.

Lam, B. M., Lui, G. M., and C. Shum. 2020. Social Trust, Market Competition, and Tax Avoidance: Evidence from Contemporary China. *Journal of Forensic Accounting Research*, *5*(1), 94-122.

Leung, S.C.M., G. Richardson, and G. Taylor. 2019. The Effect of the General Anti-Avoidance Rule on Corporate Tax Avoidance in China. *Journal of Contemporary Accounting and Economics* 15 (1): 105-117.

Li, H., J. W. Lien, and Q. Peng. 2014. Trust by region: Attitudes and China's millennial generation. Working Paper.

Lisowsky, P. 2010. Seeking shelter: Empirically modeling tax shelters using financial statement information. *The Accounting Review* 85 (5): 1693-1720.

Liu, F. and P. L. Liu. 2004. Theoretical analysis of tax evasion and its influencing factors. *Journal of Wuhan University of Technology* 2004 (2):8487. In Chinese.

Macy, M. W., and J. Skvoretz. 1998. The evolution of trust and cooperation between strangers: A computational model. *American Sociological Review* 63 (5): 638-660.

McClure, R., R. Lanis, P. Wells, and B. Govendir. 2018. The impact of dividend imputation on corporate tax avoidance: The case of shareholder value. *Journal of Corporate Finance* 48: 492-514.

McGuire, S., T. Omer, and N. Sharp. 2012. The impact of religion on financial reporting irregularities. *The Accounting Review* 87 (2): 645-673.

McGuire, S. T., T. C. Omer, and D. Wang. 2012. Tax avoidance: Does tax-specific industry expertise make a difference? *The Accounting Review* 87 (3): 975-1003.

Molm, L., G. Peterson, and N. Takahashi. 1999. Power in negotiated and reciprocal exchange. *American Sociological Review* 64 (6): 876-890.

Nee, V., and J. Sanders. 2001. Trust in ethnic ties: Social capital and immigrants. In K.S. Cook (Series ed. and Vol. ed.), *Trust in Society*, Vol. 2. The Russell Sage Foundation Series on Trust (1st ed., pp. 374-394). New York: Russell Sage Foundation.

Phillips, J. 2003. Corporate tax planning effectiveness: The role of compensation-based incentives. *The Accounting Review* 78 (3): 847-874.

Pickhardt, M., & Prinz, A. 2014. Behavioral dynamics of tax evasion–A survey. *Journal of Economic Psychology*, *40*, 1-19.

Puhr, R., Heinze, G., Nold, M., Lusa, L., and Geroldinger, A. 2017. Firth's logistic regression with rare events: accurate effect estimates and predictions?. *Statistics in medicine*, *36*(14), 2302-2317.

Putnam, R. 2000. *Bowling Alone: The Collapse and Revival of American Community*. New York: Simon and Schuster.

PwC China. 2024. Statement from PwC China and PricewaterhouseCoopers Zhong Tian LLP. https://www.pwccn.com/en/press-room/press-releases/pr-130924.html. Retrieved on November 17, 2024.

Rego, S. O., and R. Wilson. 2012. Equity risk incentives and corporate tax aggressiveness. *Journal of Accounting Research* 50 (3): 775-809.

Reid, B. 2011. *The Importance of Social Trust*. New York: Russel Stage Foundation. Available at: https://www.huffingtonpost.com/brad-reid/the-importance-of-social-_b_889538.html

Rice, T. W., and B. Steele. 2001. White ethnic diversity and community attachment in small Iowa towns. *Social Science Quarterly* 82 (2): 397-407.

Richardson, G., B. Wang, and X. Zhang. 2016. Ownership structure and corporate tax avoidance: Evidence from publicly listed private firms in China. *Journal of Contemporary Accounting & Economics* 12 (2): 141-158.

Robinson, J. R., S. A. Sikes, and C. D. Weaver. 2010. Performance measurement of corporate tax departments. *The Accounting Review* 85 (3): 1035-1064.

Sorrentino. R. M., S. E. Hanna, J. G. Holmes, and A. Sharp. 1995. Uncertainty orientation and trust in close relationships: Individual differences in cognitive Styles. *Journal of Personality and Social Psychology* 68 (2): 314-327.

Stolle, D. 2001. Clubs and congregations: The benefits of joining an association. In K.S. Cook (Series ed. and Vol. ed.), *Trust in Society*, Vol. 2. The Russell Sage Foundation Series on Trust (1st ed., pp. 374-394). New York: Russell Sage Foundation.

