Tax Aggressiveness, Profitability, and Social Responsibility Disclosure: Evidence from Indonesia

Cahyaningsih

School of Economics and Business, Telkom University, Bandung, Indonesia

Abstract. *This study examines whether tax aggressiveness and profitability affect social responsibility disclosure. Using firms listed in the Indonesia Stock Exchange, the result provides evidence that firms with higher tax aggressiveness have lower social responsibility disclosure. Further, the result shows that in the lower profitable firms, the higher tax aggressiveness associated with the lower social responsibility disclosure. This result indicates that lower profitable firms are more likely to undertake aggressive tax avoidance to generate tax saving and less interested in being socially responsible.*

Keywords. tax aggressiveness; profitability; social responsibility disclosure.

I. INTRODUCTION

Shareholders expect the company could make a profit growing from year to year, because the profit is a reflection of the wealth of shareholders. One way that can be used by the company to meet the expectations of shareholders is to do tax planning. Tax planning can be done by utilizing the tax incentives given by the government. Tax planning is used to maximize the tax advantage by avoiding excess tax expense in the current year.

One way to avoid taxes is to take advantage of tax incentives related to the cost of social responsibility. The Indonesian Government through the Directorate General of Taxation issued regulation no. 93 year 2010. The government provides tax incentives based on these regulations to allow expenditures of corporate social responsibility (CSR) is embodied in the national disaster response donation, research and development donation, educational facility donation, sports fostering donation, construction and social infrastructure costs deductible from gross income, so that the obligations of social responsibility does not further burden the company. The regulation is made so that the social responsibility activities in line with the government program is to improve the quality of community life but sometimes companies do social responsibility activities just to make a positive contribution to the reputation of a company that is part of the company’s marketing program.

The company’s policy related to social responsibility program is highly dependent on the policy of the top management team. If the leader’s policy is for the cost efficiency, so that social responsibility activities performed only to fulfill the rules. The management that has short term orientation will reduce the costs that are considered irrelevant as social responsibility costs because these costs are not directly related to revenue generation.

Firms may compensate managers for aggressive tax reporting for various reasons, the most obvious of which is the tax savings associated with tax planning activities [1]. These tax savings often increase after-tax cash flows, book income, net assets, and more generally, financial slack – attributes that typically have a positive impact on firm value [1]. In addition, firms may also compensate managers for aggressive tax reporting to reward risk-taking behaviors, which managers may otherwise avoid [1-2].

Corporate tax aggressiveness has increased considerably over the past 20 years, and such aggressiveness has a significant negative impact on society as it severely affects the government’s ability to provide public good [3]. This study investigates the effect of tax aggressiveness and profitability on social responsibility disclosure among public firms in Indonesia. This study considers tax aggressiveness as tax planning practices that do not violate income tax rules.

This study is important to do for several reasons. First, the empirical evidence to explain whether and how tax aggressiveness (TAG) and profitability affect social responsibility disclosure (SRD) are still rare. Second, studies on that topic seem to show mixed result. Lanis and Richardson [3] find a positive association between tax aggressiveness and social responsibility disclosure, so the result supports legitimacy theory that in line with risk management perspective. Hoi et al. [4] find a negative association between aggressive tax avoidance practices and responsible CSR activities, so the result supports corporate culture perspective.

Using 674 firm-year observations, this study finds that in general, firms with higher tax aggressiveness report lower social responsibility disclosure. Further test indicates that in the lower profitable firms, the higher tax aggressiveness associated with the lower social responsibility disclosure. Overall, findingsfrom this study indicate that corporate culture is an important factor affecting many corporate policies.

This study has several important contributions. This study contributes to the accounting and management literature by providing evidence on the effect tax aggressiveness on social responsibility disclosure and how firm profitability influences the association between the two variables. This study provides insight to investors that public firms in Indonesia implement social responsibility only for obey the rules so there is still lack of awareness to implement social responsibility activities. This study gives information to government that tax incentives not only attract foreign investors but also provide opportunity to avoid tax that could decrease government revenue. The government also needs to make more effective policies to stimulate corporate social responsibility activities.

The next section of this paper presents the theoretical basis which is used to explain the relationship of tax aggressiveness, profitability, and social responsibility disclosure. This is followed by discussions of the research design and empirical results. Finally, the paper concludes with a discussion of the major findings, contributions, limitations and suggestions for future research.

