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Tax Avoidance And Corporate Risk In Indonesia: The Role Of Tax Risk And Executive Characteristics

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ABSTRAK

Penelitian ini bertujuan untuk menemukan pengaruh penghindaran pajak terhadap risiko perusahaan dengan tax risk dan karakteristik eksekutif sebagai variabel moderasi. Individu eksekutif dinilai berpengaruh terhadap keputusan mereka dalam pengambilan keputusan yang berisiko termasuk keputusan untuk melakukan penghindaran pajak. Penelitian ini menggunakan 10 tahun data untuk menganalisis praktik penghindaran pajak jangka panjang perusahaan di Indonesia kecuali perusahaan yang bergerak di sektor keuangan, Penelitian ini menggunakan regresi moderasi data panel dengan bantuan eviews 12. Hasil penelitian menunjukkan bahwa secara jangka panjang, praktik penghindaran pajak dapat meningkatkan risiko perusahaan, serta tax risk dan karakteristik eksekutif terbukti memperkuat pengaruh penghindaran pajak terhadap risiko perusahaan.

Kata Kunci: penghindaran pajak; risiko perusahaan; tax risk; karakteristik eksekutif.

ABSTRACT

This study aims to examine the impact of tax avoidance on corporate risk, utilizing tax risk and executive characteristics as moderating factors. Those in executive positions are perceived to exert influence over their decisions, including those pertaining to the avoidance of taxes, which could be considered a risky decision. The study utilizes ten years of data to analyze the long-term tax avoidance patterns of non-financial Indonesian companies. The findings reveal that over the long run, tax avoidance practices can amplify a corporate's risk, and that tax risk and executive characteristics have been shown to intensify the impact of tax avoidance on corporate risk.

Keywords: tax avoidance; corporate risk; tax risk; executive characteristics.

INTRODUCTION

Tax avoidance practices remain a significant concern for Indonesia, as evidenced by the government's ongoing endeavors to enhance multiple tax regulations and inhibit tax avoidance practices. The newest policy, Peraturan Penerintah no. 55 Tahun 2022, modifies income tax regulations and is derived from Undang-Undang no. 7 Tahun 2021 concerning Tax Harmonization. This regulation serves as definite proof of the government's action to address tax avoidance practices in Indonesia. Efforts to prevent tax avoidance practices are driven by the high frequency of companies reporting fiscal losses for three consecutive years while still managing to maintain commercial operations and generate sales for five years (Redaksi DDTC News, 2023).

Tax avoidance happens when taxpayers have the opportunity to do so. The Self Assessment System, in effect in Indonesia, entrusts taxpayers with the responsibility of computing and declaring their own taxes, which creates a chance for tax avoidance. The aim is to reduce the burden of taxes on taxpayers. Lim (2011) defines tax avoidance as an endeavor to reduce taxes by exploiting legal tax provisions. This practice aims to save taxes while adhering to the law. Moreover, according to Dyreng et al., (2019), tax avoidance encompasses not only saving taxes, but also reducing taxes through a wide range of activities, from innocuous tax-saving initiatives to aggressive strategies with little chance of success in court. Thus, tax avoidance creates uncertainty for the business.

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The future uncertainties faced by companies demonstrate a lack of transparency in financial information for investors, which can diminish company value (Desai & Dharmapala, 2006; Desai & Dharmapala, 2009). The company's risk increases due to the uncertainty of future taxes and a lack of corporate transparency. Kim et al., (2011) suggest that aggressive tax avoidance activities affect the risk of share price collapse. Therefore, this study seeks to obtain empirical evidence on the impact of tax avoidance on corporate risk in Indonesian firms over the past decade, considering tax risk and executive characteristics as moderating variables.

Neuman et al., (2013) defined tax risk as any action or activity that could lead to tax expenditures that deviate from the originally planned or expected expenditures of a company, affecting its cash flow. Meanwhile, according to MacCrimmon & Wehrung (1990), executives have two tendencies in their perception of risk. Executives who take risks are more willing to make business decisions with potential for high risk, such as evading taxes, conversely, risk-averse executives prefer business decisions with lower risk (Lewellen, 2003; MacCrimmon & Wehrung, 1990).

