



RESEARCH ARTICLE

Capital Structure and Social Signaling: A Dual Mechanism Analysis of Tax Aggressiveness in Emerging Markets

Happy Tatemba¹ | Ika Prayanthi^{2*}

^{1,2*} Faculty of Economics and Business, Universitas Klabat, Minahasa Regency, North Sulawesi Province, Indonesia.

Correspondence

^{2*} Faculty of Economics and Business, Universitas Klabat, Minahasa Regency, North Sulawesi Province, Indonesia.
Email: ikaprayanthi@unklab.ac.id.

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Universitas Klabat.

Abstract

Purpose This research investigates the influence of capital structure and social signaling on corporate tax behavior, specifically testing the Monitoring Hypothesis and the Substitution Effect within the Indonesia Stock Exchange. **Design and Methodology** A quantitative explanatory design was employed, analyzing 85 observations from non financial companies. Data were retrieved from the Bloomberg Terminal and annual reports. The Generalized Linear Model (GLM) with a Gaussian distribution and identity link function was utilized to examine the causal relationships between the Debt to Equity Ratio (DER), Social Scores, and the Effective Tax Rate (ETR), while controlling for governance and innovation metrics. **Findings** Empirical Results demonstrate that DER has a significant positive effect on ETR, confirming that leverage serves as an effective external monitoring mechanism that reduces tax aggressiveness. Conversely, Social Scores exhibit a significant negative impact on ETR, supporting the Substitution Effect. This suggests firms utilize high social performance as a reputational shield to mask tax avoidance, validating the "CSR-Tax Paradox." Internal governance variables showed no significant influence. **Originality and Value** This study contributes to the literature by highlighting how external market signals such as leverage and social reputation that are more dominant drivers of tax behavior than internal oversight in emerging markets, providing regulators with new indicators for identifying tax risks.

Keywords

Effective Tax Rate; Capital Structure; Social Performance; Monitoring Hypothesis; Tax Aggressiveness.

1 | INTRODUCTION

The global corporate landscape has recently witnessed a profound shift in how firm performance is evaluated, moving beyond purely financial metrics to include Environmental, Social, and Governance (ESG) commitments (Angelina & Carolina, 2025). However, Srimindarti et al. (2022) point out that while this transition suggests a move toward more ethical business practices, a paradoxical phenomenon has emerged regarding corporate tax behavior. Furthermore, Arianti & Soesila (2025) argue that tax avoidance, while legally permissible in many jurisdictions, is increasingly viewed as an aggressive strategy that undermines a firm's social contract. Observing recent global trends, Nadapdap (2024) notes that many multinational and domestic entities continue to engage in sophisticated tax planning. This discrepancy creates a significant tension between a firm's public social signaling and its private fiscal responsibilities, raising a fundamental question: does high social performance reflect genuine ethical commitment, or does it serve as a strategic "reputational shield" to mask tax opportunism (Angelina & Carolina, 2025)?

Theoretically, this complexity can be analyzed through two competing lenses: Agency Theory (Jensen & Meckling, 1976) and Legitimacy Theory (Dowling & Pfeffer, 1975). From an agency perspective, the inherent friction between managers (agents) and stakeholders (principals) often leads to tax aggressiveness as a means of satisfying short-term objectives (Alkurdi & Mardini, 2020). However, the Monitoring Hypothesis suggests that certain capital structure choices, specifically high leverage, can mitigate these agency costs. Creditors, acting as disciplined external principals, demand transparency and prudent management to secure their claims, thereby exerting a restraining effect on aggressive tax behavior. Conversely, Legitimacy Theory introduces the Substitution Effect, where firms may invest in highly visible social initiatives to build moral capital. In this scenario, a high Social Score may not indicate superior ethics but rather a tactical move to divert regulatory and public scrutiny away from tax avoidance practices, a phenomenon often described as the "CSR-Tax Paradox" (Wahab et al., 2022).