II. LITERATURE REVIEW

A. The Risk Management Perspective on TAG and SRD

There is an emerging trend among academics and in the popular press focusing on risk management implications of CSR activities because CSR is best seen as the avoidance of damages to the company's reputation from negative events that can arise inadvertently and unexpectedly, such as oil spills [4]. According to the risk management argument, a firm could serve the interests of its shareholders by managing its positive CSR reputation which can potentially mitigate the risk associated with negative corporate events [4]. A positive CSR reputation is particularly important when negative corporate events occur because it provides some degree of insurance protection [4-5].

CSR disclosure denotes not only as an outcome of and part of reputation risk management processes [6], but also enhances the corporate reputation by showing to society via CSR disclosure that corporate is complying and managing the environmental, social and ethical aspects of its existence [3]. There is also an evidence in support of the risk management argument suggests that increasing social responsible activities can enhance a firm's positive CSR reputation that provides some degree of insurance protection against the risk of market, political, regulatory and social sanctions when negative corporate events occur [7].

Aggressive tax avoidance practices might result in significant negative sanctions and judgments toward firms because they are costly to society and likely resemble opportunistic behavior contrary to societal interests [4]. Furthermore, firms could either reduce

irresponsible CSR activities or increase responsible CSR activities to build up the firm's positive CSR reputation so as to mitigate the risk of severe sanctions when negative events occur, specifically their CSR reputation to lessen the severity of potential negative sanctions associated with undertaking aggressive tax avoidance activities [4]. Accordingly, the risk management perspective suggests that if negative events could damage company's reputation, then tax aggressiveness and social responsibility disclosure are likely to be positively related.

B. The Corporate Culture Perspective on TAG and SRD

Hambrick and Mason [8] vieworganizational outcomes as reflections of the values and cognitive bases of powerful actors in the organization, referring to the chief executive officer (CEO) and the top level executives or top management team. Corporate culture could be viewed as a set of shared beliefs within the firm about the "right" corporate behavior, or the "optimal" course of action, or a set of conventions of doing business [9-10; 4). In addition, some researchers argue that corporate culture reduces agency problems because it produces shared beliefs and/or conventions of business practices that persist over time [11; 4].

Although the payment of tax is a fundamental way corporations engage with society, it is seldom classified as a significant CSR activity [4]. Aggressive tax avoidance practices are often regarded by some of society's arbiters as irresponsible, unethical and even unpatriotic [4].Moreover,aggressive tax avoidance practices can be viewed as an opportunistic behavior whereby the firmis exploiting the implicit contract between the firm and society [4]. Accordingly, the corporate culture perspective suggests that if corporate culture drives company policies, then tax aggressiveness and social responsibility disclosure are likely to be negatively related.

C. The Political Cost and Power Theory on Profitability

Noor et al. [12] explain that the relationship between profitability and tax aggressiveness are mostly inconsistent across studies, because of two different points of view related to the issue of company profitability, i.e. political cost theory and political power theory. Adhikari et al. [13] found a positive relationship between tax aggressiveness and ROA, while Noor et al. [12] found a negative relationship between tax aggressiveness and ROA. Based on political power theory, the possible reason was that highly profitable companies bear lower income tax burdens since they utilized tax incentives and other tax provisions to reduce their taxable income which would result in higher tax aggressiveness [12]. Based on political cost theory, the profitable companies faced higher income tax burdens [12].

Hypotheses Statement

Based on the arguments above, this study proposes the following the hypotheses:

H1: There is an association between tax aggressiveness and social responsibility disclosure.

H2: The firm profitability influences an association between tax aggressiveness and social responsibility disclosure.

III. DESIGN RESEARCH

A. Population and Sampling

The study uses firms listed in the Indonesia Stock Exchange (IDX) from 2011 to 2014 as the sample. Data were obtained from the company's annual reports for the periods 2011 - 2014. The initial sample consisted of a sum total of 1888 firms-years. However, the initial sample was reduced by the following exclusions:

1) Financial corporations, because government regulations are likely to affect their ETRs and SRDs differently from other corporations (315 firms-years).

2) Corporations that delisted or listed in IDX (120 firms-years).

3) Corporations that have effective tax rate (ETR) less than zero or ETR more than one, and outlier data (779 firms-years).

Therefore, the final sample for testing hypothesis is 674 firms-years. The final sample consists of 344 firms-years in high profile industry and 330 firms-years in low profile industry.

B. Variables Measurement

The dependent variable for empirical tests is social responsibility disclosure (SRD). SRD is measured by firm's total scoring SRD divided by total criteria for SRD based on 91 assessment criteria from the Global Reporting Initiative (GRI) guideline G4. GRI G4 is consisting of economic category, environmental category, and social category. The approach to scoring SRD is dichotomous in that an item score one if disclosed and zero if it did not.

