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RESEARCH PAPER

Tax Avoidance and Financial Policy: Evidence from Corporate Firms

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ABSTRACT

The present study examines the effects of tax avoidance on corporate financial decisions by analysing firms that cross traded G20 economies between 2012 and 2022. The concept of tax avoidance is proxied by the effective tax rate (ETR) and the financial policy is measured with the short term leverage and total debt. In the analysis, secondary data from DataStream is used. A fixed-effects model regression model is used to analyze the relationship between these variables using a Hausman test to select the model. The results are also confirmed with robustness by running two-step System Generalized Method of Moments (GMM) estimations and Two-Stage Least Squares (2SLS) estimations. It is found that companies with greater tax avoidance are more leveraged up. This positive association between tax avoidance and leverage holds true across all estimation methods thereby validating the findings. Overall, the study underscores the fact that corporate tax planning has a considerable impact on financing decisions and boosts the reliance on debt capital.

Keywords: Corporate Sector Decisions, Finance, Tax

Introduction

Tax avoidance has become the more defined part of the modern financial strategy and managerial decision making of a business. It is defined as a legal tax planning strategy involving a series of actions by which companies can minimize their tax liability as compared to their accounting income. Top management is said to have a significant influence on the degree of tax planning, since they decide on the aggressiveness of tax planning in the firm. Firms are always pressured to pay as little as possible in taxes, as this is a significant cash drain. Tax avoidance can also, however, give rise to governance concerns, especially when monitoring systems are weak, as this may provide opportunities for managerial discretion.

Tax avoidance can create opportunities for opportunistic management from a governance perspective particularly in companies with low monitoring and control systems (Yee et al., 2018). Although legally acceptable, these practices can have wider economic impacts by impacting overall tax revenues for the government because of lower tax collected (Napitupulu et al., 2019; Choi, 2021). In order to optimize the after-tax profitability, firms often try to take advantage of the tax law and reduce the taxable income, thereby increasing the firm valuation (Noor et al., 2009; Chung et al., 2002; Salehi et al., 2019).

Graham and Tucker (2005) suggest that the positive cash flow effects of tax avoidance can be used as an internal financing source and thus reduce the dependence of companies on external financing markets. Furthermore, tax avoidance can help a company to have more financial flexibility, to be more credit worthy, to be less likely to enter financial

distress and to have lower borrowing costs as well as lower overall cost of capital (Lim, 2009; Molina, 2005). As a result, tax planning has become an important factor that has entered the considerations of corporate finance in our times.

There are two broad theoretical approaches that are commonly used to explain the choice of financial policy: the trade-off theory and the pecking order theory. According to trade-off theory, companies strive to achieve an optimal capital structure by considering the tax advantages of debt financing and the costs of financial distress. Pecking order theory (Myers, 1984) suggests that firms have a financing priority and they will use their own funds first, followed by debt financing, and equity financing being their last resort because of information asymmetry and financing costs. Leverage behavior and the changes firms make towards target capital structures have been the subject of much research based on trade-off theory (Leary & Roberts, 2005; Flannery & Rangan, 2006; Lemmon et al., 2008; Frank & Goyal, 2009).

The body of the literature offers inconclusive results on the link between tax avoidance and debt financing. Recent research indicates that lenders may perceive more risk of aggressive tax behavior, which may result in higher borrowing costs and lower reliance on debt (Lee et al., 2019; Chang et al., 2006). Other studies, however, indicate that companies that engage in tax avoidance would likely prefer to be more highly leveraged as this generates tax shields that further lower taxable earnings (Harrington & Smith, 2012). This view is in line with the idea of the trade-off theory that highlights the role of tax benefits in determining capital structures (Auerbach, 2002, Graham, 2008).