Despite growing academic interest in corporate tax behavior, a significant literature gap remains in emerging markets such as Indonesia, particularly concerning the interaction between external market pressures and corporate social signaling. Previous studies examining the impact of Environmental, Social, and Governance (ESG) components on tax aggressiveness continue to yield highly fragmented results. Some literature argues that high corporate social responsibility (CSR) disclosures reflect genuine ethical commitment, thereby mitigating tax avoidance (Lanis & Richardson, 2012; Lanis & Richardson, 2015; Laguir et al., 2015; Pratiwi & Cahyonowati, 2025). Conversely, competing research reveals that firms may opportunistically exploit these social scores as a "reputational shield" to obscure aggressive tax behavior, supporting the CSR-Tax Paradox theory (Chen et al., 2010; Desai & Dharmapala, 2006; Wilson, 2009; Zeng, 2019).

The influence of capital structure, specifically leverage quantified by the Debt-to-Equity Ratio (DER), remains equally contentious in the literature. On one hand, scholars such as Jaeni et al. (2018) and Saputra & Asyik (2017) contend that heavy dependence on debt motivates companies to undertake aggressive tax strategies to alleviate cash flow pressures. On the other hand, proponents of the Monitoring Hypothesis, such as Umar et al. (2021) and Swingly & Sukartha (2015), argue that creditors serve as rigorous external monitors, effectively restricting management's ability to execute opportunistic tax maneuvers. Adding another layer of complexity, some empirical studies conclude that leverage has no statistically significant impact on corporate tax behavior (Alkurdi & Mardini, 2020; Gultom, 2021; Ngadiman & Puspitasari, 2014; Pasaribu & Mulyani, 2019). Therefore, there is an urgent need to clarify how these two distinct mechanisms external monitoring by creditors and external social signaling jointly influence the Effective Tax Rate (ETR) within the Indonesia Stock Exchange (IDX).

Despite extensive literature on corporate taxation, there remains a notable scarcity of empirical research examining the combined impact of external creditor monitoring, measured through the Debt-to-Equity Ratio (DER), and external social signaling, represented by social scores, on the Effective Tax Rate (ETR) within the Indonesia Stock Exchange (IDX). Consequently, this study is driven by the necessity to determine whether these external market pressures, specifically leverage and social reputation, serve as more influential determinants of corporate tax behavior compared to conventional internal governance mechanisms.

By employing a Generalized Linear Model (GLM) and utilizing high-fidelity data from Bloomberg Terminal, this study investigates these causal relationships among non-financial companies listed on the IDX. The significance of this research lies in its potential to provide tax authorities with new "red flags" for identifying tax aggressiveness and to offer investors a more nuanced framework for evaluating corporate integrity. Ultimately, this study seeks to determine whether corporate social benevolence in Indonesia reflects a sincere commitment to society or merely functions as a channel for fiscal opportunism.

2 | BACKGROUND THEORY

2.1 Agency Theory and the Monitoring Hypothesis

Agency Theory (Jensen & Meckling, 1976) addresses the inherent friction between managers (agents) and stakeholders (principals), where managers may pursue aggressive tax avoidance to satisfy short-term objectives. While tax savings can increase cash flow, they often entail significant agency costs, including legal risks and potential financial instability. This study posits that Total Debt to Total Equity serves as a vital external monitoring mechanism. Creditors, acting as disciplined principals, demand transparency and prudent financial management to ensure the security of their claims. Consequently, higher leverage exerts a restraining effect on management, discouraging high-risk tax avoidance maneuvers.

H1: Total Debt to Total Equity has a significant positive effect on the Effective Tax Rate.

2.2 Legitimacy Theory and the Substitution Effect

Legitimacy Theory (Dowling & Pfeffer, 1975) suggests that corporations operate under a social contract and must align their actions with societal expectations to maintain their license to operate. However, a “CSR–Tax Paradox” may arise where firms use high Social Scores as a tool for strategic signaling. Under the Substitution Effect, companies may invest in highly visible social initiatives to build “moral capital.” This capital functions as a reputational shield, allowing firms to engage in more aggressive tax planning while diverting public and regulatory scrutiny. In this context, social benevolence may act as a channel for fiscal opportunism.

