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Corporate Governance and Corporate Tax Avoidance: an Interactive Effects (Evidence from Indonesia Capital Market)

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Abstract

This study shows that the phenomenon arising from low governance practices is identified as one of the causes of the global financial crisis and corporate financial scandals that have an effect on the increase of tax avoidance. In addition, research in Indonesia that examines tax avoidance information by taking into account corporate governance mechanisms is still less consistent and is such a new perspective that it becomes a main consideration for this study. Likewise, the calculation using the Avoidance Tax Rate proxy developed in this study was conducted to test how much tax avoidance has been done by companies. The population for this study was taken from the manufacturing industries listed on the Indonesia Stock Exchange from 2015-2019 assumed to have conducted tax avoidance. The total samples of 87 companies were selected by following a purposive sampling procedure. The statistical analysis using multiple regression shows that the board of commissioners had a significant negative effect on tax avoidance; while, Independent commissioners had a significantly negative effect on tax avoidance and institutional ownership on tax avoidance. This study indicates that the interactive effect of corporate governance and tax avoidance is the better and optimal corporate governance as a control mechanism and the balancing power. The lower corporate governance mechanism will make it easier for companies to take tax avoidance actions.

Keywords **:**Corporate governance mechanism; Tax avoidance; Board of commissioners; Independent commissioners and institutional ownership

JEL Classification **:** G18

1. INTRODUCTION

The tax paid by the company is the transfer of wealth from the company to the state (Dyreng et al, 2017). Shareholders encourage management to be more aggressive towards taxes so as to encourage management to take tax avoidance actions. Tax avoidance actions will increase cash flow and have an effect on increasing shareholder wealth. Tax avoidance action has finally become a practice that many companies do with a variety of motivations, which in essence, provide benefits for the company.

The character of tax avoidance is usually the presence of an artificial element in which various arrangements appear to be in place when they are not and this is done because of the absence of tax factors. There is no business reality or risk, and utilizing loopholes from the law or applying legal provisions for various purposes is actually different from what is intended by lawmakers (Seely, 2020). The fiscal affairs committee of the Organization for Economic Cooperation and Development (OECD) states that there are three characteristics of tax avoidance.

1. The existence of engineering elements (artificial) in various arrangements as if there is in it when not, and this is done because of the absence of tax factors.
2. Such schemes often make use of loopholes from the law or apply legal provisions for various purposes, even though that is not what the legislator actually intends.
3. Confidentiality is also a form of this scheme in which consultants generally show tools or ways to avoid tax on the condition that taxpayers keep confidentiality possible.

According Seely, (2020) in many countries tax avoidance is divided into: 1. Acceptable tax avoidance when acceptable tax avoidance is carried out by taxpayers by carrying out transactions for which the purpose is not solely to avoid taxes and not to perform engineered transactions. 2. Unacceptable tax avoidance, namely, the transactions carried out solely to avoid taxes and engineer transactions to incur costs or losses. Tax avoidance increases after tax cash flows and tax avoidance can be seen as one of many risky investment opportunities available to management. (Armstrong et al, 2015) . Tax avoidance actions have the potentials to reduce tax payments; thereby, it increases the company's cash flow. On the other hand, it is risky to provide high additional costs for companies so that companies in countries with unclear tax avoidance regulations tend to commit higher tax avoidance compared to those with clear tax avoidance rules (Armstrong et al, 2015). Based on the phenomenon of high levels of tax avoidance in Indonesia and government oversight about it, that is, in this case the governance is not strict, the opportunity to commit tax avoidance is greater.

Several reasons that cause managers' actions to minimize taxation obligations are considered to be increasingly important corporate activities. First, taxes will reduce at least one third of profits before corporate tax (Davis et al., 2016) ; second, the purpose of business and financial policy of the company is to maximize the value after tax (Dyreng et al, 2017).

