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# Can ESG Performance Moderate The Effect of Tax Avoidance on Corporate Risk?

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**Keywords:**

Environmental, Social, and  
Governance (ESG), tax avoidance,  
corporate risk.

**ABSTRACT**

Very few companies in Indonesia implement environmental, social, and governance (ESG), but nowadays investors are interested in investing in companies that have good ESG profiles. This study aims to find the moderating effect of ESG performance on the effect of tax avoidance on corporate risk. The ESG score was obtained through the Thomson Reuters Eikon (Refinitiv), while tax avoidance was measured using the Effective Tax Rate and Cash Effective Tax Rate. This study used a sample of companies with ESG scores in the 2012-2021 period. The data was analyzed using panel data moderation regression with eviews 12. The best regression model obtained is the Fixed Effect Model (FEM). The results showed that ESG performance can moderate the effect of tax avoidance on corporate risk.

## INTRODUCTION

Many companies use the Covid-19 pandemic, which is currently still happening, as an excuse for them not to implement their corporate social responsibility (CSR) programs. Companies reduce their commitment to implementing CSR programs because their business is disrupted (Machmudi, 2021). Therefore, the 2021 CSR Award Teropong was held to give appreciation to companies that carry out CSR amid this pandemic situation (Kurniawan, 2021). The event was held because CSR is considered important in building the economy in this downturn. CSR is considered a reflection of the business actor's concern for the condition of the social environment.

The problem that the Indonesian government is facing during this pandemic is not only about reduced corporate commitment to carrying out CSR, but also reduced tax revenues. In 2020, tax revenues experienced a slump, but in 2021 a positive performance was obtained in the form of an increase of 19.2% compared to 2020 (Kementerian Keuangan, 2022). Even though it has experienced recovery, the Tax Justice Network (2020) states that during the pandemic, Indonesia has experienced losses from tax evasion by corporate taxpayers. Taxes are considered to be a burden for taxpayers so taxpayers often try to avoid paying taxes that are too high than they should be paid.

Tax and CSR are two interrelated things. According to Grayson and Hodges (2004), that companies do not operate in an empty space, but in conditions of complex interactions with scientific and technological developments, political situations, social and economic development, as well as risks that may arise, so everything they do the company will affect the surrounding community, the environment, and ultimately the company itself. Therefore, Christensen and Murphy (2004) further stated that complying with government regulations (in this case paying taxes) is a form of CSR carried out by companies. Furthermore, CSR issues are now developing into ESG (Environmental, Social, Governance), namely how companies integrate ESG into the company business model. Even though very few companies implement ESG in Indonesia, more and more investors are interested in investing in companies that have good ESG profiles (Dewi, 2021).

The crisis that is being faced by all business actors has made them increasingly convinced that taxes will essentially reduce net profit or returns to owners. The view that taxes will reduce the economic capacity of the company, makes the company try to avoid taxes as much as possible to avoid corporate risk. This view is not proven in the results of Kim et al. (2011) which state that aggressive tax avoidance will destroy stock prices.

Therefore researchers are interested in examining the effect of tax avoidance on corporate risk by using CSR moderation as measured by ESG performance, which will strengthen or weaken this effect. If the company considers that paying taxes is part of CSR, then tax avoidance will make the company's image worse. Therefore, socially responsible companies should reduce tax avoidance (Hoi, et al., 2013). Thus, a low level of tax avoidance will minimize corporate risk, reinforced by a good ESG profile, so that the more socially responsible the company, the lower the risk the company has (El Ghouli, et al., 2011; Hoepner, et al. , 2020; Hong & Kacperczyk, 2009).

### Literature Review and Hypothesis Development

According to the legitimacy theory stated by Gray et al. (1996), a good company is a company that is oriented towards legitimacy or partiality towards the community, government, and community groups. Companies must operate through activities and performance that are acceptable to the community so that if the company's value system is in line with the value system that exists in the community, the company can survive (Deegan, 2002). Therefore, recognition from the environment, society, and governance becomes very important for the company.

The importance of CSR gave rise to the term Environmental, Social, and Governance (ESG). ESG is how companies and investors integrate Environmental, Social, and Governance into business models. The difference between CSR and ESG is that if ESG covers governance explicitly, then CSR includes governance issues that are indirectly related to the environment and social issues (Gillan, et al., 2021). So ESG is a broader term than CSR, but both of these are strongly related to the company's market, corporate risk, performance, and company value.

