

Financial Distress and Tax Avoidance: The Role of ESG as an Ethical Safeguard in Emerging Markets

Lusi Andriyana^{1*}, Alfa Rahmiati², Heru Tjaraka³

¹ *Fakultas Ekonomi dan Bisnis, Universitas Airlangga, Surabaya, Indonesia*

² *Fakultas Ekonomi dan Bisnis, Universitas Airlangga, Surabaya, Indonesia*

³ *Fakultas Ekonomi dan Bisnis, Universitas Airlangga, Surabaya, Indonesia*

Abstract

This study aims to examine the effect of financial distress on tax avoidance and the moderating role of Environmental, Social, and Governance (ESG) in non-financial companies listed on the Indonesia Stock Exchange during the 2019-2023 period. Tax avoidance is measured using the Current Effective Tax Rate (CETR), financial distress is proxied by the Altman Z-score, and ESG is measured using Bloomberg ESG Disclosure Scores. This study applies a quantitative approach using panel data regression and firm size as a control variable. The results show that financial distress has a positive and significant effect on tax avoidance, indicating that financially pressured firms tend to reduce tax burdens to preserve cash flow. However, ESG does not significantly moderate this relationship, although the interaction coefficient is negative as theoretically expected. This study contributes to the literature by integrating financial risk, governance, and sustainability perspectives in the context of post-pandemic corporate behavior in emerging markets.

Keywords: financial distress; tax avoidance; ESG.

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✉ Corresponding author :

Email Address : lusi.andriyana-2024@feb.unair.ac.id

INTRODUCTION

Tax avoidance is a critical issue in accounting and finance because it directly relates to state revenue, corporate governance, and corporate social responsibility. Generally, tax avoidance is carried out through legal tax planning strategies to reduce a company's tax liability. While not always illegal, this practice can raise ethical concerns because it potentially reduces a company's contribution to public funding. In the Indonesian context, this issue is even more relevant because the tax-to-GDP ratio is still relatively low, and numerous cases of tax avoidance in publicly listed companies demonstrate that this practice remains a challenge for tax authorities.

The post-COVID-19 pandemic period provides an important context for examining corporate fiscal behavior. The pandemic has placed significant pressure on corporate revenue, cash flow, profitability, and capital structure. While the Indonesian economy has shown signs of recovery since 2020, companies still face uncertainty, increased debt burdens, and the need to maintain liquidity. These conditions can influence managerial decisions, including the decision to reduce tax burdens as a

means of maintaining cash flow. Therefore, research on tax avoidance in the post-pandemic period is crucial for understanding how companies respond to financial pressures and sustainability demands.



Source: Central Statistics Agency of the Republic of Indonesia.

Figure 1. Indonesia's gross domestic product growth in 2020-2024

Financial distress is a condition where a company experiences a decline in financial health, characterized by a decline in the company's ability to meet its obligations. From an agency theory perspective, this condition can increase conflicts of interest between managers and owners because managers have an incentive to make decisions oriented towards short-term business continuity. One decision that can arise in this situation is tax avoidance. Sadjiarto et al. (2020) and Kamayanti et al. (2023) show that companies experiencing financial distress tend to engage in tax avoidance to maintain liquidity and operational cash flow.

Empirical findings on the relationship between financial distress and tax avoidance still show mixed results. Kamayanti et al. (2023) and Sadjiarto et al. (2020) found that financial distress has a positive effect on tax avoidance. Conversely, Ariff et al. (2023) showed that companies under financial stress may become more cautious in engaging in tax avoidance, especially when the risk of sanctions and supervision increases. Kalbuana et al. (2023) also found that financial distress does not always have a significant effect on tax avoidance. These differing findings indicate the need for moderating variables to explain when financial distress may or may not encourage tax avoidance.

Environmental, Social, and Governance (ESG) is seen as a mechanism that can influence corporate behavior under financial stress. ESG reflects a company's commitment to sustainability, governance, transparency, and responsibility to stakeholders. Companies with strong ESG performance tend to consider reputational and legitimacy risks more carefully when making decisions, including tax decisions. From a stakeholder theory perspective, companies are responsible not only to shareholders but also to the government, society, employees, and the environment.

ESG is believed to weaken the tendency of companies experiencing financial distress to engage in tax avoidance. Companies with strong ESG commitments will be more cautious in implementing aggressive tax strategies because such practices can conflict with the principles of transparency, fairness, and social responsibility. Yadav and Asongu (2024) explain that companies with strong ESG are more resilient in the face of crises and tend to avoid high-risk activities. Elamer et al. (2024) also show that

ESG can act as an ethical and reputational mechanism in assessing corporate tax behavior.

