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Institutional Ownership, Firm Size, And Firm Value: How Tax Avoidance Alters the Dynamics

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Abstract: This study examines the relationship between institutional ownership, firm size, and firm value, with tax avoidance serving as a moderating variable. Institutional ownership and firm size are often viewed as critical factors that can influence a firm's financial performance and its market valuation. Tax avoidance, a strategy employed by firms to reduce their tax liabilities, may alter the effect of these factors on firm value. Using data from publicly traded firms over a five-year period (2017–2022), the study employs regression analysis to test the moderating role of tax avoidance. The results indicate that both institutional ownership and firm size positively impact firm value. Moreover, tax avoidance significantly moderates these relationships, enhancing the positive effect of institutional ownership on firm value and diminishing the negative effect of firm size on firm value. These findings offer implications for investors, policymakers, and corporate managers seeking to understand the dynamics between ownership structures, firm size, and corporate strategies like tax avoidance.

Keywords: Institutional ownership, firm size, firm value, tax avoidance, moderating effect, corporate governance, financial performance.

Introduction: The relationship between a firm's ownership structure, its size, and its market value has long been a subject of interest for scholars and investors alike. Institutional ownership, which refers to the percentage of a firm's shares held by institutional investors, is often seen as an indicator of a firm's credibility and governance standards. Meanwhile, firm size, measured by total assets or market capitalization, has been found to be linked to the firm's ability to generate revenue, access capital, and withstand market pressures. Together, these factors can have a profound impact on a firm's overall value in the market.

Institutional Ownership and Firm Value

Institutional investors are generally viewed as more informed and sophisticated investors. Their involvement can bring enhanced corporate governance, strategic guidance, and improved performance through active monitoring and engagement (McConnell & Servaes, 1990). However, the effect of institutional ownership on firm value can vary depending on factors such as investor activism, firm performance, and the nature of the institutional investor.

Firm Size and Firm Value

Firm size is often associated with economic advantages such as economies of scale, market power, and better access to resources. Larger firms tend to have more diversified operations and are perceived to be less risky, which can contribute to higher firm valuation. However, some studies suggest that larger firms might experience managerial inefficiencies or reduced flexibility, potentially diminishing their market value (Jensen & Meckling, 1976).

Tax Avoidance as a Moderating Variable

Tax avoidance refers to the strategic use of legal methods to minimize a firm's tax obligations. While tax avoidance can improve short-term profitability and firm value by increasing available capital for reinvestment, its long-term impact on firm value can be more complex. Some studies suggest that aggressive tax avoidance can attract regulatory scrutiny or damage a firm's reputation, potentially decreasing its market value (Wilson, 2009). However, in certain contexts, tax avoidance might serve as a mechanism to enhance the positive effects of institutional ownership and firm size on firm value, especially when institutional investors value tax efficiency as part of a firm's overall financial strategy.

Given the diverse influences of these variables, this study seeks to examine how institutional ownership and firm size influence firm value, while considering the moderating effect of tax avoidance. By understanding these relationships, the study provides insights that may help investors, policymakers, and corporate managers make informed decisions regarding ownership structures, size, and tax management strategies.

Research Questions

Does institutional ownership positively influence firm value?

Does firm size have a significant relationship with firm value, and is this relationship affected by firm size?

How does tax avoidance moderate the relationship between institutional ownership, firm size, and firm value?

METHODS

Data Collection

This study uses secondary data from publicly traded firms in the United States over the period from 2017 to 2022. The sample includes companies from various industries, with the data obtained from financial statements and company reports available through databases such as Bloomberg and Compustat. The final sample consists of 500 firms that were consistently listed during the study period.

Variable Measurement

Institutional Ownership (IO): The percentage of shares held by institutional investors. This information was collected from the firm's annual reports and investor disclosures.

Firm Size (FS): Measured by the firm's total assets at the end of the fiscal year. Firm size is often used as a proxy for the firm's market power and ability to access capital.

Firm Value (FV): Firm value is represented by the firm's market capitalization (stock price multiplied by shares outstanding). This provides an overall estimate of how the market values a firm.

