Corporate Sustainability Disclosure and Tax Avoidance in a Developing Region

Samuel Makokha[*]
PhD Student
Moi University, Eldoret, Kenya
Email: drumakokha@gmail.com

Prof. Lucy Rono
Department of Accounting & Finance
Moi University, Eldoret, Kenya
E-mail: jepchoge@yahoo.com

Dr. Peter Githaiga
Department of Accounting & Finance
Moi University, Eldoret, Kenya
E-mail: kgithaiga@gmail.com
[*]Correspondence: drumakokha@gmail.com

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Abstract

The present paper provides empirical evidence on the relationship between corporate sustainability disclosure (CSD) and tax avoidance among listed firms in the East Africa Community (EAC). The study utilizes data that was handpicked from listed firms in the Stock/Securities Exchange of the EAC partner states, specifically from the period 2012-2023. The results indicate a positive correlation between CSD and the effective tax rate (ETR), and consequently, a negative correlation with tax avoidance. The fixed effect regression results remained robust for an alternative regression estimation model that accounts for the possibility of endogeneity. The findings may provide valuable insights to policymakers and investors. This study suggests that in-creased adoption of CSD may lower corporate tax avoidance practices among listed firms in EAC. This finding may also provide financial reporting standards setters and regulators with valuable information on the link between CSD and tax avoidance practices in developing countries. Perhaps there is a need for mandatory adoption of CSD. This study contributes to the literature on CSD and tax avoidance practices from a developing region perspective.

Keywords: *Tax avoidance; corporate sustainability reporting; East Africa Community; Global Reporting Initiative (GRI-4)*

1. Introduction

Corporate tax avoidance has become more prominent in recent years, as seen by the growing number of discussions on the topic (Hanlon & Heitzman, 2010; Wilde & Wilson, 2018; Beer, de Mooij, & Liu, 2020). The public expressed strong disapproval after media reports revealed that several multinational companies were paying very little in taxes. Leaked information further reinforced these reports, illuminating the intricate strategies these companies employed to evade paying billions in taxes (Sandell, 2012). Corporate tax avoidance was a significant topic of discussion in the USA following corporate scandals in the early 2000s. However, it took longer for other OECD countries to address tax avoidance as a political issue. Simultaneously, the general public became cognisant of the fact that prominent corporations such as Google, Apple, and Facebook pay minimal taxes in countries other than the United States, despite generating significant portions of their revenue there (Kovermann & Velte, 2021). Numerous empirical studies confirm the widely condemned practice of multinational companies actively engaging in tax avoidance (Rego, 2003). The issue of firms making significant profits without paying a fair amount of taxes, while many states and public entities face financial difficulties, has gained widespread attention. In response to this pressing concern, the OECD initiated the "BEPS" (base erosion and profit shifting) project. The objective of this project was to address aggressive tax avoidance and ensure the collection of public revenue. By implementing the Anti-Tax Evasion Directive (Council Directive 2016/1164), the European Union implemented the recommendations outlined in the final reports of the BEPS project, with the aim of restricting opportunities for tax evasion. Despite extensive efforts to address the issue, corporate tax dodging is widespread (Dyreng et al., 2017; Thomsen & Watrin, 2018). Dyreng et al. (2008) demonstrate that there exists a specific group of companies that consistently attain exceptionally low levels of corporate tax rates for extended durations.

The advantages and disadvantages associated with tax avoidance activities influence the decision to participate in these activities, according to tax avoidance literature (Kovermann & Velte, 2019). Several studies suggest that tax avoidance, when undertaken solely to reduce corporate tax liabilities, links to efficiency objectives and tends to enhance firm value. This is because it helps boost cash flows and after-tax income (Austin & Wilson 2017; Rego & Wilson 2012). For instance, studies have demonstrated a positive correlation between extensive tax avoidance practices and increased firm value (Irawan & Turwanto, 2020), greater investments (Graham & Tucker, 2006), and enhanced acquisition quality (Blouin et al., 2021).