H2: Social Score has a significant negative effect on the Effective Tax Rate.

3 | METHOD

This study employs a quantitative research design with an explanatory approach to investigate the causal relationships between capital structure, social signaling, and tax behavior. The research is structured to test the Monitoring Hypothesis and the Substitution Effect by analyzing how leverage and social performance scores influence the Effective Tax Rate (ETR). Using a longitudinal framework, the study observes these strategic behaviors among listed entities to understand how they navigate the tension between social legitimacy and financial optimization.

The population of this research consists of non-financial companies listed on the Indonesia Stock Exchange (IDX). Non-financial firms were specifically selected because they possess greater flexibility in managing capital structures and operational costs compared to financial institutions, which are subject to stricter oversight and capital requirements. The sampling process uses a purposive sampling method based on predefined criteria, including the availability of complete ESG data and audited financial statements. The final research sample comprises 85 observations, providing a focused dataset for statistical inference within the Indonesian capital market.

This study utilizes secondary data in the form of an unbalanced panel dataset, systematically retrieved from the Bloomberg Terminal, a global financial database, and supplemented by official corporate annual reports. The use of Bloomberg ensures data consistency and high fidelity reporting for both financial and non financial metrics across different firms and time periods. The research instruments are categorized as follows.

- 1) **Financial Metrics:** Longitudinal panel data for Total Debt to Total Equity and the components required to compute the Effective Tax Rate (ETR) were extracted to evaluate capital structure and fiscal behavior over time.
- 2) **ESG Metrics:** The Social Score and Environmental Score were sourced from Bloomberg’s ESG disclosure database, serving as standardized instruments to quantify social signaling and environmental commitment within the panel framework.
- 3) **Governance and Control Metrics:** To isolate the effects of the primary variables, panel data on Audit Committee Attendance, Percent Independent Directors, and R&D Intensity (R&D/Total Assets) were gathered to serve as robust control variables.
- 4) **Analytical Tools:** All datasets were processed and analyzed using the Jamovi open source statistical software. This platform was selected to provide a transparent and reproducible environment for the Generalized Linear Model (GLM) estimation, which is well suited for handling the complexities and variances inherent in unbalanced panel data, allowing for rigorous testing of the research hypotheses.

The study utilizes a Generalized Linear Model (GLM) to analyze the dual mechanisms of monitoring and social signaling. The GLM is particularly appropriate as it allows for a flexible distribution of the dependent variable and can account for the complexities of corporate tax behavior. To capture the dynamics of the panel data from the Indonesia Stock Exchange, the model incorporates subscripts for both individual firms (i) and time periods (t). The conceptual model is defined as follows.

$$ETR_{it} = \beta_0 + \beta_1 (DER_{it}) + \beta_2 (SocScore_{it}) + \sum \beta_3 (Controls_{it}) + \varepsilon_{it}$$

Where ETR_{it} : The Effective Tax Rate for firm i in year t , serving as the dependent variable representing tax aggressiveness. DER_{it} : Total Debt to Total Equity for firm i in year t , the primary independent variable used to test the Monitoring Hypothesis. $SocScore_{it}$: The Social Score for firm i in year t , the primary independent variable used to test the Substitution Effect. $Controls_{it}$: A vector of control variables for firm i in year t , including Audit Committee Attendance, Percent Independent Directors, Environmental Score, and R&D Intensity. ε_{it} : The idiosyncratic error term representing unobserved factors affecting firm i at time t .

