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The Effect of Financial Distress and Corporate Social Responsibility on Tax Avoidance

(Case Study of Manufacturing Companies in the Pharmaceutical Sub-Sector Listed on the Indonesia Stock Exchange for the years 2017-2021 Period)

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Abstract

This study aims to examine the effect of financial distress and corporate social responsibility on tax avoidance in the pharmaceutical manufacturing subsector during the period of 2017-2021. The population of this study consists of pharmaceutical manufacturing companies. The research methodology employed is quantitative. The data used for this study were obtained from the website www.idx.co.id and annual reports that have been audited for each year, accessible through the official websites of the respective companies. Data collection was conducted using purposive sampling, with a total sample size of 30 data points over a 5-year observation period. The collected data were analyzed using SPSS version 25 for Windows. The results of the analysis indicate that the variable of financial distress does not have a significant effect on tax avoidance, while the variable of corporate social responsibility has a negative effect on tax avoidance.

Keywords *Financial distress, Corporate Social Responsibility, Tax Avoidance.*

INTRODUCTION

The primary source of national revenue is derived from tax receipts. According to Law No. 28 of 2007, which pertains to the General Provisions and Procedures of Taxation (GPT), taxation is defined as an obligatory contribution imposed by the state upon individuals or entities, enforced coercively and without direct remuneration, and utilized for the purposes of national development and the utmost welfare of the citizenry (Susanto & Veronica, 2022).

The payment of taxes constitutes the embodiment of a civic duty and the active involvement of taxpayers in collectively and directly fulfilling their tax obligations towards the funding of the state and the advancement of national development.

It can be asserted that the nation is highly dependent on tax revenue to execute the programs enshrined in the Annual State Budget (APBN), formulated on a yearly basis. Thus, any reduction in tax receipts would significantly impede the state's financial capacity, leading to challenges in funding various initiatives (Destama, 2019).

The occurrence of a decrease in tax revenue is attributed, in part, to the perceived attempts by taxpayers to engage in tax avoidance. The government's objective of maximizing revenue from the tax sector is inherently at odds with the goals pursued by corporations. Taxation poses a considerable concern for corporations, as it has a substantial impact on the net profits they accrue (Putri & Raharja, 2019). Consequently, companies endeavor to mitigate their tax liabilities by minimizing tax payments and resorting to tax avoidance strategies. The objective is to minimize the amount of taxes borne by the company and maximize the retention of net profits (Mutia Dewi Arsanti & Nuryana Fatchan, 2021).

Reported by (Kompas.com, 2020), the Tax Justice Network has estimated that Indonesia suffers losses of up to 4.86 billion US dollars per year due to tax avoidance. This figure is equivalent to Rp 68.7 trillion when using the exchange rate of Rp 14,149 per US dollar, as recorded in the spot market on Monday (22/11/2020). Out of the mentioned figure, approximately 4.78 billion US dollars, equivalent to Rp 67.6 trillion, is attributed to corporate tax avoidance in Indonesia. Meanwhile, the remaining 78.83 million US dollars, approximately Rp 1.1 trillion, originates from individual taxpayers.

In (Swandewi & Noviari, 2020) states that considering the significant opportunities for companies to engage in tax avoidance, it is common for such actions to be pursued when companies face financial difficulties. As we are aware, the global economy and the conditions of economic actors are subject to fluctuations and not always favorable. When a crisis begins to emerge, numerous companies experience financial challenges.

Several researchers such as Freedman (2003), Slemrod (2004), and Landolf (2006), as cited in the journal article by (Setiawati & Adi, 2020) argue that corporate tax avoidance policies may have a negative impact on society. This is because companies that engage in tax avoidance are perceived as not contributing to the government in terms of financing public facilities. Therefore, corporate tax avoidance is considered one of the socially irresponsible actions by companies. Companies will go to great lengths to ensure their survival, often disregarding the negative reputation they may acquire in the process.