Leverage is the amount of debt obligations (Kasmir, 2014) that a firm has in its financial makeup. The higher the leverage ratio, the more reliance is placed on borrowed funds, and the higher the interest expenses (Welch, 2011). The higher the debt ratio the more taxable income is reduced, and the less the tax burden is, since interest payments are tax deductible. This means that a firm's tax planning might be more robust the higher its leverage ratio, as it can be expected to have greater motivation to do so in order to maximize returns after tax (Taylor & Richardson, 2020). The tax shield effect (Buttner et al., 2013) will be further reinforced by a rise in debt financing. Tax avoidance can, however, also add to the uncertainty as payments of lower taxes can be correlated with increased financial risk, and can affect external financing choices. Notwithstanding this, companies seeking tax minimization can nonetheless keep high leverage because of its tax attributes, even in the case of potential distress. Tax avoidance and debt financing also have been proposed as alternative mechanisms in corporate financial decision-making in earlier work (DeAngelo & Masulis, 1980; Bradley et al., 1984; Slemrod, 2004; Crocker et al., 2005).

The impact of tax avoidance on corporate financial policies in companies operating in G20 countries is explored in this study. The subject has attracted much research attention but there are many unanswered research questions. Moreover, there are few empirical studies that specifically target G20 countries and this study fills this gap by offering new cross-country assessment of the major economies. Tax avoidance has been investigated from various perspectives, such as earnings management (Frank, Lynch & Rego, 2009), transparency issues (Neuman, Omer & Shelley, 2012), internal controls (Bauer, 2016), cost of capital implications (Goh et al., 2016), audit pricing effects (Donohoe & Knechel, 2014), firm valuation (Gallemore et al., 2014; Desai & Dharmapala, 2006), ethical and religious influences (Salehi et al., 2017; Huseynov & Klamm, 2012), environmental uncertainty (Huang et al., 2017), demographic factors (Hoseini et al., 2019), and governance structures (Zeng, 2019; Kovermann & Velte, 2019; Minnick & Noga, 2010; Adeyani & Winnie, 2016). But there is less specific evidence regarding G20 economies.

Second, this study builds on previous research by looking at the association between tax avoidance and various indicators of leverage in firms' financial policies. The study restricted its attention to the G20 countries to offer a wider and more up-to-date dataset of

the impact of tax planning behavior on the capital structure choice and debt dependence of the major global economies.

Literature Review

Tax Avoidance and Financial Policy

There has been extensive accounting and finance research on corporate tax avoidance. The concept of differential tax is well known as the difference between the amount of tax actually paid by the company and the tax it is legally entitled to pay under the rules and regulations regarding taxation (Plesko, 1999). According to Dyreng et al. (2008), tax avoidance is defined as any managerial activity that is aimed at lowering the effective tax rate of the firm. Similarly, Lanis and Richardson (2011) characterize it as a "legitimate tax planning strategy" to reduce tax expenses and increase "cash available internally. Tax avoidance is conducted within the law and is based on exploiting ambiguities and provisions that are hidden in the tax codes, and is not illegal (Sandmo, 2005).

Capital structure theories are usually used to examine the relationship between tax avoidance and the financing structure of a company. The trade-off theory of Kraus & Litzenberger (1973) suggests that the financing mix that a firm chooses depends upon the advantages and disadvantages of debt financing. While debt financing benefits the company by providing tax benefits as the interest incurred can be deducted, having too much debt raises the risk for the company to suffer financial distress and possibly become bankrupt. Companies therefore seek a capital structure that maximizes the value of the company, that is, the point where the marginal tax benefit of debt equals the marginal cost of debt. This theory has been extensively applied when explaining the effect of tax considerations on the leverage ratio (Bhojraj & Sengupta, 2003; Desai & Dharmapala, 2009; Graham & Tucker, 2005; Lim, 2009; Nguyen Minh et al., 2021).

In the trade-off model, firms are expected to consider the tax advantages of debt financing and the risks to their finances when they make a financing decision. Previous research indicates that non-debt tax shields can be substitutes for debt tax shields (Miller & Warner, 1977). Brennan and Schwartz (1984), Kane et al. (1984), and Graham (1984) further supported this concept. Moreover, DeAngelo and Masulis (1980) suggested that, besides taxes, other means such as tax avoidance strategy and debt financing can also be used to reduce the tax burden of a corporation. Another explanation for corporate financing behavior is the pecking order theory (Myers & Majluf, 1984). It suggests a sequence of financing options, beginning with the internal financing option, which has a lower level of information asymmetry and transaction costs, followed by the debt, and finally, the equity financing option. Tax avoidance, from this point of view, can actually increase internal cash flow which lowers the need to obtain cash flow from external sources like borrowing.