Wahl, I., Kastlunger, B., and Kirchler, E. 2010. Trust in authorities and power to enforce tax compliance: An empirical analysis of the "slippery slope framework". *Law & Policy*, *32*(4), 383-406.

Watson, L. 2011. Corporate social responsibility and tax aggressiveness: An examination of unrecognized tax benefits. Working Paper, Pennsylvania State University.

Welch, M. R., R. E. N. Rivera, B. P. Conway, J. Yonkoski, P. M. Lupton, and R. Giancola. 2001. Determinants and consequences of social trust. Available at: http://www.blackwell-synergy.com/toc/soin/75/4

Wilson, R. 2009. An examination of corporate tax shelter participants. *The Accounting Review* 84 (3): 969-999.

Xia, C., C. Cao, and K. C. Chan. 2017. Social trust environment and firm tax avoidance: Evidence from China. *North American Journal of Economics and Finance* 42: 374-392.

Yamagashi, T. 2001. Trust as a form of social intelligence. In K.S. Cook (Series ed. and Vol. ed.), *Trust in Society*, Vol. 2. The Russell Sage Foundation Series on Trust (1st ed., pp. 121-147). New York: Russell Sage Foundation.

Yang, D. Q. 2009. An empirical analysis of the influencing factors of voluntary tax compliance. *Tax Research* 2009 (10):7477. In Chinese.

Zheng, S. 2017. Can corporate diversification induce more tax avoidance? *Journal of Multinational Financial Management* 41: 47-60.

Table 1: Sample Selection

	No. of Firm-year Observations
Observations from 2012 to 2021	35,485
Less: Observations associated with financial institutions and utility companies	(979)
Less: Observations with missing control variables	(4,810)
Final sample	29,696

Table 2: Summary Statistics

	Mean	Std	Min	Q1	Median	Q3	Max
TaxEvasion	0.007	0.084	0.000	0.000	0.000	0.000	1.000
Trust	0.037	0.155	-0.281	-0.019	0.043	0.138	0.606
Dist	6.585	0.580	4.792	6.197	6.484	7.135	7.889
RaceHHI	0.079	0.129	0.006	0.014	0.030	0.084	0.624
SOE	0.166	0.372	0.000	0.000	0.000	0.000	1.000
Size	22.208	1.309	19.129	21.290	22.040	22.948	26.496
ROA	0.049	0.088	-0.385	0.013	0.044	0.086	0.423
MB	0.002	0.002	0.000	0.001	0.002	0.003	0.023
Lev	0.042	0.072	0.000	0.000	0.004	0.054	0.404
CAPEX	0.047	0.045	0.000	0.014	0.033	0.065	0.242
NOL	0.116	0.320	0.000	0.000	0.000	0.000	1.000
M&A	0.621	0.485	0.000	0.000	1.000	1.000	1.000
EquOffer	0.122	0.328	0.000	0.000	0.000	0.000	1.000
CrossList	0.027	0.162	0.000	0.000	0.000	0.000	1.000
OwnConcen	0.034	0.015	0.008	0.022	0.031	0.043	0.076
MgmtOwn	0.587	0.492	0.000	0.000	1.000	1.000	1.000
DualCEO	0.209	0.406	0.000	0.000	0.000	0.000	1.000
TaxPreference	0.133	0.340	0.000	0.000	0.000	0.000	1.000
GDPGrow	0.075	0.055	-0.251	0.064	0.086	0.106	0.226

Notes: This table presents summary statistics for our sample for the period 2012-2021.