Aggressive tax avoidance activities are proven to be detrimental to the company itself, even though many companies in Indonesia do it. Tax avoidance by companies is usually reflected in aggressive financial reporting by companies (Frank et al., 2009). Aggressive financial reporting means increasingly reflecting the non-transparency of the report. This is what can mislead investors. Dhaliwal et al. (2017) proved that fiscal profit can predict the uncertainty of a company's future performance. The more aggressive the company is in tax avoidance, the greater the difference between commercial profit and taxable profit, and this creates uncertainty in the future. In the end, Kim et al. (2011) support the results of this study by proving that tax avoidance will eventually lead companies to a crash in stock prices.

Even though Lanis & Richardson (2012) stated that paying taxes is a form of CSR activity, companies that actively carry out CSR programs will tend to avoid aggressive activities. Because according to the definition and function of tax, namely the tax collected is used for the needs of the state for the greatest prosperity of the people. Taxes are used to build infrastructure and so on. Companies that pay taxes indirectly contribute to the environment and society. Furthermore, Christensen and Murphy (2004) stated that complying with regulations is a form of CSR carried out by companies.

CSR, which is characterized by good ESG (Environmental, Social, Governance) performance, has been shown to reduce corporate risk, even during a crisis (Hong & Kacperczyk, 2009; Lins et al., 2017; Gillan, et al., 2021). In line with the legitimacy theory that companies act by paying attention to the environment and society to get alignment so that the company's value becomes good in their eyes. Dewi (2021) states that currently in investing, investors are paying more and more attention to ESG. When a company takes aggressive tax avoidance actions that will increase corporate risk, good ESG performance will reduce that risk. A good ESG assessment also shows good financial performance.

Thus the hypothesis in this study includes:

**H1:** tax avoidance affects corporate risk

**H2:** ESG performance moderates the effect of tax avoidance on corporate risk

## RESEARCH METHODS

In this study, the population is all companies listed on the Indonesia Stock Exchange (IDX) during the 2012-2021 period. The selection of the year starts from 2012 because some companies have implemented ESG since ten years ago. Samples will be taken from the population based on a nonprobability sampling approach using a purposive sampling method.

The considerations used by researchers in taking this sample are as follows:

1. Business entities that are registered on the IDX and publish audited financial reports consistently and completely from 2012-2021
2. Provide complete financial reports for 2012-2021
3. The business entity is not suspended or delisted during 2012-2021
4. Business entities that have an ESG score (which is in the Thomson Reuters Eikon), tax avoidance, and corporate risk.
5. The business entity did not experience any losses during the study period.
6. Business entity has a CETR score from 0-1.
7. The business entity uses the Rupiah currency in presenting its financial statements.

This study used data taken from Thomson Reuters Eikon (Refinitiv). The type of secondary data used is pooled data which is a combination of time series data and cross-section data.

Variable operational definitions in this research include:

1. Independent variable is tax avoidance. Tax avoidance is tax deduction activities range widely, from engaging in activities that would harmlessly reduce taxes, to pursuing aggressive strategies that are unlikely to win if cases are brought to court (Dyreng et al., 2019). Measurements used include:
  - a. Effective Tax Rate (ETR) is formulated by comparing income tax expense with earning before tax (Dyreng et al., 2008). The ETR formula stated as follows:

$$ETR = \frac{\text{Income tax expense}}{\text{Earning before tax}}$$



b. Cash Effective Tax Rate (CETR) is formulated by comparing cash tax paid with earning before tax (Dyreng et al., 2008; Hanlon and Slemrod, 2009; Hanlon and Heitzman, 2010). According to Dyreng et al. (2008), CETR is the best proxy for measuring long-run tax avoidance. The greater the CETR value, the less aggressive tax avoidance is carried out by the company. The CETR formula stated as follows:

$$CETR = \frac{\text{Cash tax paid}}{\text{Earning before tax}}$$

2. Dependen variable is corporate risk. According to Guenther et al. (2017), the corporate risk is a reflection of the future uncertainty faced by the company. This uncertainty concerns all matters that may result in a loss to the company or company in an unfavorable condition. Corporate risk uses a volatility proxy for stock returns. The volatility of stock returns was obtained by calculating the standard deviation of stock returns for 12 months per period.
3. Moderating variable is Environmental, Social, Governance (ESG). ESG means integrating Environmental, Social, and Governance into business models (Gillan et al., 2021). ESG is measured using the ESG score on Thomson Reuters Eikon.