Based on empirical evidence, it can be seen that companies that engage in tax avoidance tend to have higher leverage in that companies have higher interest expenses so that they can generate more tax shields, which is in the form of reducing taxable income (Irianto et al., 2017; Danis & Zulaikha, 2014; Ngadiman & Puspitasari, 2017). But contrary evidence suggests that aggressive tax planning can also raise interest expenses. A positive relationship between tax avoidance and the cost of debt is documented by Hasan et al. (2014) and Shevlin et al. (2020) and it is suggested that lenders may view tax-aggressive firms as riskier. Isin (2018) reaches similar findings to report that tax avoidance exacerbates financial uncertainty, which could increase debt costs.

Tax considerations also have a significant role in influence long-term leverage decisions. Devereux, Maffini and Xing (2018) demonstrate that changes in the average tax rate are less effective than changes in the marginal tax rate at affecting firms' leverage. Likewise, Faulkender and Smith (2016) discover that companies in high-tax setting have

higher leverage and lower interest coverage ratios, as predicted by theory. Similarly, other studies provide evidence of a systematic link between taxation and capital structure decisions (Desai et al., 2004; Faccio & Xu, 2015; Graham, 1996, 2003; Lin et al., 2014). Graham and Tucker (2006) offer some support for a potential subsitution between tax avoidance and leverage. Additionally Barclay et al. (2013) find that taxable real estate firms typically have greater leverage than their non-taxable counterparts. According to Faccio and Xu (2015), an increase in the corporate tax rate by 1 percent is correlated on average with an increase in leverage of 0.41 percent.

However, the results of the empirical studies are inconsistent. Hamid et al. (2018) demonstrate that tax avoidance leads to higher bank borrowing and higher bank loan costs, along with a detrimental impact on the terms of bank loans, suggesting more stringent lending conditions for tax aggressive firms. However, Da (2016) finds negative association between tax avoidance and leverage ratios. This is also consistent with Tingting (2012) who finds that firms that undertake more tax avoidance are less likely to use debt financing. Other research offers some other shades. According to Gang (2013), the higher the tax avoidance, the higher the cash holding, the lower the default risk, the lower the borrowing costs, and the better the asset-liability structure. Wijaya and Bernawati (2021) also found that there is a significant relationship between leverage and tax avoidance, where interest expenses are tax deductible is the reason why companies tend to use leveraged financing. On the other hand, from the viewpoint of dynamic trade-off theory, companies that pursue tax avoidance could also have a relatively high level of leverage after refinancing when they make tax avoidance decisions. On the other hand, Lin et al. (2014) find a substitution effect between leverage and tax planning strategies in that more tax aggressive firms have less leverage. Heider and Ljungqvist (2015) present a positive relationship between one percentage point increase in corporate tax rates and the corresponding change in leverage of 0.38 percentage points. Devereux et al. (2018) also report a persistent positive impact of taxes on leverage, and Jin (2021) finds that the tax-leverage link becomes weaker in times of financial crises.

These mixed findings are corroborated by other evidence gathered in other institutional settings. The findings of Wu and Yue (2006) indicate that the higher the corporate tax rates are, the higher will be the leverage ratios in the companies, while tax reduction after Tax Reform will make the leverage ratios of companies lower, according to the findings of Wang (2010). However, Wang et al. (2018) also find an important negative link between tax avoidance and the debt ratio, while Dan et al. (1992) find that firms with higher tax avoidance ratios have lower debt financing.

Material and Methods

This paper explores the relation between tax avoidance and the financial policies of non-financial corporations in the G20 countries. This research is of quantitative research type and using deductive reasoning approach in a positivist paradigm. The study used empirical analysis and covered the period 2012-2022. The data is created from secondary data from the DataStream database. Firm-year observations that had missing or incomplete observations were removed from the final sample to ensure that the data were accurate and complete. Financial institutions were specifically excluded as they have their own regulatory regime and capital requirements that make their financial structures very different from the non-financial firms.