Nevertheless, when tax sheltering results in an instant augmentation of companies' cash flows, managers have the potential to gain personal advantages through tax planning while simultaneously diminishing shareholders' returns (Hanlon & Heitzman 2010). The transfer of wealth from shareholders to managers serves as proof of agency concerns related to tax aggression (Desai & Dharmapala 2009). Multiple empirical studies support this perspective by demonstrating that engaging in tax avoidance creates favourable conditions for managerial opportunism, as evidenced by the diversion of managerial rent (Lim 2011), persistence of earnings and accruals (Blaylock et al. 2011), manipulation of earnings (Balakrishnan et al. 2019), management of earnings (Desai & Dharmapala, 2009), transactions with related parties (Park, 2018), reduced investment opportunities (Armstrong et al. 2015), inefficient investment practices (Khurana et al. 2018), inadequate corporate social responsibility activities and performance (Hoi et al. 2013; Lanis and Richardson 2018), and profits from insider trading

(Chung et al. 2019). This study builds upon previous research by utilizing CSD as a tool to limit managerial opportunism in business policy decisions. Corporate sustainability disclosures frequently function as a tool for discipline and are often associated with increased visibility and supervision of managerial activities (Jensen & Meckling, 1976). Therefore, this study therefore proposes that if tax avoidance results in agency issues, implementing a robust CSD policy is designed to serve as a disciplinary measure, resulting in a reduction in tax avoidance behaviour. The rest of the paper is organised as follows: The next section discusses the empirical literature. Section 3 presents the methodology. Section 4 discusses the findings, while the final section concludes.

2. Literature review

2.1. Theoretical review

Agency theory suggests that enterprises should provide reports in order to mitigate information asymmetry with stakeholders, particularly shareholders (Jensen & Meckling, 1976). Since enterprises are required to disclose their tax payment in financial statements, shareholders are aware of the extent to which the firms engage in tax avoidance (Government of the Republic of Indonesia, 2007). Shareholders have limited information on the source of tax avoidance by firms, as they only have access to the tax payment number. In the absence of further details regarding the origin of tax avoidance, shareholders will perceive it as a violation of ethical business practices, as it reduces the firm's contribution to societal welfare (Prebble & Prebble, 2010; Raiborn, Massoud & Payne, 2015). Studies show that the level of information transparency of firms influences shareholders' response to tax avoidance (Chen et. al., 2014; Goh et. al., 2016). Companies require additional disclosures to provide shareholders with information regarding the origin of tax avoidance.

According to signalling theory, only firms that excel at distinguishing themselves from other companies are capable of providing a signal (Spence, 2011). Due to the need for resource allocation, only specific enterprises engage in voluntary reporting (Arniati et al., 2019). Voluntary reports distinguish firms from one another. Thus, only the act of providing a voluntary report can convey signals (Francis, Nanda & Olsson, 2008).

Firms that engage in appropriate tax management demonstrate a commitment to promoting social welfare (Hardeck & Hertl, 2014). They limit themselves to engaging in irresponsible behaviours that have the potential to decrease societal well-being. In order to indicate to shareholders that corporate tax avoidance is a result of responsible actions, companies must produce a sustainability report. Sustainability reporting is a detailed and all-encompassing document that presents a company's corporate social and environ-mental initiatives. Corporate social and environmental initiatives serve as evidence that companies prioritize social well-being. The term "corporate social and environmental initiatives" refers to the actions companies take to assume responsibility for the consequences of their decisions and operations on society and environment. These activities aim to enhance social welfare (ISO, 2010). While corporate social and environmental initiatives have the potential to enhance societal welfare, it is important to note that not all shareholders view these efforts favourably. Hendarto and Purwanto (2012) found that the majority of Indonesian companies lack understanding of corporate social and environmental initiatives, viewing them solely as a humanitarian endeavour that wastes company resources. Due to their obligation to engage in corporate social

responsibility (CSR) activities and report on them, companies usually only disclose a limited portion of their philanthropic CSR initiatives. Hence, shareholders would react more positively toward companies that possess a comprehensive understanding of corporate social responsibility (CSR) and engage in CSR initiatives that go beyond mere philanthropy.

