Journal of
Risk and Financial Management

MDPI

Article

Tax Tightrope: The Perils of Foreign Ownership, Executive Incentives and Transfer Pricing in Indonesian Banking

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Abstract: Despite being a crucial source of funding for the government, tax revenue collection in Indonesia has yet to reach its ideal and satisfying level for the economy. Therefore, this study explores the impact of executive incentives, foreign ownership, and transfer pricing on tax avoidance. The conventional banks of Indonesia that were listed on the Indonesia Stock Exchange (IDX) between 2015 and 2019 are the subject of this study. This study employed a purposive selection technique, with a final sample of 17 banks chosen after screening to ensure they met the requirements of having foreign ownership and not having suffered losses during the study year. The results of this study show that while CEO incentives harm tax avoidance, foreign ownership has a beneficial effect. Furthermore, tax avoidance is not significantly impacted by transfer pricing. The findings of this investigation open the door for accountable authorities in the economy.

Keywords: tax avoidance; foreign ownership; transfer pricing; executive incentive

Citation: Putri, Vidiyanna Rizal, Nor Balkish Zakaria, Jamaliah Said, Farha Ghapar, and Rizqa Anita. 2024. Tax Tightrope: The Perils of Foreign Ownership, Executive Incentives and Transfer Pricing in Indonesian Banking. *Journal of Risk and Financial Management* 17: 26. https://doi.org/10.3390/jrfm17010026

Academic Editor: Thanasis Stengos

Received: 2 November 2023
Revised: 17 December 2023
Accepted: 19 December 2023
Published: 11 January 2024

1. Introduction

Generally, taxes contribute to a nation's gross domestic product (GDP). Due to this contribution, taxes stimulate economic growth, which expands the nation's economy, resulting in a higher quality of living, more job creation, etc. However, if no one submitted a corporate tax return, tax avoidance would skyrocket, and the federal government, which already has enormous deficits, would receive considerably less revenue. Therefore, the government would have to borrow far more money and drastically reduce spending. In addition to revenue losses, tax avoidance leads to the misallocation of resources when individuals adjust their behavior to avoid paying taxes, such as their choice of working hours, vocations, and investments. In addition, governments must devote resources to detect, quantify, and punish noncompliance.

In a study conducted by Cobham and Janský (2018), it was found that the United States is significantly affected by international tax exploitation, witnessing the highest revenue loss globally. The research positions the USA among the leading contributors to tax losses incurred by other nations. This assertion is in line with the findings of Hanlon et al. (2019), whose research delves into the correlation between tax avoidance and corporate transparency. Their work explores the legal dimensions of tax avoidance and its implications for a company's transparency and public image. Additionally, the research conducted by Hines (2003) sheds light on the concept of tax havens and their pivotal role in facilitating tax avoidance by multinational corporations. That study provided valuable insights into how the utilization of tax havens contributes to revenue losses for countries, encompassing not only developing nations but also wealthier countries such

as the United States. These comprehensive studies collectively highlight the multifaceted nature of international tax exploitation and its impact on global economic dynamics.

Tax avoidance is usually carried out with a tax strategy using various deductions available to taxpayers, functioning as a way to reduce tax liabilities because costs reduce income (Woźniak 2019). This practice effectively reduces the tax burden for individuals and businesses, as well as much larger companies. Tax avoidance is generally used as a legal method to minimize tax liabilities in an economy without violating the tax rules applicable in a country. However, it is important to consider that while tax avoidance is legal, it violates business ethics. Committing tax avoidance means ignoring social commitments, and this behavior can make a company vulnerable to accusations of greed and egoism. This can tarnish the company's reputation and erode public trust in the community. Therefore, the business world must be careful and ethically responsible in its tax practices to maintain its reputation and foster stakeholder trust.

The concepts of tax avoidance and tax evasion have been studied extensively in the fields of taxation and accounting. In previous research, Dyreng et al. (2019) examined the influence of executives on corporate tax avoidance, highlighting the influence of key decision makers on corporate tax practices. Dharmapala et al. (2016) examined the unintended consequences of foreign investment law, emphasizing the importance of observing investor behavior, especially regarding tax compliance. Garcia-Bernardo et al. (2017) discussed offshore financial centers and their role as conduits and absorbers of global corporate ownership networks, thereby providing insight into the complexity of international tax structures. Hanlon et al. (2018) investigated the influence of tax cuts and employment law on tax avoidance, contributing to understanding tax policy changes and their implications. Luzzi et al. (2019) explored tax avoidance and tax evasion in developing countries, focusing on the role of international profit shifting and highlighting tax practices in developing countries. These studies offer valuable insights into tax avoidance, tax evasion, and international tax strategies, thereby contributing to a comprehensive understanding of tax practices in various contexts. It has been stated that tax evasion refers to engaging in unlawful activity to avoid paying taxes. In contrast, tax avoidance entails legally minimizing tax burden by appropriate preparation and conformity with tax regulations.

Apart from this research, several further studies have also examined the relationship between tax avoidance and corporate risk. Chen et al. (2016) investigated whether tax avoidance is related to corporate risk, exploring the potential implications of tax avoidance on a company's risk profile. Apart from that, Hoopes et al. (2018) stated that foreign ownership influences the avoidance of use in manufacturing companies listed on the Indonesian stock exchange. In addition, Milliron and Snow (2017) studied the impact of materiality information on aggressive tax avoidance, testing whether providing materiality information can deter companies from engaging in aggressive tax practices.