The data in this study will be tested and analyzed using panel data moderation regression with eviews 12. Before testing the classical assumptions on research data, the best model is selected between the Common Effect Model (CEM), Fixed Effect Model (FEM), or Random Effect Model (REM).

1. To compare whether CEM or FEM is the best, the Chow Test is used, with the criteria that if the probability value is > 0.05 then CEM is the best model, otherwise, if the probability value is <0.05 then FEM is the best model.
2. To compare whether FEM or REM is the best, the Hausman Test is used, with the criteria that if the probability value is > 0.05 then REM is the best model, otherwise, if the probability value is <0.05 then FEM is the best model.
3. To compare whether CEM or REM is the best, the Lagrange Multiplier Test is used, with the

criteria that if the probability value is > 0.05 then CEM is the best model, conversely, if the probability value is <0.05 then REM is the best model.

After finding the best model, then a classic assumption test is carried out which consists of normality test, heteroscedasticity test, multicollinearity test, and autocorrelation test. Hypothesis testing was carried out using panel data moderation regression with the following stages:

1. Goodness Fit Model Test  
The Goodness Fit Model test is carried out to ensure that the regression model is correct so that the independent variables can actually predict the dependent variable. The regression model is said to be appropriate if the significance value on the F test <0.05.
2. Multiple Linear Regression Test with moderating variable. The regression equation in this study is:

$$CR = \beta_0 + \beta_1 CETR + \beta_2 ETR_{it} + \beta_3 MOD1_{it} + \beta_4 MOD2_{it} + \varepsilon$$

where:

CR: corporate risk

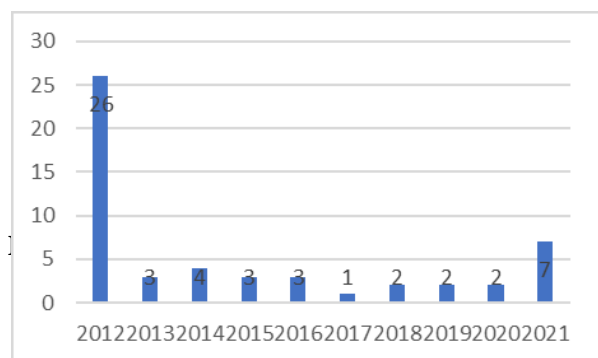
ETR: tax avoidance as measured by ETR

CETR: tax avoidance as measured by CETR

MOD1: interaction of ESG performance with ETR

MOD2: interaction of ESG performance with CETR

ε: residual value



Source: Thomson Reuters Eikon

Figure one shows companies in Indonesia, apart from financial sector companies, that have implemented ESG starting in 2012. Twenty six companies have implemented ESG since 2012.



Also can be seen that seven companies started implementing ESG in 2021. More investors are interested in investing in ESG-based stocks. Stocks and bonds issued by companies with higher ESG scores generally perform better (Noviani & Tari, 2021).

Based on the sample criteria previously described, only 16 companies met the sample criteria for this study with a period of 10 years, from 2012-2021. The company consists of consumer discretionary, consumer staples, energy, health care, industrial, materials, and communication services.

Before carrying out the regression test with the moderating variable using eviews 12, the best model between the Common Effect Model (CEM) and Fixed Effect Model (FEM) will be selected using the Chow Test.

**Table 1. Chow Test**

Effects Test	Statistic	d.f.	Prob.
Cross-section F	5.729375	(15,141)	0.0000
Cross-section Chi-square	76.148566	15	0.0000

From the results of the Chow Test shown in the table above, a probability value of 0.000 is obtained, which means it is smaller than 0.05. Proved that FEM is better than CEM.

The result from previous tests that FEM is better than CEM, then it will be tested which model is better between FEM and the Random Effect Model (REM) using the Hausman Test.

**Table 2. Hausman Test**

Test Summary	Chi-Sq. Statistic	Chi-Sq. d.f.	Prob.
Cross-section random	13.865287	3	0.0031

From the results of the Hausman Test shown in the table above, a probability value of 0.0031 is obtained, which means it is smaller than 0.05, proved that FEM is better than REM. Because in this study it has been found that FEM is the best model among other models, the Lagrange Multiplier Test is not needed.

The following presents the results of testing the classical assumptions.

