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Pay Less Today, Suffer Tomorrow? Tax Avoidance and Financial Distress

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Abstract: Corporate tax avoidance has long been a continuous issue in Indonesia, where government revenue is heavily reliant on tax revenue. For firms, financial distress is one of the critical issues faced because it may eventually lead to bankruptcy risk if left unresolved. Because tax avoidance strategies carry inherent risks, these practices may potentially serve as a key determinant of financial distress. Therefore, extending prior research, this research aims to examine the effect of corporate tax avoidance on financial distress. This study utilizes secondary data from 2019 to 2023 extracted from the audited financial statements of listed firms within the consumer cyclical sector, analyzed using a panel data regression approach. The results show that corporate tax avoidance increases financial distress because tax avoidance itself embeds risks through tax audits and penalties and agency costs. Further analysis of the coronavirus pandemic demonstrates that corporate tax avoidance does not affect financial distress because firms focus on survival. Theoretically, this study extends the existing literature by shifting the focus from the immediate cash-flow benefits of tax avoidance to its potential financial consequences. Practically, this research serves as a strategic framework for corporate managers, emphasizing that tax avoidance practices must not compromise organizational sustainability.

Keywords: Agency Costs, Consumer Cyclical Sector, Corporate Tax Avoidance, Financial Distress

INTRODUCTION

Corporate tax avoidance has become a major issue in accounting and financial research due to its implications for both corporate performance and, most importantly, government revenue. The central government's audited financial statements for the year ended in 2024 show that tax revenues increased by 3.60% from 2,154.208 trillion in 2023 to 2,231.839 trillion in 2024 (Kementerian Keuangan, 2025). Moreover, data further shows that tax revenue accounted for 78.29% of total government revenue in 2024, up from 77.38% in 2023 (Kementerian Keuangan, 2025). This year-on-year increase highlights the expanding reliance on taxation as its primary fiscal pillar. However, in practice, firms frequently engage in tax avoidance strategies to reduce tax expenses and maximize after-tax profit (Menchauoi & Hssouna, 2024). This directly conflicts with the government's revenue-generation goals

(Tanjung & Amin, 2022). Nonetheless, firms often consider these strategies beneficial because they can improve cash flow and provide firms with additional resources to support operational and investment activities (Koay & Sapiei, 2025).

However, despite its potential benefits, tax avoidance inarguably creates significant risks for firms. In the context of Indonesia, aggressive tax avoidance practices can expose firms to sanctions in the form of fines and interest, as well as increased monitoring from tax authorities. At the same time, financial distress remains one of the most critical issues faced by firms because it reflects a decline in a firm's financial condition that may eventually lead to bankruptcy (Farooq et al., 2023), which in turn, reduces operational flexibility and access to external financing. Consequently, understanding the determinants of financial distress has become increasingly important. For instance, Altman et al. (2019) identify key drivers of corporate financial distress, including high leverage, liquidity issues, industry deregulation, and unexpected liabilities. Building on these drivers, this raises the possibility that tax avoidance strategies themselves can function as a critical determinant of financial distress. Because tax penalties and heightened regulatory scrutiny can manifest as unexpected liabilities or drain a firm's cash reserves, such practices could theoretically exacerbate a firm's liquidity risk.

Taking these points into account, this study extends the research conducted by Stanley & Widianingsih (2025a), which previously examined the effect of financial distress on corporate tax avoidance. Interestingly, findings of the study show that financially distressed firms engage in fewer tax avoidance practices due to increased financial vulnerability and potential risks in the near future. While the prior study focused on how firms experiencing financial difficulties engage in tax avoidance practices, the present research reverses the direction of analysis by investigating how corporate tax avoidance influences financial distress. This reversal raises an important question: can tax avoidance, which is traditionally viewed as a strategy to improve cash flow and reduce tax expenses, actually increase a firm's likelihood of experiencing financial distress in the long run? By addressing this question, the aim of this study is to provide a deeper understanding of whether tax avoidance practices can contribute to a firm's state of financial distress. By shifting the causal perspective, this study further seeks to enrich the literature on corporate taxation. Theoretically, the findings are expected to broaden the understanding of the broader implications of tax avoidance beyond its expected short-term tax-saving benefits. Practically, for firms, the research highlights the importance of balancing tax efficiency with financial stability and corporate sustainability.