This study offers novelty by examining the effect of financial distress on tax avoidance and the role of ESG as a moderating variable in non-financial companies listed on the Indonesia Stock Exchange during the 2019-2023 period. This period was chosen because it reflects post-pandemic recovery and increased corporate attention to sustainability issues. This study integrates agency theory, positive accounting theory, and stakeholder theory to explain the relationship between financial distress, tax behavior, and sustainability commitment in an emerging market context.

From an agency theory perspective, financial distress can drive managers to take opportunistic actions to maintain the company's business continuity. When companies face liquidity pressures and declining financial performance, tax avoidance can be viewed as a cost-efficiency strategy that can increase cash availability. Richardson et al. (2015) showed that companies experiencing financial distress tend to increase tax avoidance as a coping mechanism during times of crisis. Dang and Tran (2021) also found that companies under capital pressure are more active in pursuing tax avoidance strategies. Based on this description, the first hypothesis is formulated as follows:

H1. Financial distress has a positive effect on tax avoidance.

ESG can act as a social control mechanism that limits management's tendency to engage in opportunistic tax practices. According to stakeholder theory, companies with strong ESG performance tend to maintain legitimacy and stakeholder trust. Therefore, ESG is expected to weaken the influence of financial distress on tax avoidance. Companies experiencing financial distress but with a strong ESG commitment tend to be more cautious in engaging in tax avoidance due to considerations of reputational risks and long-term sustainability. Based on this description, the second hypothesis is formulated as follows:

H2. ESG weakens the influence of financial distress on tax avoidance.

METHODOLOGY

This study uses a quantitative approach with panel data. The study population is non-financial companies listed on the Indonesia Stock Exchange during the 2019-2023 period. The sample was selected using a purposive sampling method with the following criteria: the company is not in the banking or financial sector, the company published an annual report and complete financial statements during the observation period, and has the data needed to calculate tax avoidance, financial distress, ESG, and control variables.

The dependent variable in this study is tax avoidance, measured using the Current Effective Tax Rate (CETR). A lower CETR value indicates a higher tendency for tax avoidance. The independent variable is financial distress, measured using the Altman Z-score. A lower Z-score indicates a higher risk of financial distress. The moderating variable is ESG, measured using the Bloomberg ESG Disclosure Score.

This study also uses company size as a control variable, proxied by the natural logarithm of total assets.

Hypothesis testing was conducted using panel data regression. The first model was used to examine the direct effect of financial distress on tax avoidance, while the second model was used to examine the moderating role of ESG in the relationship between financial distress and tax avoidance. Classical assumption testing was conducted prior to hypothesis testing to ensure that the regression model met the analysis feasibility criteria.

RESULTS AND DISCUSSION

Descriptive statistics were used to provide an overview of the characteristics of the research data. The results of the descriptive statistics are presented in Table 1.

Table 1. Descriptive statistics of research variables

Variables	Mean	Median	Standard Deviation	Minimum	Maximum
Y_fixed	0.1874	0.1549	0.7218	-1.9726	17.0972
ESG_avg	42.9284	42.9284	3.7676	27.9980	73.4980
Z_avg	2.7102	2.7163	0.3754	1.5035	3.9557
Interaction	1.0537	0.0395	30.8752	-34.2301	874.7724

Note: Y_fixed = transformed and stabilized CETR changes from 2019 to 2023; ESG_avg = ESG score; Z_avg = financial distress based on Altman Z-score; Interaction = ESG x Z_avg interaction.

Based on Table 1, the average Y_fixed value of 0.1874 indicates that the level of corporate tax avoidance in the sample varies. The ESG_avg variable has an average value of 42.9284, indicating that corporate ESG disclosure is at a moderate level. The Z_avg variable has an average of 2.7102, indicating that most companies are in relatively healthy financial condition, although some companies are approaching the distress category.

Table 2. t-test (partial)

Variables	Estimate	Std. Error	t-value	p-value	Conclusion
(Intercept)	0.22397	0.02083	10,750	2.4392e-25	Significant positive
ESG_c	-0.00480	0.00553	-0.868	0.38585	Not significant
Z_c	0.88355	0.05563	15,879	7.748e-50	Significant positive
ESG_c:Z_c	-0.03153	0.01695	-1,861	0.063164	Not significant

Note: p-value < 0.05 indicates significance at the 5% level. ESG_c = centered ESG score; Z_c = financial distress based on the centered Altman Z-score; ESG_c:Z_c = interaction variable.

