CHAPTER I

INTRODUCTION

1.1. Background of the Study

Tax is a source of state income that plays an essential role in the growth of a country; thus, the implementation of taxation is closely regulated by the Indonesian government to sustain state revenues. Taxes, according to Law No. 16 of 2009 on General Requirements and Tax Procedures, are mandatory contributions to the state owed by individuals or entities that are coercive under the law, without receiving direct reciprocity and are used for the needs of the state for the greatest prosperity of the people (Pratomo & Rana, 2021). Tax plays an essential role in the functioning of a state, particularly in the implementation of development, as taxes are a source of state money that is used to fund all expenditures, including routine expenditure and development expenditure (Mardiasmo, 2019). Also, tax revenue is utilized to carry out and support national development operational activites including infrastructure, education, health, social affairs, and other activities.

Taxes are the largest source of income of state revenue, hence they are critical for the state. According to data provided by the Central Bureau of Statistics (also known as *Badan Pusat Statistik*), tax collections account for over half of the state revenue, with the remainder coming from non-taxes and grants. Therefore, taxes is concluded to play a crucial part in Indonesia's economy, as they account for the majority of the nation's sources of income. Table 1.1 contains data published by the Central Bureau of Statistics, which shows that tax revenue is the largest part of the State Revenue and Expenditure Budget.

Table 1.1 Indonesia's Revenue Realization Period 2016 – 2020 (In Billion Rupiah)

Year	Tax Revenue	Non-Tax Revenue	Others	Total	% Tax Revenue
2017	1,343,529	311,216	11,629	1,666,375	80.62%
2018	1,518,789	409,320	15,564	1,943,674	78.14%
2019	1,546,141	408,994	5,497	1,960,633	78.85%
2020	1,285,136	343,814	18,832	1,647,783	77.99%
2021	1,375,832	357,210	2,700	1,735,742	79.26%
AVERAGE					**78.972%**

Source: (*Badan Pusat Statistik*, 2021)

As presented in table 1.1, the largest contribution to the state revenue is from taxes, which contributed by averagely 78.972% of the total revenue from 2017 until 2021. With a contribution of more than 50% of total state revenue, this shows the importance of taxes as a source of state revenue. Therefore, the government continues to strive to improve tax payment compliance so that taxpayers pay taxes on time and in the correct amount. However, the government's objective of improving taxpayer compliance does not always work as planned as taxpayers and the government have competing interests when it comes to tax payments.

Because taxpayers and government have conflicting interests in the execution and fulfillment of tax payments, tax collection is often not maximized. Taxes are the primary source of state income for the government; nevertheless, for some businesses, taxes are viewed as a burden that would affect the firm since it becomes a deduction from corporate revenues, resulting in small earnings. The conflict of interests, also known as the agency problem, will result in non-compliance by the company's management, which will result in tax avoidance practices. Despite the fact that taxes are an important part of the state's budget, many people fail to pay their taxes.

One of the impediments to improving tax collection is the occurrence of tax avoidance practice. Tax avoidance is an effort to reduce tax burden by taking advantage of loopholes in tax laws or regulations (Yustrianthe & Fatniasih, 2021). The main purpose of tax avoidance practice is only to minimize company's tax obligations, not to embezzle tax obligations. Although tax avoidance does not violate any laws or regulations, however, it could still create negative impact on the state’s revenue as it would reduce taxes revenue. Suryo Utomo, the Director General of Taxes at the Ministry of Finance, spoke about the findings of tax avoidance, which is anticipated to cost the state Rp 68.7 trillion each year (Santoso, 2020). The opportunity for tax avoidance to occur is also because the Indonesian government adheres to a self-assessment system in its tax collection system where taxpayers have complete control over how they calculate, pay, and report their tax obligations.

In Indonesia, the tax collecting system is a self-assessment system, which requires individuals to compute the amount of tax payable on their own. Due to this nature, tax fraud and violations in the form of attempts to evade or avoid taxes are extemely likely to occur (Mulyani, Darminto & Endang, 2014 as cited in Yustrianthe & Fatniasih, 2021, p. 365). Tax avoidance and evasion are two active strategies to avoid or reduce tax payment. Tax avoidance is an attempt to reduce taxes payable via legal methods, whereas tax evasion is an attempt to reduce taxes payable by unlawful means (Yustrianthe & Fatniasih, 2021).