Agency theory explains the conflict of interest between principals (shareholders) and agents (managers) (Jensen & Meckling, 1976). In modern corporations, shareholders expect managers to maximize firm value and ensure long-term sustainability. However, managers tend to pursue their own interests (Imen & Anis, 2021), such as short-term performance targets or compensation benefits, even when such actions build up long-term corporate risk. From the perspective of agency theory, tax avoidance can be viewed as a managerial strategy to improve reported financial performance and increase short-term cash reserves. By reducing tax payments, managers may present higher after-tax profits, which can create the appearance of improved managerial performance. The agency problem emerges because the benefits obtained by managers from tax avoidance are often short-term and private in nature, whereas the costs are borne by the firm and its shareholders in the long run (Al-Faryan, 2024). Aggressive tax avoidance practices may increase the risk of tax audits and sanctions. Furthermore, complex tax avoidance strategies require sophisticated financial planning and opaque reporting practices, which can reduce transparency and increase information asymmetry between the agents and principals. When monitored by both internal and external stakeholders without adequate oversight, managers may have greater discretion to engage in opportunistic tax avoidance strategies. Consequently, firms become more vulnerable to financial instability and eventually fall into a state of financial distress.

Through the lens of agency theory, managerial utilization of tax avoidance strategies to prioritize personal opportunistic interests increases financial risk, ultimately accelerating firm financial distress due to the adverse consequences of tax avoidance practices. Research by Rahiminejad (2025) revealed that firms with large positive book-tax differences, arising from tax avoidance practices, are more likely to experience financial distress compared to firms with negative book-tax differences, a vulnerability mainly driven by inefficient cost management and a subsequent decline in firm performance. Another research by Guedrib & Bougacha (2024) demonstrated that tax avoidance increases firm risk when tax risk is probable to happen. Agency problems prevent the principal from having full and transparent access to corporate information, thus reducing their ability to assess tax avoidance strategies. Furthermore, Guedrib & Bougacha (2024) also argued that complex and risky tax avoidance activities escalate financial risk by increasing cash flow unpredictability and the probability of tax sanctions; therefore, the cost of tax avoidance outweighs its benefits, which may increase the firm's overall risk on cash flow. Similarly, Guedrib & Marouani (2023) found that tax avoidance is deemed negatively by investors when it is associated with tax risks, as it reduces firm value by elevating agency costs, tax penalties, reputation, and political costs. Based on the concept of agency theory and prior studies, the hypothesis of this study is as follows:

H: Corporate tax avoidance has a significant positive effect on financial distress.

METHOD

Data, Population, and Sample

This quantitative study aims to examine the effect of corporate tax avoidance on financial distress by utilizing secondary data derived from firms' annual financial statements from 2019 to 2023, which are publicly available on the firms' official websites or the Indonesian Stock Exchange website. The population of this study consists of 154 firms from the consumer cyclical sector, resulting in a total of 770 firm-year observations. To obtain the final sample of 93 firms, the purposive sampling technique is employed based on specific criteria, as shown in Table 1. Specific criteria are heavily weighted on the proxy of corporate tax avoidance. For example, only effective tax rates (ETR) between 0 and 1 are included (Stanley & Widianingsih, 2025b, 2025a). Since only ETR between 0 and 1 is used, following Sánchez-Ballesta & Yagüe (2021), firms without positive income before tax are excluded.

