Investors' reaction to tax avoidance: Evidence from Indonesia

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Abstract

The main objective of this study is to determine the effect of tax avoidance on firm value. The study sample consists of 164 firms listed in the Indonesian capital market (IDX) from the period of 2017 to 2019. The results of the multiple regression analysis show that Tax avoidance has a significant negative impact on firm value. Furthermore, the results demonstrate the pervasiveness of tax avoidance in the average firms listed in (IDX).

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1. INTRODUCTION

One of the objectives laying behind the firm establishment, is to maintain and boost the firm value (here referred as FV) continuously, where a high FV seen from the share price will have an impact on the prosperity of the shareholders (Ilmiani & Sutrisno, 2015). According to Susanto (2017), FV refers to the firm's performance which is reflected in the stock price arising from the supply and demand of the capital market, and reflects the public's assessment of the firm's performance. In an endeavor to maximize the FV, the owners urge managers to conduct many actions, but at the same time several factors may influence the FV size. (Karimah & Taufiq, 2016).

One of these factors is tax avoidance (abbreviated here as TA). Tax literature defines TA in different ways; we here take the definition broadly that it is the reduction of explicit taxes (Dyreng et al., 2008). For instance, in the Indonesian context plethora of research conducted to analyze the impact of TA on FV, and demonstrated different results. Anasta (2019) and Mappadang et al (2020) investigated the relationship between TA and FV. The authors argue that TA is a value enhancing activity, and it adds to the value of shareholders. However, other studies like Andayani and Yanti (2021) and Violeta and Serly (2020), provided counter evidence. The authors found that the more firms optimize tax expenses, the more FV mitigates. Other challenging evidences in the literature, Ahmad and Haliah (2021) and Indo and Anwar (2021) suggest that TA has no impact on FV.

The inconclusive results in the literature, especially in the Indonesian context, provide the opportunity to further investigate the impact of TA on FV. Therefore, by adopting the agency theory approach, the following are the objectives of the study:

- To investigate the impact of TA on FV.

- To analyze the prevalence of this phenomenon in the context of Indonesian listed firms in the capital market
- To check consistency of the analysis results by use of three different measures of TA.

In the current study, we use three different proxies of TA to measure its effect on FV. The proxies to measure TA include: Effective Tax rate (ETR), Cash Effective Tax Rate (Cash ETR) and Book-Tax Differences (BTD). Tobin's Q is used to calculate FV. The Multiple Regression analysis is used to estimate the effect of TA on FV. The findings indicate that TA has a significant negative effect on FV, and these results are consistent across all three proxies. Descriptive statistics results also show that TA on average is a prevalent phenomenon in the study sample. Additionally, the current study adds to the body of knowledge in a number of different ways. Firstly, most of the studies in literature are conducted in the context of developed nations, but this study provides evidence from the emerging economy i.e., Indonesia, where the studies on the relationship between TA and FV are somehow scarce. Secondly, this study utilizes a more robust methodology to test the hypothesis by incorporating three different proxies of TA, to check how investors value this activity. Fourthly, this study utilizes a large set of data (492 firms/year observation) from 2017 to 2019 as compared to other studies. This data set encompasses firms from different sectors, including financial institutions. Here we should mention that the year 2019 was chosen to be the cut-off year, since COVID-19 pandemic appeared during that year and its consequences have not been reflected directly on the economic year in question.

2. Literature review and hypotheses developement

2.1 Agency theory

According to Jensen and Meckling (1976) agency relationship is due to a contract. It occurs when the principal gives authority and delegates the control of the company resources to the manager (agent) with the aim of obtaining maximum profit. As a result of this relationship, the principal might bear many costs as a result of the interest conflict which may arise between the two parties of the contract.

The inclination on the way to lessen tax burden, is further essential to the firms which apply the separation of proprietorship from management (Choi & Park, 2022), and this preference ought to be rooted in an agency point of view (Edwin & Victor, 2019), which elucidates the agent and principal relationship regarding firm's any sort of activity that generates agency costs (Cabello et al., 2019). TA is an activity as well and, consequently, gives increase to agency costs (Cabello et al., 2019).

