



The impact of Tax avoidance on corporate social responsibility and profitability

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Abstract

The study investigates the relationship between tax avoidance, corporate social responsibility (CSR), and profitability within the banking sector in Indonesia, focusing on the period from 2021 to 2023. Using a quantitative research design, the study explores both direct and indirect effects of tax avoidance on CSR and financial performance. It examines the mechanisms through which tax avoidance influences a bank's CSR activities and its financial outcomes, particularly profitability. The study finds that tax avoidance negatively impacts CSR, aligning with previous research that suggests aggressive tax avoidance strategies can tarnish corporate reputation and social legitimacy. Additionally, the results indicate that while tax avoidance can improve short-term profitability, it may harm long-term financial sustainability and reputation. This research provides insights into how banks in Indonesia navigate the delicate balance between minimizing taxes and maintaining social responsibility, with significant implications for both regulators and financial managers.

Keywords: Tax Avoidance, Corporate Social Responsibility (CSR), Profitability, Banking Sector, Indonesia

Introduction

Tax avoidance, while legally permissible, remains a highly controversial practice due to its potential to negatively impact public perception and a company's social legitimacy. As businesses seek to reduce their tax liabilities, they often turn to tax avoidance strategies that exploit existing legal loopholes, adhering to the letter of the law but potentially violating its spirit. While tax avoidance provides immediate financial benefits, it poses long-term challenges, particularly in maintaining trust and legitimacy among stakeholders, including consumers, investors, and regulatory bodies. This is especially critical in industries like banking, where public trust is essential for long-term success and stability.

In the banking sector, tax avoidance is not merely a financial strategy but one that intersects with broader ethical concerns. Banks are often seen as pillars of the economy, and as such, their actions are subject to intense scrutiny. Despite the opportunity for banks to leverage tax minimization strategies due to the inherent complexity of their operations—such as cross-border transactions, derivative management, debt securities, and foreign investments—this complexity can lead to both advantages and risks. On one hand, these financial instruments and cross-border dealings provide banks with various opportunities to legally reduce their tax obligations. On the other hand, the very nature of these transactions complicates the monitoring and enforcement of tax regulations, increasing the risk of perceived or actual tax avoidance.

The banking sector's vulnerability to scrutiny arises from its dual responsibility: to generate profits for shareholders while maintaining ethical practices that align with societal values. Tax avoidance, while beneficial in the short term, can raise significant concerns in this regard. The financial benefit achieved through aggressive tax strategies may be overshadowed by potential damage to a bank's public image and its long-term relationships with key stakeholders. Furthermore, when banks are seen to minimize their tax

obligations excessively, they may face accusations of undermining the economy, public services, and societal welfare—critical elements in maintaining their social license to operate.

In light of these dynamics, this research focuses on the Indonesian banking sector, exploring how tax avoidance impacts corporate social responsibility (CSR) and profitability. The Indonesian banking sector offers a compelling case study due to its growing influence on the national economy and its exposure to regulatory and social expectations. Understanding how tax avoidance practices within this sector affect CSR activities—such as community engagement, environmental initiatives, and charitable contributions—is crucial. It provides insights into the delicate balance banks must strike between maximizing profits through tax minimization and fulfilling their societal obligations.

Moreover, the complex relationship between tax avoidance and profitability warrants careful examination. While tax avoidance can boost short-term financial performance by reducing tax liabilities, it may have long-term consequences, such as legal risks, regulatory changes, and reputational damage. These factors can ultimately undermine the profitability that tax avoidance initially seeks to enhance. Therefore, this research aims to offer a comprehensive analysis of how tax avoidance influences not only CSR but also the broader financial sustainability of banks, specifically within the highly regulated Indonesian banking environment.

This study will shed light on the intricate balancing act that banks face when implementing tax avoidance strategies and their alignment with corporate responsibility and long-term profitability. It will provide insights into the ethical consideration's banks must take into account while navigating the pressures to optimize their financial performance, all while maintaining trust and meeting societal expectations in a complex and regulated market.