The t-test results in Table 2 show that financial distress has a positive and significant effect on tax avoidance. This indicates that a company's financial condition plays a significant role in explaining tax avoidance behavior. Conversely, ESG has a negative but insignificant effect on tax avoidance. The interaction term for ESG and financial distress also shows a negative trend, but is not significant at the 5% level.

Table 3. F test (simultaneous)

F statistic	df Regression	df Residual	p-value
86,892	3	838	< 0.001

Note: a p-value < 0.001 indicates that the regression model is simultaneously significant.

Based on Table 3, the F-statistic value of 86.892 with a p-value <0.001 indicates that the regression model is simultaneously significant. This means that financial distress, ESG, and their interaction together have the ability to explain variations in tax avoidance.

The effect of financial distress on tax avoidance

The results of the study indicate that financial distress has a positive and significant effect on tax avoidance. This finding supports the first hypothesis. From an agency theory perspective, financial distress can encourage management to make decisions oriented toward short-term business continuity. One strategy is to reduce the tax burden through tax avoidance. This strategy is considered to help companies maintain cash flow and reduce liquidity pressures.

This finding aligns with those of Sadjarto et al. (2020), Kamayanti et al. (2023), and Dang and Tran (2021), which show that companies under financial stress tend to engage in more active tax avoidance. Richardson et al. (2015) also showed that during the global financial crisis, distressed companies increased tax avoidance strategies as a coping mechanism. Thus, financial distress can be understood as a condition that drives companies to adopt more aggressive fiscal strategies to preserve financial resources.

The role of ESG in the relationship between financial distress and tax avoidance

The test results indicate that the interaction between ESG and financial distress is negative, but not statistically significant. This negative correlation indicates that ESG has the potential to weaken the influence of financial distress on tax avoidance. However, because the results are insignificant, the second hypothesis is not empirically supported in this study. Therefore, ESG has not been strongly proven to act as a mechanism limiting the tendency of distressed companies to engage in tax avoidance.

Theoretically, ESG should function as a social and reputational control mechanism. Companies with strong ESG are expected to be more cautious in making tax decisions due to considerations of reputational and legitimacy risks. Yadav and Asongu (2024) state that companies with strong ESG are more resilient to financial distress and tend to avoid high-risk behavior. Elamer et al. (2024) also show that ESG can influence how the market assesses a company's tax behavior. However, the results

of this study indicate that ESG is not strong enough to significantly moderate the relationship between financial distress and tax avoidance.

The insignificant moderation results may occur because ESG disclosure does not fully reflect the company's substantive commitments. In practice, ESG can serve as a form of reporting and communication to stakeholders, but it is not necessarily integrated into all strategic decisions, including tax decisions. Furthermore, the pressure of financial distress can cause management to focus more on short-term cash efficiency than on long-term reputational considerations. Therefore, ESG in this study is not strong enough to limit tax avoidance in companies experiencing financial distress.

CONCLUSION

This study concludes that financial distress has a positive and significant effect on tax avoidance. The findings indicate that companies facing financial difficulties are more likely to engage in tax avoidance practices as a strategic effort to preserve liquidity, improve cash flow, and sustain business operations. This result is consistent with Agency Theory and Positive Accounting Theory, which suggest that managers tend to adopt policies that maximize short-term economic benefits when firms are under financial pressure. Consequently, financial distress may create incentives for management to reduce tax burdens in order to alleviate financial constraints and maintain organizational stability.

Furthermore, this study reveals that Environmental, Social, and Governance (ESG) performance does not significantly moderate the relationship between financial distress and tax avoidance. Although the interaction coefficient is negative and consistent with theoretical expectations, the moderating effect is not statistically significant. This finding implies that while ESG practices may have the potential to discourage opportunistic tax behavior and promote ethical decision-making, their influence remains insufficient to effectively constrain tax avoidance among financially distressed firms. These results highlight the need for regulators, policymakers, and investors to strengthen oversight mechanisms related to corporate tax practices, particularly for firms experiencing financial difficulties. Future research is encouraged to examine the individual dimensions of ESG separately, employ alternative measures of tax avoidance, and extend the analysis across different industries, countries, or observation periods to provide a more comprehensive understanding of the relationship between financial distress, ESG performance, and corporate tax behavior.

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