Table 1. Research Observations

Description	Number of Observations
The firm is listed on IDX from 2019 to 2023.	770
The firm did not publish any audited financial statements or annual reports.	(158)
The firm's audited financial statement is reported in USD.	(58)
The firm experienced losses or did not report any tax payments.	(280)
Outliers (ETR < 1 and ETR > 1)	(17)
Total	257

Variables and Measurements

The independent variable examined in this study is corporate tax avoidance. The cash effective tax rate (CETR) is used as a proxy for corporate tax avoidance since it directly captures the amount of cash paid by firms for taxes (Dyreng et al., 2008, 2010). However, using income before tax as the denominator of ETR can be troublesome for firms with negative income before tax or even close to zero (Edwards et al., 2016). Therefore, to prevent large distortions of ETR values in this study, income before tax in the denominator is replaced with total assets (Mindzak & Zeng, 2020).

$$CETR = \text{Cash Paid for Taxes} / \text{Total Assets}$$

The dependent variable examined in this study is financial distress proxied by the Grover G-score model, an alternative version of the Altman Z-score model:

$$G\text{-score} = 1,650X_1 + 3,404X_2 - 0,016X_3 + 0,057$$

Where X_1 is working capital divided by total assets, X_2 is earnings before interest and taxes (EBIT) divided by total assets, and X_3 is net income divided by total assets. The G-score has two critical threshold values for interpretations. Aviantara (2023) demonstrated that the Grover G-score model serves as a highly accurate predictor of financial distress for PT Garuda Indonesia (Persero) Tbk. A G-score less than or equal to -0.02 suggests that the firm is in a state of financial distress, whereas a G-score greater than or equal to 0.01 indicates that the firm is financially healthy (Teja, 2025).

This study also incorporates several control variables, specifically related to firms' financial performance, that are commonly found in previous corporate tax avoidance studies, as these variables are considered to influence a firm's level of tax avoidance. Profitability is measured by the ratio of net income to total assets (Iazzi et al., 2023), leverage is proxied by the debt-to-equity ratio (Abdelmoula et al., 2022), firm size is proxied by the natural logarithm of total assets (Abdelmoula et al., 2022), liquidity is proxied by the current ratio (Alkurdi et al., 2024), and capital intensity is measured by the ratio of fixed assets to total assets (Hendayana et al., 2024).

The following equation illustrates the research model of this study:

$$TXV_{it} = \alpha + \beta_1 DIS_{it} + \beta_2 PFY_{it} + \beta_3 LVG_{it} + \beta_4 FRM_{it} + \beta_5 LQD_{it} + \beta_6 CAP_{it} + \varepsilon_{it}$$

Where TXV is corporate tax avoidance, DIS is financial distress, PFY is profitability, LVG is leverage, FRM is firm size, LQD is liquidity, CAP is capital intensity, α is a constant term, β is the coefficient, ε is an error term, i is a sampled firm, and t is year (2019-2023).

This study employs the panel data regression analysis to examine the effect of corporate tax avoidance on financial distress. The estimation models used in panel data regression analysis consist of the fixed effect model, random effect model, and common effect model. To determine the most appropriate model for this study, the Chow and Hausman Tests are conducted. In addition, classical assumption tests are also performed to ensure the validity of the regression model, which include tests for multicollinearity, heteroscedasticity, and autocorrelation.

RESULTS AND DISCUSSION

Descriptive Statistics

Table 2 shows the descriptive statistics of the variables included in this study, with a total of 257 observations from 93 firms. TXV has a mean value of 1.89% and a relatively high standard deviation of 1.80%, indicating that the level of tax avoidance varies considerably among the sampled consumer cyclical firms. The relatively high standard deviation, which is almost equal to the mean value, suggests that while some firms demonstrate high levels of tax avoidance, others are more compliant. A standard deviation of 1.40% across firms further indicates that tax avoidance behaviour is strongly driven by firm-specific characteristics, leading to noticeable differences in tax strategies among companies. DIS has a mean value of 0.756 and a high standard deviation of 0.819, suggesting significant differences in financial distress levels across the sampled firms. This wide variation implies that some firms maintain stronger financial conditions, whereas others experience greater financial distress, most likely due to differences in firm performance.