The concept of TA can be explained using the agency theory approach. The theory states that TA activity is influenced by conflicts of interest between interested parties (principals), and management as the party carrying out interests (agents). This conflict arises when each party is trying to achieve the level of prosperity it wants. Kusumawati and Sasongko (2005) in their research believe that between external and internal parties, sometimes there are contradicting interests. The conflict occurs not only because the management is trying to improve welfare, while the shareholders want to increase their wealth, but also because the management wishes to obtain the largest possible credit with low interest, whereas the creditors only want to provide credit according to the firm's ability, and the management wishes

to pay as little tax as possible, while the government wants to collect as much tax as possible.

2.2 Firm value

The principal objective of establishing the firm is to maximize the shareholders welfare. Through its activities, the firm's aim is to achieve a high value continuously during its life cycle, and this can be seen from the share market price (Nugroho & Agustia, 2017). Basically, managers perform expense decreasing activities to increase the company profits (Mukhtaruddin et al., 2014). If the firm displays high profits, this will be a good signal in the eyes of the investors. Therefore, the investors will place higher premiums in the firm's share price, because they expect a nonvolatile profit in the future. information disclosed in the financial statements are used to influence the investors' perceptions.

FV is often related to stock prices. FV is the investor's perception of the firm (Cipto & Choerudin, 2020). This definition coincides with Sujoko and Soebiantoro (2007) who define FV as investors' perception of the firm's level of success in managing resources this year, which is reflected in the stock price next year. The firm will have a high value when investors expect high economic returns. For instance, if a firm reports high earnings, investors will place a high value on the firm, and decide to invest because they expect a sustainable level of profit in the future.

2.3 Tax avoidance

One word may have several meanings and connotations. Although TA is not a new notion, many researchers contend that TA is commonly mis-defined due to a wide-spread misunderstanding of TA as a legitimate activity (Desai & Dharmapala, 2009; Lee et al., 2015). Several concepts such as:

aggressive TA, tax management, tax planning and even tax fraud have been used to depict the conceptual meaning of TA (Desai & Dharmapala, 2009; Lee et al., 2015). Despite there are differences between these concepts, they have been employed interchangeably in previous studies related to TA, which is a sign that there is no consensus or agreement on a standard definition (Gebhart, 2017; Hanlon & Heitzman, 2010).

According to (Slemrod, 2004), TA comprises anything, a firm does to reduce its tax obligations, as well as anything that it can quickly be obliterated when posed as an ethical issue. A more comprehensive meaning is found in Hanlon and Heitzman (2010) definition, where they introduce TA as "a continuum of tax planning strategies, where there is something like municipal bond investments at one end (lower explicit tax, perfectly legal), and then terms like "non-compliance" and "evasion", "aggressiveness" and "sheltering" would be closer to the other end of the continuum" (p. 137). As a result, "all transactions that have any effect on the firm's explicit tax liability" are reflected in their standpoint (Hanlon & Heitzman, 2010, p. 137). In line with this trend, this paper looks at TA. Furthermore, to avoid the emphasis on semantics, the generic phrase ''TA'' will be used to discuss the literature, for the most part in this study.

2.4 Investors' reaction to tax avoidance

FV is determined by investors' reactions to management's activities and policies in operating the company. One of the management's activities is TA which is carried out in an endeavor to save money (Firmansyah & Widodo, 2021). TA is applied because decisions in the matter of tax are crucial, and therefore, affects capital structure, and can influence the FV, due to the non-

financial costs of TA considered in the agency theory (Chen et al., 2015; Dang et al., 2019).

Plethora of previous studies reveal that TA activities aren't always valued by investors. These studies adopted the agency standpoint. According to this viewpoint, obfuscatory, complex TA practices can shield the opportunistic management behavior, and cause the firm to bear expenses due to the agency issues. Thus, the FV can possibly decrease, since the integrated costs, which include direct expenditure connected to TA activities, additional compliance costs, and non-tax costs (e.g., agency cost particularly), may offset the tax benefits to shareholders (Wang, 2010, p. 7).

Nevertheless, there are findings that TA positively affects FV in Indonesia, Permatasari et al (2021) and Hendra and Erinos (2020) studied the phenomenon in the consumer goods sector, and they found strong evidence of a negative impact. This finding give a hint to immediate dependable conclusions, one of them is the deliberate intention to reduce FV, because there's no bonus plan compensation linked to targeted earnings, Hendra and Erinos stated. In the same vein, two other studies maintained the investors sensitivity towards TA in Indonesia. For example, Syura et al (2020) stated that friction of costs borne by investors provoked by managerial irregularities, may adversely affect manufacturing firms' value. Likewise, Pratama (2019) in his research, FV appeared to be negatively influenced by TA. The author mentioned that investors lack trust in non-compliant firms which disclosed tax amnesty information. Another possible explanation is that investors consider TA as misconduct which brings tax uncertainty.