**Figure 2. Normality Test**

Series: Standardized Residuals	
Sample 2011 2020	
Observations 160	
Mean	7.63e-18
Median	-0.022607
Maximum	0.726965
Minimum	-0.988636
Std. Dev.	0.296191
Skewness	-0.133571
Kurtosis	3.193591
Jarque-Bera	0.725615
Probability	0.695720

From the picture above, a probability value of 0.695720 is obtained which is greater than 0.05, thus it can be concluded that the research data is normally distributed.

**Table 3. Multicollinearity Test**

Variable	Coefficient Variance	Uncentered VIF	Centered VIF
C	0.008168	9.606018	NA
X1	0.053105	10.98715	1.706471
X2	0.082240	13.43130	1.816664
XM	1.67E-06	3.503905	1.129015

From the table above it can be seen that the Centered VIF value of all the variables tested is less than 10, proved that the data is free from multicollinearity assumptions.

**Table 4. Heteroscedasticity Test**

F-statistic	1.018865	Prob. F(3,149)	0.3861
Obs*R-squared	3.075560	Prob. Chi-Square(3)	0.3801
Scaled explained SS	3.103617	Prob. Chi-Square(3)	0.3759

From the table above, a probability value of 0.3801 is obtained, which is greater than 0.05, which means that the data is free from heteroscedasticity.

**Table 5. Autocorrelation Test**

Mean dependent var	6.24E-17
S.D. dependent var	0.357117
Akaike info criterion	0.712448
Schwarz criterion	0.831289
Hannan-Quinn criter.	0.760724
Durbin-Watson stat	1.964813

From the table above, the Durbin Watson (DW) value is 1.96, while the DU value is 1,774 (Ghozali, 2018). Thus  $1.774 < 1.96 < (4 - 1.96)$ , which means that there is no positive or negative autocorrelation in the data of this study.

After it is concluded that the FEM model was the best model and all classical assumption tests had been fulfilled, the following is the result of the analysis of the FEM model:

**Table 6. Fixed Effect Model**

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.069698	0.013873	5.023970	0.0000
X1	-0.050822	0.021967	-2.313555	0.0221
X2	0.044265	0.041832	1.058157	0.2918
XM	0.000706	0.000245	2.878672	0.0046

R-squared	0.447997	Mean dependent var	0.089861
Adjusted R-squared	0.377528	S.D. dependent var	0.039129
S.E. of regression	0.030871	Akaike info criterion	-4.006883
Sum squared resid	0.134380	Schwarz criterion	-3.641706
Log likelihood	339.5506	Hannan-Quinn criter.	-3.858597
F-statistic	6.357398	Durbin-Watson stat	1.812363
Prob(F-statistic)	0.000000		

From the table above, the probability value for the F test is 0.00, which is smaller than 0.05. Therefore, it can be concluded that the regression model can described the effect of the independent variables on the dependent variable. The magnitude of the influence of tax avoidance (both CETR and ETR proxies) and ESG performance on corporate risk is 0.3775 or 37.75%.

**Table 7. Moderation Regression Test (I)**

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.061123	0.013906	4.395362	0.0000
X1	0.006682	0.028333	0.235829	0.8139
XM	0.001361	0.000393	3.465620	0.0007
X1M	-0.001570	0.000779	-2.016833	0.0456

R-squared	0.459214	Mean dependent var	0.089861
Adjusted R-squared	0.390177	S.D. dependent var	0.039129
S.E. of regression	0.030556	Akaike info criterion	-4.027413
Sum squared resid	0.131649	Schwarz criterion	-3.662236
Log likelihood	341.1931	Hannan-Quinn criter.	-3.879128
F-statistic	6.651749	Durbin-Watson stat	1.866764
Prob(F-statistic)	0.000000		

The table above is a test of the moderating variable (ESG performance) in the influence of tax avoidance (CETR) on corporate risk. X1M in the table above represents the interaction between CETR and ESG score, showing a probability value of 0.0456, which is smaller than 0.05, proving that ESG performance is a moderating variable. In table 6, the probability value for CETR 0.0221 is smaller than 0.05, which means that tax avoidance measured by CETR has an effect on corporate risk, with a large influence of 37.75% as previously described. With the emergence of the moderating variable, the magnitude of the influence becomes 0.3901 or 39.01%, which means that ESG performance strengthens the effect of tax avoidance on corporate risk.