The independent variables are tax aggressiveness (TAG) and profitability. TAG is denoted by dummy variable tax aggressiveness (TAG), which takes a value of 1 if the corporation has high tax aggressiveness (i.e. the value of ETR is lower than 0.26) and 0 if the corporation has low tax aggressiveness (i.e. the value of ETR is 0.26 or higher). TAG is measured using ETR, namely the income tax expense divided by income before taxes. ETR is the most widely used proxy in the previous research and the tax aggressiveness is high when the value of ETR is low [3]. Profitability is measured by return on assets (ROA) as pre-tax income divided by total assets. Lang and Lundholm [14] find a positive association between financial performance and level of CSR disclosure. Lang and Lundholm [14] suggest that corporation with better quality earnings performance tends to have a higher propensity to disclose its "good news" to financial markets.

This study includes several control variables in the OLS regression for other effects. They include corporation size (STA), solvability (LTA), and public ownership (PO). This study measures STA as the natural logarithm of total assets. Patten [15] and Cho et al. [16] find a positive association between STA and CSR disclosure, that the larger companies are likely to disclose more extensive CSR information in the annual report than smaller companies.

LTA is measured as total liabilities divided by total assets. Managers typically disclose more CSR information as solvability increases in a corporation to reduce the level of information asymmetry [17], as a consequence of additional scrutiny from financial institutions [18], and also to lower a corporation's cost of capital [19].

PO is incorporated in this study to control the effect of corporate governance on CSR. Khan et al. [20] find public ownership has positive significant impacts on CSR disclosures. Khan et al. [20] suggest that pressures exerted by external stakeholder groups and corporate governance attributes play a vital role in ensuring organizational legitimacy through CSR disclosures.

Sensitivity analysis is done by adding a dummy variable year of research and industrial sector because there is a possibility that social responsibility disclosure fluctuates across different years and industries. YEARis research period, measured by a dummy variable that takes a value of 1 if the company in 2011 and 0 if the company in 2012-2014. INDUSTRYis industry membership, measured by a dummy variable that takes a value of 1 if the company in high profile industry (i.e. agriculture, mining, basic industry and chemicals, miscellaneous industry, consumer goods industry, and infrastructure, utilities and transportation), and 0 if

the company in low profile industry (i.e. property, real estate and building construction and trade, services and investment). This study use industry classification according to high-profile industry and low-profile industry [21]. Hackston and Milne [22] have been found that firms in high-profile industries (i.e. high consumer visibility, high regulatory risk or concentrated intense competition) have higher levels of CSR reporting.

C. Research Model

This study tests the hypothesis by using ordinary least squares (OLS) regression. This study estimates the following OLS regression model:

$$SRD_{it} = \beta_0 + \beta_1 TAG_{it} + \beta_2 PROFIT_{it} + \beta_3 STA_{it} + \beta_4 LTA_{it} + \beta_5 PO_{it} + \beta_6 YEAR_{it} + \beta_7 INDUSTRY_{it} + \varepsilon_{it} \quad (1)$$

Variables definition: SRD = SR disclosure index between 0 and 1; TAG = a dummy variable that takes a value of 1 if high TAG and 0 if low TAG; PROFIT = income before income tax divided by total assets; STA = the natural logarithm of total assets; LTA = total liabilities divided by total assets; PO = public ownership divided by the total ownership; YEAR = a dummy variable that takes a value of 1 if the company in 2011 and 0 if the company in 2012-2014; INDUSTRY = a dummy variable that takes a value of 1 if the company in high profile industry and 0 if the company in low profile industry.

IV. RESULTS

The descriptive statistics test results of the variables are presented in Table 1. Table 1 shows that the average social responsibility disclosure is 12.9%, with the highest is 76.9% and the lowest is 3.3%. Further, table 1 shows that the majority of the firms are high tax aggressiveness (55.5%), while the highest profit is 88.5% and the lowest profit is 0,005%.

Table 1. Descriptive Statistics

Variables	N	Minimum	Maximum	Mean	Median	Std. Dev.
SRD	674	0.033	0.769	0.129	0.110	0.082
TAG	674	0	1	0.555	1	0.497
PROFIT	674	5.19E-05	0.885	0.106	0.082	0.095
STA	674	10.313	18.764	14.644	14.617	1.545
LTA	674	0.001	2.116	0.442	0.435	0.212
PO	674	0.001	0.847	0.300	0.280	0.185
YEAR	674	0	1	0.518	1	0.500
INDUSTRY	674	0	1	0.510	1	0.500

Variables definition: SRD = SR disclosure index between 0 and 1; TAG = a dummy variable that takes a value of 1 if high TAG and 0 otherwise; PROFIT = income before income tax divided by total assets; STA = the natural logarithm of total assets; LTA = total liabilities divided by total assets; PO = public ownership divided by the total ownership; YEAR = a dummy variable that takes a value of 1 if the company in 2011 and 0 otherwise; INDUSTRY = a dummy variable that takes a value of 1 if the company in high profile industry and 0 otherwise.