Tax avoidance is proxied by Cash Effective Tax Rate (CETR) in this study. CETR compares the amount of money spent on tax expenses to the amount of money earned before taxes. Because it incorporates the taxes that have been paid in calculating tax avoidance, CETR is the most relevant measurement to depict the actual situation of a firm in terms of tax avoidance practices. Also, Dyreng et al. (as cited in Sari & Devi, 2018) explained that CETR is not affected by changes in estimates such as allowances, tax assessment, or tax protection. Therefore, CETR is the best indicator to measure tax avoidance.

According to Adegbite & Bojuwon (2019), profitability is a motivating factor for companies to conduct tax avoidance. Oftentimes, high earning companies would attempt to reduce their tax obligations as high profitability means greater tax expense for them (Ichsani & Susanti, 2019), which is also supported by Gunaasih (2021), who stated that companies with high profit are more likely to conduct tax avoidance practice.

Profit ratio is used to determine how much profit a firm could generate (Yusuf et al. , 2019). In this study, profitability is proxied by return on assets (ROA). ROA is one of the metrics that can be used to assess a company's profitability. The higher the ROA value that a company could achieve, the better its financial success. The greater the profit of a company, the better its performance; yet, profit is an important aspect in taxation; the bigger a firm's profit, the higher the amount of tax burden that must be paid by the company. As a result, high earning companies are more likely to engage in tax avoidance practices.

Another factor that motivates companies to avoid paying taxes is leverage. Leverage is used to assess a company's capacity to satisfy all of its short-term and long-term obligations. Leverage refers to the amount of debt a company employs to fund itself. When a company utilizes debt to fund its operations, an interest expenditure is incurred, and interest expenses are tax deductible. Therefore, many companies seek to employ leverage to avoid a greater tax burden because the greater the leverage in a firm, the lower the tax burden they should bear. To put it another way, the more debt a company incurs, the more interest it must pay. This can lower pre-tax profit, which can further reduce tax liability.

Sales growth is another aspect that may have an effect on tax avoidance. Greater sales growth leads to the increase in profit, hence greater tax expenses. The income earned from sales can be used to measure the amount of sales growth, which is an essential sign of market acceptability of a company's products or services. Sales growth is a reflection of previous investment performance that may be used to forecast future growth. Growth in sales is also a measure of demand and the competitiveness of businesses in a given industry. The ability of a business to maintain earnings in future possibilities is influenced by its growth rate.

Until recently, there have been numerous tax avoidance practices in Indonesia. The most recent tax avoidance case was reported on one of the largest tobacco producer in Indonesia, PT Bentoel Internasional Investama Tbk (IDX:RMBA). In 2019, the company was reported to conduct tax avoidance practice that was estimated to cost Indonesia a loss of US$ 14 million per year. The company was reported to avoid taxes by carrying out intra-company lending transactions in 2013-2015 with affiliated companies in the Netherlands as well as making payments back to the UK for royalties, fees, and services to avoid paying taxes in Indonesia (Prima, 2019).

This research selects manufacturing company as the focus of this study due to two reasons. First, manufacturing sector is the sector that contributes the most to Indonesia's tax revenues. In 2020, tax revenues from the manufacturing industry sector were reported as the main contributor to the state tax revenue, with a value of Rp108.36 trillion, equivalent to 29.5% of the total realized tax revenue. The manufacturing sector succeds to grow by 4.68% year-on-year despite the COVID-19 pandemic (Santoso, 2020). Second, manufacturing sector is the main contributor to the Indonesian economy. As reported by the Ministry of Industry, the manufacturing industry contributed 17.33% to GDP in the third quarter of 2021, the highest among all economic sectors (Ministry of Industry of the Republic of Indonesia, 2021).

Research findings from several previous studies do not show consistent results. Previous research analyzing the effect of profitability, leverage, and sales growth on tax avoidance is found in research by Hidayat (2018), who concluded that profitability and sales growth had a negative and significant effect on tax avoidance, while leverage was found to have no effect on tax avoidance. Research by Pamungkas and Mildawati (2020) discovered that profitability, leverage, and sales growth had no effect on tax avoidance. However, research by Umar et al. (2021) concluded that profitability and sales growth had no effect on tax avoidance, but leverage had a negative effect on tax avoidance. Meanwhile, Yustrianthe and Fatniasih (2021) concluded that profitability had a positive effect on tax avoidance, while sales growth and leverage had no effect on tax avoidance. Tanjaya and Nazir (2021), who linked profitability, leverage, sales growth, and firm size towards tax avoidance found that profitability had a positive significant effect on tax avoidance, firm size had a negative effect on tax avoidance, while leverage and sales growth had no effect on tax avoidance.