**Table 8. Moderation Regression Test (II)**

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.046784	0.014722	3.177901	0.0018
X2	0.089365	0.043400	2.059083	0.0413
XM	0.002192	0.000464	4.725074	0.0000
X2M	-0.004959	0.001365	-3.633477	0.0004

R-squared	0.476096	Mean dependent var	0.089861
Adjusted R-squared	0.409215	S.D. dependent var	0.039129
S.E. of regression	0.030075	Akaike info criterion	-4.059129
Sum squared resid	0.127539	Schwarz criterion	-3.693952
Log likelihood	343.7303	Hannan-Quinn criter.	-3.910843
F-statistic	7.118518	Durbin-Watson stat	1.959413
Prob(F-statistic)	0.000000		

The table above is a test of the moderating variable (ESG performance) in the influence of tax avoidance (ETR) on corporate risk. X2M in the table above represents the interaction between ETR and ESG performance, showing a probability value of 0.0004, which is smaller than 0.05, proving that ESG performance is a moderating variable. In table 6, the probability value for ETR of 0.2918 is greater than 0.05, which means that tax avoidance as measured by ETR has no effect on corporate risk. With the emergence of the moderating variable

(ESG performance), the ETR variable becomes significantly influential, and the magnitude of the influence becomes 0.4092, or 40.92%, which means that ESG performance strengthens the effect of tax avoidance on corporate risk.

Environmental, Social, Governance (ESG) refers to how companies and investors integrate Environmental, Social, and Governance into business models (Gillan, et al., 2021). Several companies in Indonesia have implemented ESG in their business models even since 10 years ago, although the issue of ESG has resurfaced in the last 2 years and is now in the spotlight of investors.

More researchers are interested in researching the importance of ESG not only for the company itself but also for the shareholders. Gillan, et al. (2021) stated that from the ESG profile of a company, you can see the company's market, company characteristics, values, and even performance of the company. The greater the ESG score owned by a company, the more it reflects the social responsibility carried out by the company. Companies with good ESG profiles tend to have good financial performance so that various risks can be avoided, such as financial risk, loss risk, and even bankruptcy risk (Hoepner, et al., 2020; Lins et al., 2017; El Ghoul, et al., 2011; Hong & Kacperczyk, 2009), thus ESG performance is proven to increase firm value (Albuquerque et al., 2019; Fatemi et al., 2015; Benabou & Tirole, 2010; Baron, 2007).

On the other hand, there are still many tax avoidance actions taken by companies that are considered not to reflect socially responsible behavior. Companies that carry out social responsibility are considered to have a good ESG profile, this will encourage companies to pay taxes or avoid tax evasion (Van & Ly, 2021) because tax avoidance can damage the company's reputation (Lin et al., 2017).

From the results of this research that has been conducted in Indonesia with a sample of companies that have an ESG score for the last 10 years, it is proven that tax avoidance both as measured through CETR and ETR, affects corporate risk. The more aggressive the company is in carrying out tax avoidance, the greater the corporate risk (Frank et al., 2009; Kim et al., 2011; Dhaliwal et al., 2017). ESG performance is proven to be a moderating

variable that strengthens the effect of tax avoidance on corporate risk. Good ESG performance shows that the company pays attention to environmental, social, and governance aspects, so it will consider tax avoidance as an action that can damage the company's reputation and ultimately have an impact on the value of the company itself (Van & Ly, 2021; Abdelfattah & Aboud, 2020; Albuquerque et al., 2019; Fatemi et al., 2015; Benabou & Tirole 2010; Baron, 2007).

## CONCLUSION

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Investors are interested in investing in ESG-based stocks. Shares issued by companies with higher ESG scores generally perform better. On the other hand, tax avoidance can be risky for the company itself. This study provides empirical evidence that tax avoidance affects corporate risk. However, with a good ESG profile, as indicated by a high ESG score, it can moderate the effect of tax avoidance on corporate risk. Companies that integrate ESG into their business model will tend to judge that tax avoidance is an action that can increase corporate risk.

Limitations in this study include the lack of companies in Indonesia that have ESG scores for 10 years according to the research period, so the results of the study have not been able to generalize to all companies in Indonesia. We hope that in the future more companies will have ESG profiles so more research can be carried out comprehensively.

After it has been proven that ESG performance strengthens the effect of tax avoidance on corporate risk and more investors are focusing on investing in companies that have good ESG performance, it is recommended that every business consider ESG in their business processes.

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