Since we will use 3 proxies to measure TA, as it is mentioned in the introduction and it will be explained in the methodology

section, and based on the preceding discussion, we develop the following hypothesis:

- **H$_1$:** ETR negatively impacts firm value.
- **H$_2$:** Cash ETR negatively impacts firm value.
- **H$_3$:** BTD negatively impacts firm value.

3. Methods and materials

3.1 Sample and sampling techniques

The population of this research includes all companies listed on the Indonesia Stock Exchange (IDX) in 2017-2019. Sampling method is used in the process of determining the sample size following some criteria, with the aim of obtaining data in accordance with the objectives of this study. The criteria used in this study and the total size of the sample can be seen in Table (1).

Table 1. Sample selection criteria and results

No	Explanation	Total
	Companies listed on the Indonesia Stock Exchange (IDX)	713
1	Firms listed on the IDX in a row during 2017-2019.	556
2	Firms with unavailable financial statements on the IDX in a row during 2017-2019	(108)
3	Financial reports are published in Rupiah currency	(73)
4	Firms that make profits or do not experience losses	(131)
5	The firms have relevant data according to the research needed	(80)
6	The firms provide complete information on managerial ownership and institutional ownership during the research period (2017-2019)	(0)
	Number of selected samples used	164
	Number of observations: company x 3 years	492

Source: Collected data from: www.idx.co.id.

Based on the criteria determined in Table (1), 549 companies were eliminated. The overall sample size for this study was 164 companies throughout a three-year period, with a total of 492 observations to be examined.

3.2 Type and data source

This study uses secondary quantitative data collected manually from the audited annual reports published on the official websites of companies, as well as the Indonesia Stock Exchange (IDX) official website, from 2017 to 2019 which are related to the research and can be accessed at www.idx.co.id. Also, share prices are obtained from Yahoo finance electronic website, which can be accessed also at https://finance.yahoo.com/. 2019 was chosen to be the cut-off year, since COVID-19 pandemic appeared during that year and its consequences have not been reflected directly on the economic year in question.

3.3 Research variables

The measurement of variables is presented in the table (2):

Table 2. Variables measurement

Nature of variables	Variables	Measurement	Reference
Dependent	Tobin's Q FV	$\text{Tobin's Q} = \dfrac{(\text{Total Assets} - \text{Equity}) + \text{Market Value of Equity}}{Total\ Assets}$	(Santana & Rezende, 2016)
Independent	ETR TA	$\text{ETR} = \dfrac{\text{Total tax expense}}{Income\ before\ tax}$	(Kurniawan & Syafruddin, 2017)
	Cash ETR TA	$Cash\ ETR = \dfrac{Payments\ of\ taxes}{Income\ before\ tax}$	(Adityamurti & Ghozali, 2017)
	BTD TA	$BTD = \dfrac{\text{Taxable income} - \text{Accounting income}}{Average\ assets\ book\ value}$	(Kurniawan & Syafruddin, 2017)
Control	SIZE Firm Size	$\text{SIZE} = \text{Ln (Total Assets)}$	(Shin-Ae Kang & Kim Taejoong, 2019)
	DER Leverage	$DER = \dfrac{Total\ debts}{Total\ equity}$	(Razali et al., 2019)
	ROA Firm Performance	$ROA = \dfrac{Net\ profit}{Total\ assets}$	(Oktavani & Putra, 2017)

3.4 Research model:

After multiplying the values of both ETR and cash ETR by (-1), because they represent the inverse direction of TA. Additionally, after mean-centering all the variables to avoid Multicollinearity problems, hierarchical multiple linear regression is used, to empirically examine the effect of TA (proxied by ETR, Cash ETR and BTD) on FV. The research regression models are built as follows:

- $FV_{i,t} = \alpha + \beta_1\ ETR_{i,t} + \beta_2\ SIZE_{i,t} + \beta_3\ DER_{i,t} + \beta_4\ ROA_{,i,t} + \varepsilon_{i,t}$ *Equation 1.*