Sustainability reporting emphasizes the importance of engaging stakeholders in developing the most effective corporate social and environmental initiatives to address their demands (Ayuso, Ángel Rodriguez, & Enric Ricart, 2006; Fraser et al., 2006). Companies that possess a comprehensive understanding and a robust framework of CSR initiatives, as per signalling theory (Schreck & Raithel, 2018), create voluntary sustainability reports. Companies in Indonesia, through the creation of sustainability reports, can effectively communicate to their shareholders their engagement in commendable corporate social and environmental activities, as opposed to solely engaging in charity endeavours. Therefore, shareholders respond favourably to sustainability reports. Sustainability reports also serve as indicators, demonstrating that companies use funds saved from taxes to directly enhance social welfare through their involvement in corporate social responsibility (CSR) initiatives (Davis et al., 2016).

Studies indicate that shareholders react unfavourably to tax avoidance due to its classification as a violation of social responsibility (Antonetti & Maklan, 2016; DeZoort, Pollard & Schnee, 2018). Providing more information about their sustainability initiatives can lead shareholders to reassess their views on corporations' tax avoidance practices (Wang, 2012; Zeng, 2016).

2.2. Review of empirical literature and Hypothesis development

There is a large body of literature that extensively documents the significant impact of company governance quality and the use of tax avoidance strategies. There is increasing empirical evidence indicating that external parties consider tax avoidance to be a significant contributor to agency costs. This highlights the need for corporate governance in organizations that engage in aggressive tax practices. Lim (2011) reported that higher levels of institutional ownership can effectively mitigate the problem of management rent diversion caused by tax avoidance. Chung et al. (2019) found that with more effective out-sider monitoring, particularly by institutional investors, they are less inclined to use the obscurity and intricacy associated with tax aggressiveness for personal gain. Chan et al. (2016) found empirical evidence supporting the presence of tax avoidance connected to tunnelling. They also find that the degree of tunnelling diminishes as the level of investor protection offered by a legal system increases. Other studies examine the importance of company disclosure in mitigating costs associated with tax avoidance. Hope et al. (2013) examine the relationship between tax avoidance and the disclosure of geographic earnings. They discover that companies that choose not to disclose their geographic revenues have lower current effective tax rates compared to those who do disclose their geographic earnings. This finding implies that managers are inclined to employ inadequate disclosure policies as a means to conceal their tax planning techniques. Similarly, Balakrishnan et al. (2019) found that tax-aggressive firms might address information challenges by enhancing their tax-related disclosures, which would reveal and clarify the underlying rea-sons behind managers' tax tactics. Consistent with this concept, Kerr (2019) states that improved corporate governance and stricter corporate disclosure regulations result in a greater capacity for external entities such as investors, tax authorities, and public interest

groups to identify tax-planning strategies. Consequently, the likelihood of tax avoidance decreases.

Boubaker et al. (2022) found a link between voluntary disclosure and a decrease in tax avoidance practices, based on an analysis of 3,448 instances of French listed firms between 2007 and 2013. This suggests that voluntary disclosure, such as CSD, can be considered an effective means of monitoring that reduces the probability of insiders engaging in rent extraction through tax avoidance activities. The findings also reveal that voluntary disclosure has a considerable negative impact on tax avoidance, but only when family control is less than 40%. However, Jiang et al. (2022) conducted a study using data from Chinese listed corporations to investigate the effect of mandatory corporate social responsibility (CSR) disclosure on corporate tax avoidance. The researchers employed propensity score matching and difference-in-difference approaches to analyse the data. The findings suggest that enforcing obligatory CSR disclosure results in a significant increase in corporate tax avoidance.