The relationship between agency theory and company tax avoidance analysis is a study of new and emerging empirical literature and should be the one theory of the relevant analytical bases to improve the understanding of the interactions between managers and shareholders with respect to corporate tax avoidance. (Lee et al., 2015). Tax avoidance and agency problems inherent in publicly owned companies have a relationship as evidenced in the increase of accounting earnings and tax or fiscal earnings. The increase in this difference can be caused by tax planning whose purpose will be to reduce taxable income, or the company's fiscal profit can also result in a decrease in accounting profits. Normally managers will minimize taxes without reducing corporate profits, or it can be said that managers like to increase accounting profits without increasing fiscal profits. However, according to Wilde & Wilson, (2018) that shareholders might benefit from tax avoidance through either higher dividends or higher share prices.

The existence of corporate governance in relation to tax avoidance which is related to the agency's view will affect the tax avoidance actions taken by companies. In large companies, especially public companies, there is a separation of ownership and control that can lead to conflicts of interest between agents and principals. Tax avoidance actions by companies are usually related directly to shareholders. Tax avoidance structure and transactions are usually so complex and confidential that tax authorities do not detect them. This allows managers to carry out their actions with implications for the interests of the company owners as shareholders. The differences between company owners and management can be harmonized with corporate governance oversight mechanisms and the broad quality of corporate governance mechanisms associated with better corporate performance.

Weak corporate governance is reflected in the lack of financial performance reporting and the lack of supervision of management activities. Financial scandals occur in many companies in a situation where the global financial crisis occurred such as the one in 1998 and 2008. The situation shows the importance of corporate governance. Weak good corporate governance was identified as one of the causes of the global financial crisis (Financial Services Authority, 2015). According to Kovermann & Velte, (2019) that investigating the determinants of tax avoidance in company requires a more comprehensive approach taking into account corporate governance institutions and all stakeholders relevant to the firm. When corporate governance is weak, an increase in tax rates results in a deviation, which is to reduce state revenues from corporate income taxes. When corporate governance is strong, an increase in corporate tax rates will increase state revenues from taxes. Tax avoidance actions are so complex and confidential that they allow managers to engage in various processes, which endanger shareholders. Asymmetry of information between agents and principals causes a high chance of misusing managerial positions in carrying out tax avoidance methods and schemes.

According Putri et al., (2016), the principles of corporate governance applied by the company in terms of fairness, accountability, transparency and responsibility will provide benefits including: (1) minimizing agency costs; (2) minimizing the cost of capital by creating a positive signal to investors; (3) improving company image; (4) increasing company value; (5) increasing stakeholder perceptions of company performance in the future. The application of good corporate governance principles requires a corporate governance structure on which companies in Indonesia are generally based like most companies in Europe. The difference only in the board of commissioners who are not directly in charge of the board of directors. This is in accordance with the Limited Liability Company Law no. 40 of 2007 where the board of commissioners and the board of directors are responsible to the GMS. The corporate governance mechanism is needed by companies to manage, monitor, control and give rewards in a form of monitoring from the principal to the agent. Corporate governance will also be able to eliminate the negative effects of arising from agency problems that exist in every tax avoidance action because corporate governance mechanisms are able to harmonize the interests of the management (agent) and shareholders (principal) so as to eliminate the negative effects resulting from tax avoidance actions.

This research aims to synthesize research on the impact of corporate governance on corporate tax avoidance. Previous literature reviews in this field such as Armstrong & et al, (2015); Goh et al., (2016) are either much broader in scope or did not cover corporate governance explicitly. While the research by Wilde & Wilson, (2018) have cover corporate governance as a determinant of tax avoidance and very briefly. Wilde and Wilson (2018) only considers the relationship between management and shareholders. That's why it differs from prior research mainly by exploring the relationship between corporate governance and corporate tax avoidance in depth.

In our research, we considered empirical articles published that examine the relationship between the two, whereby corporate tax avoidance as a dependent variable and corporate governance mechanisms serves as an independent variable using the board of commissioners, independent commissioners and institutional ownership as proxies.

This research give contribution to practitioners, regulators and researchers alike which for practitioners' implication show how corporate governance institution such as board independency, institutional ownership control using high quality audits have the potential to induce more effective but less risky corporate tax avoidance an thereby making firms more profitable and also limiting risk exposure. Contribution for regulator show that tax enforcement with high rates of audit is necessary to contain tax avoidance and external monitoring by fiscal authorities needs to be complemented with internal monitoring. We identify contributions for researchers show linkages the several topics for future research such as concept of tax avoidance and corporate governance.