LITERATURE REVIEW

Jensen & Meckling (1976) and Eisenhardt (1989) propose the agency theory which posits that a company is composed of a principal being the investor and an agent being the manager who has been granted the authority by the former. The ultimate aim of both parties is identical, that of maximizing the company's value, though the methods applied often differ. Managers employ various techniques to maximize company profits for the sake of earning larger incentives, despite the associated high risks. One such technique includes tax avoidance, as taxes are viewed as reducing company profits. This results in inevitable information asymmetry, whereby company managers selectively present information in financial reports that is profitable for their own interests, rather than reflecting the actual condition of the company. This information mismatch arises when both parties solely prioritize profits. Company owners aim for favorable profits without a clear comprehension of their source. Conversely, company managers strive to exhibit impressive profits on financial reports to attain rewarding compensation. Managers additionally aim to showcase optimal profits to investors.

Balakrishnan et al., (2019) found that companies that engage in aggressive tax avoidance tend to provide less transparent information to investors. Similarly, Ginting & Martani (2017) demonstrate a strong correlation between aggressive tax avoidance and financial reporting that lacks transparency. Desai & Dharmapala (2006) note that these companies may resort to non-transparent and complex reporting practices. The company's share price collapse is likely due to the lack of corporate transparency and uncertain future taxes, as indicated by Kim et al., (2011). The first hypothesis in this study is that tax avoidance has an effect on corporate risk.

On the contrary, according to Guenther et al., (2017), tax avoidance does not have a significant correlation with company risk. However, the uncertainty resulting from tax avoidance is associated with company risk. Furthermore, Dyreng et al., (2019) elaborated that tax avoidance can lead to substantial tax uncertainty in the future, and corrective actions by tax authorities could lead to increased tax payments. Tax risk has been defined by Neuman et al., (2013), Guenther et al., (2017), and Dyreng et al., (2019). Accordingly, the second hypothesis of this study is that tax risk moderates the effect of tax avoidance on corporate risk.

Based on agency theory, managers may act differently from owners to achieve their goal of maximizing profits, despite the associated risks. Tax avoidance is a strategy employed by companies to increase profits as taxes are deemed to have a negative impact on profits. The decision to practice tax avoidance lies with executives and is contingent on individual choices. Dyreng et al., (2010) have

demonstrated that individual executives significantly influence the extent of tax avoidance practices implemented by their organization. MacCrimmon & Wehrung (1990) and Lewellen (2003) found that executives who are risk takers tend to make bolder decisions, including those related to tax avoidance, whereas those who are risk averse are more cautious to avoid greater risks in the future. Dyreng et al., (2010) found that managerial characteristics account for the variance in corporate tax avoidance behavior that is not explained by firm characteristics. Thus, the third hypothesis is that executive characteristics moderate the effect of tax avoidance on corporate risk.

This study will investigate tax avoidance over a decade, with reference to Dyreng et al., (2008) work on long-term tax avoidance, which has yet to be widely utilized in Indonesia. The inclusion of tax risk and executive characteristics as moderating variables is a novelty in this research.

METHOD

This research analyzes long-term tax avoidance in Indonesia using secondary data from Thomson Reuters Eikon (Refinitiv) spanning the period of 2013-2022. The measurements below are used for each variable:

1. Tax avoidance, including two measures:
   a. Cash Effective Tax Rate (CETR) is calculated by dividing the cash spent on taxes by the pre-tax profit (Dyreng et al., 2008; Hanlon & Heitzman, 2010; Hanlon & Slemrod, 2009). CETR is the most accurate measure of long-term tax avoidance. A higher CETR value indicates less aggressive tax avoidance by the company. The CETR formula can be expressed as follows:

$$\text{CETR} = \frac{\text{Tax Paid}}{\text{Pretax Income}}$$

   b. Discretionary Permanent Difference (DTAX) is the residual value obtained from the regression equation that investigates the permanent differences on non-discretionary items that cause the permanent differences themselves (Frank et al., 2009). According to Carolina & Oktavianti (2021), DTAX is the most effective measurement in forecasting tax avoidance. The regression equation formulated to acquire DTAX encompasses:

$$PERMDIFF_{it} = \alpha 0 + \alpha 1 INTANG_{it} + \alpha 2 UNCON_{it} + \alpha 3 MI_{it} + \alpha 4 CSTE_{it} + \alpha 5 \Delta NOL_{it} + \alpha 6 LAGPERM_{it} + \varepsilon_{it}$$