4 | RESULTS AND DISCUSSION

4.1 Results

4.1.1 Model Fit and Diagnostic Overview

Prior to conducting hypothesis testing, the suitability of the Generalized Linear Model (GLM) was evaluated to ensure the validity of the estimations. Based on the model specifications, this study utilizes a Gaussian distribution with an identity link function, which is appropriate for continuous data within a classical regression framework. Regarding the goodness of fit, the model yields an R² value of 0.247, indicating that the combination of independent variables specifically capital structure and social signaling along with control variables accounts for 24.7% of the variance in the Effective Tax Rate (ETR). Furthermore, the AIC (523.871) and BIC (543.780) provide a baseline for model comparison, where lower values signify a more parsimonious and efficient model in explaining the data. In terms of sample adequacy, the model achieved successful convergence with 82 residual degrees of freedom; given that seven parameters were estimated (including the intercept), this confirms that the model operated on 89 final observations following the automated listwise deletion process. Finally, a Chi-squared/DF value of 19.115 provides an indication of residual dispersion, which remains within acceptable limits for a linear model characterized by a normal distribution.

Table 1. Summary of Generalized Linear Model (GLM) Fit and Diagnostic Results

Info	Value	Comment
Model Type	Linear	Classical Regression/ANOVA
Call	glm	EFF_TAX_RATE" ~ 1 + `TOT_DEBT_TO_TOT_EQY" + `SOCIAL_SCORE" + `AUDIT_COMMITTEE_MTG_ATTEND_PCT" + `PCT_INDEPENDENT_DIRECTORS" + `IS_RD_EXPEND/Total Asset` + `ENVIRONMENTAL_SCORE"
Link function	Identity	Coefficients in the same scale of y
Distribution	Gaussian	Normal distribution of residual
R-squared	0.247	Proportion of reduction of error
AIC	523.871	Less is better
BIC	543.780	Less is better
Deviance	1567.407	Less is better
Residual DF	82	
Chi-squared/DF	19.115	Overdispersion indicator
Converged	yes	Whether the estimation found a solution

Source: Data processed using jamovi (2026)

Table 1. Presents the summary of the Generalized Linear Model (GLM) fit and diagnostic results. The model uses a linear specification with an identity link function and assumes a Gaussian distribution of residuals. The R-squared value of 0.247 indicates that the model explains 24.7% of the variation in the effective tax rate. The AIC and BIC values are 523.871 and 543.780, respectively, suggesting model fit efficiency. The chi-squared/DF value of 19.115 indicates potential overdispersion, while the model successfully converged, confirming estimation stability for further interpretation of results.

4.1.2 Hypothesis Testing and Empirical Results

After establishing model fitness, the primary variables were tested to address the research hypotheses, with the comprehensive results of the Log-likelihood ratio tests and Parameter Estimates presented in Table 4.2. Regarding the first hypothesis, the Debt to Equity Ratio (DER) demonstrates a highly significant positive effect on ETR (Estimate = 2.471; $p < .001$), thereby providing empirical support for H1. This finding confirms the Monitoring Hypothesis, suggesting that higher leverage intensifies external oversight by creditors, which subsequently mitigates tax aggressiveness and results in a higher effective tax rate. Conversely, the Social Score exhibits a significant negative influence on ETR (Estimate = -

1.084; $p = 0.045$), leading to the acceptance of H2. This evidence supports the Substitution Effect, wherein firms with superior social performance tend to maintain lower effective tax rates, potentially utilizing social signaling as a legitimacy tool to mask tax avoidance practices. Finally, an analysis of control variables including the Environmental Score ($p = 0.674$), Audit Committee Attendance ($p = 0.301$), Independent Directors ($p = 0.424$), and R&D Intensity ($p = 0.606$) reveals no statistically significant impact on ETR. These results indicate that, within the current sample, corporate tax behavior is more robustly driven by capital structure mechanisms and social signaling than by internal governance structures or innovation driven investments.