Problem Statement

This study aims to explore the direct and indirect effects of tax avoidance on corporate social responsibility (CSR) and profitability within Indonesia's banking sector. Specifically, the research investigates how tax avoidance practices not only affect short-term financial performance but also impact a bank's CSR initiatives and long-term sustainability. By examining the influence of tax avoidance on CSR, this study contributes to understanding how tax policies intersect with corporate governance and public perception, particularly in the context of an emerging market like Indonesia. Furthermore, the study seeks to determine how tax avoidance strategies influence the profitability of banks and whether such strategies align with the long-term value creation for shareholders and stakeholders alike. The long-term implications of these effects are especially pertinent for both regulators and corporate leaders as they shape the future landscape of tax and corporate responsibility in Indonesia's financial sector.

Theory and Hypothesis

Agency Theory

Agency theory, developed by Jensen and Meckling (1976)^[1], provides a framework for understanding the dynamics between principals (shareholders) and agents (managers). In this relationship, conflicts of interest are often inherent. Shareholders, as the owners of the company, are primarily concerned with maximizing long-term shareholder value, while managers, acting as agents, may prioritize their personal interests such as short-term profits, bonuses, or other incentives over the long-term goals of the company. This misalignment of interests is the core of the agency problem, which can lead to behaviors that are detrimental to the overall company performance.

In the context of tax avoidance, managers may see the practice as a way to boost immediate financial outcomes, such as reducing tax expenses and increasing profits for bonus or short-term performance targets. However, agency costs arise from these short-term decisions. These costs include reputational damage from perceived unethical behavior, legal risks from aggressive tax planning strategies that might attract regulatory scrutiny, and the potential loss of shareholder trust if tax avoidance is seen as a sign of poor governance. These effects can ultimately erode the company's long-term value. Managers, focused on meeting short-term financial goals, may overlook the broader, long-term implications of their actions, leading to adverse consequences for the company's reputation and overall value.

- **H1a:** Strong corporate governance negatively affects tax avoidance as measured by the Effective Tax Rate (ETR).
- **H1b:** Strong corporate governance negatively affects tax avoidance as measured by Book-Tax Differences (BTD).

Corporate governance plays a critical role in aligning the interests of managers with those of shareholders. Strong governance structures, including independent boards, audit committees, and transparent financial reporting, are believed to reduce the likelihood of tax avoidance because they impose greater accountability and oversight on management's actions. By enforcing strict oversight mechanisms, shareholders can mitigate the agency problem,

thus discouraging the opportunistic behavior of managers, such as engaging in aggressive tax avoidance strategies.

Legitimacy Theory

Legitimacy theory posits that companies must gain and maintain social acceptance to ensure their survival in the long term. In the corporate world, legitimacy is essential for a firm's ability to operate effectively within the market and society. Organizations seek legitimacy by aligning their operations with societal norms and expectations, which often include ethical considerations such as paying fair taxes. Tax avoidance, while legal, may be viewed negatively by the public and stakeholders, leading to reputational damage and questioning of the company's ethical stance. To counterbalance the negative perception created by aggressive tax avoidance practices, companies may engage in Corporate Social Responsibility (CSR) activities. CSR allows companies to demonstrate their commitment to social good, including environmental sustainability, community development, and ethical business practices. By actively participating in CSR initiatives, companies can offset the harm caused by tax avoidance, maintaining or even improving their public image. Thus, CSR can act as a tool for maintaining legitimacy, enabling companies to strengthen their social license to operate and foster goodwill among stakeholders, including consumers, investors, and regulators.

- **H2a:** Higher financial performance measured by Return on Assets (ROA) negatively affects tax avoidance as measured by ETR.
- **H2b:** Higher financial performance (measured by ROA) negatively affects tax avoidance as measured by BTD.

Companies with higher financial performance are often under less pressure to engage in tax avoidance, as they can afford to meet their tax obligations without impacting profitability. The relationship between financial performance and tax avoidance is therefore expected to be negative: as a company's financial health improves, its need for aggressive tax planning strategies diminishes. Furthermore, higher profitability provides companies with greater opportunities to invest in CSR, thereby maintaining their social legitimacy even when engaging in tax minimization practices.