   wherein:
   PERMDIFFit: The ratio of the permanent difference to the total assets in year t-1
   INTANGit: The ratio of goodwill and other intangible assets to total assets in the previous year (t-1)
   UNCONit: The ratio of consolidated net profit or loss to total assets in the previous year (t-1).
   MIit: The ratio of net profit (or loss) of the minority group to total assets in the previous year (t-1).
   CSTEit: The ratio of current year local taxes to total assets in the previous year (t-1).
   ΔNOLit: Changes in loss compensation divided by total assets in the previous year.
   LAGPERMit: Permanent difference in year t-1 is divided by total assets in year t-1.
   εit: residual value
2. Corporate risk reflects uncertainties that a company may face in the future Guenther et al., 2017). Such uncertainties could lead to potential losses in unfavorable conditions. Corporate risk is typically measured using a proxy for stock return volatility obtained from calculating the standard deviation of stock returns over 12 months per period.

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3. Tax risk, as described by Guenther et al., (2017), is measured by the volatility of future tax rates, which leads to uncertainty for companies regarding future tax payments. The greater the volatility of the tax rates, the more uncertain these businesses become. The standard deviation of the annual CETR is used to determine the volatility of future tax rates.
4. Executive characteristics can be measured through standard deviation of income before interest, tax, depreciation, and amortization (EBITDA) divided by total assets (Paligorova, 2010). This shows deviations in profits, indicating the level of risk-taking by the executives. Higher deviation from profits indicates more willingness to take risks, while lower deviation shows less willingness.

$$\text{EC} = \text{standard deviation of } \frac{\text{EBITDA}}{\text{Total Assets}}$$

Hypothesis testing is conducted via panel data moderated regression using the EViews 12 software, with the following steps:

1. The Goodness of Fit Model Test is conducted to verify the correctness of the regression model and ensure that the independent variables can reliably predict the dependent variable. The regression model is considered correct if the significance value in the F Test is less than 0.05.
2. Multiple Linear Regression Test with moderating variables. The regression equations in this research include:
   $CR = \beta0 + \beta1CETR + \varepsilon$
   $CR = \beta0 + \beta1CETR + \beta2TRit + \beta3MOD1it + \varepsilon$
   $CR = \beta0 + \beta1CETR + \beta2ECit + \beta3MOD2it + \varepsilon$

This model tests the impact of tax avoidance measured by CETR on corporate risk (CR) while considering the moderating effects of tax risk (TR) and executive characteristics (EC).

RESULTS AND DISCUSSION

Before testing the hypothesis, it is essential to test the optimal model. The ensuing results present the outcomes of the Chow Test and Hausman Test that were conducted.

Table 1. Chow Test

Effects Test	Statistic	d.f.	Prob.
Cross-section F	10.644182	(69,626)	0.0000
Cross-section Chi-square	543.353554	69	0.0000

Table 2. Hausman Test

Test Summary	Chi-Sq. Statistic	Chi-Sq. d.f.	Prob.
Cross-section random	5.292964	4	0.0485

Based on the results in Table 1, the Fixed Effect Model (FEM) outperforms the Common Effect Model (CEM) with a probability value of 0.00. Similarly, the FEM performs better than the Random Effect Model (REM) based on the results in Table 2, with a probability value of 0.00. Therefore, it can be concluded that the FEM is the optimal regression model utilized in this research.

The effect of tax avoidance on corporate risk (using the Cash Effective Tax Rate/CETR)

From Table 3 below, we obtained a probability value of 0.0391, indicating that using CETR to measure tax avoidance has an impact on company risk. The negative constant obtained implies that companies with higher CETR values (i.e., non-aggressive tax avoidance) face lower risks. Furthermore, Table 3 demonstrates that the degree of influence is 49.75%.

Table 3. Regression 1 $CR = \beta 0 + \beta 1 CETR + \varepsilon$

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	1078.734	134.1349	8.042160	0.0000
CETR	-830.4356	401.5732	-2.067955	0.0391

R-squared	0.547895
Adjusted R-squared	0.497581
S.E. of regression	1751.307
Sum squared resid	1.93E+09
Log likelihood	-6183.507
F-statistic	10.88955
Prob(F-statistic)	0.000000

The effect of tax avoidance on corporate risk, using Cash Effective Tax Rate (CETR) and moderated by Tax Risk (TR).