Table 2. Descriptive Statistics

Variable	Mean	Std. Dev.	Min	Max	
TXV	Overall	0.0189306	0.0180249	0.0000221	0.0870333
	Between		0.0140849	0.0002901	0.0658679
	Within		0.0097297	-0.0157201	0.0633688
DIS	Overall	0.7564135	0.8187325	-9.940474	2.031136
	Between		1.193116	-9.940474	1.844417
	Within		0.1993036	-0.0657749	1.604034
PFY	Overall	0.0764431	0.2939217	-0.0110199	4.693277
	Between		0.4831713	0.0011217	4.693277
	Within		0.0287759	-0.0501945	0.2257537
LVG	Overall	1.499657	11.85809	-1.023203	190.3071
	Between		5.31051	-1.023203	51.45048
	Within		10.03042	-48.18382	140.3562
FRM	Overall	5.22	7.52	0.0279	35.9
	Between		6.18	0.0448	33.5
	Within		1.16	-0.662	12.9
LQD	Overall	5.891945	27.83352	0.0369568	406.9266
	Between		23.70444	0.0369568	185.5573
	Within		17.62718	-156.011	227.2613
CAP	Overall	0.2928521	0.2097818	0.0003243	0.969526
	Between		0.2161352	0.0005142	0.9493922
	Within		0.0368452	0.1301836	0.4524506
Firm (<i>i</i>)					
Year (<i>t</i>)					

Estimation Model Tests

Table 3 displays the results of the panel data regression model selection tests using the Chow Test and Hausman Test. The significant results obtained from both tests indicate that the fixed effect (FE) model is the most appropriate model for this study.

Table 3. Estimation Model Test

Test	Description
Chow Test	0.0000
Hausman Test	0.0000
Result	Fixed Effect Model

Classical Assumption Tests

Table 4 presents the classical assumption tests for panel data regression. The mean VIF value of 2.38 indicates that there are no multicollinearity issues. Since the results of the Modified Wald Test yield a significant value, it indicates that there are heteroscedasticity issues within the model. The robust standard errors are applied to resolve heteroscedasticity issues. Furthermore, the insignificant value from the Wooldridge Test indicates that there are no autocorrelation issues within the model.

Table 4. Classical Assumptions Test

Test	Description
Multicollinearity (Mean VIF)	2.38
Heteroscedasticity (Modified Wald Test)	0.0000
Autocorrelation (Wooldridge Test)	0.6554

Regression Analysis

Table 5 shows the panel data regression analysis with a fixed effect model after it has been robustified to solve heteroscedasticity issues. The significant F-test result indicates that

the model is feasible for analysis. The main findings demonstrate that CETR has a significant positive effect on G-score, indicating that a lower CETR is associated with a lower G-score; therefore, TXV has a significant positive effect on DIS. This denotes that firms with higher levels of tax avoidance tend to experience greater financial distress. As for the controlled variables, PFY and LQD have significant positive effects on DIS, whereas LVG has a significant negative effect. FRM is found to have no effect on DIS. The R-squared value of 0.2570 indicates that the variables included in the research model are able to explain financial distress by 25.70%, while other unexamined variables explain the remaining percentage.

Table 5. Regression Analysis

Description	DIS
TXV	5.419874 (0.005)***
PFY	2.807251 (0.000)***
FRM	0.0741999 (0.531)
LVG	-0.001864 (0.000)***
CAP	-1.612084 (0.004)***
LQD	0.0037568 (0.001)***
Constant	-1.202372 (0.712)
Prob > F	0.0000
R-squared	0.2570

Note: robust p-values in parentheses, *** $p < 0.01$, ** $p < 0.05$, * $p < 0.1$

Discussion

Since tax avoidance has a significant positive effect on financial distress, the formulated hypothesis is accepted. This occurs because tax avoidance practices are not always a sound cash efficiency strategy. At a certain point, tax avoidance can actually signal an increase in a company's risk, especially if it is carried out aggressively, in a complex manner, and without the support of strong corporate governance. The results of this study show that the higher the level of tax avoidance, the greater the likelihood that a company will experience financial distress. These findings suggest that tax avoidance does not merely reflect tax burden efficiency but may also indicate financial strain, opportunistic management behavior, and increased corporate risk. Companies that engage in aggressive tax avoidance face the potential risks of tax audits, penalties, compliance costs, reputational costs, and uncertainty regarding future cash flows. Thus, the short-term benefits of tax savings may be offset, or even outweighed, by the costs of risks that arise later.