Leverage and Profitability

Leverage, or the use of debt financing, plays a significant role in corporate tax planning. According to tax shield theory, companies with higher leverage are more likely to engage in tax avoidance strategies. The tax shield theory suggests that firms with substantial debt benefit from interest expense deductions, which reduce their taxable income and, consequently, their tax liabilities. The greater the amount of debt in a company's capital structure, the larger the potential tax savings from these deductions, creating an incentive for firms to engage in tax avoidance.

In the banking sector, where leverage is common, companies often use debt to reduce their taxable income, improving short-term profitability. However, the use of high leverage as a tax avoidance strategy can have long-term consequences. Excessive debt can increase financial risk and, if not managed carefully, lead to a deterioration of profitability and reputation. Moreover, aggressive tax

avoidance practices driven by high leverage can raise ethical concerns and damage a bank's public image, ultimately reducing its value and harming its CSR efforts.

- **H3a:** Higher managerial ownership negatively affects tax avoidance as measured by ETR.
- **H3b:** Higher managerial ownership negatively affects tax avoidance as measured by BTM.

Managerial ownership refers to the proportion of the company's shares held by its managers. According to agency theory, higher managerial ownership reduces the agency problem by aligning the interests of managers with those of shareholders. Managers with a significant stake in the company are more likely to act in the long-term interests of the company, reducing the incentive to engage in tax avoidance practices that might harm the company's reputation or incur legal risks. Therefore, it is hypothesized that higher managerial ownership will result in lower levels of tax avoidance, as measured by both ETR and BTM.

Methodology

This study employs a quantitative research design to examine the impact of tax avoidance on corporate social responsibility (CSR) and profitability in the Indonesian banking sector. The research focuses on 30 conventional banks listed on the Indonesia Stock Exchange (IDX) during the period from 2021 to 2023. The primary approach for selecting the sample is purposive sampling, which allows for a focused selection of companies that are representative of the population in question—banks that are publicly listed and whose financial and CSR data are readily available for analysis.

Data Collection

The study utilizes secondary data, primarily derived from the annual reports and sustainability reports of the selected banks. These reports are publicly available and contain detailed financial information, along with disclosures about CSR activities. The annual reports provide comprehensive data on financial performance, tax payments, and corporate strategies, while sustainability reports offer insights into the banks' CSR efforts and their alignment with broader social and environmental goals. Using these sources allows for an in-depth understanding of how tax avoidance practices might correlate with CSR disclosures and profitability outcomes.

The time period selected (2021–2023) is particularly relevant as it encompasses a post-pandemic recovery phase where financial institutions in Indonesia were re-adjusting to both economic challenges and new regulatory measures. This period is also crucial in evaluating the post-COVID landscape, as tax avoidance strategies may have been influenced by changes in government fiscal policies, business operations, and societal expectations.

Key Variables

The following key variables are used in the study to assess the relationships between tax avoidance, CSR, and profitability

1. Tax Avoidance (Independent Variable)

Tax avoidance is measured using two commonly recognized proxies:

- **Effective Tax Rate (ETR):** The ETR is calculated by dividing the total tax expense by pre-tax income. A lower ETR typically indicates higher tax avoidance, as it suggests that the company is legally minimizing its tax burden.
- **Book-Tax Differences (BTD):** BTD refers to the difference between the book income (reported in financial statements) and taxable income (as reported to tax authorities). Larger discrepancies between book and tax income can indicate tax avoidance practices.

2. Corporate Social Responsibility (CSR) (Dependent Variable)

CSR is measured by CSR disclosure scores, which reflect the extent to which a company reports on its environmental, social, and governance (ESG) activities. These scores are derived from the banks' sustainability reports and are often evaluated based on established CSR reporting frameworks, such as the Global Reporting Initiative (GRI) or the Sustainability Accounting Standards Board (SASB) guidelines. Higher CSR disclosure scores indicate greater transparency and commitment to social responsibility. The relationship between CSR and tax avoidance is particularly important in understanding how aggressive tax strategies may influence a bank's public image and ethical standing.