Based on the empirical literature this study hypothesises as follows.

H1. CSD has a negative effect on tax avoidance.

3. Methods

3.1. Sample selection and data

This study utilizes secondary data from 47 firms that were listed on the Stock/Securities Exchange of the EAC partner states between 2012 and 2023. The study applied an inclusion/exclusion criterion to derive the sample. Firstly, the study period required the firms to remain listed. Second, the data was available and complete. We only considered cross-listed firms in their parent country and utilised consolidated financial reports. We obtained the secondary data from the companies' websites, annual reports, and the African Financials database. After eliminating some missing variables, we get a total sample of 564 firm-year observations. The data was winsorized at the 1st and 99th percentiles to reduce the effect of outliers.

3.2. Measurement of variables

Dependent variable – tax avoidance

Going by earlier studies, the study applied the cash effective tax rate (ETR) to capture corporate tax avoidance (Xu, 2024; Duan et al., 2018). Cash ETR is the ratio of tax expense to pre-tax income as reported in the income statement. A higher cash ETR means lower tax avoidance, while a lower cash ETR is an indicator of tax avoidance.

Independent variables

The proxy variable that will be used is SRDI (Sustainability Report Disclosure Index), regulated in GRI-G4 Guidelines. In GRI-G4 Guidelines, the disclosure of items is more than GRI-G4 Guidelines, which is 79 items. The economic dimension consists of 9 disclosures, the environmental dimension consists of 30 disclosures, and the social dimension consists of 40 disclosures.

Control variables.

In order to enhance the accuracy of predictions and the reliability of the analysis's inference, we incorporated three firm-specific features as control variables in our empirical models. Firm age: Firm age (the natural logarithm of the number of years since incorporation). Due to the presence of economies of scale, larger organisations are more inclined to engage in corporate tax avoidance. On the other hand, large firms are less motivated to engage in corporate tax avoidance because of their extensive operations, larger profits, and the potential negative impact on their reputation. Also, older firms are more experienced in effective tax planning than younger ones (Kovermann & Wendt, 2019). Existing literature has demonstrated that firm size has an effect on tax avoidance. Irianto et al. (2017) found that firm size had a positive effect on tax avoidance. Arguably, large firms tend to have a more assertive approach towards their tax policy compared to small firms. Nevertheless, Kalbuana et al. (2020) and Prabowo (2020) show that the size of a company does not influence tax avoidance. Hence, the study included size (SIZE) as a covariate in our analysis. Firm size is quantified by calculating the natural logarithm of the total assets (Jarboui et al., 2020; Riguen et al., 2021). Firms with high leverage (LEV), calculated by dividing the total debt by the total assets, are more likely to aggressively pursue opportunities to reduce taxes through interest payments (Sari & Tjen, 2017; Dharma & Ardiana, 2016). Nevertheless, a study conducted by Swingly and Sukharta (2015) demonstrated that leverage had a negative but insignificant effect on tax avoidance. Profitability, measured as the return on assets (ROA), is a measure of a firm's financial performance. A greater ratio value indicates high corporate performance, thus less likelihood of engaging in tax avoidance. Furthermore, ROA is directly linked to a company's net profit and the amount of taxes it is required to pay. ROA is usually computed by dividing pre-tax income by total assets (Mafrolla & D'Amico, 2016; Rahman & Leqi, 2021). Prior studies have determined that profitable companies are more motivated to engage in corporate tax avoidance in order to reduce their tax obligations (Lanis & Richardson, 2012).