Empirical estimation uses the panel data techniques to account for both cross-sectional and time-series variation. The fixed-effects model is used as the main estimation method, based on the Hausman specification test, which verifies the appropriateness of the model to deal with unobserved firm-specific unobservables. In order to enhance the robustness of the results, further estimations are conducted with two-step System

Generalized Method of Moments (GMM) and Two-Stage Least Squares (2SLS) methods, to ensure that the results are consistent across alternative econometric specifications.

Econometric Model

In light of the preceding theoretical and empirical discussion, the following model was developed to examine the effect of tax avoidance on the financial policies of firms operating in G20 countries.

$$FP_{it} = \beta_0 + \beta_1 TA_{it} + \beta_2 Prof_{it} + \beta_3 FS_{it} + \beta_4 SGA_{it} + \beta_5 Tang_{it} + \beta_6 MTB_{it} + \varepsilon_{it}$$

Financial policy (FP) in this study refers to the leverage decisions of firms and is proxied by two indicators, namely long-term debt and total debt ratios. Both variables are standardized by total assets, consistent with prior empirical literature (Lin et al., 2014; Anindita et al., 2022). The key explanatory variable, tax avoidance (TA), is measured using the effective tax rate (ETR), which is computed as total tax expense divided by pre-tax income (Dyreng et al., 2010; Laguir et al., 2015; Lanis & Richardson, 2012; Mouakhar et al., 2020).

The empirical framework further includes a set of control variables to account for firm-specific characteristics. Profitability (Prof) is defined as net income relative to total assets (Correia, 2020; Sanusi, 2014). Firm size (FS) is proxied by the natural logarithm of total assets (Eliwa et al., 2022; Lee et al., 2022). Selling, general, and administrative expenses (SGA) are incorporated to capture operational cost structure (Correia, 2020). Asset tangibility (Tang) is measured as the ratio of property, plant, and equipment to total assets (Cheng & Green, 2008; Lee et al., 2022; Chang et al., 2009). Additionally, the market-to-book ratio (MTB) is included to reflect firms' growth opportunities and market valuation levels (Lanis & Richardson, 2015; Strater, 2017).

Results and Discussions

Descriptive Statistics

All of the variables used in analyses are described here. All variables are winsorized at 1st and 99th percentile levels to minimize possible distortion from outliers. The distributions of the variables indicate that they are reasonably normally distributed. The findings are listed in Tab 1.

The results suggest that, on average across the G20 countries, firms finance about 12.73% of their assets from long-term debt. The ranges and standard deviations for firms' long-term debt are 0.000-0.6692 with a standard deviation of 0.1590, indicating substantial variability among the firms. The mean of total debt is 0.3546 and the standard deviation is 0.1881, meaning that about 35.46% of a firm's assets are financed by debt, on average.

As an index of tax avoidance, the effective tax rate, the average is 0.1776, with a standard deviation of 0.1331. This is indicative of a significant degree of variability in tax planning activity across the sample of firms.

Table 1
Descriptive Statistics

Variables	Obs	Mean	Std. Dev	Min	Max
LTD	145255	0.1273	0.1590	0.0000	0.6692
TD	145255	0.3546	0.1881	0.0000	0.6835
TA	145255	0.1776	0.1331	0.0000	0.4983
Prof	145255	0.0049	0.1024	-.2899	0.2913
FS	145255	16.1224	6.3729	0.0000	28.2761

SGA	145255	16.3352	7.7835	0.0000	32.008
Tang	145255	0.1946	0.1722	0.0000	0.5992
MTB	145255	0.7876	1.7323	0.0000	14.9589

Note: The variables are long term debt ratios (LTD) and total debts (TD), TA is the Tax Avoidance activities of firms, Profitability (Prof), firm size (FS), selling, general and admin expenses (SGA), asset tangibility (TAN), market to book ratios (MTB).

Correlation Analysis

Correlation analysis is done to measure the strength and direction of the relationships between variables that are part of the research. The range of the correlation coefficient is from -1 to +1, with the closer the number is to +1 or -1, the greater the positive or negative correlation, respectively; the closer the number is to 0, the weaker the correlation. Generally, values of +/- 0.50 or greater are deemed relatively strong associations and values of less than +/- 0.50 are considered low to medium associations.