3. Profitability (Dependent Variable)

Profitability is measured using the Return on Assets (ROA) ratio, which indicates how efficiently a bank uses its assets to generate profits. ROA is calculated by dividing net income by total assets. It serves as a crucial metric for evaluating the overall financial performance of the bank, as it reflects the ability of the bank to generate profits from its assets, which is essential for its long-term sustainability. The study hypothesizes that tax avoidance might influence profitability by reducing tax expenses in the short run, but the long-term effects on profitability, especially if it harms reputation or leads to legal challenges, will also be considered.

4. Control Variables

To account for other factors that may influence CSR and profitability, several control variables are included in the model:

Leverage: Leverage is measured by the debt-to-equity ratio (D/E ratio). Higher leverage can incentivize tax avoidance due to the potential tax benefits of interest expense deductions. This variable controls for the impact of financial leverage on tax avoidance and profitability.

Firm Size: Firm size is measured by the natural logarithm of total assets. Larger banks tend to have more complex operations and greater opportunities for tax avoidance due to their diversified financial activities. Larger firms may also face more regulatory scrutiny, which could influence their tax avoidance strategies.

Capital Intensity: Capital intensity is measured by the ratio of capital expenditures to total assets. Capital-intensive banks may engage in tax avoidance through depreciation and other capital-related tax planning strategies. This

variable accounts for the impact of a bank’s investment in fixed assets on its tax strategies.

Data Analysis

The data collected will be analyzed using multiple linear regression analysis, which allows for testing the relationship between the independent variable (tax avoidance) and the dependent variables (CSR and profitability), while controlling for the effects of firm size, leverage, and capital intensity. Multiple regression analysis helps to determine the strength and direction of the relationships, providing insights into whether tax avoidance practices significantly affect CSR disclosures and profitability.

Before running the regression analysis, the data will undergo several preliminary tests:

- **Descriptive Statistics:** To provide an initial understanding of the data and its distribution.
- **Normality Test:** To ensure that the data is normally distributed, which is a key assumption for running regression analysis.
- **Multicollinearity Test:** To check whether any of the independent variables are highly correlated with each other, which could distort the results of the regression model.
- **Heteroscedasticity Test:** To ensure that the variance of residuals is constant across all levels of the independent variables.

Descriptive Statistics

The descriptive statistics provide an insightful overview of the data set used in this study, summarizing key variables that influence tax avoidance, CSR, and profitability in the Indonesian banking sector.

Table 1

Variable	N	Min	Max	Mean	Std. Deviation
ETR (Effective Tax Rate)	90	0.09	2.90	0.5285	0.32372
CSR (Corporate Social Responsibility)	90	0.36	1.88	0.9528	0.35415
ROA (Return on Assets)	90	0.00	1.88	0.1118	0.38287
CAR (Capital Adequacy Ratio)	90	0.17	1.39	0.5282	0.16727
Leverage (LVR)	90	0.00	5.74	2.2914	0.99339
Firm Size (SIZE)	90	4.95	6.15	5.6963	0.23092

The Effective Tax Rate (ETR) shows significant variation across the sample of banks, ranging from 0.09 to 2.90. The mean value of 0.5285 indicates a moderate level of tax avoidance. However, the relatively high standard deviation (0.32372) indicates that there is a considerable spread in the extent to which different banks engage in tax avoidance. Some banks minimize their tax liabilities more aggressively than others, while others exhibit relatively lower tax avoidance practices.

The CSR disclosure scores also display a broad range, from 0.36 to 1.88, with a mean of 0.9528. This suggests that banks have varying levels of commitment to social responsibility, with some banks being more transparent and active in their CSR efforts than others. The standard

deviation (0.35415) further supports the observation that there are significant differences in CSR practices across banks.

For profitability, as measured by Return on Assets (ROA), the values range from 0.00 to 1.88, with a mean of 0.1118. This indicates that, on average, banks are generating modest profits relative to their total assets. However, the high variability (0.38287) in ROA suggests that some banks are more profitable than others, with profitability potentially being influenced by various factors, including tax avoidance practices.

The Capital Adequacy Ratio (CAR), which measures the financial stability of the banks, has a mean of 0.5282, indicating that banks, on average, maintain a healthy buffer of capital. This is important because a higher CAR typically signifies stronger financial stability, which may influence a bank’s willingness and ability to engage in tax avoidance.