Table 2. Parameter Estimates and Hypothesis Testing Results

Variable	Estimate	SE	z-value	p-value	Decision
(Intercept)	0.769	0.463	1.660	0.101	-
DER (Total Debt to Equity)	2.471	0.558	4.430	< .001	H ₁ Accepted
Social Score	-1.084	0.533	-2.034	0.045	H ₂ Accepted
Audit Committee Attendance	0.535	0.514	1.040	0.301	Not Significant
Independent Directors	-0.763	0.949	-0.803	0.424	Not Significant
R&D Intensity	0.454	0.877	0.517	0.606	Not Significant
Environmental Score	0.231	0.549	0.422	0.674	Not Significant

Source: Data processed using jamovi (2026)

Table 2 presents the parameter estimates and hypothesis testing results from the GLM analysis. The findings show that Debt to Equity Ratio (DER) has a significant positive effect on the effective tax rate ($p < 0.001$), supporting H1. Social Score has a significant negative effect ($p = 0.045$), supporting H2. Other variables, including audit committee attendance, independent directors, R&D intensity, and environmental score, are statistically not significant in influencing the effective tax rate.

4.1.3 Hypothesis Testing and Empirical Results

This section provides a deeper analysis of the empirical findings by contextualizing them within the established theoretical framework of Agency Theory and Legitimacy Theory. The Role of Debt as a Monitoring Mechanism (Agency Theory) The empirical results reveal that the Debt to Equity Ratio (DER) has a highly significant positive effect on the Effective Tax Rate (ETR) (Estimate = 2.471; $p < .001$), thereby providing robust support for H1. This finding aligns with Agency Theory, specifically the Monitoring Hypothesis. As debt levels increase, the inherent friction between managers (agents) and stakeholders (principals) is mitigated by the intervention of creditors. These external parties act as disciplined principals who demand greater transparency and prudent financial behavior to safeguard their claims. The results suggest that the presence of high leverage effectively restrains managers from engaging in aggressive tax avoidance, as such maneuvers could lead to financial instability or legal risks that jeopardize creditor interests. Consequently, debt serves not only as a capital structure component but also as a vital corporate governance tool that enhances tax compliance.

Social Signaling and the Substitution Effect (Legitimacy Theory) The analysis further demonstrates a significant negative relationship between Social Score and ETR (Estimate = -1.084; $p = 0.045$), which confirms H2 and supports the Substitution Effect derived from Legitimacy Theory. This finding validates the existence of a "CSR-Tax Paradox" within the sample. While corporations are expected to align their actions with societal expectations through a "social contract," the results suggest that firms with high Social Scores may use these achievements as a strategic signaling tool. By building moral capital through highly visible social initiatives, companies create a reputational shield that allows them to pursue more aggressive tax planning (lower ETR) while diverting public and regulatory scrutiny. In this context, corporate social benevolence appears to function as a legitimacy tool to mask fiscal opportunism, effectively substituting transparent tax contributions with symbolic social performance.

4.2 Discussion

The empirical results indicate that capital structure and social signaling play an important role in shaping corporate tax behavior measured through the Effective Tax Rate (ETR). These findings are consistent with Agency Theory (Jensen & Meckling, 1976) and Legitimacy Theory (Dowling & Pfeffer, 1975), and align with prior literature on corporate tax avoidance and CSR relationships (Lanis & Richardson, 2012; Laguir et al., 2015; Wahab et al., 2022).

The results show that the Debt to Equity Ratio (DER) has a significant positive effect on ETR. This indicates that higher leverage is associated with a higher effective tax rate, implying lower tax avoidance practices. This finding supports Agency Theory, which explains conflicts between managers and stakeholders that can be reduced through external monitoring mechanisms (Jensen & Meckling, 1976). Creditors function as external monitors who impose discipline on managerial decisions. When debt levels increase, firms face stronger pressure to maintain financial stability and comply with debt agreements. This situation encourages management to avoid risky financial strategies, including aggressive tax avoidance

practices. These results are consistent with Swingly & Sukartha (2015), Umar et al. (2021), and Saputra & Asyik (2017), who also found that leverage strengthens managerial discipline in financial and tax decisions. However, previous studies report mixed evidence. Jaeni et al. (2018), Arianti & Soesila (2025), and Nadapdap (2024) found that leverage may increase tax avoidance due to firms' efforts to reduce cash outflows from interest obligations. These differences suggest that the relationship between leverage and tax behavior is not uniform and depends on firm characteristics and external financial pressure.