- $FV_{i,t} = \alpha + \beta_1\ Cash\ ETR_{i,t} + \beta_2\ SIZE_{i,t} + \beta_3\ DER_{i,t} + \beta_4\ ROA_{,i,t} + \varepsilon_{i,t}$ *Equation 2*

- $FV_{i,t} = \alpha + \beta_1\ BTD_{i,t} + \beta_2\ SIZE_{i,t} + \beta_3\ DER_{i,t} + \beta_4\ ROA_{,i,t} + \varepsilon_{i,t}$ *Equation 3*

Where :
- FV: firm value of firm (i) in the year (t), proxied by Tobin's Q.
- α is the regression constant.
- ETR: TA of firm (i) in the year (t), measured by effective tax rate.
- Cash ETR: TA of firm (i) in the year (t), measured by Cash effective tax rate.
- BTD: TA of firm (i) in the year (t), measured by Book tax differences.
- SIZE: Size of firm (i) in the year (t), measured by the natural logarithm of total assets.
- DER: leverage of firm (i) in the year (t), proxied by Debt ratio.

- ROA: Firm performance of firm (i) in the year (t), proxied by the Return on Assets.
- ε = Error Term.
- β1_β4 : Multiple regression coefficients.

4. Research results

4.1 Classical assumptions test

4.1.1 Normality test

A histogram was created to assess the assumption that the values of residuals are normally distributed. We can see that the histogram is moderately symmetrical and located at the near center of the normal density curve, which indicates there is no violation of this assumption (Figure 1).

Fig.1. Result of Normality Test
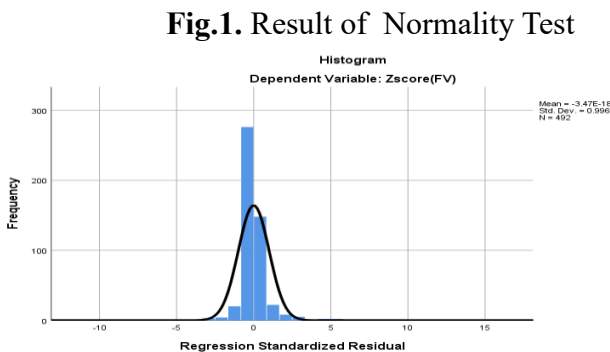
Source: Proccessed Data On SPSS V 24

4.1.2 Multicollinearity test

To ensure that there was no multicollinearity, a collinearity test was conducted, to examine the relationship between the predictors. The table (4) shows that the variance inflation factor of (VIF) of ETR, SIZE, DER and ROA in the first model, is less than 3 (VIF = 1.060, 1.170, 1.279, 1.114), respectively. VIF of Cash ETR, SIZE, DER and ROA in the second model is also less than 3 (VIF = 1.060, 1.171, 1.279, 1.114),

respectively. Moreover, the VIF of BTD, SIZE, DER and ROA in the third model is also inferior to 3 (VIF = 2.114, 1.168, 1.269, 2.127), respectively. This indicates that there is no problem of multicollinearity between the independent variables.

4.1.3 Interdependency of residuals values test

A Durbin-Watson statistics was calculated assess the assumption that the values of residuals are independent. The results in the table (4) demonstrates that Durbin-Watson value in the three models (Model 1, Model 2, Model 3) is between 1 and 3 (1.219, 1.206, 1.175), respectively. This indicates that this assumption also is met.

4.1.4 Homoscedasticity test:

A scatterplot was created to assess that the variance of the residuals was constant we can see in the Figure (2) no obvious pattern, which indicates that the assumption of Homoscedasticity was not violated.

Fig.2. Figure title (this is an example of figure 1)
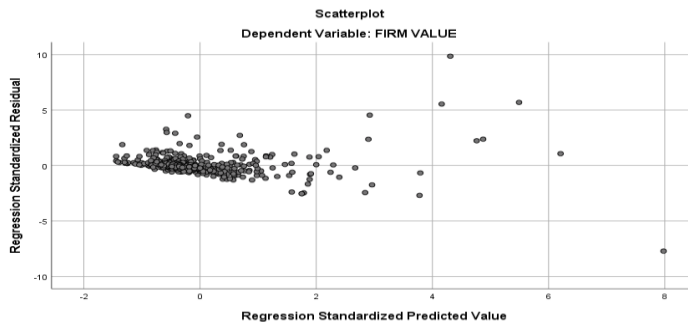
Source: Proccessed Data On SPSS V 24

5. Results

5.1 Descriptive statistics

Descriptive Statistical analysis was conducted to obtain an overview of the initial characteristics of the variables studied and included in the research model. Analysis includes average values,

minimum values, maximum values, and standard deviations. Data variables analyzed included FV, TA, firm size, leverage ratio, Return on Assets. Table (3) presents the results of descriptive statistical analysis.