Table 4 shows the results of the regression equation that includes tax risk and the interaction between tax risk and CETR (MOD1) as predictor variables of corporate risk. The probability value resulting from the TR variable is insignificant, but MOD1 is significant at 0.0447. This indicates that tax risk serves as a pure moderating variable since TR cannot function as a predictor variable, but its interplay with CETR (moderating variable) is proven to be significant (Solimun, 2011). Tax risk enhances the association between tax avoidance and corporate risk by increasing its impact to 49.92%.

Table 4. Regression 2 $CR = \beta 0 + \beta 1 CETR + \beta 2 TRit + \beta 3 MOD1it + \varepsilon$

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	1406.789	211.0205	6.666599	0.0000
CETR	-1867.952	691.1248	-2.702770	0.0071
TR	-1746.796	1154.754	-1.512700	0.1309
MOD1	3134.606	1558.194	2.011691	0.0447

R-squared	0.550794
Adjusted R-squared	0.499211
S.E. of regression	1748.465
Sum squared resid	1.92E+09
Log likelihood	-6181.256
F-statistic	10.67773
Prob(F-statistic)	0.000000

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The effect of tax avoidance on corporate risk, using Cash Effective Tax Rate (CETR) and moderated by Executive Characteristic (EC)

Table 5 shows the results of the regression equation that incudes executive characteristics and the interaction between executive characteristics (EC) and CETR (MOD2) as predictor variables of corporate risk. The probability values for both EC and MOD2 variables are significantly below alpha. These findings prove that executive characteristics act as a quasi moderator variable since EC can function as a predictor variable and as a moderating variable (Solimun, 2011). Executive characteristics enhances the association between tax avoidance and corporate risk by increasing its impact to 51.07%.

Table 5. Regression 3 CR = β0 + β1CETR + β2ECit + β3MOD2it + Ɛ

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	677.1208	162.5376	4.165932	0.0000
CETR	-180.3620	472.0593	-0.382075	0.7025
EC	20740.36	4841.694	4.283700	0.0000
MOD2	-34453.49	12986.27	-2.653071	0.0082

R-squared	0.561188
Adjusted R-squared	0.510799
S.E. of regression	1728.117
Sum squared resid	1.87E+09
Log likelihood	-6173.062
F-statistic	11.13693
Prob(F-statistic)	0.000000

The effect of tax avoidance on corporate risk (using the Discreationary Permanent Different/DTAX)

From Table 6, we obtained a probability value of 0.0477 indicating the impact of tax avoidance as measured by DTAX on corporate risk. With a negative constant value, the higher the DTAX value of a company (non-aggressive tax avoidance), the lower its risk. Furthermore, Table 6 demonstrates that the degree of influence is 49.73%.

Table 6. Regression 4 CR = β0 + β1DTAX + Ɛ

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	1251.845	219.0895	5.713852	0.0000
DTAX	-2026.444	1021.346	-1.984091	0.0477

R-squared	0.547652
Adjusted R-squared	0.497311
S.E. of regression	1751.778
Sum squared resid	1.93E+09
Log likelihood	-6183.695
F-statistic	10.87889
Prob(F-statistic)	0.000000

The effect of tax avoidance on corporate risk, using Discreationary Permanent Different/DTAX and moderated by Tax Risk (TR).

Table 7 shows the results of the regression equation that includes tax risk and the interaction between tax risk and DTAX (MOD3) as predictors of corporate risk. The probability value resulting from the TR variable is insignificant, but MOD3 is significant at 0.0129. This finding confirms tax risk as a pure moderating variable since TR cannot function as a predictor variable, but its interaction with DTAX (moderating variable) proves significant (Solimun, 2011). Tax risk enhances the association between tax avoidance and corporate risk by increasing its impact to 49.82%.