3.3. Regression model

The study applied the following regression model to estimate the relationship between CSD and tax avoidance.

$$ETR_{it} = \beta_0 + \beta_1 CSD_{it} + \beta_2 FA_{it} + \beta_3 FS_{it} + \beta_4 ROA_{it} + \beta_5 LEV_{it} + \varepsilon_{it}$$

Where,

ETR is cash effective tax rate; CSD, corporate sustainability disclosure; FA is firm age; FS, firm size; ROA, return on assets; LEV, leverage; ε_{it}, is an error term; β_0 is the constant. β_1 to β_5 are the beta coefficients

4. Results and discussion

4.1 Descriptive statistics

Table I presents the sample's descriptive statistics. As shown in the table, the mean values of Cash ETR are 0.234 and a standard deviation of 0.152, respectively. The mean ETR is below the 30% charged in the region, suggesting on average the selected firms engage in tax avoidance. The mean CSD disclosure is 22.73, suggesting a low level of dis-closure by EAC-

listed firms over the study period. The table further reports an average ROA of 0.076 and a standard deviation of 0.087, confirming large variation in firm performance. The average leverage of 0.465 is an indicator of judicious use of external borrowing among the selected firms. The average firm size was 10.608 (logarithm of total as-sets). The findings further reveal that the mean firm age was 44 years (e^3.788).

Table I. Descriptive statistics

Variable	Obs	Mean	Std. Dev.	Min	Max
ETR_CTA	564	.2342218	.152103	.0015174	.45
CSD	564	.2272501	.1483179	0	.6294118
FS	564	10.6082	.5161521	9.656974	11.76807
ROA	564	.0759339	.0872359	-.1621376	.3854168
LEV	564	.4647693	.2693991	.0008219	.9630926
FA	564	3.787841	.2247099	2.995732	4.290459

Source: Research study (2024)

4.2 Correlation analysis

Table II presents the correlation analysis between tax avoidance, CSD, and control variables. The results show a strong positive correlation (at the 5% confidence level) be-tween ETR and CSD. Furthermore, ETR is significantly positively correlated with most control variables, e.g., firm age, ROA, and leverage. However, ETR is negatively correlated with firm size (FS). The correlation coefficients reported in Table 2 are all below 0.5, which denotes the less likelihood of a multicollinearity problem between explanatory variables. To reinforce this, the study further estimated the variance inflation factors (VIF) shown in the last column of Table 2. The results show that VIF values for all the predictor variables are well below 10, with an average of 1.10 (close to 1) and the highest value of 1.43, below the rule-of-thumb critical value of 10 (Gujarati, 2004). This confirms that multicollinearity is not a problem for this specification.

Table II. Correlation analysis

	ETR_CTA	CSD	FS	ROA	LEV	FA	VIF
ETR	1.0000						
CSD	0.3477*	1.0000					1.43
FS	-0.2696*	-0.1529*	1.0000				1.11
ROA	0.3020*	0.4103*	-0.1778*	1.0000			1.28
LEV	0.1083*	0.2656*	0.1770*	-0.0953*	1.0000		1.21
FA	0.2142*	0.2362*	-0.1410*	0.0440	0.1767*	1.0000	1.10

Source: Research study (2024)

4.3 Regression

This section provides a multivariate analysis of the effect of CSD on tax avoidance. Table III reports the results of fixed effect regression (FEM) as supported by the Hausman test. Hence, the hypothesis is tested using the results of FEM. The R-squared is nearly the same for the FEM, approximately 19.24%, while the Prob>F value is less than 0.05, suggesting that the model fits to explain the variation in ETR. The findings show a positive and significant relation between CSD and cash effective tax rate (ETR) with a negative co-efficient, which is significant at the 5% confidence level. This suggests that CSD positively affects tax avoidance, meaning that firms with higher CSD tend to engage in fewer tax avoidance activities. Overall, the findings are consistent with the study's main hypothesis predicting that CSD reduces tax avoidance, thereby reinforcing the view that corporate disclosure plays an effective disciplinary role. As the level and quality of CSD improve, there is less likelihood that firms will engage in tax avoidance practices. In summary, CSD may be a useful tool for monitoring executives' actions and reducing the chances of insiders engaging in rent extraction through tax avoidance. Legitimacy theory posits that corporation's endeavour to maintain their legitimacy by entering into agreements with society, demonstrating their fulfilment of community and societal standards. CSD is a significant means of signalling legitimacy. Legitimacy can be perceived as a state of being that is at risk when a firm employs aggressive tax techniques. Borrowing from Lanis and Richardson (2013), corporations may employ CSD when threatened by legitimacy issues. Consequently, a firm can enhance its level of legitimacy by either disclosing its social and environmental activities or by increasing its tax payments, if any of these approaches is deemed appropriate for obtaining legitimacy. Sikka (2010) posits that when a firm fails to pay its fair share of taxes, it might undermine the credibility of the organisation.

