Journal of Strategic Management and Business Simulation (JMASSBI) Vol 5. No. 2 2024
Permalink: http://jmassbi.fekon.unand.ac.id/index.php/mssb/article/view/128
Doi: https://doi.org/10.25077/mssb.5.2.62-71.2024
ISSN 2746-6868 (online)

The Effect of Corporate Sustainability Practices on Tax Avoidance: Evidence from Indonesia

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Abstract

Environmental, Social, and Governance (ESG) factors are currently receiving significant attention from investors and company management. This study aims to analyze the relationship between ESG performance and tax avoidance among companies in Indonesia. The research utilizes financial statement data from non-financial sector companies listed on the Indonesia Stock Exchange for 2019–2023. Financial data and ESG scores were sourced from the LSEG Refinitiv database. Data analysis was conducted using a quantitative approach with the EViews 13 software. The results indicate a significant negative relationship between ESG scores and tax avoidance. This finding suggests that companies with strong ESG performance are less likely to engage in tax avoidance practices. These results align with agency and stakeholder theories, which propose that companies with effective governance are less inclined to participate in tax avoidance activities.

Abstrak

Aspek lingkungan, sosial, dan tata kelola perusahaan (Environmental, Social, and Governance/ESG) saat ini mendapat perhatian besar dari para investor dan manajemen perusahaan. Penelitian ini bertujuan untuk menganalisis hubungan antara kinerja ESG dengan penghindaran pajak pada perusahaan di Indonesia. Penelitian menggunakan data laporan keuangan perusahaan sektor non-keuangan yang terdaftar di Bursa Efek Indonesia selama periode 2019-2023. Data keuangan dan skor ESG diperoleh dari database LSEG Revinitif. Analisis data dilakukan dengan pendekatan kuantitatif menggunakan aplikasi EViews 13. Hasil penelitian menunjukkan bahwa skor ESG memiliki hubungan negatif signifikan dengan penghindaran pajak. Temuan ini mengindikasikan bahwa perusahaan dengan kinerja ESG yang baik cenderung tidak melakukan penghindaran pajak. Hal ini sejalan dengan agency theory dan stakeholder theory bahwa perusahaan dengan tata kelola yang baik cenderung menghindari praktik penghindaran pajak.

Keywords: tax avoidance, sustainability, ESG Score, BTD

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Acknowledgment: (10 pts, kalau ada, maksimum 100 kata)

Introduction

Tax avoidance has become a significant global challenge, diminishing tax revenues and obstructing progress toward sustainable development (Van de Vijver et al., 2020). A report by the Tax Justice Network, released at the end of 2020, estimated that corporate tax avoidance leads to a worldwide revenue loss of approximately USD 245 billion annually. This financial drain is driven by corporate strategies to reduce tax liabilities by leveraging legal loopholes and ambiguities in tax regulations, resulting in tax payments that fall below what should be properly owed. In Indonesia, the impact of tax avoidance is particularly substantial, with annual losses estimated at USD 4.86 billion, equivalent to IDR 68.7 trillion (using an exchange rate of IDR 14,149 per USD).

On the other hand, tax revenues play a vital role in maintaining economic stability and driving development across countries, including Indonesia. As the primary source of government income, taxes are essential for funding a wide range of programs, such as infrastructure development, education, healthcare, and other public services. In 2023, Indonesia's tax revenue reached IDR 2,118.348 trillion, making up 80.32% of the total national income. This significant share underscores the importance of tax revenue as the dominant and indispensable funding source for government operations and developmental projects.

In the short term, tax avoidance offers advantages to companies by lowering their tax liabilities (Kim et al., 2019). The aim of aggressive tax planning through avoidance is to reduce the tax costs incurred by the company (Balakrishnan et al., 2019). An increase in after-tax profits benefits shareholders by enhancing their wealth (Hasan et al., 2021). Company management is driven to boost profits as a key performance measure, reflecting their effectiveness in overseeing the company from the shareholders' perspective. This objective contrasts with the goals of tax authorities, who seek to maximize government revenue and ensure the security of public finances (Eberhartinger & Zieser, 2021). While shareholders and executives aim to minimize tax expenses, the government focuses on maximizing tax collections. This creates a conflict of interest between tax authorities and companies as taxpayers.