It cannot be denied that the government of a country needs large funds for regional development from all aspects. Therefore, governments need to obtain more funding sources to increase growth (Soemarsono 2007). Likewise, in Indonesia, one of the developing countries in the Asian region, the government is trying to increase income from several sources, one of which is taxes. Taxes have an important role as the government's main source of income because they provide the largest contribution to state revenue (Nugraha and Lewis 2013). Furthermore, according to the Central Bureau of Statistics (2021), the realization of tax revenues in 2017 amounted to IDR 1472.7 trillion or 90.98% of the total tax target set by the state government. The following year, in 2018, the percentage of actual tax collection increased until it reached 94.02% of the overall target. However, there was a significant decline in the realization of tax revenues in 2019, namely down to 84.44% of the target. Despite temporary setbacks in 2019, taxes remain an important source of revenue for the government. The Ministry of Finance Directorate General of Taxes commented that taxes provide income for national growth, public services, and government operations. This shows that even though Indonesia has a high potential source of tax revenue due to its large population and commercial activities, its tax revenue still needs to be improved.

According to the Centre for Indonesia Taxation Analysis (CITA), tax aims and realization produced less-than-ideal outcomes in 2019, decreasing from the previous year. As well as the transition to the COVID-19 period, there were various other contributing factors, according to CITA data, which were as follows: (1) The fall in the price of commodities was influenced by the condition of the world's economy. (2) There was a growth in the number of tax benefits the government offered, such as tax holidays, tax credits, and income that is not taxable. (3) Because of the election season in Indonesia, the state was compelled to restrict access to additional data and information and to prolong tax collection by several different departments.

The decline in state revenues, particularly from tax revenues, is a critical concern attributed to various tax tactics employed by corporate taxpayers to alleviate their tax burdens. This trend holds significant consequences for the welfare of the populace, given that taxes serve as a crucial source of state revenue, funding routine expenditures and enhancing public facilities. With the banking industry, especially in Indonesia, playing a pivotal role in contributing to tax revenue, its impact on the country's economy becomes even more pronounced. Recognizing the urgency of addressing tax avoidance practices, the purpose and objectives of this paper revolve around investigating the influence of key variables—foreign ownership, executive incentives, and transfer pricing—on tax avoidance within the Indonesian banking sector for the 2015–2019 period. This research aims to shed light on the dynamics of these variables during this specific timeframe and their collective impact on tax avoidance practices, thereby contributing to understanding their implications for the broader economic landscape. In essence, comprehending these factors becomes imperative in devising strategies to address the challenges posed by tax avoidance in the banking industry, ultimately fostering the sustainable development of Indonesia's economy.

The remainder of the discussion is divided into several sections. This introduction is followed by a review of the literature, which explains the underlying theories and previous research on the topic. The variables, measures, framework, and data collection processes are all explained in the methodology section. Following that, the results section summarizes the analysis's findings. The limits and consequences of the research are highlighted in the concluding portion of this publication.

2. Literature Review

2.1. Grand Theory

Agency theory assigns responsibility for the company's strategic decisions; the principal enters a contract with another person (agent) (Jensen and Meckling 1976). Agency problems between two partners in a firm are typically caused by the separation of ownership by the principal and control by the agent. The principal wants to see his investment grow the value of the company's shares because he is a capital owner. On the other hand, the management want to be compensated as they are in charge of its control. This contrast between welfare-seeking goals is crucial. The company's goal is to keep everyone happy so it can stay in business and compete. This fits with the application of stakeholder theory, with reference to the people who have the most to lose or gain from a government decision (Donaldson and Preston 1995).

Positive accounting theory looks at the things that affect how managers feel about accounting standards, which in turn affects how companies lobby against accounting standards (Watts and Zimmerman 1990). Companies can choose one of two accounting policies to cut costs and increase the value of their business. With this independence, managers are more likely to take advantage of opportunities to make profits (Scott 2014). Since corporate tax is seen as a political cost, companies are more likely to act as opportunists with accounting methods that lower taxable income.

2.2. Tax Avoidance

Tax avoidance is a legitimate tax arrangement achieved by exploiting loopholes in a country's legal tax system (Salihu et al. 2015; Armstrong et al. 2015; Desai and Dharmapala

2006). Tax avoidance is a strategy that companies or individuals carry out to reduce the tax burden without violating tax regulations. This action could be detrimental because it reduces sources of state revenue. The same thing also happens to banks and financial institutions, which support economic activities and contribute to increasing tax revenues. Tax avoidance is achieved by using loopholes in existing regulations and applying tax strategies to reduce tax liabilities through providing excessive incentives, bonuses, transferring debt, and other tax strategies (Rizal Putri et al. 2023). During growth, the banking sector and financial institutions are considered indicators of economic development, which causes increased demand for goods and services, thereby increasing the contribution to state revenue (Desai and Dharmapala 2006).

2.3. Executive Incentives

Desai and Dharmapala (2006) examined whether firms with executives receiving high-powered incentives are more inclined to engage in corporate tax avoidance strategies. The findings of their study contribute valuable insights into the intersection of executive compensation and corporate tax behavior. Although the Desai and Dharmapala model is undeniably influential in expanding tax models, comparing different tax models can offer a more comprehensive comprehension of tax avoidance tactics. While cumulative effective tax rates (ETRs) over long periods are applicable, shorter and more dynamic timeframes are equally crucial for capturing current shifts in tax avoidance patterns. Moreover, tax avoidance practices might differ significantly depending on unique factors between the banking and non-banking industries. In addition, Indonesia calculates tax expenses using a fiscal standard based on a cash basis rather than an accrual basis, unlike Desai and Darmapala.

2.4. Foreign Ownership

The interest of foreign investors in joining commercial banks in Indonesia is increasing. Indonesia Investing have reported that in the last five years, six national banks were bought by foreign companies. PT Bank BTPN Tbk was bought by Japan's Sumitomo Mitsui Bank Corporation (SMBC), and PT Bank Danamon Tbk joined them in 2018 with the Bank of Japan, namely MUFG. In addition, several other national banks have recently received capital from foreign investors, such as PT Bank Bukopin Tbk from Kookmin Bank of South Korea (South Korea) and PT Bank Agris Tbk, whose shares were bought by the Industrial Bank of Korea (IBK).