Results of the correlation are presented in Table 2. The results indicate that there are no serious concerns of multicollinearity in the data since the pairwise correlation between all variables are acceptable. It should be noted, however, that the correlation matrix is only a first-order diagnostic tool for examining the relationships between variables, and does not provide enough information to draw causal conclusions or to make definitive statements.

Table 2
Correlation Analysis

Variables	STD	LTD	ESG	Prof	FS	SGA	Tang	MTB
LTD	1							
TTD	0.2656	1						
TA	0.1306	0.1902	1					
Prof	0.2928	0.3745	0.3500	1				
FS	-0.0204	0.0349	0.0348	0.0317	1			
SGA	-0.0125	0.0169	0.0585	0.0419	0.1184	1		
Tang	0.3619	0.2328	0.1816	0.3742	0.0187	0.0298	1	
MTB	0.1785	0.4191	0.2563	0.4007	-0.0295	-0.0120	0.3363	1

Tax Avoidance and Financial policy of the firm

The empirical findings in this section, which test the impact of tax avoidance on firms' financial policies, are summarized in Table 3. There are two proxies for financial policy: long-term debt ratio and total debt ratio. In Panel A, estimations using long-term debt as the dependent variable are reported and in Panel B, estimations using total debt ratio as the dependent variable are reported. The findings reveal that tax avoidance is statistically significantly related to the capital structure decisions of the firms, especially the greater use of debt financing. The more intense tax planning is undertaken by a firm, the higher the level of leverage in the firm's financial structure. The net result of this evidence is a positive linkage between efficient tax rates and the use of debt; tax considerations are important in influencing financing behavior. But in particular, companies with aggressive tax strategies seem to be more likely to borrow money to take advantage of the tax benefits of deductible interest.

These results also indicate that companies experiencing higher tax pressures might be tempted to undertake tax avoidance and thus have a higher reliance on debt financing. Previous studies also suggest that aggressive tax planning might be linked to higher debt costs and greater financial risk (Hasan et al., 2014; Shevlin et al., 2020). Notwithstanding these issues, firms are still found to be using debt financing because the interest deductibility benefits firms by lowering taxable income and increase after tax profitability. On this score, debt can serve as a partial mechanism to avoid direct tax strategies in reducing

corporate tax liabilities, according to DeAngelo and Masulis (1980), and Crocker et al. (2005).

Moreover, the findings confirm the hypothesis that companies with ongoing tax avoidance operations are more inclined to keep their leverage higher even in the face of financial distress risks. It seems that tax planning activities conducted before capital financing decisions increase firms' debt use in their capital structures. Debt financing has the disadvantage of making the cost of finance higher, but if it can generate tax savings through tax deductibility then the use of debt financing is an attractive choice for financial management that focuses on taxes (Irianto et al., 2017; Danis & Zulaikha, 2014; Ngadiman & Puspitasari, 2017). As per previous research, the findings also support the positive correlation between tax avoidance and cost of debt (e.g., Hasan et al., 2014; Shevlin et al., 2020).

Table 3
Estimation results about the Tax avoidance and financial policy

Variables	Panel A	Panel B
TA	0.2831***	.4754***
	(0.0610)	(.0668)
Prof	-0.3215***	-.0992***
	(0.0932)	(.0054)
FS	0.0128***	.0267***
	(0.0012)	(.0007)
SGA	0.0477***	-.0884***
	(0.0024)	(.0237)
Tan	0.3352***	.1674***
	(0.0552)	(.0446)
MTB	.0419***	.0292***
	(0.0018)	(.0049)
Observations	160000	160000
Groups	13205	13205
R^2	0.2844	0.4492

Note: The table 3 is showing the regression results about the impact of Tax Avoidance (TA) on financial policy of the firm. Dependent variable is long term debt ratio and total debt ratio. Prof is the profitability of the firm (ROA), FS is the firm size, SGA is the selling, general and admin expenses, Tan is the asset tangibility (PPE), MTB is the market to book ratios. Figures in parentheses shows the standard errors; "***", "**" and "*" shows the significance level at 1%, 5% and 10% respectively.