Table 3. Descreptive Statistics Results

Variables	N	Minimum	Maximum	Mean	Std. Deviation
FV	492	.09	23.29	1.7210	2.10142
SIZE	492	24.62	34.89	29.2356	1.83171
DER	492	.00	1.95	.4725	.24897
ROA	492	.00	.73	.0697	.07812
ETR	492	-.95	.58	-.2295	.13825
CASHETR	492	-.98	.00	-.2451	.13413
BTD	754	-.19	.07	-.0219	.02698
Valid N (listwise) 492					

Source: Proccessed Data On SPSS V 24

Table (3) shows that the average of FV in the sample is 1.721 with a standard deviation of 2.101. The ratio of Q which is above 1 shows a good firm's value, while the ratio of Q which is below 1 or close to zero shows that the value of the firms is less attractive. The average Q ratio of the sample firms is above 1, which means that the average sample firms is a place for investment activities. The absolute value of the average accounting effective tax rate, cash effective tax rate and book tax differences rate as an approximation of TA are (0.229, 0.245, 0.021) respectively i.e., (22.9%, 24.5%, 2.1%), Which indicates that in the average firms not only practice TA activities, but it shows also high levels of TA in the study sample firms compared to the legal tax rate of 25% (especially BTD = 2.1%) during the study period. The standard deviation is (0.139, 0.134, 0.027) respectively with the lowest value of (-0.583, 0.001, -0.070) and the highest value of (0.954, 0.979, 0.191) respectively.

Concerning the control variables, firm size shows an average of 29.236 with a standard deviation of 1.832. The leverage ratio

has an average value of 0.472 with a standard deviation of 0.248974. The average Return on Asset is 0.069 and the standard deviation is 0.026

5.2 Regression results

To test the hypotheses of the study, which is related to "there is a significant negative effect of TA on the value of companies listed on the Indonesian Stock Exchange", regression models No. 1, 2 and 3 were performed respectively, after mean-centering all the variables to avoid Multicollinearity problems.

The table (4) shows that the model 1, model 2 and model 3 are significant, F (94.63, 88.69, 143.27), respectively. P< .001, explaining 43.3%, 41.7% and 53.7%, respectively (Adjusted R^2 = .433, .417, .537) of the variance in the outcome variable. this indicates the quality of the models' fit, which indicates its explanatory power for the independent and control variables on the dependent variable.

As for As for the effect of the independent variables on the dependent variable in the multiple regression model 1, model 2 and model 3, it is noted that the TA practices of firms, measured by ETR, Cash ETR and BTD have a negative effect on the FV (β = -.168, -0.111, -.552), at a level of significance of 1% (*P = .000, .002, .000)*, which means a Significant decrease in the FV is a result of the increase in TA practices. Thus, we can conclude that H_1, H_2 and H_3 are accepted. It is noted that these results are similar, despite the different methods of measuring TA. The results also posit evidence that the three proxies used in the study i, e, ETR, Cash ETR and BTD, are able to detect TA activities conducted by firms listed in (IDX), furthermore they confirm the robustness of

Table 4. Model Fit, Collinearity And Regression Results

	TA BTD			TA Cash ETR			TA ETR		
	P-value	Coefficient	VIF	P-value	Coefficient	VIF	P-value	Coefficient	VIF
Constant	1.000	0.018		1.000	1.643E-15		1.000	9.9716E-16	
TA	.000	-.552**	2.114	.002	-.111**	1.060	.000	-.168**	1.019
SIZE	.834	.007	1.168	.089	.063	1.171	.169	.050	1.154
DER	.000	.172**	1.269	.009	.102**	1.279	.001	.125**	1.250
ROA	.000	.298**	2.127	.000	.680**	1.114	.000	.689**	1.115
F test		143.277** (.000)			88.696** (.000)			94.631** (.000)	
Durbin-Watson		1.175			1.206			1.219	
Adjusted R^2		.537			.417			.433	

**. Coefficient is significant at the 0.01 level (2-tailed).

*. Coefficient is significant at the 0.05 level (2-tailed).