Gaertner et al. (2023) argues that ownership structure is an essential factor influencing corporate tax avoidance, requiring further research from this perspective. Executives in a company are those who are at the top management level. Top management, comprising commissioners, managing directors, and directors, is the party with authority to make decisions. The tax burden is frequently reduced intentionally to avoid paying taxes, and executives are directly involved in making tax decisions. Executive incentives are organizational behavior that transfers company assets and profits in their interests, namely in the form of high executive compensation costs, and are beneficial for executives and valuable for the company because the tax burden is reduced.

2.5. Transfer Pricing

Another tax manipulation strategy in business activities involves transferring the cost of products or services or the selling price of intangible assets to subsidiaries, related companies, or other third parties, better known as transfer pricing. Transfer pricing is a fair transaction between affiliated companies which determines the transfer price. However, ordinary companies deliberately transfer their profits to affiliated companies with unique relationships in countries with low tax rates (Putri 2019). The practice of transfer pricing often has a negative connotation because of its potential to harm the state, especially in the context of aggressive tax avoidance implemented by companies. Therefore, research was conducted to explore concrete evidence regarding the impact of transfer pricing on the tendency to practice tax avoidance. Jarallah et al. (2021) also added insight by stating

that Japanese multinational companies, after switching to a territorial taxation system, tend to apply more aggressive transfer prices, shifting their domestic income abroad. Not only transfer pricing but also treaty shopping is a feature of the tax avoidance strategies carried out by multinational companies. This practice includes attempts to exploit gaps or loopholes in bilateral tax agreements to avoid tax obligations. This often involves the transfer of income and interest payments to foreign affiliates, which has become a focal point for most governments to tackle tax avoidance practices that harm state revenues.

In 2016, Google Indonesia (now Alphabet Inc., Mountain View, CA, USA) faced allegations of tax avoidance and engaging in aggressive transfer pricing practices in Indonesia. The Indonesian tax authorities claimed that Google had transferred substantial profits from Indonesia to jurisdictions with lower tax rates (Purba 2018). This case underscored the importance of tackling transfer pricing issues to safeguard the country's tax revenue (Rixen 2011). A study conducted by Winarto (2009) stated that Indonesia has responded to this by strengthening tax regulations and law enforcement mechanisms, increasing transfer pricing documentation requirements, and strengthening Indonesia's ability to identify and investigate potential tax avoidance schemes. The issues of transfer pricing and tax avoidance are not limited to Indonesia but have become a global concern. Countries, including Indonesia, are working together to address these issues and ensure a fair and transparent international tax system through initiatives such as the Base Erosion and Profit Shifting (BEPS) project led by the Organisation for Economic Co-operation and Development (OECD 2019; Cockfield 2018).

PT. Adaro Energy Tbk was involved in transfer pricing to one of its Singapore subsidiaries, Coaltrade Service International, in one of the transfer price cases. According to Global Witness (2019), Adaro's transfer pricing method involves tax evasion through the formation of a foreign firm. Adaro makes use of legal loopholes to sell coal to its subsidiary, Coaltrade Service International, at a lower price than it would to other companies (Astrina et al. 2022). Coal is resold to foreign countries at higher prices by its corporations. As a result, taxable income in Indonesia is lower since Adaro declares earnings lower than its real profits (Christy et al. 2022). Even though Adaro collects resources in Indonesia, their contribution to the country should be increased and addressed more frequently. Despite the numerous regulations that strictly govern everything from operating licenses to profit sharing, existing regulations still have shortcomings, one of which is due to overlapping regulations and legal loopholes which can be exploited for tax fraud, as demonstrated by the case of PT. Adaro. However, when assessing taxes, the tax authorities still need more monitoring, which means that tax challenges initiated by the tax authorities typically fail in tax court (Aurinda 2018).

The Indonesian government reduced the corporate tax rate from 28% to 25% through the Law No. 36 of Republic of Indonesia's Ministry of Finance (2008), hoping that taxpayers, particularly business players, would be more compliant and honor their commitments. Nevertheless, this has had little effect on people's desire to pay taxes. There are various ways/loopholes for businesspeople to avoid paying taxes without violating the law, including transfer pricing.

Tax avoidance and evasion can disrupt public sector financing in developing countries. Tax avoidance is a legal form of tax strategy, while tax evasion is an illegal tax strategy (Shubhang 2013). Developing countries are said to have a larger shadow economy than developed countries. The shadow economy includes "unreported income from the production of legal goods and services, whether from monetary or barter transactions and thus all economic activities that would generally be taxable if reported to the tax authorities" for taxation and revenue mobilization (Schneider and Enste 2000). Tax revenue to GDP ratios decline with some shadow economy estimates, but not the above. A large shadow economy may lower tax revenue. However, this view is disputed. First, the "shadow economy" comprises non-tax-avoidance activity. Second, empirical research into tax revenue and shadow economy size provides inconsistent conclusions, as discussed below.

To determine the amount of tax due, the taxable income is multiplied by the applicable tax rate (Huizinga et al. 2018). Tax avoidance is defined as the legal utilization of tax regulations to achieve tax savings, and it is now considered an acceptable method to reduce tax liabilities. Unlike tax evasion, tax avoidance complies with the law, allowing taxpayers to lower, avoid, or reduce their tax burden in a manner that adheres to legal requirements (Leigh and Neill 2019). Tax avoidance is when a business uses a specific tax approach to ensure their tax measures will not be scrutinized or challenged legally. Still, it is dangerous if the tax strategies are illegal (Rizal Putri 2020). Because of the tax burden, a corporation's owner wants the company to pursue tax minimization actively (Chen et al. 2016). Hizazi et al. (2022) investigated the relationship between a new measure of tax avoidance and earnings persistence, which indicates earnings quality. The result shows that tax avoidance exhibits a persistent characteristic with a negative slope, implying that it tends to persist over time.