The use of ESG (Environmental, Social, and Governance) indicators in evaluating corporate performance, social impact, and business sustainability is becoming increasingly focused by both companies and investors. ESG scores are indicators used to assess a company's performance in the areas of Environment, Social, and Governance (Gillan et al., 2021). The higher the ESG score, the better the company's performance in conducting business practices that are sustainable and socially and environmentally responsible. On the other hand, tax avoidance refers to strategies employed by companies to take advantage of legal loopholes in order to lower their tax obligations. This behavior is seen as socially irresponsible and unethical, potentially damaging the company's reputation and goodwill (Souguir et al., 2024). With growing awareness of corporate social and environmental responsibility, the question of how ESG score or awareness of a company's social impact influences tax avoidance is becoming increasingly important.

Previous studies on tax avoidance in Indonesia generally did not exclude companies that are predominantly subject to Final Income Tax (PPh Final) under Article 4(2) of the Income Tax Law. Companies subject to PPh Final have fundamental differences in the calculation of tax and the application of rates compared to companies subject to non-final PPh. PPh Final is typically applied directly to gross income without considering deductions or other expenses, while non-final PPh is calculated based on taxable income, which is reduced by related costs. These differences may result in heterogeneity within the research sample, potentially affecting the accuracy of the analysis and interpretation of the results. In light of this, this study explicitly excludes companies subject to PPh Final from the sample to maintain data homogeneity and ensure more consistent, relevant, and reliable findings in the context of tax avoidance research.

Literature Review and Hypothesis Development

Literature Review

Agency Theory

Agency theory is a concept in economics and management that describes the relationship between principals (shareholders) and agents (directors). This theory focuses on conflicts of interest that arise because owners and managers have different goals and unbalanced information. Agency problems occur when there are differences in interests between the principal and the agent (Jensen & Meckling, 1976). Principals want agents to act in their best interests, but agents may have different personal interests. Management tends to focus on achieving short-term profits or high salaries, while principals want long-term growth and increased company value.

Agency costs are expenses incurred to mitigate or address agency problems (Balakrishnan et al., 2019) (Jensen & Meckling, 1976). These costs arise due to conflicts of interest between shareholders and directors as agents. They include monitoring costs borne by shareholders to oversee the directors' performance and costs incurred by directors as agents to assure shareholders that they are acting in the principal's best interests, such as the preparation of audited financial statements. Additionally, there are residual costs, which represent losses resulting from decisions made by agents that do not fully align with the principals' interests, even when oversight mechanisms are in place.

Stakeholder Theory by Freeman (1984) is a theory in management and business ethics that states that the success of a company is not only measured by the financial benefits obtained by shareholders but also by how the company manages its relationship with all stakeholders involved or affected by its business activities. By addressing the needs and interests of all stakeholders, a company can create greater long-term value. This often involves balancing short-term profitability with long-term sustainability. Stakeholder Theory is closely associated with business ethics and Corporate Social Responsibility (CSR), emphasizing that companies are expected to operate ethically, not only pursuing profit but also considering their impact on society and the environment.

Tax Avoidance

Tax avoidance refers to activities undertaken by taxpayers to reduce or even eliminate their tax liabilities by exploiting loopholes or ambiguities (grey areas) in tax laws (Fisher, 2014). Although tax avoidance does not directly violate the law, it is contrary to the purpose of tax legislation (OECD, 2022). In contrast, tax evasion is a scheme to reduce or eliminate tax liabilities through unlawful means (Fisher, 2014). Tax evasion is illegal in Indonesia. Under tax law, such actions are subject to administrative penalties and can also result in criminal charges.

The traditional view assumes that tax avoidance can enhance firm value. This activity maximizes profitability and shareholder wealth by transferring resources from the government to shareholders. By reducing tax expenses, companies can allocate more resources for investment, thereby increasing their value. This perspective aligns with the findings of Blaufus et al. (2019), who observed that legal tax avoidance receives a positive response from the stock market. Investors perceive reduced tax burdens as having a favorable impact on the company's future profitability. However, Thai et al. (2023) and Kim et al. (2011) found the opposite, reporting a positive correlation between tax avoidance and declining stock prices in the market. Similarly, Chen et al. (2014) observed that tax avoidance lowers a company's value and increases agency costs. This aligns with political cost theory, which states that tax avoidance negatively impacts a company's reputation in the eyes of consumers and the stock market (Fisher, 2014).