Source: Proccessed Data on SPSS V 24

the regression models developed to investigate the effect of TA on FV.

With regard to the effect of the control variables on the dependent variable in the regression model, it is observed that there is a positive effect of the firm size (SIZE) on the FV, but this effect was not significant. On the other hand, the financial leverage (DER) and financial performance (ROA) have a positive impact on FV, at a level of significance of 1% and less than 1%, respectively.

6. Discussion

The results demonstrate a negative effect of TA on FV, which means a Significant decrease in the FV is a result of the increase in TA practices. Investors do not place a high value on TA, believing that the nontax expenses incurred as a result of Indonesia's weak tax enforcement coupled with non-deterrent penalties outweigh the benefits of avoiding taxes, this was one of the potential explanations. Another possible explanation for this finding is that Indonesia's capital market could be not mature enough to protect investors' rights from the linkage of TA activities with managerial opportunistic behavior (rent extraction). As a result, investors regard TA to be a detrimental way to save money (Assidi et al., 2016). The values of the regression coefficients of TA (ETR, Cash ETR, BTD) are (-.168, -0.111, -.552), respectively, which indicates that if TA practices increase by 1%, it will lead to a decrease in the value of the firm by (16,8%, 11.1%, 55.2%), respectively, assuming the control variables remain constant. This is consistent with the findings of (Permatasari et al., 2021; Violeta & Serly, 2020) and contradicts the results of (Firmansyah et al., 2022; Irawan, 2020) that there is a positive impact of TA on FV.

In the view of the preceding analysis and discussion, the final form of the research Regression models is:

- $FV_{i,t} = 9.9716E\text{-}16 - 0.168\ ETR_{i,t} + 0.125\ LEV_{i,t} + 0.689\ ROA,_{i,t} + \varepsilon_{i,t}$ *Equation 1*

- $FV_{i,t} = 1.643E\text{-}15 - 0.111\ Cash\ ETR_{i,t} + 0.102\ LEV_{i,t} + 0.680\ ROA,_{i,t} + \varepsilon_{i,t}$ *Equation 2*

- $FV_{i,t} = 0.018 - 0.552\ BTD_{i,t} + 0.172\ LEV_{i,t} + 0.298\ ROA,_{i,t} + \varepsilon_{i,t}$ *Equation 3*

7. Conclusion

The study aims were threefold, first to check the impact of TA on FV, to investigate the consistency of the results using three proxies to measure TA and finally, to explore the spread of the TA in the Indonesian firms listed in (IDX). A sample of 164 firms was chosen from 2017 to 2019 to achieve these objectives. The results of this study are: Firstly, we found evidence of a positive impact of TA on FV. Secondly, we found evidence about the robustness of this relationship by using three different proxies of TA (ETR, Cash ETR, BTD), and results are consistent across all three proxies. Thirdly, the results demonstrate the pervasiveness of TA in the average firms listed in (IDX). These results are consistent with the traditional perspective of TA.

This study also provides some practical implications to the management, investors and tax authorities. Firstly, management of the firms can get a better picture of how the capital market reacts to its TA behavior and how the positive impact can be boosted by better implementing the corporate governance mechanisms. Secondly, investors and security analysts can also use the findings to value a firm by incorporating different measures of TA activities to predict their impact on the FV. Thirdly, this study provides evidence to the tax authorities that firms use different techniques to do TA which can be detected using a plethora of proxies so, the policies can be developed to reduce the TA behavior of the firms. However, this paper also has some limitations and shortcomings that provide the path for further exploration. Firstly, the sample population is still limited to the years of 2017-2019. Future studies may expand the observations by extending the span time of the sample. Secondly, study results can only be generalized in Indonesian firms' context; further studies can include international companies and MNCs.

Thirdly, the variables used in this study cannot fully explain TA. Therefore, further research can explore TA components such as permanent and temporary differences, as well as Current ETR. Additional control variables also could be used to better enhance the research model, such as: Firm Age, Return on Equity and liquidity. Fourthly, the impact of TA on FV was investigated in the context of all the firms listed in (IDX), hence future research may split the sample in categories according to the firms-sector affiliation and compare the impact of TA on FV according to the firm's affiliation. Fifthly, the paper investigated solely the effect of TA on FV, thus other variables representing corporate governance could be incorporated in the research model to explore its moderating effect.

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