2. HYPOTHESES DEVELOPMENT

According to Mozaffar Khan & Srinivasan, (2017), the costs incurred by companies in doing tax avoidance are the basis of initial research on the motivation of companies to commit tax avoidance. Another perspective on tax avoidance research and corporate governance mechanisms has recently been introduced into the literature (Lee et al., 2015). Koester et al., (2017) propose a situation where opportunistic managers arrange complex companies to facilitate transactions that reduce corporate taxes and divert company resources for personal use (which may include manipulating after-tax profits for personal gain).

Tax avoidance is a transfer of wealth from the government to shareholders expected to be a positive signal for investors to increase companies' stock price. Thus, this study used an independent variable that is a corporate governance mechanism with a proxy of an independent commissioner, a board of commissioners, and institutional ownership as well as a dependent variable namely tax avoidance using the Avoidance Tax Rate (ATR) measurement.

The board of commissioners is the head of a company who is responsible for and has full authority in controlling, directing and supervising the management of resources in accordance with the companies' objectives (Belen, et al, 2016). If a company has a good board of commissioners, the company has a good performance because the effectiveness of corporate governance is determined by the quality of the function of the board of commissioners. The size of the board of commissioners is a proxy used for the board of commissioners' variable. According to Bottenberg et al., (2017) which states that the board of commissioners is responsible and has the authority to oversee management actions so that a corporate governance mechanism significantly influences managerial opportunistic behavior.

From the description above, the hypothesis that can be formulated in this study include the followings:

H1: The board of commissioners has a negative significant effect on tax avoidance

The effectiveness of the board of commissioners as a counterweight to the strength of the CEO is strongly influenced by the level of independence of the board of commissioners. KNKG (2008) states that an independent commissioner is a member of the board of commissioners that is not affiliated with management and other members of the board of commissioners, free from business relations and other relationships so that they really act professionally. The minimum number of independent commissioners required in the OJK is 30% of all members of the board of commissioners. If the proportion of independent directors is greater than control, each managerial decision is stronger and this is the best position to carry out the supervisory function in order to create good governance. In agency theory, the principal expects the agent to improve performance and cost efficiency including tax costs as a result of the addition of wealth from the profits being generated, but the existence of an independent commissioner can be an obstacle for the principal to make tax cost efficient. On the other hand, the agents carry out opportunistic actions. Therefore, researchers argue that tax avoidance measures can be reduced by the presence of an independent commissioner. Previous research conducted by Wijayanti and Masitoh (2018) found that the independent commissioners had a positive effect on tax avoidance whereas other researchers found no significant effect on tax avoidance (Putri, Rohman, & Chariri, 2016; (Armstrong & et al, 2015). So, the present research proposes the following hypothesis:

H2: The Independent Commissioner has a negative significant effect on tax avoidance

Institutional ownership is one of the variables that proxies a corporate governance mechanism and is often referred to as sophisticated investors or sophisticated investors. Institutional ownership is an investor classified as having large capital, access to fast and wide information and high knowledge. Institutional ownership on average has a majority shareholding in a company that it is able to control management with policies that are more effective and more compliant with applicable regulations. Therefore, the company remains to be under concern and gains a return on investment with minimized risk. Researchers argue that with institutional ownership the negative effect of tax avoidance will be further reduced. In their previous research, Tandean & Winnie, (2016); Putri et al., (2016) founds that institutional ownership has a negative significance to tax avoidance whereas (Jamei, 2017) state that institutional ownership no significant with tax avoidance and Mozaffar Khan & Srinivasan, (2017) in his research found that institutional ownership have positive significant on tax avoidance.

From the description above, the hypothesis that can be formulated in this study as follow:

H3: The Institutional ownership has a negative significant effect on tax avoidance

3. METHOD, DATA, AND ANALYSIS

This research was focused on empirical testing of the model, which was developed on the basis of corporate governance mechanisms variable on tax avoidance that has an impact on companies' value. This type of research is a causal descriptive study with purposive sampling method. The total sample for the study included 87 companies from the population of manufacturing companies listed on the IDX (according to TICMI for the period 2015 – 2019) with total 435 observations.

