CHAPTER I

INTRODUCTION

1.1 Background of the Study

Indonesia is a country that has various industries that produce products and services needed by the Indonesian people. The industrial sector is one of the sectors in Indonesia that is able to encourage accelerated economic growth due to its role to solve the problem of poverty and create a labor-intensive agro industry-based economy (Kemenperin, 2023). Industrial activities have added value to economy due to the goods or services produced by the industry provide great benefit to consumers and producers. Therefore, the presence of the industrial sector is needed in the process of accelerating economic development.

The industrial sector includes companies that provide products and services generally consumed by industry, not directly by individual consumers. The products or services produced are products or services that are reprocessed to become raw materials. The types of product companies included in this sector are aerospace and defence, building products and fixtures, electrical, machinery. Meanwhile, services companies included in this stock sector are diversified industrial trading, commercial services, professional services and multi-sector holdings.

Government of Indonesia obtain largest sources or proportion of revenue from tax revenues, collected from either individual or corporate taxpayers. State revenue from taxes until end of July 2023 has reached IDR 1,109.1 trillion or 64.6

percent of the 2023 State Revenue and Expenditure Budget (APBN) target (Humas, 2023, August 14. Sekretariat Kabinet Indonesia. https://setkab.go.id/hingga-akhir-juli-2023-penerimaan-pajak-tembus-rp1-1091-triliun/). Tax plays an important role in supporting a country's development. Many companies conduct the effort to minimize tax payments. For a company, tax as a cost can affect profit and will affect the rate of return on investment.

The company will endeavor to manage the amount of its tax payment to the lowest level because it will increase after tax income, rate of return, and cash flow. Manager as an agent is given the authority to manage the company, such as managing funds and making other company decisions on behalf of the principal, which is the owner. However, company managers often have other goals that conflict with these main goals so that conflicts of interest arise between managers and shareholders. The relationship between managers and shareholders in agency theory is described as a relationship between the agent (manager) and the principal (shareholders) (Firdaus, 2021).

Masum et al. (2023) state that "Apart from saving company funds, tax avoidance can also worsen agency conflicts. For example, some shows that tax avoidance reduces company transparency and then provides opportunities for managers to realize their personal interests".

According to Kemenkeu (2007), tax is a mandatory levy imposed on the government by an individual or entity without direct compensation from the government and used for the needs of the government in the public interest. On the one hand the government seeks to increase the optimization of tax revenues, whereas the government efforts are contrary to the company as taxpayers because taxes can reduce profits so the company wants minimum tax payments. The act of minimizing the amount of tax payments is illegally termed tax evasion while the aaction to minimize the amount of tax payment is legally referred to as tax avoidance.

Tax avoidance tends to be carried out by companies when the company has higher profits so profitability can be one of the causes of tax avoidance practices in a company. Profitability indicates the company's competence to profit in a certain period. The company's tax burden is low if the profitability low (Andhari & Sukartha, 2017). Muslim and Nengzih (2015) mentioned that "there are several factors that influence tax avoidance, which is profitability and corporate governance. Several previous studies have tried to link factors in a company's financial condition to tax avoidance, including focusing on level of company profitability" (p.131).

Profitability is the extent of the corporate's effort to result earning. Profitability is a guidance for financial condition determined by the company in increasing the company's asset reflected by the company's income. The higher the profitability, the higher gain in corporate. This condition can increase the number of tax payment in corporate. The profit can enhance the attempt of company to lessen the tax expense. The minimum tax expense reflects the manner of tax avoidance in corporate. It can apply because the association between corporate tax and income obtained by corporate is connected. The high income can provide the result to the great payment of tax by corporate. If the corporate can create the high income, this net income will determine the greater tax burden in the corporate with result that there is manner of corporate in implementing tax avoidance to decrease this expenditure. The corporate with good business turnover and high earning incline to minimize tax burden. This company can create low tax expenditure because it uses many ways in substracting the tax payment. (Sherly and Fitria, 2019).