When a business uses a specific tax technique to avoid an audit or legal action, it is said to be engaging in tax avoidance. However, it poses a risk if the tax approach is ruled unlawful (McLaren 2008). The company receives a preferential tax load if a firm engages in active tax avoidance (Blaufus et al. 2019). Tax avoidance is management's endeavor to reduce the effective tax rate on income before taxes (Dyreng et al. 2010). The study of tax avoidance is approached from two distinct perspectives. First, tax avoidance is viewed as tax planning by management to increase the value of the company (Lee and Kao 2018) by conserving cash and reinvesting the tax expense. Another viewpoint is that management engages in tax avoidance to avoid or reduce tax payments for management's benefit, such as to increase management's bonuses and compensation (Desai and Dharmapala 2006).

Tax avoidance, as described by Dyreng et al. (2010), is when management makes a deliberate effort not to pay large amounts of tax. Management does this in order to have more funds to develop the business, which affects the overall value of the company. Shin and Park (2019) say that achieving tax avoidance goals will be easier if management acts opportunistically. According to agency theory, management is motivated to avoid taxes because managers obtain benefits in the form of higher incentives, i.e., salaries and bonuses (Armstrong et al. 2015). Usually, management reduces the tax burden to increase after-tax profits by increasing these incentives (Gaaya et al. 2017). This research concludes that tax avoidance, whether in the form of tax planning or other forms, has tax risks.

Internal control ensures the accomplishment of company objectives, the absence of material misstatements in financial statements, compliance with laws, regulations, and company policies, and the protection of company assets (Rubino and Vitolla 2014; Rae et al. 2017). Effective internal control can prevent and detect both intentional and unintentional management errors. Doyle et al. (2007), Ashbaugh-Skaife et al. (2008), and Han (2020) provide empirical evidence that internal control influences management behavior in compiling financial information and other company policies. Specifically, Gleason et al. (2017) and Huang and Chang (2015) provide empirical evidence that competent internal control reduces management's opportunistic tax avoidance behavior. According to Doss and Jonas's (2004) conceptualization, effective internal control ensures that tax planning is effective and contributes to achieving company objectives.

The investment tax incentives and standard corporate tax rates in developing countries are frequently lower than those in developed countries (Rubino and Vitolla 2014), which also casts doubt on the notion that direct income shifting from developing to developed countries is primarily motivated by taxation. If it is true that observed trade price patterns reflect at least a portion of income shifting from developing countries to countries such as the United States and the United Kingdom, then this type of income shifting could be caused by forces other than taxation, as firms would increase their tax payments. Tax-driven capital flight from developing nations is more likely to occur through tax havens (Gleason et al. 2017).

To determine whether prices reflect product quality or income shifting for pricing distortions and corporate revenue shifting, both income transfer methods must be consid-

ered. Understanding why mispricing or debt financing pushes money out of poor nations is crucial. Multinational firms in underdeveloped nations may utilize microdata. This method lets researchers determine whether and how taxes, business regulation, governance arrangements, property rights, etc., impact corporate tax.

Han (2020) addresses tax avoidance by wealthy persons in developing nations who hide their overseas financial holdings. Tax avoidance cost developing countries USD 15 billion in the 1990s and USD 124 billion subsequently. Following rough estimations of offshore financial assets, ad hoc assumptions are made concerning taxable returns, tax rates, and developing nations' citizens' asset share. These calculations are complex to comprehend. This domain contains even less data than the corporate. Informative research is scarce.

The unique function of tax havens is related to international tax avoidance (corporate income shifting and offshore asset holdings by private individuals). Tax havens contribute significantly to the tax disparity in developing nations (Han 2020). Existing figures on the volume of tax expenditure reported by various countries could be more accurate since they are based on different measurement concepts. Existing estimates of these revenue losses distinguish between domestic and international tax avoidance and tax avoidance components (Bazo 2008).

In Indonesia, a few owners dominate, causing tensions between majority and minority shareholders (Francis et al. 2017). Dominant shareholders, often called controlling shareholders, may pressure senior management to favor them over minority owners. Their analysis found that government and foreign ownership may predict firms' tax avoidance, with board composition possibly interacting. According to the agency hypothesis, foreign-owned companies avoid taxes more than others (Salihu et al. 2015). Foreign ownership is meant to strengthen company governance and prevent tax avoidance. Higher foreign share percentages reduce tax avoidance (Fuest and Riedel 2009).

For companies that avoid taxes due to management, tax avoidance incentives will motivate executives to boost firm performance. One strategy is tax avoidance to increase tax payment efficiency. Tax aggression, tax avoidance, CEO incentives, and company governance have been studied. The data show that excellent company governance reduces high tax avoidance to surface levels, which may indicate managerial overinvestment. Whether a company evades taxes depends on its executives (Dyreng et al. 2008). Tax avoidance is a significant economic issue, and CEOs are involved. Agency and positive accounting theories state that principals and agents have interests and goals. Executive incentives address knowledge asymmetry and conflict of interest.

Transfer pricing manipulates taxes by moving product, service, and intellectual property prices to subsidiaries or linked enterprises in different states (Horngren et al. 2012). Transfer pricing is determined by fair transactions between connected businesses. Corporations transmit earnings to linked low-tax entities (Richardson et al. 2013). Transfer pricing is seen negatively because it may harm the state. According to the traditional accounting literature, transfer pricing distributes expenditures and revenues across subsidiaries, joint ventures, and divisions of related enterprises (Putri 2019). Transfer pricing maximizes private profits without government taxes by determining value. Profits from high-tax jurisdictions generally go to low-tax jurisdictions (Putri 2019). The corporation conducts expensive commerce across divisions using transfer charges and other methods. Taxes move from high-tax to low-tax nations. Fair exchanges between interdependent entities set transfer prices. Companies purposefully transfer earnings to low-tax entities with unique linkages (Richardson et al. 2013). Transfer pricing affects the state, making it unpopular. The impact of transfer pricing on firms' aggressive tax avoidance has been investigated. According to Sikka and Willmott (2010), transfer pricing helps enterprises in wealthy and poor nations evade taxes. Such conduct is expected.