Leverage (LVR), with a mean of 2.2914 and a range from 0.00 to 5.74, indicates that banks in the sample are moderately leveraged, suggesting that debt is a significant component of their capital structure. The standard deviation (0.99339) shows that some banks rely more heavily on debt than others, which may contribute to variations in tax avoidance practices, as higher leverage often leads to higher tax shield opportunities.

Finally, Firm Size (SIZE), measured by the natural logarithm of total assets, has a mean of 5.6963 and ranges from 4.95 to 6.15. Larger banks may have greater opportunities for tax planning due to the scale and complexity of their operations. The low standard deviation (0.23092) suggests that the size of the banks in the sample is relatively consistent.

Hypothesis Testing

The regression models used in this study examine the relationships between tax avoidance, CSR, and profitability, while accounting for the effects of control variables such as leverage, firm size, and capital intensity.

Coefficient of Determination (R²)

The adjusted R² for CSR is 0.891, meaning that approximately 89.1% of the variation in CSR disclosures is explained by the independent variables (tax avoidance, leverage, firm size, and capital adequacy). This high value indicates that the regression model explains a substantial portion of the variation in CSR, suggesting that tax avoidance, corporate governance, and other financial factors are strong determinants of CSR activities in the banking sector.

For profitability (ROA), the adjusted R² is 0.419, indicating that 41.9% of the variation in profitability is explained by the independent variables. While this is a lower value compared to CSR, it still suggests that tax avoidance, firm characteristics, and leverage significantly influence a bank’s profitability.

Simultaneous Test (F-test)

The F-test result for CSR indicates that the overall regression model is significant, with an F-value of 183.730 and a p-value of 0.000. This confirms that the independent variables (tax avoidance, CSR disclosure, firm size, leverage, and capital adequacy) collectively have a statistically significant effect on CSR.

Partial Test (T-test)

The T-test results provide insights into the individual effects of each independent variable on CSR and profitability:

1. Tax Avoidance (ETR)

The t-value for ETR is -3.400 ($p = 0.001$), indicating a significant negative effect of tax avoidance on CSR. This suggests that higher levels of tax avoidance are associated with lower CSR disclosures, supporting the hypothesis that aggressive tax avoidance undermines a company's commitment to social responsibility and reduces transparency in CSR activities.

2. Leverage

The t-value for leverage is -20.711 ($p = 0.000$), showing a significant negative effect on CSR. This result suggests that higher leverage, often associated with debt-driven tax avoidance strategies, can harm a company's CSR efforts, possibly due to the increased financial risk and pressure to prioritize short-term financial performance over social responsibility.

3. Firm Size

The t-value for firm size is 3.448 ($p = 0.002$), indicating a significant positive effect on CSR. Larger firms tend to have greater resources and capabilities to engage in CSR activities, and their scale allows them to implement more comprehensive CSR programs. This finding aligns with the expectation that larger companies are more likely to be under public scrutiny and, thus, are more proactive in demonstrating their social responsibility.

4. Profitability (ROA)

The t-value for ROA is -2.663 ($p = 0.009$), suggesting a negative significant effect of tax avoidance on profitability. This implies that while tax avoidance may improve short-term financial performance by reducing tax expenses, it can negatively affect long-term profitability due to reputational risks, legal consequences, and potential loss of public trust.

Conclusion

The findings of this study provide clear evidence that tax avoidance has a significant negative impact on both corporate social responsibility (CSR) and profitability in the Indonesian banking sector. Banks engaging in aggressive tax avoidance practices tend to have lower CSR disclosures, which can undermine their social legitimacy and damage their public image. Furthermore, while tax avoidance may offer short-term financial benefits, it negatively affects long-term profitability, suggesting that such practices come at a greater cost than their immediate financial gains.

The results underscore the importance of strong corporate governance in mitigating tax avoidance and enhancing CSR. Regulatory oversight is essential to ensure that banks do not prioritize financial gains from tax avoidance over their social responsibilities and long-term sustainability. Policymakers should consider reinforcing regulations that balance tax efficiency with ethical business practices to promote transparency and fairness in the banking sector.

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