Tax avoidance can enable managers to conceal relevant information from shareholders, thereby undermining corporate transparency. Kim et al. (2011) found that tax avoidance increases stock price crash risk because this activity can facilitate managerial hoarding of bad news and hidden opportunistic behavior. When information quality declines, investors and creditors may perceive the company as riskier, which ultimately increases funding pressure and the probability of financial distress. Tax avoidance is viewed as rational because the tax savings for shareholders are considered to outweigh the potential costs of being caught (Adijaya & Radianto, 2025; Khan & Nawaz, 2023; Putra et al., 2018). However, managers' rational (and sometimes opportunistic) response to reduce the tax burden, improve cash flow, and simultaneously protect their reputation and compensation actually leads the company into financial trouble, because their effectiveness and risks depend heavily on governance and

oversight. These findings are also consistent with Bayar et al. (2018), who explain this phenomenon from a governance perspective. When corporate governance is weak, tax avoidance tends to be associated with greater financial constraints and an elevated risk of financial distress. This is important because tax avoidance is only an efficient strategy when a company has strong governance. Conversely, if governance is weak, tax avoidance can be interpreted as a signal of agency problems and information asymmetry.

In addition, tax avoidance can increase the cost of debt. Isin (2018) shows that tax avoidance is positively correlated with loan spreads, meaning that creditors charge a higher risk premium to companies that engage in tax avoidance. When the cost of debt rises, a company's financial burden also increases, which can reduce its ability to meet its financial obligations. Under these circumstances, tax avoidance, which was originally intended to conserve cash, can actually exacerbate financial pressure. Further support is provided by Dhawan et al. (2020), who found that companies involved in tax avoidance are exposed to a higher risk of bankruptcy. This finding reinforces the argument that tax avoidance is a risk-enhancing activity. That is to say, tax avoidance not only affects tax-related aspects but is also linked to a company's financial sustainability risk. In the context of firms facing financial pressure, tax avoidance may also emerge as a strategy to preserve short-term cash (Dang & Tran, 2021). Companies that are increasingly aggressive in avoiding taxes may be perceived as facing liquidity pressures, governance risks, or short-term cash needs that are ultimately linked to financial distress.

Thus, the positive effect of tax avoidance on financial distress makes sense if tax avoidance is understood not as normal tax planning, but as an aggressive practice that carries risk consequences. Tax avoidance can increase financial distress through several channels: first, increased risk of tax audits and penalties; second, increased information asymmetry and agency costs; third, higher borrowing costs because creditors perceive the firm as riskier; and fourth, the emergence of signals that the firm is attempting to preserve cash through aggressive tax strategies.

Moreover, since the research covers the period from 2019 to 2023, an additional test was performed to further examine the effect of corporate tax avoidance on financial distress during the coronavirus pandemic from 2020 to 2022. The results of this additional test with the fixed effect model are shown in Table 6, while the corresponding estimation model test and classical assumption test results are untabulated. To address heteroscedasticity issues, the model is estimated using robust standard errors.

Table 6. Regression Analysis (2020-2022)

Description	DIS
TXV	4.086251 (0.101)
PFY	2.94168 (0.000)***
FRM	0.104301 (0.647)
LVG	-0.1276803 (0.272)
CAP	-1.789325 (0.029)**
LQD	0.0077764 (0.044)**
Constant	-2.016154 (0.751)
Prob > F	0.0000
R-squared	0.4704