Profitability is closely related to profit but the two have one key differentiator. Profit is an absolute amount, while profitability is a relative amount. Profitability is used as a metric to determine the scope of a company's profits in relation to its size business. So, it can be said that profitability is a measure of efficiency shows the success or failure of a company. Profitability is calculated by using profitability ratio, which measures the efficiency of using company's assets to generate profits over a period. According to Corporate Finance Institute (2020), one of the financial indicators used to access a firm's ability to generate revenue is the profitability ratio. This ratio shows how the business's performance in undertaking its resources generates added value for shareholders and increase business income. There are several types of profitability ratios. This study will use return on assets (ROA) measurement to access company profitability.

From the description above, companies can carry out tax avoidance actions by reducing costs on debt costs. In this case, cost of debt will affect the company's profit level over a certain period of time so that the company's profits will decrease which results in reducing tax payments (Dewi, 2021, chap.1). Therefore, companies should act more carefully in making decisions and consider the level of risk due to high levels of debt to carry out tax avoidance. (Noveliza & Crismonica, 2021, p. 190-193).

Cost of debt is a cost that the company must incur because it uses debt funds, where these debt funds will generate interest charges after tax and/or various other forms of costs. The cost of debt includes the interest rate that must be paid by the company when making a loan. The company's ability to manage debt costs is needed. The cost of debt is calculated from the amount of interest paid by the company divided by the number of loans that generate interest. Companies use debt to finance most of their assets. (Utami, 2021). Robiansyah et al. (2017) state that "Debt policy is positively related to financial risk. Increasing financial risk means creating conflict, so it is necessary to regulate the use of debt to reduce agency conflicts" (p.99).

According to Pratiwi (2021), cost of debt must be paid by the company for each of its debts, such as bank debt or corporate bonds. For example, when the company apply for a loan to the bank, and from the company's application, there will be additional fees that must be paid in addition to the principal of the loan which is the interest on the debt. But usually to determine the cost of debt, there are several variables or factors that must be considered such as, what is the current interest cost, the risk of the company going bankrupt, and the tax advantage for the company with the debt it has. This can be seen from how the company conducts good cost management in its business. The company's cost of debt can cause damage to company's financial condition. The company needs to know how to manage the cost of debt correctly. The company should know the basics of business debt starting from the due date and obligations that must be paid. There are several sources of loans that company should know when the company make a debt loan, for example from commercial loans, term loans or by issuing bonds. Many large companies make these commercial loans for various reasons such as buying equipment, increasing workforce, renovating owned properties, and so forth.

Tax avoidance is the way and manner based on appropriate way in assured approach for the taxpayer because it is done with considering the regulation or permitted by law. The consideration of each company is to reduce tax payment or make efficient payment appropriately based on tax provision by making way in the shortcoming of tax provision. Tax avoidance is means by the company in evading the tax expense in appropriate manner based on tax law and this method get opportunity from the shortcoming of deficiency of tax regulation.

One of the factors that influences tax avoidance is profitability which is measured using the return on assets (ROA) ratio. The higher the ROA value, the better the company's performance (Damayanti et al., 2020, p.133). Another factor is cost of debt. The greater the tax avoidance, the amount of debt will be reduced which will incur debt costs because it can reduce income.

The following are three industrial sector that are used as samples for this research phenomenon, which:

Table 1.1 Profitability, Cost of Debt and Tax Avoidance in Industrial Sector Listed on Indonesia Stock Exchange in Year 2021-2022.

No	Company	Year	Profitability	Cost of Debt	Tax Avoidance
1	PT. Astra International, Tbk	2021	0.0697	0.01508	0.1712
		2022	0.0978	0.01243	0.2086
2	PT. United Tractors, Tbk	2021	0.0942	0.01851	0.1954
		2022	0.1637	0.01491	0.2228
3	PT. Supreme Cable Manufacturing & Commerce Tbk	2021	0.0302	0.00000	0.1846
		2022	0.0208	0.00000	0.2109

Source: Indonesia Stock Exchange (2023)

The industrial sector is one of the most important sectors in the Indonesian economy. The industrial sector is the largest contributor to Indonesia's Gross Domestic Product (GDP), which is around 50%. The growth of the processing industry sector in the last few months of 2022 shows positive signals. This condition is reflected in the trend in the expansion level of the Industrial Confidence Index (IKI) value which has increased. The industrial sector can determine the fund proper based on the company’s condition (Kemenperin, 2023).