Environmental, Social, and Corporate Governance (ESG) Score

Sustainable investing and the focus on environmental, social, and governance (ESG) factors have become increasingly important to both investors and companies. One of the main issues of concern is the relationship between ESG and tax avoidance. Public reputation drives companies to avoid engaging in tax avoidance practices (Menicacci & Simoni, 2024). ESG score is a measure of environmental and governance aspects that are closely related to corporate reputation. Jiang et al. (2024), Yoon et al. (2021) found that ESG score is negatively related to the level of tax avoidance. Abdelmoula et al. (2022) state that companies committed to ethical practices and good governance tend not to minimize their tax obligations to maintain the company's reputation and image. these findings also align with research conducted by Du & Li (2023), which states that corporate tax avoidance is negatively related to corporate social responsibility performance. This finding supports the corporate culture theory, suggesting that companies consistently behave ethically in CSR practices and tax payments (Du & Li, 2023).

Hypothesis Development

Menicacci & Simoni (2024) argue that in order to obtain legitimacy and build a positive reputation in the eyes of the public, companies often strive to reduce their levels of tax avoidance. This is driven by the growing expectation that businesses should act responsibly in terms of financial performance and how they contribute to society and the environment. Environmental, Social, and Corporate Governance (ESG) is a critical framework used to assess corporate responsibility. ESG measures a company's commitment to environmental sustainability, social responsibility, and strong governance practices. Companies with high ESG scores are generally perceived as having better governance structures and being more conscientious in their long-term environmental and social sustainability approach. A higher ESG score signals to investors, regulators, and consumers that the company is managing its operations with greater transparency and ethical standards.

Several studies have established a significant negative relationship between a company's ESG performance and its level of tax avoidance. For instance, research by Jiang et al. (2024), Abdelmoula et al. (2022), and Yoon et al. (2021) suggests that companies with higher ESG scores are less likely to engage in aggressive tax avoidance strategies. This is likely because companies with strong ESG practices are more concerned about their long-term reputation and the risks associated with unethical practices, such as tax avoidance, which may damage their public image. Additionally, these companies may be subject to greater scrutiny from regulators and stakeholders, further discouraging tax avoidance behavior. In the context of Indonesia, where corporate governance and sustainability are gaining increasing attention, the impact of ESG on tax avoidance is particularly relevant. The growing emphasis on transparency, accountability, and responsible corporate practices in the Indonesian business environment suggests that companies with high ESG scores may engage in less tax avoidance.

H1: ESG score has a negative and significant effect on tax avoidance.

Research Methods

This study adopts a quantitative research approach, using purposive sampling, with data obtained from the LSEG Refinitiv database. Data analysis is performed using regression techniques and processed through the EViews 13 software. The study's population consists of financial statements from non-financial sector companies listed on the Indonesia Stock Exchange. The total population tested was 773 companies with financial report years from 2019 to 2023 or for 5 (five) years. The sampling method implemented is nonprobability sampling, where not all elements or members of the population have an equal chance of being selected (Sinulingga, 2022), (Sugiyono, 2019). Instead, sample selection is conducted using purposive sampling based on specific predefined criteria (Kusumah, 2023).

The following are the sample criteria used in this study:

1. Non-financial sector companies listed on the Indonesia Stock Exchange.
2. Companies with Environmental, Social, and Corporate Governance (ESG) scores accessible through the LSEG Refinitiv database for 2019–2023.
3. Under Indonesian tax regulations, majority-income Companies are subject to non-final Income Tax (PPh).

Table 1
Research Sample

Description of sample selection	Total Number of Companies
1. Non-financial sector companies listed on the Indonesia Stock Exchange based on LSEG Revinitif data as of June 06, 2024.	773
2. Excluded: Non-financial sector companies that do not have ESG scores based on the complete LSEG Revinitif database for 2019-2023.	(735)
3. Deducted: Companies with dominant income subject to Final Income Tax.	(5)
4. Total of selected companies	33
5. Total Research Sample (2019-2023)	165

The method employed in this study is multiple regression analysis using panel data. This method examines the relationship between the dependent variable and several independent variables. The purpose is to estimate or predict the average value of the dependent variable based on the known independent variables. The multiple linear regression formula applied in this study is as follows:

$$BTD = \alpha + \beta 1SIZE + \beta 2PROFIT + \beta 3ESG + e \quad (1)$$

Where:
BTD : book tax different
Size : firm size
Profit : profitability
ESG : Environmental, Social, and Corporate Governance (ESG) score

