

CHAPTER I

INTRODUCTION

1.1 Background

The advancement of the technology era has pushed the alteration of the market's trading system, making the transactions more rapid and contentious. The journal by O'Hara (2015) states that with various locations trading means that it is almost improbable that all prices would stay the same within one another, thus it does not disclose the fact that arbitrage opportunities do exist. The break necking pace of buying and selling also distorts the view of liquidity existence within each market, creating even more open doors for-profit exploitation through the arbitrage trading opportunities. Traders are also able to exchange trading information directly to the party for a certain amount of extra fee, providing market transparency compared to the conventional trading systems. Therefore, it is intriguing to examine how stocks react to several factors in the midst of rapid trading.

A journal by Amihud and Mendelson (1986) states that investors who seek merit upon stock returns from trading costs would seek higher returns for less liquid stocks as a form of compensation through the higher price paid for the liquidity service. Thus, stocks with lower liquidity produces higher return as it costs more for investors to liquidate the stocks up to a certain trading size.

However, despite the relationship, Chung and Chuwonganat (2017) says that no previous study has pointed out the function of between market

volatility and liquidity in the examination of stock returns. Thus it will be interesting to measure the effect on illiquidity premiums to the market volatility and stock returns, especially when the stock movements are stochastic.

Stock return is afflicted by market volatility in reason of the indication of the risk swelling attributed to the size of the price motion. In accordance with the Capital Asset Pricing Model (CAPM), the model stipulates the higher risk the asset is involved, the higher the asset returns it generates. Investors seek compensation upon the risk where they put their money into, just like how they want higher returns for stocks that have slow liquidation. However, there may also be another factor contributing to stock return such as government regulation changes.

According to Al-Jafari et al. (2011) there is a relationship between the macroeconomy conditions to many developed and emerging markets. Investors are free to take the presence of opportunities to make the maximum result in allocating scarce resources. Emerging and developed countries each have unique macroeconomic fundamentals and it is why investors have to investigate all information in order to compare and predict their stock return. If a domestic stock price goes up, automatically the domestic financial assets shines and investor would probably shift their demand to domestic assets. Moreover, investor has to be more observative of the stocks since it reflects the information of the assets they are holding. Developed market tends to have smaller inflation compared to emerging

market, and nominal risk free rate and discount rate to value stocks of either emerging or developed market could be seen by the help of the inflation rate. Looking at the market risk based on their macroeconomic help investors decide where to put their money.

Claessens et al. (1995) reviewed twenty countries included in emerging markets and measured the stock return behavior. From the study, they particularly found that there is high predictability in stock price behavior of IFC's Emerging Market DataBase that may arise from high jumps in stock returns and gigantic changes in the market structure. They also point out that this predictability may impact negatively to the emerging market in the long run; hindering investors with no information access that it does not liquidate the market and disrupts stock market images in providing economic roles. Since Indonesia is an emerging country, it means that the country has an emerging market for stocks.

Another journal by Kohers et al. (2007) indicates that emerging countries tend to have a much bigger illiquidity problem compared to the developed countries which sometimes leads to a phenomenon that appear caused by how risky emerging market works. One example is the flight-to-quality or liquidity phenomenon which talks about how investors' behavior is shifting to a safer kind group of assets and they tend to get away from the riskier asset since they are afraid of the negative return the risk might cause. This might also explain that investors are more risk-averse in emerging markets (Vayanos, 2004).

An additional variable to be researched upon in terms of taxpayer behavior in both emerging and developed market is tax amnesty, Bayer et al. (2014) reports a phenomenon that is likewise in Indonesia, also has occurred in developing markets. The journal introduced that many countries, not just Indonesia, also implements tax amnesty to increase the company's main income to solve problems that may have occurred after any financial 'storm' faced by that country. However, the authors also point out that since tax amnesties are mostly conducted in a short time period, whether tax amnesty increases the country's tax income or not depends on the people's awareness and desire to participate in the country. Bayer et al. (2014) also added the theory of tax evasion by Alm and Beck (1991) predicts that a taxpayer who is reasonable will participate during the extra stimulants provided by, perhaps different tax rates or the forgiveness of law enforcement.