2.6. Theoretical Framework

Figure 1 depicts a comprehensive framework that explains the relationship between variables in the context of tax avoidance. Three independent variables influence, among

others, foreign ownership, executive incentives, and transfer pricing—each of which significantly and positively impacts tax avoidance. The framework presented in Figure 1 aligns with the hypothesis proposed in the research. The significant positive impacts caused by foreign ownership, executive incentives, and transfer pricing not only corroborate theoretical expectations but also contribute empirical evidence to support the main claims of this study. This framework serves as a visual representation of the various dynamics regarding the factors contributing to tax avoidance strategies in the context studied.

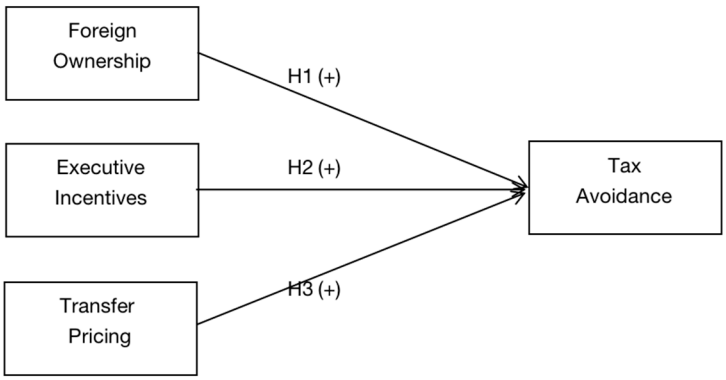

Figure 1. Framework.

2.7. Hypotheses

This study focuses on how tax avoidance is affected by foreign ownership, executive incentives, and transfer pricing. This study was conducted due to conflicts between previous studies, notably in the Indonesian banking industry. This is because banking laws are strict and ever-changing. This prevents financial fraud, especially tax avoidance. Businesspeople consistently find loopholes to dodge taxes, causing state losses. Agency theory emphasizes knowledge asymmetry between foreign shareholders and local bank management, leading to tax avoidance methods that benefit both sides. Foreign ownership has increased local corporate tax avoidance, according to Hasan et al. (2019). Albring and Alimov (2018) prove that foreign ownership positively affects German enterprises' tax avoidance. This supports agency theory's theoretical ideas. Omran et al. (2018) explored how foreign ownership affects tax avoidance in Egyptian enterprises. This study found that foreign ownership significantly affects company tax avoidance. Corporations may use tax avoidance tactics to maximize earnings or satisfy foreign shareholders. This is in agreement with the research reported by Boubakri et al. (2018), who found a positive relationship between foreign institutional ownership and tax avoidance in several states. This reinforces the idea that foreign investors can influence corporate tax strategies. Based on previous studies and in line with the framework in Figure 1 then:

H1. *Foreign ownership has a significant and positive effect on Tax avoidance.*

In the context of executive incentives and tax avoidance in banking, agency theory and positive accounting theory offer valuable insights. According to agency theory, executives within banks may prioritize their interests over those of shareholders, leading to the adoption of aggressive tax strategies. This could manifest in the manipulation of earnings, the pursuit of higher salaries, bonuses, and stock-based incentives. Positive accounting theory further emphasizes that executives may engage in tax avoidance to enhance reported earnings and, consequently, their compensation.

Chen et al. (2016) support these theories by finding that managerial influence increases the likelihood of adopting aggressive tax planning strategies. This suggests that influential leaders are more inclined to pursue tax strategies that may be advantageous for personal gain. In contrast, Huang and Chang (2015) discovered a negative correlation between management ownership and tax avoidance, indicating that CEOs with higher ownership tend to avoid aggressive tax planning, aligning with the predictions of agency theory.

Moreover, Huang et al. (2019) established a link between stock-based incentives and tax avoidance. This finding suggests that CEOs with higher stock-based remuneration are more inclined to employ tax planning strategies to bolster profitability and elevate stock prices. These results align with positive accounting theory, highlighting how executive incentives, particularly those tied to financial indicators influenced by tax planning, can shape tax avoidance behaviors within the banking sector. Based on previous research and aligning with the framework in Figure 1, then:

H2. *Executive incentives have significant and positive effects on tax avoidance.*

Agency theory and positive accounting theory provide crucial insights into the topic of transfer pricing and tax avoidance in the banking sector. According to agency theory, bank executives may manipulate transfer pricing to align with the preferences of foreign shareholders seeking to minimize tax obligations. This manipulation is strategically employed to reduce tax liabilities, resulting in financial gains. Positive accounting theory complements this perspective by suggesting that management may engage in transfer pricing practices as part of strategic measures to optimize financial outcomes.

Many studies shed light on this topic. Wallace and Xie (2018) examined how transfer pricing affects multinational bank tax avoidance and income. Their study illuminated the relationship between transfer pricing, tax avoidance, and government tax income. Haslinda and Roslan (2019) explored the relationship between transfer pricing, tax avoidance, and Malaysian bank performance. The researchers examined how transfer pricing affects tax avoidance and financial results. Fisman et al. (2018) analyzed banking tax evasion and avoidance. The researchers examined these practices and their effects on tax income and the tax system. De Mooij and Liu (2016) examined multinational businesses' transfer pricing behavior. The study used simulation to evaluate how such practices affect various economic indicators. These studies improve our understanding of transfer pricing and tax avoidance in the banking business, involving stakeholders and society.