Table 3: Correlation

	TaxEvasion	*Trust*	*Dist*	*RaceHHI*	*SOE*	*Size*	*ROA*	*MB*	*Lev*	*CAPEX*
TaxEvasion	1.000									
Trust	-0.020***	1.000								
Dist	0.013**	-0.529***	1.000							
RaceHHI	0.007	0.054***	0.358***	1.000						
SOE	0.010*	0.034***	-0.018***	0.053***	1.000					
Size	-0.025***	0.036***	-0.062***	0.038***	0.180***	1.000				
ROA	-0.024***	0.006	-0.034***	-0.084***	0.017***	0.058***	1.000			
MB	0.014**	-0.051***	0.044***	-0.026***	-0.069***	-0.476***	0.224***	1.000		
Lev	-0.001	0.005	0.038***	0.106***	0.118***	0.406***	-0.117***	-0.269***	1.000	
CAPEX	0.009	-0.013**	0.032***	-0.034***	0.011*	-0.030***	0.156***	0.048***	0.103***	1.000
NOL	0.005	0.037***	0.036***	0.118***	0.023***	-0.130***	-0.269***	0.049***	0.025***	-0.133***
M&A	-0.005	-0.045***	0.022***	-0.039***	-0.066***	-0.050***	-0.004	0.106***	-0.049***	-0.006
EquOffer	0.028***	0.006	-0.008	0.000	0.298***	0.102***	0.104***	0.017***	0.030***	0.042***
CrossList	0.001	0.006	-0.048***	-0.018***	0.036***	0.300***	-0.014**	-0.103***	0.111***	0.005
OwnConcen	-0.012**	0.009	-0.018***	0.008	0.086***	0.209***	0.140***	-0.092***	0.080***	0.043***
MgmtOwn	-0.018***	-0.103***	0.046***	-0.105***	-0.118***	-0.182***	0.096***	0.134***	-0.154***	0.113***
DualCEO	-0.018***	0.016***	-0.019***	-0.045***	-0.017***	0.010*	0.006	-0.003	-0.015***	0.021***
TaxPreference	0.027***	-0.486***	0.336***	-0.125***	-0.023***	0.097***	-0.002	-0.003	0.033***	0.014**
GDPGrow	0.015**	0.009	0.026***	0.005	0.023***	-0.014**	0.027***	-0.002	0.002	0.031***

Table 3: Correlation (Continued)

	NOL	*M&A*	*EquOffer*	*CrossList*	*OwnConcen*	*MgmtOwn*	*DualCEO*	*TaxPreference*	*GDPGrow*
NOL	1.000								
M&A	0.017***	1.000							
EquOffer	-0.015**	0.066***	1.000						
CrossList	0.000	-0.052***	-0.016***	1.000					
OwnConcen	-0.134***	-0.177***	-0.044***	0.077***	1.000				
MgmtOwn	-0.118***	0.173***	0.050***	-0.103***	-0.208***	1.000			
DualCEO	-0.004	0.036***	0.017***	-0.010*	-0.046***	0.028***	1.000		
TaxPreference	-0.026***	0.016***	-0.008	0.424***	0.020***	0.075***	0.003	1.000	
GDPGrow	-0.011*	-0.026***	0.016***	-0.004	0.007	0.003	-0.007	-0.026***	1.000

Notes: *, **, and *** denote significance at the 10 percent, 5 percent, and 1 percent levels respectively.

Table 4: Baseline Model

	TaxEvasion	(z-statistic)
Trust	**-1.416**	**(-2.87)*****
SOE	0.215	(1.46)
Size	-0.017	(-0.16)
ROA	-4.174	(-2.68)***
MB	43.371	(1.37)
Lev	-0.597	(-0.47)
CAPEX	1.271	(0.76)
NOL	-0.165	(-0.39)
M&A	0.122	(0.62)
CrossList	-0.425	(-0.64)
OwnConcen	-14.213	(-2.32)**
MgmtOwn	-0.331	(-1.62)
DualCEO	-0.469	(-1.95)*
TaxPreference	0.654	(1.48)
GDPGrow	-0.079	(-0.06)
Constant	-15.288	(-6.56)***
Province FE	Yes	
Industry FE	Yes	
Year FE	Yes	
Observations	29696	
Prob > chi2	0.000	

Notes: This table presents the logistic regression results from testing the effect of social trust on tax evasion. The dependent variable is tax evasion. Refer to Appendix A for variable definitions. All continuous variables are winsorized at the 1 percent and 99 percent levels. *, **, and *** denote significance at the 10 percent, 5 percent, and 1 percent levels (two-tailed) respectively. The variables of interest are shown in bold. Estimates on country fixed effects (Country FE), industry fixed effects (Industry FE) and year fixed effects (Year FE) are not reported for brevity.