The dependent variable was measured by using Avoidance Tax Rate (ATR) where ATR was developed from the calculation of effective tax rates (ETR) so that it could be seen how much tax avoidance was committed by the company. Some previous studies used the value of ETR directly, but this study gained the percentage of tax avoidance reduction according to the companies. The ETR value was deducted from the current tax rate. If tax avoidance rate (ATR) value is positive, the tax rate paid by the company is smaller than the applicable tax rate. In contrast, if the TA value is negative then the tax rate paid by the company is greater than the applicable tax rate.

Tax rate applied is 25%.
ETR Measurement as follows (Hanlon & S Heitzman, 2010) :

$$\text{ETR} = \textit{Effective Tax Rate}_{\text{it}} = \left(\frac{\textit{Total tax expenses}\text{it}}{\textit{Earning before tax}\text{ it}}\right)$$

Tax Avoidance Rate = tax rate applied – effective tax rate (ETR)

Meanwhile, the measurement of the independent variable for the corporate governance mechanism namely the Board of Commissioners was measured by the number of board of commissioners owned by a company. The Independent Commissioner was measured by the percentage of the number of board members who come from outside the company and Institutional Ownership. This was measured by the percentage of the total share ownership by institutional investors from all the company's share capital. This study used multiple regression analysis which was used to test two or more independent variables that affect the dependent variable. The following is the equation used to test the hypothesis in this study.

$$\textit{Tax avoidance} = \alpha_0 + \beta_1 \text{dekom} + \beta_2 \text{komin} + \beta_3 \text{kins} + \varepsilon$$

- α_0 : constants
- β 1,2,3 : coefficient
- Dekom : Board of commisioner (X1)
- Komin : Independent commisioner (X2)
- Kins : Institutional Ownership (X3)
- ε : residual of error

4. RESULTS

Table 1 shows descriptive statistics data of a company's general description of corporate governance and tax avoidance mechanisms.

Table 1. Descriptive Statistics

Variables	Mean	Standard Deviation	Minimum	Maximum
ATR	3.354	8.371	0.000	75.635
KOMIN	0.325	0.028	0.260	0.346
KINS	61.175	28.421	0.000	90.000
DEKOM	4	1.427	3	7

Source: Data processing results, 2019

Table 1 explains the minimum, maximum, average values and standard deviations of each variable used in this study.

a. Independent Commissioner (KOMIN)

The results showed that the independent commissioner on an average value was 0.325. This shows that on average, manufacturing companies listed on the Indonesia Stock Exchange have an independent commissioner of 32.5% and are in accordance with one of the terms of share listing, which must have an independent commissioner of at least 30% of the members of the Board of Commissioners.

b. Institutional Ownership (KINS)

Institutional ownership has an average of 61,175. These results indicate that on average the shares of manufacturing companies listed on the Indonesia Stock Exchange are owned by the Institution during the study period.

c. Board of Commissioners (DEKOM)

The board of commissioners is an average of 4 people. The board of commissioners is one of the company's organs that have the task of carrying out supervision in general or specifically in accordance with the Articles of Association of the company. The board also provides advice to the Directors in carrying out company activities.

d. Tax avoidance (ATR).

Tax avoidance has an average of 3,354. These results indicate that the average manufacturing company listed on the Indonesia Stock Exchange in the 2015-2019 period had an ATR of 3,354%. This means that manufacturing companies do tax avoidance at a rate of 3.4% less than the normal tax rate in force in Indonesia. A positive ATR value means that the tax rate paid by the company was smaller than the applicable tax rate. The greater the value of ATR, the greater the tax is saved or the greater the tax avoidance was committed by the company.