H3. *Transfer pricing has a significant and positive effect on tax avoidance.*

3. Methodology

Data and Sample Selection

This study's research uses bank financial statements from 2015 to 2019. The sampling strategy was purposeful sampling. The following factors were used to choose the sample: (a) The study objects are banks listed on the Indonesia Stock Exchange between 2015 and 2019; (b) Foreign firms own at least 20% of the sampled financial institutions; (c) No losses were experienced by the financial institutions under examination throughout the observation period.

The period chosen for research was 2015–2019, before the COVID-19 pandemic occurred. This research does not include the years 2020, 2021, and 2022. The aim is to examine periods characterized by relatively stable company financial conditions before the COVID-19 pandemic occurred. This decision aims to maintain the integrity of the sample categories and mitigate potential distortions caused by the economic impact of the disadvantages of the COVID-19 pandemic era. Exceptions were made because many companies experienced losses during this time, reducing the number of samples.

One dependent variable and three independent variables make up this study. This study examines how tax avoidance affects transfer pricing, executive incentives, and foreign ownership. A thorough explanation of each independent and dependent variable may be found below.

For several compelling reasons, the effective tax rate (ETR) was used in this study as a stand-in for tax avoidance. ETR is the ratio of tax burden (or tax liabilities) to profit before tax, based on an earlier study by Hanlon and Heitzman (2010). A lower ETR suggests that a business can efficiently manage its tax liability, which indicates the presence of a tax

avoidance plan, and vice versa. Because they have different understandings, effective tax rates and tax avoidance practices have a conflicting relationship. Business actors often do not try to avoid taxes as the effective tax rate rises, since doing so raises the cost of capital and lowers the rate of return before taxes. On the other hand, because it reduces the cost of capital and increases the pretax rate of return, a drop in the effective tax rate tends to promote tax avoidance techniques like financial arbitrage and biased financial decision making (Fullerton 1984). In particular, Frank et al. (2009) use ETR to draw attention to the distinctions between accounting profit on an accrual basis and fiscal profit on a cash basis, demonstrating how ETR can be used to assess the efficiency of corporate tax payments and their compliance with fiscal and accounting standards.

Hence, the effective tax rate (ETR) represents tax avoidance as tax expense minus deferred tax over income before tax. FO is foreign ownership, the number of foreign shares divided by total outstanding shares. EI represents executive incentive, calculated by executive incentive over total remunerations.TP is transfer pricing measures expressed as related party receivables over total receivables. Only seventeen financial institutions remained eligible for this purposive sample method after filtering. As of 31 December 2014, there were 61 banking companies listed on the Indonesia Stock Exchange for the five-year research period of 2015–2019. However, 37 businesses that do not have a special connection were left out. A final sample of 17 banks was formed by subtracting 7 banks that do not possess foreign shares. After multiplying these 17 sample banks by the five-year research period, 85 firm–year observations were gathered.

4. Results and Discussion

4.1. Descriptive Statistic

Descriptive statistics offer insights into the features of each variable within the study's sample. This information includes the average (mean), minimum, and maximum values, standard deviation, skewness, and kurtosis for each variable, providing a comprehensive understanding of their characteristics.

Table 1 shows the data for each variable based on the model that was processed. The mean value of foreign ownership is 0.67997, with a standard deviation of 0.258067. This means that the mean value is greater than the standard deviation, indicating that the data for this variable are evenly distributed. According to the data processing, the EI variable has an average value (mean) of 0.067851 and a standard deviation value of 0.055726. This means that the average value (mean) is higher than the standard deviation, indicating that the data for this variable are evenly distributed. The transfer pricing variable's average value (mean) is 0.021044, with a standard deviation of 0.048214. This demonstrates that the average value (mean) is less than the standard deviation, indicating that the data for this variable are not evenly distributed.

Table 1. Descriptive Results.

	ETR	FOR	INS	TP
Mean	0.047552	0.679970	0.067851	0.021044
Median	0.037220	0.768450	0.051230	0.003500
Maximum	0.462560	1.000000	0.265410	0.215720
Minimum	−0.536420	0.000000	0.000005	0.000000
Std.Dev.	0.247863	0.258067	0.055726	0.048214
Skewness	−0.258623	−0.926084	1.438519	3.187306
Kurtosis	1.974558	3.010799	4.949841	12.28930
Jarque–Bera	3.572494	9.291322	32.71456	343.7598
Probability	0.167588	0.009603	0.000000	0.000000
Sum	3.090880	44.19804	4.410310	1.367890
SumSq.Dev.	3.931914	4.262311	0.198747	0.148775

Source: processed secondary data, 2023. ETR: tax avoidance. FO: foreign ownership. EI: executive incentives. TP: transfer pricing.

4.2. Normality Test

Based on the descriptive statistics table, there are variables that have a skewness value far from 0 and kurtosis greater than 3, which usually gives an indication that the data are not normally distributed, but this can be justified by the results of the histogram normality test in Figure 2 showing a Jarque–Bera value of 0.813, greater than significance at the 0.05 level (5%). This value suggests that the data are normally distributed.

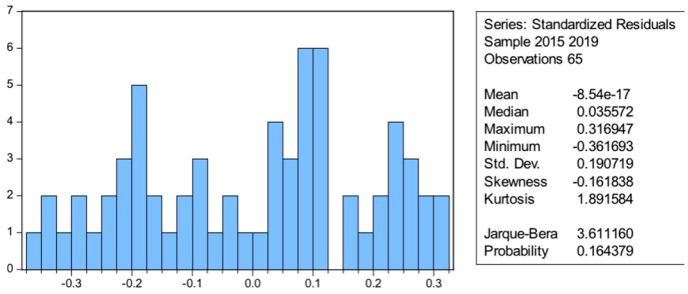

Figure 2. Normality test.