Based on table 1.1, PT. Astra International, Tbk had the increasing profitability from 2021 to 2022. In year 2021, the profitability was 0.0697 and in 2022, the profitability was 0.0978. It indicated the increasing of profitability in amount of 40.3%. From the financial statement, the net profit in year 2021 is Rp 25.586 billion and year 2022 is Rp 40.420 billion and has increase in the amount of 58%. Profitability is measured using ROA proxy, the higher the profit obtained by company, the higher the company’s profitability level, so that it uses depreciation and amortization expenses as a tax deduction which looks like tax avoidance. In the same period, the tax avoidance decrease in amount of 21.85% due to the increasing of tax payment of 89.8% from year 2021 Rp 5.538 billion to Rp 10.513 billion in year 2022.

Based on table 1.1, PT. United Tractors, Tbk in year 2021, cost of debt was 0.01851. Companies will tend to use less debt when they carry out tax avoidance. Vice versa, companies will engage in less tax avoidance when they are involved in a lot of debt and in year 2022 the cost of debt had decreased 0.01491 or 19% due to the increasing of liabilities in the amount of 25% higher than increasing of interest expense which is in year 2021 is Rp 40.738 billion and year 2022 is Rp 50.964 billion.

According to research by Alfiansyah (2020), Return on Assets (ROA) has a significant effect on tax avoidance. However, one of empirical studies according to Napitupulu (2020) has shown that ROA has no effect on tax avoidance. Apart from ROA, another variable that influences tax avoidance is the Cost of Debt. According to the findings of other studies, Cost of debt has a significant effect on tax avoidance (Maswa Satia, 2019) while research on cost of debt was conducted by Sugma Dewi (2020) who stated that cost of debt has no significant effect on tax avoidance.

Based on the explanation above, there are several differences between previous research. So researchers want to know the effect of profitability and cost on debt on tax avoidance of industrial companies, because there are a lot of tax avoidance carried out by companies in Indonesia, including industrial companies. Therefore, the author has interested in conducting the research with title "**The Effect of Profitability and Cost of Debt toward Tax Avoidance in Industrial Sector Listed on the Indonesia Stock Exchange**".

1.2 Problem Limitation

The limitations of the problem in this study are as follows:

1. This research will be carried out in industrial sector listed on Indonesia Stock Exchange by taking financial statement data for the 2021-2022 period.
2. The independent variables are Profitability and Cost of Debt.
3. The dependent variable is the Tax Avoidance.

1.3 Problem Formulation

Based on the research background described above, the formulation of the problem in this study is as follows:

1. Does profitability has an effect toward tax avoidance in the industrial sector listed on Indonesia Stock Exchange?
2. Does cost of debt has an effect toward tax avoidance in the industrial sector listed on Indonesia Stock Exchange?

1.4 Research Objective

In accordance with the formulation of the problems that have been stated, the objectives of this study are as follows:

1. To provide empirical evidences regarding the effect of profitability toward tax avoidance in industrial sector listed on the Indonesia Stock Exchange partially.
2. To provide empirical evidences regarding the effect of cost of debt toward tax avoidance in industrial sector listed on the Indonesia Stock Exchange partially.
3. To provide empirical evidences regarding the effect of profitability and cost of debt toward tax avoidance in industrial sector listed on the Indonesia Stock Exchange simultaneously.

1.5 Benefit of the Research

The benefits of research is as follows:

1.5.1 Theoretical Benefit

The theoretical benefits in conducting this research are:

1. For students, this research can be used as a reference to analyze and increase knowledge about the effect of profitability and cost of debt toward tax avoidance.
2. For the public, this research can be used as information about the tax avoidance.
3. For the author, this research can be used as material for analysis so that it can increase knowledge and experience about the tax avoidance.

1.5.2 Practical Benefit

The practical benefits of conducting this research are:

1. For companies, the results of this study can provide useful information for companies in increasing the understanding toward tax avoidance behavior.
2. For researchers, the results of this study can be used as reference material.