Table 7. Regression 5 $CR = \beta0 + \beta1DTAX + \beta2TRit + \beta3MOD3it + \varepsilon$

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	1568.764	285.5996	5.492878	0.0000
DTAX	-3266.604	1320.602	-2.473572	0.0136
TR	-2510.507	1402.359	-1.790202	0.0739
MOD3	7273.250	4581.954	1.587369	0.0129

R-squared	0.549953
Adjusted R-squared	0.498273
S.E. of regression	1750.101
Sum squared resid	1.92E+09
Log likelihood	-6181.910
F-statistic	10.64150
Prob(F-statistic)	0.000000

The effect of tax avoidance on corporate risk, using Discreationary Permanent Different/DTAX and moderated by Executive Characteristic (EC)

Table 8 shows the results of the regression equation that inludes executive characteristics and the interaction of executive characteristics (EC) and CETR (MOD4) as predictor variables for corporate risk. The probability value derived from the EC variable is insignificant, whereas MOD4 is significant at 0.0463. This study supports that executive characteristics act as pure moderating variables since they cannot act as predictor variables. However, their interaction with DTAX (moderating variable) has been shown to have a significant impact (Solimun, 2011). Executive characteristics enhance the association between tax avoidance and corporate risk by increasing its impact to 50.59%.

Table 8. Regression 6 $CR = \beta0 + \beta1DTAX + \beta2ECit + \beta3MOD4it + \varepsilon$

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	1145.914	246.5502	4.647790	0.0000
DTAX	-2433.997	1079.356	-2.255045	0.0245
EC	3097.951	6709.597	0.461719	0.6444
MOD4	30074.30	22731.25	1.323038	0.0463

R-squared	0.556795
Adjusted R-squared	0.505900

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S.E. of regression	1736.747
Sum squared resid	1.89E+09
Log likelihood	-6176.549
F-statistic	10.94020
Prob(F-statistic)	0.000000

Therefore, it may be inferred that tax avoidance impacts the corporate risk, with greater corporate risk being associated with more aggressive tax avoidance activities. This aligns with signaling theory by Spence (1973), which posits that the actions of the signal giver (the company) can affect the perceptions and actions of the signal recipient (investor). Aggressive tax avoidance practices may lead to increased audit risks in the future, which could result in legal issues and harm the company's reputation. Such practices are viewed unfavorably by investors (Cao et al., 2021; Dhawan et al., 2020; Gallemore et al., 2014; Thai et al., 2023; Yuwono & Mustikasari, 2022).

The study provides empirical evidence that tax risk and executive characteristics are moderating variables that enhance the impact of tax avoidance on corporate risk. Neuman et al., (2013) define tax risk as an activity or action that may lead to tax expenditures differing from the originally anticipated or planned expenses. Tax risk can have a cascading effect on all areas of a company and lead to additional risks. Therefore, the higher the tax risk, the greater the overall risk for the company (Cozmeia & Uerbana, 2014; Hutchens & Rego, 2015).

Every strategic decision made by a company, including those related to taxes, is inherently tied to the individual executive. It should be noted that effective tax planning strategies demand creativity, a willingness to employ new and complex strategies, and acceptance of certain risks (Chen et al., 2010). This research demonstrates that executives who take on more risks or exhibit a tendency towards risk-taking will likely experience a decrease in their CETR value, which in turn indicates a more aggressive approach towards tax avoidance. CEOs who are averse to risk typically dislike uncertainty regarding the future. Consequently, these CEOs tend to exercise greater caution in decision-making, avoiding risks and becoming more sensitive to aggressive tax avoidance (Chowdhury et al., 2023; García-Meca et al., 2021). Conversely, CEOs who embrace risk tend to favor aggressive tax planning strategies (Baghdadi et al., 2022; Gracelia & Tjaraka, 2020; Rego & Wilson, 2012; Xu, 2023).

CONCLUSION

The more aggressive the company's tax avoidance strategy, the greater the risk it faces. Uncertainty regarding future tax audits creates additional tax liabilities for the company if taxes were avoided. Greater tax risk and executive characteristics strengthen the effect. As the tax risk of the company increases, there is a corresponding domino effect on the various risks the company faces. The higher the potential taxes a company might have to pay, the greater the risk of impacting its liquidity ratio and potentially facing bankruptcy. In tax policy decisions, individual executives undoubtedly play a crucial role, as their character shapes the choices they make. Executives with a higher propensity for risk-taking are more likely to exhibit an aggressive approach towards tax avoidance, while their risk-averse counterparts tend to be more cautious and attentive towards tax avoidance.It is anticipated that this research will validate signaling theory, as a company's actions can impact the investor's views and behavior. Engaging in aggressive tax avoidance could lead to audits and legal issues, which adversely affect the company's reputation and are generally disapproved by investors.

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