Furthermore, based on empirical experience, Gujarati (2021) shows that if the observation size is large enough (n > 30), then the data can be assumed to be normally distributed. This is often referred to as a large sample. In such cases, the central limit theorem comes into play, which states that as the sample size increases, the distribution of sample means approaches a normal distribution. Hair et al. (2019) further support the idea of the influence of the central limit theorem on normality testing on large samples. This highlights how researchers can make more reliable assumptions about normality in large samples, even when the original data distribution may deviate from normality due to skewness or kurtosis (Barri 2019).

4.3. Panel Data Regression

The Chow test determines whether the study model uses the common or fixed effect. The Chi-square cross-section has a probability value of 0.0131 (see Table 2). Because this value is less than 0.05, the equation regression results in this study were based on a fixed-effect model based on the Hausman test. The test determines whether the research model employs a random effect or fixed effect probability value of 0.4827. The regression equation results in this study were based on a random effect model because this value was more than the 0.05 significance level. According to the Lagrange test of the processed data, the Breusch–Pagan cross-section has a probability value of 1.79. This value exceeds the significance threshold of 0.05. The outcomes of the appropriate regression model utilized in this study, the common effect model, can be concluded.

Table 2. Panel Data regression Test.

	Prob
Cross-section Chi square (Chow test)	0.0131
Cross-section random (Hausman test)	0.4827
Breusch–Pagan (Lagrange multiplier test)	1.79

4.4. Robustness Test

The purpose of carrying out robustness tests in the form of multicollinearity and heteroscedasticity tests is to validate the assumptions of the regression model and ensure the reliability of the results (Wilcox 2014). The multicollinearity test is used to detect the presence of multicollinearity among independent variables, which can cause unreliable

coefficient estimates and increased standard errors, thereby interfering with model interpretation (Shrestha 2020). Meanwhile, the heteroscedasticity test is used to identify non-constant variance in the error term, which can result in inefficient estimates and biased standard errors, thereby affecting confidence intervals and hypothesis testing.

4.4.1. The Heteroscedasticity Test

The heteroscedasticity test determines whether the regression model detects a relationship between the independent variables. If the probability value is greater than 0.05, the regression model is devoid of heteroscedasticity. According to Table 3, the heteroscedasticity test results suggest the following:

Table 3. Heteroscedasticity Test.

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.172504	0.037554	4.593555	0.0000
FO	0.028159	0.048973	0.574995	0.5674
EI	−0.237009	0.207464	−1.142410	0.2577
TP	−0.508880	0.257862	−1.973460	0.0530

Source: processed secondary data, 2023. ETR: tax avoidance. FO: foreign ownership. EI: executive incentives. TP: transfer pricing.

Based on Table 3, the results of the heteroscedasticity test show that there is no probability coefficient with a value of less than 0.05. As a result, the data can be considered heteroscedastic.

4.4.2. Multicollinearity Test

The multicollinearity test aims to test whether the regression model finds a correlation between independent variables. A good regression model should not correlate with independent variables. To see the multicollinearity problem of a variable, a correlation matrix is used as in Table 4:

Table 4. Multicollinearity Test.

	FO	EI	TP
FO	1.000000	0.179893	−0.40405
EI	0.179893	1.000000	0.008279
TP	−0.404049	0.008279	1.000000

Source: processed secondary data, 2023. ETR: tax avoidance. FO: foreign ownership. EI: executive incentives. TP: transfer pricing.

Based Multicollinearity Test on Table 4, the coefficient value across variables in this study is less than 0.80, indicating no multicollinearity between the independent variables, according to the results of this multicollinearity test.

4.5. Autocollinearity Test

The Durbin–Watson test was utilized in this investigation to ascertain the existence of autocorrelation. In the given scenario, it was observed that a value of 1.611319 was detected within the range where d is greater than dU. Specifically, this value was found to lie between the upper limit value (dU) of 1.74 and the lower limit value (dL) of 1.46. The regression model utilized in this study may be deficient in autocorrelation.

4.6. Regression Result

The current study employs regression analysis using panel data from a cohort of 17 companies covering five years, resulting in a total sample size of 85 observations. We are aware of a panel model that could incorporate both banks and years. Nonetheless, it is essential to assess the benefits and difficulties involved carefully. Panel models provide

valuable insights but can be intricate and provide obstacles in interpretation, data prerequisites, and assumptions of uniformity. Furthermore, the availability of computational resources and the potential for model overfitting need to be considered. It is crucial to evaluate whether the advantages of a panel model surpass these problems and whether other, less complex models or approaches may be more appropriate depending on the research inquiry and accessible data. However, given a variable distribution of the data, an outlier analysis was performed on the study data, resulting in a dataset of 65 observations, as described by the following equation:

$$\text{ETR}_{i,t} = \alpha_0 + \beta_1 \text{FO}_{i,t} + \beta_2 \text{EI}_{i,t} + \beta_3 \text{TP}_{i,t} + e \quad (1)$$

where ETR: *tax avoidance*; α_0: constant; B: regression coefficient; FO: foreign ownership; EI: *executive incentives*; TP: transfer pricing; E: *error term*.

Based on the regression results above, the regression equation obtained from this research is:

$$\text{ETR}_{i,t} = \alpha_0 - 0.6185 \text{FO}_{i,t} + 1.3503 \text{EI}_{i,t} - 0.3156 \text{TP}_{i,t} + e \quad (2)$$

where C: constant; FO: foreign ownership; EI: executive incentives; TP: transfer pricing.