Table 1.2 Research Gap

Author(s)	**Independent Variable (X)**		
	Profitability	Leverage	Sales Growth
Hidayat (2018)	Negative significant effect	No effect	Negative significant effect
Pamungkas & Mildawati (2020)	No effect	No effect	No effect
Umar et al. (2021)	No effect	Negative significant effect	No effect
Tanjaya & Nazir (2021)	Positive significant effect	No effect	No effect
Yustrianthe & Fatniasih (2021)	Positive significant effect	No effect	No effect

Source: Prepared by the writer (2022)

Based on this understanding, this study attempts to fill the research gap by examining the effect that profitability, leverage, and sales growth has on tax avoidance in manufacturing companies listed on the Indonesia Stock Exchange. Therefore, the title of this research is "**The Effect of Profitability, Leverage, and Sales Growth on Tax Avoidance (A Study on Manufacturing Companies Listed on The Indonesia Stock Exchange)**".

1.2. Problem Limitation

In order to keep the discussion become more focused and not too broad, the research problem is confined to several limitations. There are four limitations to this study that readers should be aware of. First, the purpose of this study is limited to describing and assessing the effect of profitability (X1), leverage (X2), and sales growth (X3) on tax avoidance (Y). Second, the variables used in this study is only proxied with the stated indicator in chapter 3. Third, data collected in this study is only from the year 2015 to 2019. Finally, the focus of this research is only on studying and defining the effect of profitability, leverage, and sales growth on tax avoidance in manufacturing companies that are listed on the Indonesia Stock Exchange (IDX).

1.3. Problem Formulation

The problems to be investigated in this study are as follows:

a. Does profitability have partial effect on tax avoidance in manufacturing companies listed on the Indonesia Stock Exchange?
b. Does leverage have partial effect on tax avoidance in manufacturing companies listed on the Indonesia Stock Exchange?
c. Does sales growth have partial effect on tax avoidance in manufacturing companies listed on the Indonesia Stock Exchange?
d. Does profitability, leverage, and sales growth have simultaneous effect on tax avoidance in manufacturing companies listed on the Indonesia Stock Exchange?

1.4. Objective of the Research

The following research objectives would explain the goals of this study:

a. To test whether there is a partial effect of profitability on tax avoidance in manufacturing companies listed on the Indonesia Stock Exchange.
b. To test whether there is a partial effect of leverage on tax avoidance in manufacturing companies listed on the Indonesia Stock Exchange.
c. To test whether there is a partial effect of sales growth on tax avoidance in manufacturing companies listed on the Indonesia Stock Exchange.
d. To test whether there is a simultaneous effect of profitability, leverage, and sales growth on tax avoidance in manufacturing companies listed on the Indonesia Stock Exchange.

1.5. Benefit of the Research

The writer hopes to deliver the following benefits to the reader as a result of this research:

1.5.1. Theoretical Benefit

This study is designed to give useful information and improve current information about the correlation between profitability, leverage, sales growth, and tax avoidance, especially in manufacturing companies listed on the Indonesia Stock Exchange. The findings of this research can be considered as a resource for future researchers who want to do research on a comparable topic.

1.5.2. Practical Benefit

Findings of this study is expected to benefit several parties, including:

a. Writer

This research is expected to provide a more in-depth understanding of accounting and taxation. This study is also expected to be able to provide empirical evidence on the effect of profitability, leverage, and sales growth on tax avoidance.

b. Reader

This research is expected to provide an overview of the effect of profitability, leverage, and sales growth on tax avoidance. Also, this study is expected to serve as a reference for future research.

c. Manufacturing Companies

This research is expected to assist every manufacturing company in carrying out better and more careful tax management, as well as implementing tax policies that address its attitude toward the requirement to pay taxes. This research can also be used as a material for consideration and evaluation of the management of manufacturing companies to resolve issues regarding tax avoidance in the future.