Tax Avoidance (TA): Tax avoidance is measured using the effective tax rate (ETR), calculated as the ratio of income tax expense to pre-tax income. A lower effective tax rate indicates higher tax avoidance.

Model Specification

The study uses multiple regression analysis to test the relationships between institutional ownership, firm size, and firm value, with tax avoidance as a moderating variable. The model is specified as follows:

$$FV = \beta_0 + \beta_1 \mathrm{IO} + \beta_2 \mathrm{FS} + \beta_3 \mathrm{TA} + \beta_4 (\mathrm{IO} \times \mathrm{TA}) + \beta_5 (\mathrm{FS} \times \mathrm{TA}) + \mathrm{e}$$

Where:

- FV = Firm value
- IO = Institutional ownership
- FS = Firm size
- TA= Tax avoidance
- Interaction terms IO×TAIO \times TA and FS×TAFS \times TA test the moderating effect of tax avoidance.

The regression analysis is performed using robust standard errors to account for heteroskedasticity, and the models are tested for multicollinearity using variance inflation factors (VIFs).

RESULTS

The regression results indicate a significant positive relationship between institutional ownership and firm value. Firms with higher institutional ownership tend to have higher market valuations, consistent with prior research that institutional investors are likely to engage in active monitoring and governance.

Similarly, firm size is positively correlated with firm value, confirming the theory that larger firms benefit from economies of scale and enhanced market power. However, the moderating effect of tax avoidance was particularly interesting.

Institutional Ownership and Firm Value: The coefficient for institutional ownership was positive and statistically significant, suggesting that higher institutional ownership is associated with increased firm value.

Firm Size and Firm Value: Firm size also showed a positive relationship with firm value, but the impact was less pronounced than institutional ownership.

Moderating Effect of Tax Avoidance: Tax avoidance moderated the relationship between institutional ownership and firm value. Specifically, firms with higher levels of tax avoidance exhibited stronger positive relationships between institutional ownership and firm value. This suggests that tax avoidance enhances the benefits of institutional ownership by improving financial efficiency, which institutional investors value. However, tax avoidance did not significantly moderate the relationship between firm size and firm value, indicating that size-related advantages are not as influenced by tax strategies.

The interaction term between institutional ownership and tax avoidance had a positive and statistically significant coefficient, suggesting that tax avoidance strengthens the positive impact of institutional ownership on firm value. The interaction term between firm size and tax avoidance was not significant, indicating that tax avoidance does not have a strong moderating effect on the relationship between firm size and firm value.

DISCUSSION

The findings of this study provide important insights into the relationships between institutional ownership, firm size, and firm value, with tax avoidance serving as a crucial moderating variable. The positive impact of institutional ownership on firm value aligns with previous literature, which suggests that institutional investors play a significant role in improving governance and financial performance. Furthermore, the results confirm that firm size has a generally positive impact on firm value, supporting the argument that larger firms have advantages in terms of market power, diversification, and capital access.

The moderating role of tax avoidance, however, is particularly noteworthy. Tax avoidance enhances the positive effect of institutional ownership on firm value, likely because institutional investors value the financial efficiency and profitability associated with effective tax strategies. By reducing tax liabilities, firms can allocate more resources to growth initiatives or shareholder returns, which positively affects their market value.

However, the lack of a significant moderating effect between firm size and tax avoidance suggests that larger firms may already benefit from their size advantages, and tax avoidance strategies do not add substantial value in this context.

These findings have important implications for corporate managers, policymakers, and institutional investors. For managers, implementing tax avoidance strategies can enhance the value of institutional ownership and help maximize firm value. For investors, understanding the impact of institutional ownership and tax avoidance on firm value can guide investment decisions. For policymakers, these findings suggest that tax avoidance, while beneficial in some contexts, should be carefully monitored to avoid potential adverse effects on public trust and long-term stability.

CONCLUSION

This study contributes to the understanding of how institutional ownership and firm size influence firm value, with tax avoidance serving as a moderating factor. The results demonstrate that both institutional ownership and firm size positively impact firm value, but tax avoidance can amplify these effects, particularly with institutional ownership. Future research could explore other moderating variables or test these relationships in different institutional contexts or geographical markets.

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