Table 2. Assumption test

Normality test

	Unstandardized Residual
Kolmogorov-Smirnov Z	0,910
Asymp. Sig. (2-tailed)	0,430

Heterocedasticity test

Model	t	Sig.
DEKOM	0,300	0,750
KOMIN	0,400	0,730
KINS	0,500	0,330

Multicollinierity and Autocorrelation test

Model	Multicollienarity Statistics		Autocorelation
	Tolerance	VIF	Durbin Watson
DEKOM	0,905	1,105	
KOMIN	0,997	1,003	1,921
KINS	0,903	1,108	

Table 2 shows the normality test seen from the Asymp value. Sig. (2-tailed) is greater than 5%. Multicollinierity test seen from VIF value, which is less than 10, it mean that independent variable free from multicollinierity because there is no variable have VIF value greater than 10 and tolerance value less than 0,1. Autocorelation test seen from Durbin Watson with value 1.921. Total observations n=435 and k = 2, DW table D_l 1,354 and D_u 1,584. DW value calculate 1,874 > upper limit is 1,584 and < 4 du, it means that there is no positive autocorrelation or negative autocorrelation in the model. While heterocedasticity test through sig. indicates a value greater than 5%. The conclusion of the assumption test that this research model has met the classical assumption test.

Table 3. Hypotheses Test

Tax avoidance = α_0 - 0.639dekom - 0.366komin – 0.068kins + ε

Dependent Variable: TA

Variable	expectation sign	Coefficient	Probability
Independent variable			
DEKOM	-	-0.639806	0.0214**
KOMIN	-	-0.365645	0.0216**
KINS	-	-0.067636	0.0468**

**) Significant at level 5%, *) Significant at level 10%

Note: This table presents the estimated model with the multiple regression method using OLS with the Random Effect model.

5. DISCUSSION

Hypothesis H1: The board of commissioners has a negative significant effect on tax avoidance.

The results in table 3 show that the size of the board of commissioners has a negative effect on tax avoidance as measured by Avoidance Tax Rate (ATR) of -0.639 because the sig value of 0.0214 is less than 5%, so the H_1 hypothesis is accepted. This means that the greater the board of commissioners, the smaller the tax avoidance measures will be. Good or bad corporate governance is reflected in the independent board of commissioners and other corporate governance mechanisms (Kovermann & Velte, 2019). According to Armstrong et al., (2015), tax avoidance action opens the opportunities for managers to be opportunistic for short-term goals, not for long-term benefits as expected by the principal. The role of corporate governance is expected to be able to control agency problems with tax avoidance actions taken by companies. Companies that have good governance mechanisms will be directly proportional to the company's compliance in meeting their tax obligations (Gallemore & Labro, 2015).

The board of commissioners as representatives of the interests of shareholders is able to carry out the monitoring function and support the management of the company so that the financial statements presented will be more objective. Although the board of commissioners is representative of shareholders who tend to be oriented towards maximizing profits, the board of commissioners is more focused on the ongoing concern effect of the company that minimizes long-term risk rather than pursuing short-term returns but will have a negative effect in the future for the company's survival. Opportunistic management actions in avoiding taxes can be suppressed by the supervision of the board of commissioners. Every policy carried out by management is able to be controlled and monitored so that transactions and financial reports are presented in accordance with applicable taxation provisions.

According to Mozaffar Khan & Srinivasan, (2017), the optimal number of board of commissioners varies depending on the characteristics of the company itself. Large companies usually have complex structures and with complex structures, the performance of the board of commissioners will be optimal because the number of boards is increasing. The number of the board of commissioners has little influence on carrying out the monitoring function especially in controlling tax avoidance actions. Other factors that make the board of commissioners have a negative relationship with tax avoidance can be analyzed from the professionalism of each member of the board of commissioners determining the level and extent of supervision given and how much input can be given to the Board of Directors.

The results of this study are in line with Belen et al., (2016); Lanis et al., (2018); Armstrong et al., (2015) stating that corporate governance mechanisms have a negative effect on tax avoidance.

Hypothesis H2: The Independent Commissioners has a negative significant effect on tax avoidance

Independent commissioners have a negative effect on tax avoidance of -0.365645 because the sig value of 0.0216 is less than 5%, thus the second hypothesis is accepted. The greater the percentage of independent commissioners, the smaller the tax avoidance action and vice versa. The results of this study indicate that the average independent commissioner in manufacturing companies is 30%, meaning that although the percentage is at the minimum level according to the requirements for companies that go public, the independent commissioner is able to monitor the implementation and effectiveness of good governance so that reports and information provided are absolutely transparent and accurate.