BTD is a book tax different that is used as a proxy to calculate tax avoidance. SIZE is the size of the company, which is calculated using the natural logarithm proxy of the company's total assets. Profit is a measure of the company's profitability as measured using the company's return on total assets (ROA). Hanlon & Heitzman (2010) identify 12 proxies that can be used to measure tax avoidance. Among these, this study adopts the Book-Tax Difference (BTD) as the proxy to assess the level of tax avoidance. This proxy is widely employed in the literature on tax avoidance research. The Book-Tax Difference (BTD) examines how management aligns financial reporting for accounting purposes with fiscal reporting for tax purposes. BTD measures the variance between financial statements prepared for accounting purposes and those prepared for taxation purposes, reflecting the extent of tax avoidance by the company (Hashfi, 2024). A positive BTD indicates that reported taxable income is lower than commercial income, suggesting a tendency for the company to employ tax avoidance strategies. Consistently positive BTD values may indicate that a company persistently exploits tax regulatory loopholes to reduce its tax burden. This study adopts the methodology developed by (Noor et al., 2009) to calculate BTD as follows:

$$\text{Book tax different (BTD)} = \frac{\text{(Income before Tax-Estimate Tax Different)}}{\text{Company's Total Assets}}$$

$$\text{Estimate Tax Income (ETI)} = \frac{\text{Current Tax Income}}{\text{Current tax income rate}}$$

Note:

The corporate current income tax rate used in this study is the applicable tax rate in Indonesia in accordance with Article 17 of the Income Tax Law (PPh), which sets a rate of 25% for 2019 and 22% for 2020 to 2023.

ESG (Environmental, Social, and Governance) is an indicator used to evaluate a company's environmental sustainability, social responsibility, and corporate governance performance. A higher

ESG score reflects better performance in implementing sustainability values across these dimensions. The ESG score used in this study is derived from the data provided by the Refinitiv database. Refinitiv calculates ESG scores based on publicly reported, verifiable data from companies. The score represents a weighted average of the performance components in environmental, social, and governance dimensions.

Analysis and Discussion

Descriptive Statistics

The average (mean) tax avoidance indication, measured by the book-tax difference (BTD) proxy, for the entire research sample is -0.014937. The negative value in BTD indicates that companies report lower commercial net income compared to fiscal net income. Therefore, based on this average value, it is known that, in general, companies in the research sample report higher fiscal profits than commercial profits. The data sample shows that the lowest BTD value is -0.300454, and the highest BTD value is 0.119237. The standard deviation of this data is 0.04653, which reflects the distribution of the BTD variable within the research sample.

The average ESG performance score of the companies in the research sample is 53.70647. The ESG score reflects the company's commitment to implementing sustainability principles, which include environmental, social, and governance aspects. The range of ESG scores in the sample spans from a minimum value of 13.58339 to a maximum value of 88.79508. The standard deviation of the ESG scores for the entire research sample is 18.83961. A relatively high standard deviation suggests that there are notable differences in the ESG performance of the companies included in the study.

Results of Classical Assumption Tests and Panel Data Model Selection

The panel data model in this study is determined through a series of tests: the Chow, the Hausman, and the Lagrange Multiplier. The Chow test results show that the cross-section F probability value is below 0.05. This indicates that the Fixed Effect Model (FEM) is more appropriate than the Common Effect Model (CEM). However, based on the Hausman test, the random cross-section probability value is above 0.05. Thus, the Random Effect Model (REM) is considered better than the FEM model. Furthermore, the Lagrange Multiplier test results also show that the REM model is more suitable for use than the CEM model. Thus, this study uses the REM model to test the research hypothesis.

Gujarati & Porter (2009) state that for research using both cross-sectional and time-series data with more than 100 observations, a normality test is not required to be strictly conducted and can be overlooked. This is because, with a large number of observations, even if the normality assumption is not fully met, statistical tests like the t-test and F-test can still yield valid and reliable results. In such cases, the deviation from normal distribution does not significantly impact the accuracy of the analysis results. Therefore, this study follows this perspective and does not perform a normality test, as it believes that the large sample size is sufficient to ensure the reliability and validity of the analysis outcomes.

The results of the multicollinearity test show that there are no signs of multicollinearity among the independent variables used in this study. This confirms that the relationships between the independent variables are relatively independent and do not significantly influence each other. Additionally, the results of the Glejser test indicate that the panel data regression model is free from heteroscedasticity, meaning the error variance is constant and satisfies the assumption of homoscedasticity. Furthermore, the Durbin-Watson (d) test yielded a d value of 2.1556, which falls between the upper limit (du) of 1.7825 and four minus the lower limit (4-dl) of 2.2915. This suggests that the panel data regression model does not exhibit autocorrelation, and the residuals between observations are independent. Overall, these test results show that the regression model used in the study meets the classical assumptions and can be relied upon for further analysis.