LITERATURE REVIEW

Agency Theory

Agency Theory is a theory that emerged due to the existence of conflicts of interest between principals and agents (Jensen & Meckling, 1976). Agency Theory explains the relationship between the principal, who is the shareholder, and the agent, who is the management of the company. Shareholders are not directly involved in the operational activities of the company; in other words, the principal provides facilities and funds for the company's operational activities.

This agency theory gives rise to diverging interests between the principal and the agent. The principal desires a larger and accurate profit distribution, while the agent seeks a substantial bonus allocation from the principal in recognition for their exemplary performance. This situation triggers a discrepancy between the actual conditions and the desired outcomes (Astuti & Aryani, 2017).

Financial Distress

Financial distress is a financial condition of a company that occurs prior to bankruptcy due to encountering issues, crises, or an unhealthy state. According to (Juanda, 2023), financial distress occurs when a company experiences losses or negative operating profits.

In (Siburian & Siagian, 2021) it is further explained that Financial Distress is caused by inadequate capital due to improper utilization of capital resources, insufficient reserves, and inefficient management of all activities. Financial constraints can increase the risk of bankruptcy resulting from economic downturns, and the financial stability of companies can enhance tax avoidance practices to maintain stability.

Corporate Social Responsibility

According to Holme and Watts (2006) in their journal article (Lie & Adiwibowo, 2017) Corporate Social Responsibility (CSR) is a form of corporate responsibility towards its social environment. CSR is a business commitment to act ethically, contribute to economic development, enhance the quality of life for employees, local communities, and society at large.

Corporate Social Responsibility (CSR) is one of the crucial factors for the sustainability of a company. This is because a company relies on the support of its stakeholders to carry out its operations. CSR, in turn, serves as a social action and a manifestation of a company's responsibility towards all its stakeholders (Nida & Sari, 2021).

Tax Avoidance

Tax avoidance is a company's effort to reduce or minimize its tax burden. Taxation is one form of a company's social responsibility to society through the government. The funds generated from tax payments are utilized by the government to fulfill its duties in various sectors of life to achieve public welfare (Putri & Raharja, 2019)

In (Selistiaweni et al., 2020) it is explained that tax avoidance is also referred to as an effort to reduce tax payments while still complying with the applicable tax regulations by taking advantage of exceptions, allowable deductions, or deferring taxes through existing tax laws and policies provided directly by the company.

HYPOTHESIS

The Effect of Financial Distress on Tax Avoidance

Based on agency theory, financial statements are reported to disclose the financial condition of a company during a specific period. Therefore, the employed managers must be highly competent and transparent about the company's affairs. Because if a company consistently generates high-value cash flows over a relatively long period, it signifies a strong financial condition and the ability to sustain its operations over time. Conversely, if a company's profits and cash flows are consistently low over an extended period, it indicates a challenging and poor financial condition, which can lead to detrimental consequences for the company's future. Such a condition leads to the company experiencing financial distress (Selistiaweni et al., 2020). When a company is in a state of financial distress, it is compelled to take significant risks in tax avoidance. This is due to the increasingly critical income situation, leading the company to choose to manipulate accounting policies and engage in tax avoidance practices (Siburian & Siagian, 2021).

Based on the explanation above, the following hypothesis can be formulated:

H_1: Financial Distress has a positive effect on Tax Avoidance

The Effect of Corporate Social Responsibility on Tax Avoidance

According to agency theory, CSR has the ability to reduce information asymmetry, thereby reducing agency costs. By involving top management in CSR activities, it will mitigate managerial opportunism. Organizations with a high Corporate Social Responsibility rating tend to have a lower tendency to engage in tax avoidance. Companies with a good reputation strive to maintain their reputation by taking responsibility for their activities and avoiding practices of tax avoidance (Ningrum et al., 2018).

(Putri & Raharja, 2019) also reveals that companies engaged in responsible Corporate Social Responsibility activities are less likely to be involved in tax avoidance practices. This indicates that the more a company discloses its Corporate Social Responsibility initiatives, the lower the level of tax avoidance.