Based on the Henderson Global Investor survey (Armstrong et al., 2015), the potential investors also expect companies to show that they are compliant with tax regulations. Because they will have a major impact on their investment. Independent commissioners can represent the interests of minority shareholders or public shareholders. Public shareholders tend to comply with tax regulations, so with the responsibility for the interests of public shareholders, the independent commissioner will fight for compliance with tax regulations so as to prevent tax avoidance. If the number of independent commissioners on the board of commissioners increases, the better it will be because the monitoring function carried out by the independent commissioners will be more stringent towards opportunistic management actions. The results of this study is supported by Putri et al., (2016).

Hypothesis H3: The Institutional ownership has a negative significant effect on tax avoidance

Institutional ownership has a negative effect on tax avoidance of -0.067636 because the sig value of 0.0468 is less than 5%, thus hypothesis three is accepted. This shows that the greater the ownership of institutions, the tax avoidance will be lower and meaningful. The institutional ownership in companies in Indonesia tend to avoid risks that can destroy the company's reputation. Another factor causing this hypothesis to be accepted is the increasingly higher awareness of institutional shareholders of the importance of taxation and about the risks that must be faced with tax avoidance.

The greater the percentage of institutional ownership, the greater the voice power and encouragement of the institution to oversee management in taking actions, which are not in accordance with the provisions of tax legislation to encourage management to comply with taxation. Institutional investors who have a strong capital will be more professional and have the ability to obtain fast and extensive information so that they are more careful in making decisions that have short-term and long-term risk implications. This research is supported by Putri et al., (2016). Otherwise the results of this study is not supported by Mozaffar Khan & Srinivasan, (2017). In their result shed lights on the effect of increased ownership concentration on tax avoidance and it means that institutional ownership have a positive significant on corporate tax avoidance.

6. CONCLUSION, LIMITATION AND SUGGESTION

Conclusion

This study investigated the results of the observation of 87 manufacturing companies in Indonesia during the period 2015-2019 including its variables related to institutional ownership, board of commissioners, independent commissioners and Avoidance Tax Rate as a proxy of Tax Avoidance. The analysis shows that corporate governance mechanism has a negative effect on tax avoidance, which is both measured by the institutional ownership, the board of commissioners and the independent commissioners. This shows that the mechanism of corporate governance has a negative influence on the level of corporate tax compliance, so that it will minimize tax aggressiveness. The institutional ownership as a sophisticated and professional investor is more careful about risks that have long-term implications for the company. This study also shows that the independent commissioners can create an objective climate and maintain fairness and do not recommend tax avoidance even though it is still in the legal corridor. Although this is representative of the interests of shareholders who tend to be oriented towards maximizing profits, the long-term risk implications are more focused on ongoing concerns than the maximization of short-term earnings.

Agency conflicts can cause the agent to select a level of tax avoidance that differs from that preferred by the principals and the principals may either prefer a high level of tax avoidance resulting increased after tax in cash flow or lower tax avoidance to avoid or less firm risk. The corporate governance is able to control the agency problem of tax avoidance actions undertaken by the company because tax avoidance actions open the opportunities for managers to be opportunistic for short-term goals, not for long-term benefits as expected by the principal with implications for the loss for the company.

Limitation and Suggestions

Based on the results of statistical testing on selected sample companies against the developed model, there are limitations of the research that become a reference for further research. This study was conducted only in the 5-year observation period. The influence of other variables such as government pressure through regulations, ethical behavior, debt structure and the capital market situation has not been studied. Considering that research on tax avoidance has not yet been developed in Indonesia, it is recommended to add other indicators that affect tax avoidance, more specifically those variables which can broaden the base of taxation. It those relating to an increase in tax ratio in Indonesia. Besides suggestion given to regulator from this research, show that tax enforcement with high rates of audit is necessary to contain tax avoidance and external monitoring by fiscal authorities needs to be complemented with internal monitoring. With the enactment of the Automatic Exchange of Information (AEOI) which is a commitment between countries for disclosure and exchange of information, every taxpayer needs to reform the tax management system which is carried out in accordance with tax compliance. The government is advised to be more assertive in the application of "Tax Gijzeling" as punishment for non-compliant taxpayers and the provision of "rewards" for compliant taxpayers.

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