Table 5: 2SLS Model

	(1)		(2)	
	Trust	(t-statistic)	*TaxEvasion*	(z-statistic)
	1st stage		2nd stage	
Dist	**-0.124**	**(-15.61)*****		
Race	**0.202**	**(8.34)*****		
$\widehat{Trust}$			**-1.491**	**(-2.73)*****
SOE	0.000	(0.11)	0.215	(1.46)
Size	-0.003	(-1.73)*	-0.017	(-0.16)
ROA	0.039	(2.13)**	-4.167	(-2.68)***
MB	-2.360	(-3.05)***	43.154	(1.36)
Lev	0.027	(1.14)	-0.593	(-0.46)
CAPEX	0.017	(0.60)	1.274	(0.76)
NOL	0.010	(2.86)***	-0.163	(-0.39)
M&A	-0.005	(-3.24)***	0.121	(0.62)
CrossList	0.135	(8.26)***	-0.405	(-0.61)
OwnConcen	-0.082	(-0.68)	-14.238	(-2.32)**
MgmtOwn	-0.008	(-2.45)**	-0.333	(-1.63)
DualCEO	0.006	(2.05)**	-0.469	(-1.95)*
TaxPreference	-0.163	(-11.96)***	0.629	(1.43)
GDPGrow	0.067	(0.28)	-0.037	(-0.03)
Constant	0.993	(15.29)***	-15.279	(-6.54)***
Province FE	No		Yes	
Industry FE	Yes		Yes	
Year FE	Yes		Yes	
Observations	29696		29696	
Adjusted R^2	0.447			
Prob > chi2			0.000	

Notes: This table presents the 2SLS regression results from testing the effect of social trust on tax evasion. The dependent variable is tax evasion. Refer to Appendix A for variable definitions. All continuous variables are winsorized at the 1 percent and 99 percent levels. Standard errors for stage 1 regression are clustered by firm and year. *, **, and *** denote significance at the 10 percent, 5 percent, and 1 percent levels (two-tailed) respectively. The variables of interest are shown in bold. Estimates on country fixed effects (Country FE), industry fixed effects (Industry FE) and year fixed effects (Year FE) are not reported for brevity.

Table 6: The moderating effect of big-4 auditors

	TaxEvasion	
Trust	**-1.374**	**(-2.73)*** **
Big4	**-1.966**	**(-2.30)** **
Trust*Big4	**2.520**	**(2.20)** **
SOE	0.176	(1.15)
Size	0.046	(0.40)
ROA	-4.652	(-2.68)***
MB	53.281	(1.78)*
Lev	-1.068	(-0.82)
CAPEX	1.368	(0.82)
NOL	-0.213	(-0.48)
M&A	0.117	(0.64)
CrossList	0.101	(0.18)
OwnConcen	-13.897	(-2.23)**
MgmtOwn	-0.343	(-1.64)
DualCEO	-0.460	(-1.84)*
TaxPreference	0.659	(1.45)
GDPGrow	-0.693	(-0.55)
Constant	-16.567	(-6.62)***
Province FE	Yes	
Industry FE	Yes	
Year FE	Yes	
Observations	29696	
Pseudo R2	0.1261	

Notes: This table presents the logistic regression results from testing the effect of social trust and big-4 auditors on tax evasion. The dependent variable is tax evasion. Refer to Appendix A for variable definitions. All continuous variables are winsorized at the 1 percent and 99 percent levels. *, **, and *** denote significance at the 10 percent, 5 percent, and 1 percent levels (two-tailed) respectively. The variables of interest are shown in bold. Estimates on country fixed effects (Country FE), industry fixed effects (Industry FE) and year fixed effects (Year FE) are not reported for brevity.

Table 7: Dichotomous social trust

	TaxEvasion	(z-statistic)
TrustHigh	**-0.449**	**(-3.16)*****
SOE	0.214	(1.45)
Size	-0.017	(-0.15)
ROA	-4.188	(-2.68)***
MB	43.768	(1.37)
Lev	-0.594	(-0.47)
CAPEX	1.265	(0.76)
NOL	-0.166	(-0.40)
M&A	0.124	(0.64)
CrossList	-0.425	(-0.64)
OwnConcen	-14.213	(-2.31)**
MgmtOwn	-0.331	(-1.62)
DualCEO	-0.472	(-1.96)*
TaxPreference	0.654	(1.48)
GDPGrow	1.366	(1.06)
Constant	-16.646	(-7.54)***
Province FE	Yes	
Industry FE	Yes	
Year FE	Yes	
Observations	29696	
Prob > chi2	0.000	

Notes: This table presents the logistic regression results from testing the effect of dichotomous social trust on tax evasion. The dependent variable is tax evasion. Refer to Appendix A for variable definitions. All continuous variables are winsorized at the 1 percent and 99 percent levels. *, **, and *** denote significance at the 10 percent, 5 percent, and 1 percent levels (two-tailed) respectively. The variables of interest are shown in bold. Estimates on industry fixed effects (Industry FE) and year fixed effects (Year FE) are not reported for brevity.