Note: robust p-values in parentheses, *** $p < 0.01$, ** $p < 0.05$, * $p < 0.1$

The baseline findings indicate that corporate tax avoidance increases financial distress. Crucially, however, sub-sample estimations restricted to the coronavirus pandemic period demonstrate that this effect becomes statistically insignificant. One possible explanation is that the sudden emergence of the pandemic created an extraordinary shock that affected firms regardless of their tax behaviour. During this period, financial distress is primarily driven by macroeconomic factors such as a decline in consumer demand, disruption in supply chains, and global economic uncertainty. Consequently, the effect of a firm's strategic approaches, such as tax avoidance, became less dominant in explaining the firm's financial conditions. Additionally, the government introduced fiscal incentives, such as reducing corporate tax rates, during the pandemic to sustain business survival. These fiscal policies may have reduced the immediate financial consequences associated with tax avoidance practices. Firms experiencing extreme financial pressure were more likely to focus on maintaining liquidity and survival rather than the potential consequences of tax avoidance. Under severe liquidity constraints and limited external financing, cash retained through tax avoidance strategies serves as a vital internal buffer against immediate bankruptcy caused by financial distress, thereby neutralizing the long-term risks and costs observed in more stable economic conditions.

Another possible explanation is that the coronavirus pandemic increased uncertainty to an unprecedented level, causing external stakeholders to pay greater attention to broader economic risks rather than the firm's tax behaviour. During the pandemic, firms across various industries faced several operational disruptions arising from restrictions on economic activity due to lockdowns. This condition caused substantial financial pressure for firms regardless of whether they make use of tax avoidance practices. Tax avoidance is viewed as a survival strategy, especially during times of financial strain or crises such as the COVID-19 pandemic (Khan & Nawaz, 2023). In addition, investors and creditors are more concerned with the firm's ability to maintain liquidity and cash flow to survive the economic downturn. As a result, corporate tax behavior may have received less attention because the market perceived the pandemic itself as the dominant source of financial risk. This situation insulated corporate entities from tax enforcement, rendering tax avoidance strategies statistically insignificant to the immediate determination of financial distress.

The findings of this study are consistent with the agency theory framework, in which the significant positive relationship between tax avoidance and financial distress is explained by conflicts of interest, principal pressure, and managers' opportunistic behavior aimed at conserving cash and maintaining performance. Furthermore, this study contributes to the existing literature by pointing out the potential financial risks of tax avoidance rather than focusing solely on its short-term cash flow advantages. Practically, corporate managers should adopt a more balanced and sustainable tax planning strategy rather than pursuing aggressive tax avoidance solely to gain short-term profitability. Managers should also strengthen internal corporate governance to ensure that the tax strategies applied do not compromise the firm's long-term stability. For investors and creditors, this study reveals that high tax avoidance activities may indicate hidden operational or governance risks that are not immediately visible in financial ratios. This serves as an 'additional warning' which implies that lower tax expenses do not necessarily reflect stronger corporate health. Lastly, tax regulators should strengthen monitoring of firms with aggressive tax avoidance practices because such behavior may signal higher financial distress risk and potential long-term financial instability. If left unchecked, this may increase the risk of corporate failure and thus reduce tax revenues.

CONCLUSION

This research aims to examine the effect of corporate tax avoidance on financial distress. The results reveal that corporate tax avoidance strategies increase financial distress because of the possible adverse consequences of tax avoidance. Further additional tests during the

coronavirus pandemic demonstrate that corporate tax avoidance has no significant effect on financial distress. During the coronavirus pandemic, firms are better off prioritizing survival and operational liquidity. External stakeholders, such as investors and creditors, also pay more attention to the macroeconomic conditions rather than the firm's tax behaviour.

This study is not without limitations. First, some firms do not publish their audited financial statements for certain periods. Second, most firms do not explicitly state the amount of cash paid for taxes or even report a pre-tax loss. These limitations force the exclusion of highly probable financially distressed firms from the sample, thus creating survivorship bias in the research sample. To address the empirical limitations of this study, future research could employ other possible proxies of tax avoidance without mathematical distortion. Additionally, applying advanced econometric models such as the Heckman Two-Step Selection Model could statistically correct for sample selection bias.

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