The behavior of taxpayers in Indonesia that conceal their assets or even stash them overseas as mentioned above is explained by the journal of Bayer et al (2014). The journal displays three previous research used in the study to explain the various behavior of taxpayers: first mentioned in the journal, Andreoni (1991) finds people as consumers fear the risk of reporting the assets so there is a spike in spending between the time of announcement and the tax amnesty execution. Next, Malik and Schwab (1991) corresponds the previous theory with another one that says the lack of knowledge and awareness of the country residents about tax amnesty

before the tax amnesty is done. Lastly, taxpayers participation usually increases due to fear of being fined or enforced for not reporting the supposedly assets (Graetz and Wilde, 1993).

Taxpayers are obliged to file in their asset statements through Annual Statement Letter (SPT) and the President Joko Widodo has provided an electronic facility so that the filing of the Annual Statement Letters can be done with technology instead of manually.

Despite the results shown in the research by Bayer et al. (2014) that taxpayers, in the developed market still take part of the tax amnesty regardless of the sanction or fines or other motivations that may be included. It is evident from the journal made by Wulandari et al. (2017) that the background of the Indonesian government to induce tax amnesty is due to Panama Pappers scandal, involving companies in Indonesia investing in illegal companies that are purposely established in tax-haven countries.

Tax amnesty in Indonesia started from July 2016 and ends on March 2017 and tax amnesty was held due to fix poverty by increasing Indonesian tax fund for the government to spend on social welfare and help decrease the unemployment rate that could help the Indonesian macroeconomic conditions.

Therefore, with the factors mentioned above and others that are considered, the researcher would like to measure the correlation of the oscillation occurring in stock market which is seen to be impactful to stock returns, through their liquidity supply, risk premiums, and other measurable

indicators with research paper titled **“THE EFFECT OF MARKET VOLATILITY, ILLIQUIDITY, AND TAX AMNESTY TOWARDS STOCK RETURN IN INDONESIA”**.

1.2 Research Questions

On the foundation of the backgrounds as mentioned in the previous sub-chapter, the following are the research questions:

1. Does market volatility affect stock return in Indonesia negatively?
2. Does illiquidity affect stock return in Indonesia positively?
3. Does the government's tax amnesty regulation affects Indonesia's stock return positively?

1.3 Purpose of the Research

Based on the research questions, the purposes sought to be achieved within this research are:

1. To connect and see how evident the relationship in market volatility and liquidity provision to stock return.
2. To evaluate the affliction of regulatory changes to the stock market in Indonesia.

1.4 Research Benefits

1. This research shall provide significant insights on factors affecting stock return which is ought to be helpful for investors upon the investment process on getting higher stock returns and benefits in the future.

2. The results from this paper can be used as guidance for further research as a reference or study medium about volatility and liquidity shocks.

3. Upon the research conducted for this paper, the author also gained more comprehension of the financial markets and theories after dedicating into the process has enlightened any doubts about the complexity of this research.

1.5 Research Limitations

The theoretical measures executed may indicate some shortcomings to be fathomed upon:

1. The difficulty of acquiring more complete journals related to the topics discussed in this paper due to limited data available,

1.6 Chapter Outlines

For the research paper to be systematically ordered, below are the outlines for the chapter:

Chapter I - Introduction

The first chapter consists of a research background, will discuss the research background, research formulations, research objectives, limitations, and outlines.

Chapter II - Literature Overview

This chapter elaborates on any previous theoretical and literature reviews, definitions for this research variables and the research model.

Chapter III - Research Method

In Chapter 3, the researcher discusses which methodology is chosen to be used in order to execute data collection and the model calibration which involves the type of data structure, the model estimator, further definitions of the research variables, and the analysis of the data.

Chapter IV - Research Results and Discussions

The fourth chapter incorporates the data, the measurement for the theoretical model to see if it is statistically adequate, and the model interpretation.

Chapter V - Conclusions and Recommendations

Lastly, the researcher encompasses conclusions, limitations occurred in the research, research implications, and upcoming groundwork recommendations.