Table 8: The moderating effect of big-4 auditors with dichotomous social trust

	TaxEvasion	
TrustHigh	**-0.445**	**(-3.13)*** **
Big4	**-1.973**	**(-2.31)** **
TrustHigh*Big4	**2.416**	**(2.25)** **
SOE	0.176	(1.15)
Size	0.047	(0.41)
ROA	-4.673	(-2.67)***
MB	53.632	(1.76)*
Lev	-1.073	(-0.83)
CAPEX	1.357	(0.81)
NOL	-0.214	(-0.48)
M&A	0.119	(0.65)
CrossList	0.104	(0.18)
OwnConcen	-13.912	(-2.22)**
MgmtOwn	-0.341	(-1.63)
DualCEO	-0.463	(-1.84)*
TaxPreference	0.659	(1.45)
GDPGrow	0.712	(0.56)
Constant	-17.928	(-7.64)***
Province FE	Yes	
Industry FE	Yes	
Year FE	Yes	
Observations	29696	
Pseudo R2	0.1266	

Notes: This table presents the logistic regression results from testing the effect of dichotomous social trust and big-4 auditors on tax evasion. The dependent variable is tax evasion. Refer to Appendix A for variable definitions. All continuous variables are winsorized at the 1 percent and 99 percent levels. *, **, and *** denote significance at the 10 percent, 5 percent, and 1 percent levels (two-tailed) respectively. The variables of interest are shown in bold. Estimates on country fixed effects (Country FE), industry fixed effects (Industry FE) and year fixed effects (Year FE) are not reported for brevity.

Appendix A: Definitions of Variables

Variable	Definition
TaxEvasion	An indicator variable that equals one if there is tax evasion and zero otherwise.
Trust	Using responses to survey questions, *Trust* is a measure constructed as the first factor in the Principal Component. The surveys were conducted by the Chinese General Social Survey (CGSS) in 2012, 2013, and 2015. The values for 2014 were interpolated from responses for 2012 and 2013, and the values for 2015 were extended to 2016.
Dist	Natural logarithm of the distance between a firm and Qufu (hometown of Confucius). It is calculated using the coordinates of the two locations in the geographic coordinate system.
RaceHHI	Herfindahl-Hirschman Index of race is calculated by summing the squares of individual race's percentage in a province. Ethnic proportion information for each province is based on China's population census conducted in year 2000.
$\widehat{Trust}$	The fitted value of *Trust* predicted from the first stage of the 2SLS test using instrument variables *Dist* and *RaceHHI*.
TrustHigh	An indicator variable with a value of one if social trust is greater than the median value; zero otherwise.
Big4	An indicator variable with a value of one if an auditor is a big-4 auditor; zero otherwise. Source: CSMAR database.
SOE	An indicator variable with a value of one if a firm is controlled by the state; zero otherwise. Source: CSMAR database.
ROA	Operating income divided by total assets at the end of the year. Source: CSMAR database.
Size	Firm size, measured by the natural logarithm of the year-end book value of total assets. Source: CSMAR database
MB	Market to book ratio, which is the sum of the year-end market value of equity divided by the year-end book value of equity. Source: CSMAR database.
Lev	Financial leverage, measured by year-end total debt divided by year-end total assets. Source: CSMAR database
CAPEX	Capital expenditure during a year divided by year-end total assets. Source: CSMAR database.
NOL	An indicator variable with a value of one if accumulated pre-tax earnings/losses reported in the prior five years are negative; zero otherwise. Source: CSMAR database.
M&A	An indicator variable with a value of one if a firm has merger and acquisition activities during the study period; zero otherwise. Source: CSMAR database.
EquOffer	An indicator variable with a value of one when there is seasonal equity offering; zero otherwise. Source: CSMAR database.
CrossList	An indicator variable with a value of one if a firm is cross-listed on other foreign stock markets; zero otherwise. Source: CSMAR database.
OwnConcen	Percentage of shareholding owned by the largest shareholder. Source: CSMAR database.
MgmtOwn	An indicator variable with a value of one if management holds shares of the

	firm; zero otherwise. Source: CSMAR database.
DualCEO	An indicator variable with a value of one if CEO and chairman of the board of directors is the same person; zero otherwise. Source: CSMAR database.
TaxPreference	An indicator variable with a value of one if a firm potentially enjoys a preferential tax rate; zero otherwise. Such a firm would be one of the following three types: 1) domiciled in special locations; 2) has foreign ownership; 3) is younger than three years. Sources: CSMAR database and Wind database.
GDPGrow	Provincial per-capita GDP growth rate. Source: CSMAR database.