Additional Testing

In order to assure the robustness of the empirical results, two other estimation methods such as GMM and 2SLS are used. The techniques are employed to determine if the base line results are stable under different econometric specifications. Table 4 shows the outcomes of these robustness checks. Evidence shows that the relationships estimated in the models are consistent. Indeed, the results are consistent and show that tax avoidance is positively related to the leverage of firms, which means that firms with higher tax avoidance have higher leverage in their overall business.

Table 4
Additional Testing Results

Variables	Panel A	Panel B	Panel C	Panel D
	GMM		2SLS	
FP (t-1)	.9253***	.8825***		
	(.1359)	(.2156)		
TA	.2674***	.2916***	.2846***	.2638***

	(.0826)	(.0896)	(.0837)	(.0193)
Prof	.0443**	.3821***	-.4661***	-.3016***
	(.0064)	(.0166)	(.0789)	(.0544)
FS	-.1681***	-.2232***	.1852***	.1131***
	(.0320)	(.0541)	(.0329)	(.0059)
SGA	.0445***	-0.0887***	.0168***	-.0226***
	(.0011)	(.0216)	(.0388)	(.0011)
Tan	.0255***	.0274	.1286***	.1688***
	(.0014)	(.0184)	(.0213)	(.0221)
MTB	.0545***	-.0608***	.0423***	.0330***
	(.0119)	(.0096)	(.0122)	(.0041)
AR (1)	0.021	0.000		
AR (2)	0.271	0.600		
Hansen	0.362	0.817		
Groups	13205	13205	13205	13205
Instruments	225	237		
Observations	145255	145255	145255	145255

Note: This table is showing the additional testing GMM and 2 SLS results. The significance of AR (1), insignificance of AR (2) and Hansen test indicates that model is correctly specified with no overidentification issue. Figures in parentheses shows the standard errors; "***", "**" and "*" shows the significance level at 1%, 5% and 10% respectively.

Conclusion

In this paper, we explore the link between tax avoidance and corporate financial policy within G20 companies. Financial policy is proxied by long-term debt ratios as well as total debt ratios. DataStream is used to secure the empirical data which is a panel data set from 2012 to 2022. The fixed-effects regression model is used as the basic estimation method, and is chosen after the Hausman specification test. Further robustness checks are performed on the validity of the results, including two-step System Generalized Method of Moments (GMM) and Two-Stage Least Squares (2SLS). These alternative estimators will aid in insuring that the estimated results are not sensitive to model specification.

It is found that tax avoidance has a significant effect on the capital structure of firms, especially on the corporate debt ratio. Firms with tax planning activities are more likely to have debt intensive financial policies in general. The consistency of these results with each of the estimation methods adds to the strength of the results. The study has relevant policy implications for policymakers in drafting the framework for corporate financial policy, particularly in regard to leverage and capital structure management. It also suggests that there is strong correlation between tax avoidance practices and increased debt financing. Future studies should consider ESG controversies as a moderating variable to gain a better understanding of this relationship. Furthermore, cost of debt and financial stress can also be used as additional moderators to further elaborate the analysis.

Recommendations

The implications derived from this research suggest that corporate managers should set the optimal mix between tax planning strategies and financing to maximize firm value, and comply with tax regulations. While tax avoidance may help you save tax and reduce your cash flow requirement, it can also raise the risk of regulatory investigation, reputational issues and agency conflicts. As such, there is a need for companies to further improve corporate governance practices, increase transparency through their financial reports, and implement prudent debt policies to provide tax-related benefits that positively impact the company's long-term performance.

In addition, appropriate tax administration systems and monitoring processes should be further strengthened by policy makers and regulatory bodies in order to curb aggressive tax avoidance tactics and encourage tax planning. In the end, researchers are

encouraged to further research this study by including other variables like the quality of corporate governance, the percentage of institutional ownership, environmental uncertainty, and the life-cycle stages of a firm. Further study is needed to increase the sample size, industry selection, or cross-country comparisons to give a better sense of the tax avoidance–capital structure–firm value relationship.

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