Table 2 shows that the variable TAGfor the regression with the full sample has a negative impact on SRD. The result implies that higher corporate tax aggressiveness is more likely to disclose lower number of social responsibility information in their annual reports than lower corporate tax aggressiveness. When public companies use aggressive tax avoidance, they will become less transparent. Many public companies pay tax as if the payment of taxes is not a

socially responsible activity. The result supports H1 and is support corporate culture perspective that views corporate culture as an important factor affecting many corporate policies.

Table 2. Regression Results

Dependent Var.	Social Responsibility Disclosure (SRD)					
	Low-Profit (< 11%)		High-Profit (≥ 11%)		Full Sample	
Independent Var.	**Coef.**	**t-stat.**	**Coef.**	**t-stat.**	**Coef.**	**t-stat.**
TAG	-0.017 ***	-3.122	-0.006	-0.469	-0.016 ***	-2.672
PROFIT					0.111 ***	3.637
Control Variables						
STA	0.017 ***	8.872	0.028 ***	7.213	0.022 ***	11.677
LTA	-0.034 ***	-2.445	-0.013	-0.467	-0.042 ***	-3.170
PO	0.000	0.656	0.001 *	1.705	0.000 *	1.820
YEAR	0.006	0.958	0.007	0.518	-0.001	-0.265
INDUSTRY	0.016 ***	2.922	0.057 ***	4.744	0.032 ***	5.825
n	427		247		674	
Adj. R^2	18.8%		26.0%		25.91%	
F-statistic	17.435 ***		15.382 ***		32.893 ***	

***, **, and * indicate significance at 1%, 5%, and 10%, respectively. See table 1 for the variables definition.

To test hypothesis 2, this study splits the sample into two groups based on the firm profitability. The first group consists of observations with firm profitability is lower than 11% (n = 427), while the second group consists of those with 11% or higher (n = 247). Table 2 shows firms that have lower profitability, higher tax aggressiveness generate lower social responsibility disclosure. This result indicates that lower profitable firms are more likely to undertake aggressive tax avoidance to generate tax saving and less interested in being socially responsible. However, for firms that have high profitability, the result does not show any association between tax aggressiveness and social responsibility disclosure. This result implies that higher profitable firms have political power to reduce tax expense by using tax planning strategy and based on political cost that firms will be more obedient to the tax regulations in order to reduce political scrutiny. The result supports H2.

Table 2 also shows that some regression coefficients for the control variables are significant. STA is positive and significant. The larger companies are likely to disclose more extensive social responsibility information in the annual report than smaller companies [15-16]. LTA is negative and significant. Managers typically disclose more social responsibility information as solvability increases in a corporation to reduce the level of information asymmetry [17], as a consequence of additional scrutiny from financial institutions [18], and also to lower a corporation's cost of capital [19]. PO is positive and significant. The pressures exerted by external stakeholder groups and corporate governance attributes play a vital role in ensuring organizational legitimacy through social responsibility disclosures [20].

The sensitivity analysis shows that social responsibility disclosure fluctuates across different industry sectors. The evidence indicates that firms in high profile industries have greater number of social responsibility disclosure [22].

This study also conducts robustness check to evaluate the reliability of the OLS regression results presented in table 2. The robustness check is done by entering the control variables consecutively into the regression model [3]. This study obtains similar results for tax aggressiveness.

V. CONCLUSIONS

This study investigates the effect of tax aggressiveness and profitability on social responsibility disclosure. This study finds that compared with lower corporate tax aggressiveness, higher corporate tax aggressiveness tend to exhibit lesser number of social responsibility disclosure. However, this study finds that the effect of tax aggressiveness is prevalent only in the lower profitable firm. In the higher profitable firm, this study does not find any significant difference in social responsibility disclosure between corporate with higher tax aggressiveness and those with lower tax aggressiveness. This study contributes to the accounting and management literature by providing evidence on the effect tax aggressiveness on social responsibility disclosure and how profitability influences the association between the two variables. This study provides insight to investors by providing a plausible explanation as to why some corporations disclose fewer number of social responsibility information than others. This study uses average ETR to separate the level of corporate tax aggressiveness, so future research could identify corporation as tax aggressiveness corporation or non tax aggressiveness corporation.

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