Based on the explanation above, the following hypothesis can be formulated:

H_2: Corporate Social Responsibility has a negative effect on Tax Avoidance

METHOD

The Scope of Research

This research was conducted on pharmaceutical manufacturing companies listed on the Indonesia Stock Exchange during the period of 2017-2021. The financial statements and annual reports, which were audited, were obtained from the official websites of each respective company or the official website of the Indonesia Stock Exchange, www.idx.co.id. The research was carried out from November 2022 to June 2023.

Population and Sample

The population of this research comprises all manufacturing companies in the Pharmaceutical Sub-Sector that are listed on the Indonesia Stock Exchange and consistently publish annual reports for the years 2017-2021. The sampling technique employed was purposive sampling, which involves selecting samples based on specific criteria. A total of 30 data samples were obtained during the observation period of 5 years. The criteria for sample selection are as follows:

1. Manufacturing companies in the Pharmaceutical Sub-Sector that are already listed on the Indonesia Stock Exchange.
2. Manufacturing companies in the Pharmaceutical Sub-Sector that issue annual financial reports certified by the company and published as an Annual Report each year, particularly during the years 2017-2021.
3. Manufacturing companies in the Pharmaceutical Sub-Sector that have positive net income after taxes from 2017-2021.
4. Manufacturing companies in the Pharmaceutical Sub-Sector that conducted an Initial Public Offering (IPO) on the Indonesia Stock Exchange before the period of 2017-2021.

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Variable

Tax Avoidance

Tax avoidance refers to the actions taken by companies to reduce or minimize the tax burden on the company (Putri & Raharja, 2019). In this research, it is proxied by using the formula Cash Effective Tax Rate, which is defined as follows:

$$\text{CETR} = \frac{Cash\ Tax\ Paid}{Profit\ before\ tax}$$

Financial Distress

Financial distress refers to the deteriorating financial condition experienced by a company over consecutive years, which can lead to bankruptcy. In this research, financial distress is measured using the Altman Z-Score formula, which is defined as follows:

$$Z = 1{,}2\ X_1 + 1{,}4\ X_2 + 3{,}3\ X_3 + 0{,}6\ X_4 + 0{,}999\ X_5$$

Note:

X_1 = Current Assets-Current Debt/Total Asssets

X_2 = Retained Earnings/Total Assets

X_3 = Profit before tax/Total Assets

X_4 = Total Equity/Total Debt

X_5 = Sales/Total Assets

In the Altman Z-Score, the potential for bankruptcy will be reflected in the Z-Score. If the Z value is 2.99, then the company is in the safe zone, which is free from distress. If the value is $1.81 < Z < 2.99$, it means that the company is in the grey zone. Meanwhile, if the Z value < 1.81, then the company is in the distress zone.

Corporate Social Responsibility

According to Holme and Watts in 2006, as cited in the journal article by (Lie & Adiwibowo, 2017) Corporate Social Responsibility *(CSR)* is a form of responsibility that companies have towards their social environment. The disclosure of Corporate Social Responsibility (CSR) is measured through the disclosure of CSR information using the CSR Disclosure Index (CSRI) with a checklist item system based on the annual report according to predetermined items. The formula used in this research is as follows:

$$CSRIj = \frac{\Sigma\ xij}{ni}$$

Note:

CSRIj = Disclosure of the Company Corporate Social Responsibility

Xij = Number of items disclosed by the company.
(Denoted by number 1 if item i is disclosed, and number 0 if item i is not disclosed)

Ni = Total number of CSR disclosure indicator items (n=91)

RESULTS AND DISCUSSION

Descriptive Statistical Test

Descriptive statistical tests in this research were conducted to demonstrate the data of maximum, minimum, mean, and standard deviation. The variables used were Financial Distress (X_1) and Corporate Social Responsibility (X_2) as independent variables, and Tax Avoidance (Y) as the dependent variable. The following are the results of the descriptive statistical tests:

Table 1 Descriptive Statistical Test Results

	N	Minimum	Maximum	Mean	Std. Deviation
FD	30	0.85	5.48	2.9893	1.69243
CSR	30	0.65	0.88	0.7953	0.06704
TA	30	0.04	0.66	0.2897	0.16330
Valid N (listwise)	30				

Based on the above results, it can be observed that Financial Distress (X_1) has a minimum value of 0.85 and a maximum value of 5.48, with a mean of 2.9893 and a standard deviation of 1.69243. Corporate Social Responsibility (X_2) has a minimum value of 0.65 and a maximum value of 0.88, with a mean of 0.7953 and a standard deviation of 0.6704. Tax Avoidance (Y) has a minimum value of 0.04 and a maximum value of 0.66, with a *mean* of 0.2897 and a standard deviation of 0.16330.

T-Test

The t-test aims to determine the individual influence of each independent variable on the dependent variable. Here are the results of the t-test:

Table 2 T-Test Results

Variable	B	T	Sig.	Note
(Constant)	0.200	0.523	0.605	
FD	-0.042	-1.489	0.051	H_1 Rejected
CSR	-0.270	-0.522	0.045	H_2 Accepted

The Effect of Financial Distress on Tax Avoidance

Based on the results of the statistical t-test of the variable Financial Distress with a t-value of -1.489 < 2.052 (t-table) and a significance value of 0.051 < 0.05 indicates that H_0 is accepted, and H_a is rejected, it can be concluded that Financial Distress does not have a significant effect on tax avoidance.

Companies experiencing financial distress or financial difficulties will always incur losses or fail to generate profits and revenues, thus they are unlikely to engage in tax avoidance. This is because companies facing losses would receive compensation regardless of their tax burden. Therefore, these companies would choose not to pay taxes (Kurubah & Waskito, 2021).

Companies engaging in tax avoidance when they are in a state of *financial distress* can lead to a decline in the company's reputation. Companies that are experiencing losses will be relieved from income tax burdens and may receive loss compensation facilities in the future (Cita & Supadmi, 2019)

The findings of this research are consistent with those of (Kurubah & Waskito, 2021) and (Cita & Supadmi, 2019) who stated that Financial Distress does not have an impact on tax avoidance.

The Effect of Corporate Social Responsibility on Tax Avoidance

Based on the results of the hypothesis testing conducted partially on pharmaceutical sector companies, which were the sample of this research, the analysis revealed that Corporate Social Responsibility has a negative influence on tax avoidance, meaning it is not aligned with tax avoidance. This is indicated by a t-value of -0.522 and a significance value of 0.045 < 0.05 indicates that H_0 is rejected, and H_a is accepted, meaning that Corporate Social Responsibility has a significant negative effect on tax avoidance. The negative value indicates that the variable Corporate Social Responsibility has a relationship that is not in line with tax avoidance.

The higher the level of Corporate Social Responsibility, the lower the level of tax avoidance by companies. This implies that paying taxes is considered one of the indirect activities of Corporate Social Responsibility towards society. Companies can be seen as socially irresponsible if they minimize the tax burden they should pay, as it is perceived to harm the broader community (Susanto & Veronica, 2022) .

The findings of this research are consistent with the research conducted by (Susanto & Veronica, 2022) and (Gerardo B. S. Dewangga, 2020) which stated that Corporate Social Responsibility has a negative impact on tax avoidance.

CONCLUSION

Based on the results of the research that has been conducted, the following conclusions can be drawn:

1. Financial Distress does not have an effect on Tax Avoidance in the Pharmaceutical Sub-Sector Manufacturing Companies from 2017 to 2021. This means that the level of financial difficulty of the company, whether high or low, will not affect the tax avoidance practices conducted by the company.
2. Corporate Social Responsibility has a negative effect on Tax Avoidance in the Pharmaceutical Sub-Sector Manufacturing Companies from 2017 to 2021. This means that the higher the level of Corporate Social Responsibility expressed, the lower the level of tax avoidance conducted by the company.

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