The results also show that Social Score has a significant negative effect on ETR. This means that firms with higher social performance tend to report lower effective tax rates, indicating higher levels of tax avoidance. This finding supports Legitimacy Theory, which explains that firms attempt to align their operations with societal expectations to maintain legitimacy (Dowling & Pfeffer, 1975). Firms may use social performance as a signaling tool to build a positive public image. Such reputation can reduce scrutiny from regulators and stakeholders, allowing firms to engage in more aggressive tax planning. This pattern aligns with the Substitution Effect, where social responsibility activities substitute for fiscal transparency. It is also consistent with the CSR–Tax Paradox described by Wahab et al. (2022). These findings are in line with Chen et al. (2010), Desai & Dharmapala (2006), and Wilson (2009), who argue that CSR activities can be used strategically to conceal tax avoidance behavior. Laguir et al. (2015) also highlight that CSR may function as a strategic tool rather than purely ethical commitment. On the other hand, Lanis & Richardson (2012; 2015) present mixed evidence, showing that CSR can either reduce or increase tax avoidance depending on transparency and monitoring mechanisms.

The control variables, including Audit Committee Attendance, Independent Directors, R&D Intensity, and Environmental Score, do not show significant effects on ETR. This suggests that internal governance mechanisms are not strong determinants of corporate tax behavior in the observed sample. This finding is consistent with Srimindarti et al. (2022), who argue that governance structures do not always translate into effective monitoring when implementation quality is weak. In several firms, boards and audit committees may function more as formal requirements rather than active monitoring bodies that influence strategic decisions such as tax planning. However, this result contrasts with Alkurdi & Mardini (2020) and Saputra & Asyik (2017), who found that corporate governance can significantly affect tax aggressiveness. The inconsistency suggests that the effectiveness of internal governance depends on institutional quality and enforcement intensity.

5 | CONCLUSIONS AND FUTURE WORK

This study examines the influence of capital structure and social signaling on corporate tax behavior, with emphasis on the Monitoring Hypothesis and the Substitution Effect. The empirical results using the Generalized Linear Model (GLM) lead to several conclusions. First, capital structure measured by the Debt to Equity Ratio (DER) shows a significant positive relationship with the Effective Tax Rate (ETR). This indicates that higher leverage functions as an external monitoring mechanism, where creditor pressure restricts managerial tendencies toward aggressive tax avoidance in order to maintain financial stability. Second, Social Scores exhibit a significant negative effect on ETR, supporting the Substitution Effect. This suggests that firms with strong social performance may utilize reputational capital as a shield to support more aggressive tax strategies, consistent with the CSR–Tax Paradox. Third, internal governance mechanisms such as board independence and audit committee diligence do not show a significant effect on tax behavior, implying that external market forces play a more dominant role than internal control structures in shaping corporate tax outcomes.

The findings provide several practical implications for stakeholders. Tax authorities and regulators should exercise greater scrutiny over firms with high social performance, as such disclosures may function as indicators of potential tax aggressiveness. Non-financial disclosures should be incorporated into audit procedures to detect gaps between social responsibility claims and actual tax behavior. Investors and creditors are advised to critically evaluate CSR reporting and assess its consistency with tax transparency. Creditors, in particular, are encouraged to strengthen debt covenants that emphasize tax compliance as part of long-term risk management. Corporate management is expected to ensure alignment between social initiatives and transparent tax practices to avoid reputational risks associated with perceived “greenwashing” or “social washing,” especially when aggressive tax practices are revealed.

Future research is encouraged to expand the sample size and sector coverage by including multiple industries or different countries to examine whether the Substitution Effect remains consistent across institutional settings. A longitudinal or panel data approach is also recommended to capture changes in the relationship between social signaling and tax behavior over time and across economic cycles. In addition, alternative measures of tax aggressiveness such as Book-Tax Differences (BTD) or tax shelter indicators may provide a more comprehensive assessment of corporate tax strategies. Finally, integrating qualitative methods such as interviews or surveys with corporate executives could offer deeper insights into the strategic motivations behind CSR activities in relation to tax planning decisions.

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