Table further shows that leverage, profitability, and firm age all have a positive and significant relationship with ETR, thus negatively affecting tax avoidance. On the other hand, firm size is negatively and significantly associated with ETR, thus positively affecting tax avoidance at the 5% significance level.

4.4 Endogeneity concerns

The earlier analysis demonstrated that CSD had a positive effect on ETR. However, it is important to note that a firm's decision on disclosure policy may be affected by tax planning methods, which raises endogeneity concerns. Furthermore, corporations that are more aggressive in their tax planning practices are more inclined to reduce their exposure to market scrutiny, as seen by a decrease in their voluntary disclosure (Kerr 2019). In order to examine endogeneity, the study utilised the two-step Generalised Method of Moments (GMM). The GMM findings, displayed in column 2 of table III, corroborate the main results of the FEM, except for the insignificant effect of firm size on ETR.

Table III. Multivariate regression analysis

	FEM	S-GMM
ETR_CTA	Coef.	Coef.
CONSTANT	1.121(0.303)**	1.407(0.501)**

L1.		-.006(0.074)
L2.		-.013(0.059)
Independent variable		
CSD	.499(0.084)**	.379(0.106)**
Control variables		
FS	-.134(0.024)**	-.118(0,042)**
ROA	.211(0.102)**	.423(0.146)**
LEV	.136(0.041)**	.167(0.061)**
FA	.091(0.044)**	.027(0.054)
R-squared	0.1924	
F-value/wald chi2	20.14	52.04
Prob>F	0.000	0.000
Post estimation		
Hausman Chi2	18.15	
Prob>chi2	0.003	
AR(2)		0.324
Sargan test of overid.		0.270
Hansen test of overid.		0.560

Source: Research study (2024)

5. Conclusion

This study examined the effect of CSD on tax avoidance among EAC. EAC served as a unique environment for studying agency conflicts since it is a developing region and CSD is voluntary. In these situations, the impact of CSD on discipline might be influenced by the tendency of corporate managers to exploit tax-planning strategies for personal gain and conceal their opportunistic actions by selectively sharing limited information with the public and investors. The study was based on a sample of 564 firm-year observations from the years 2012 to 2022. Findings indicate that the firm's involvement in tax evasion actions decreases when it publicly reveals this information. Increased adoption of CSD can be an effective form of monitoring for investors. In summary, CSD disclosure serves as an efficient means of monitoring minority shareholders, hence decreasing the probability of insiders engaging in rent extraction through tax evasion practices. Voluntary disclosure in family enterprises may only have a limited disciplinary effect on individuals with lower levels of family control. The consequences of our study are significant for both scholars and professionals. By providing further insights into tax avoidance based on the quality of disclosure, it facilitates a more comprehensive comprehension of the factors that drive tax planning in EAC. This research presents empirical evidence that corporate transparency serves as an effective means of regulating corporations' actions and holds significant economic value for the public in EAC. This finding can be generalised to apply to the other developing region countries. This study is subject to two main limitations. This study used the GRI-4 checklist as a means of measuring CSD. This checklist

may not include qualitative indicators of CSD or the managerial motives for embracing CSD. Furthermore, tax avoidance was measured by employing the effective tax rate (ETR). Subsequent re-search endeavours may consider utilising alternative measures of tax avoidance, such as book-tax differences.

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