Hypothesis Test Result

The results of the t-statistical test show in Table 2 that the coefficient of the ESG Score variable is -0.000607, with a probability of 0.0198. The negative coefficient indicates a negative correlation between the ESG score and tax avoidance, meaning that the higher a company's ESG score, the lower its tendency to engage in tax avoidance. The probability value of less than 0.05 indicates that the effect of the ESG score on corporate tax avoidance is statistically significant.

Table 2
Hypothesis Testing Results

Variable	Hypothesis	Coefficient	Std. Error	t-Statistic	Prob.
C		-0.121979	0.182446	-0.668574	0.5047
SIZE	+	0.003850	0.005800	0.663864	0.5077
PROFIT	+	0.226592	0.043914	5.159938	0,0000
ESG	-	-0.000607	0.000258	-2.353520	0.0198
N			165		
R-squared		0.160495			
Adjusted R-squared		0.144854			

The ESG (Environmental, Social, and Governance) score is used to evaluate how well a company incorporates environmental, social, and governance responsibilities into its operations. This score serves not only as a performance measure but also as a reflection of the company's ethical commitment to conducting a sustainable business. ESG is an important benchmark that demonstrates how seriously a company addresses its social and environmental impacts, as well as its adherence to transparent and responsible governance principles (Yoon et al., 2021). Furthermore, a high ESG score strongly correlates with the company's reputation in the eyes of the public and stakeholders. A positive reputation is a valuable asset for business sustainability, as it can increase public trust and foster consumer and business partner loyalty. Reputation is one of the key reasons why companies avoid harmful practices, such as tax avoidance, which is viewed as unethical and can damage a company's integrity (Menicacci & Simoni, 2024). This aligns with stakeholder theory, suggesting that good governance enhances social responsibility, negatively influencing tax avoidance.

As a form of unethical behavior, tax avoidance can harm a company's reputation and erode trust among stakeholders, including customers, investors, and governments. Therefore, companies with high ESG scores are more likely to focus on maintaining their reputation and avoiding actions that could damage their integrity in the eyes of the public. A strong commitment to ESG principles not only supports long-term sustainability but also reinforces the company's dedication to upholding higher ethical standards, including fulfilling tax obligations. This helps explain why, in this study, the ESG score is significantly negatively correlated with tax avoidance indications. The higher a company's ESG score, the less likely it is to engage in tax avoidance. These findings are consistent with the research of Hashfi (2024), Jiang et al. (2024), Abdelmoula et al. (2022), and Yoon et al. (2021), which shows a significant negative relationship between ESG scores and tax avoidance.

Conclusions

This study reveals a negative relationship between the ESG score and tax avoidance, with a significant impact on non-financial sector companies listed on the Indonesian Stock Exchange. This implies that companies demonstrating strong performance in environmental, social, and governance (ESG) practices are less likely to engage in tax avoidance. Firms with higher ESG scores generally emphasize ethical conduct, social responsibility, and transparency, which includes fulfilling their tax obligations. By incorporating ESG principles into their core business strategies, companies not only align with sustainability goals but also create an environment that discourages unethical practices such as tax avoidance. The commitment to these values reflects a broader corporate responsibility, signaling to stakeholders that the company operates with integrity, which ultimately reduces the likelihood of engaging in practices that could damage its reputation, such as tax avoidance. Furthermore, focusing on ESG often leads to better governance structures and stronger oversight, further ensuring compliance with legal and ethical standards and reinforcing the company's long-term sustainability and trustworthiness.

Directorate General of Taxes can consider the ESG (environment, social, and governance) score as an initial indicator to determine the level of risk of corporate tax avoidance in Indonesia. Companies with better ESG performance tend to have lower tax avoidance risk. This measure can be considered an initial filter to assess the risk of corporate tax avoidance in monitoring corporate tax obligations in Indonesia. For investors who consider tax compliance as one of the indicators in assessing investment prospects, ESG (Environmental, Social, and Governance) scores can be a relevant measurement tool in assessing corporate tax avoidance risk. Companies with better ESG performance tend to show a lower risk of tax avoidance, thus providing assurance of the company's compliance in carrying out its tax rights and obligations.

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