According to the findings presented in Table 5, it can be observed that the variable of foreign ownership (FOR) exhibits a regression coefficient of −0.618527. This implies that the effective tax rate (ETR) experiences a decrease of 0.61852 for each incremental unit of foreign ownership. The regression coefficient for executive incentives is estimated to be 1.3503. The effective tax rate (ETR) exhibits a positive relationship, whereby it experiences an increment of 1.3503 for each unitary rise in executive incentives. In the context of transfer pricing, it is noteworthy to mention that the regression coefficient value obtained is −0.3156. For each incremental increase of one unit in transfer pricing, the effective tax rate (ETR) will decrease by 0.3156.

Table 5. Regression Results.

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.3831	0.08097	4.7316	0.0000
FO	−0.6185	0.10559	−5.8573	0.0000
EI	1.3503	0.4473	3.01879	0.0037
TP	−0.3156	0.55594	−0.5676	0.5724

Source: processed secondary data, 2023. ETR: tax avoidance. FO: foreign ownership. EI: executive incentives. TP: transfer pricing.

The experiment was conducted utilizing a significance level of 5% to evaluate the impact of the dependent and independent variables on the outcome, determining whether their effects were statistically significant or inconsequential ($\alpha = 0.05$). Table 3 provides a concise summary of the results obtained from the panel data regression analysis.

Hypothesis 1 (H1) in this study refers to the influence of foreign ownership on tax avoidance. Foreign ownership is 0.000, or less than the significance value of 0.05, according to the findings of the regression equation in Table 4, and the regression coefficient of the foreign ownership variable is −0.618427. As a result, H1 is accepted, and foreign ownership affects the effective tax rate, meaning that foreign ownership aids tax avoidance.

Hypothesis 2 (H2) in this study examines the impact of executive incentives on tax avoidance. According to the regression equation results in Table 4, organizational incentives were 0.0037, or less than the significance value of 0.05, and the regression coefficient of the inventory intensity variable was 1.350238. As a result, H2 is accepted, and executive incentives positively influence the effective tax rate, implying a negative impact on tax avoidance.

The influence of transfer pricing on the effective tax rate is the subject of Hypothesis 3 (H3) in this study. The likelihood of transfer pricing is 0.5724, or higher than the significance value of 0.05, according to the regression equation results in Table 3, and the regression

coefficient of the fixed asset intensity variable is −0.315519. As a result, it is reasonable to conclude that transfer pricing has no impact on the effective tax rate.

Based the coefficient of determination results on Table 6, it can be concluded that the adjusted R^2 is 0.378825 or 37.8825%. This shows that the ownership structure variables of foreign ownership (FO), executive incentives (EI), and transfer pricing can influence tax avoidance by 0.378825 or 37.8825%. At the same time, the remaining 62.1175% is explained by other variables not used in this study.

Table 6. Coefficient of Determination Results.

R-Squared	0.407943	Mean Dependent var	0.047552
Adjusted R-squared	0.378825	SD dependent var	0.247863
SE of regression	0.195353	Sum squared resid	0.195353
F-statistic	14.01018	Durbin–Watson stat	1.611319
Prob(F-statistic)	0.000000		

Source: processed secondary data, 2023.

The test results presented in Table 7 demonstrate the impact of foreign ownership (FO) on tax avoidance within banking firms listed on the Indonesia Stock Exchange during the period of 2015–2019. The findings from the empirical analysis on the impact of foreign ownership on the effective tax rate are as follows. This result is evidenced by the regression coefficient value of *Foreign Ownership* of −0.618427 and the probability value of *Foreign Ownership* 0.0000 < 0.05. Hence, the hypothesis that *Foreign Ownership* affects the effective tax rate means that if foreign ownership increases, there will be tax avoidance, indicating that H1 is accepted. This happens because foreign owners who own majority shares are generally more oriented toward shareholders' welfare. Because they are not Indonesian citizens, their level of tax awareness is low. This study's results align with research conducted by Salihu et al. (2015) reporting that foreign ownership positively affects tax avoidance. Salihu et al. (2015) examined the interests of foreign investors in tax avoidance in companies in Malaysia and found a positive impact of foreign ownership structure on tax avoidance.

Table 7. Partial T Hypothesis Testing.

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.383089	0.080963	4.731652	0.0000
FO	−0.618427	0.105583	−5.857265	0.0000
EI	1.350238	0.447278	3.018786	0.0037
TP	−0.315519	0.555933	−0.567549	0.5724

Source: processed secondary data, 2023. C: constant. FO: foreign ownership. EI: executive incentives. TP: transfer pricing.

The test results above also show the effect of *Executive Incentives* (EI) on *tax avoidance* in banking companies listed on the IDX for the 2015–2019 period. *Executive Incentives* affect the effective tax rate. This result is evidenced by the regression coefficient value of *Executive Incentives* of −1.350238 and the probability value of 0.0037 < 0.05. It can be concluded that H_2 is accepted. Thus, the hypothesis stating that *Executive Incentives* (EI) positively affect the effective tax rate means that if executive incentives increase, tax avoidance decreases. Hence, the findings of this study agree with those of Gaertner (2014), who found that executive incentives have a negative impact on tax avoidance.

In addition, the test results in Table 7 show the effect of *transfer pricing* on *Tax Avoidance* as a proxy for the *effective tax rate*. In banking companies listed on the Indonesia Stock Exchange for the 2015–2019 period, transfer pricing does not affect the *Effective Tax Rate.* This result is evidenced by the probability value of *transfer pricing* 0.5724 > 0.05. This means that H3 is rejected. This study's results align with research conducted by Putri (2019), which states that transfer pricing does not affect tax avoidance.

5. Conclusions

The main purpose of this study is to ascertain the impact of foreign ownership, executive incentives, and transfer pricing on tax avoidance within banking firms that are publicly listed on the Indonesia Stock Exchange. After being filtered based on the criteria, namely foreign ownership and IPO before 2015, the final sample in this study comprised 17 commercial banks. Based on the research results, foreign ownership has a significant positive effect on tax avoidance, executive incentives have a significant negative effect on tax avoidance, but transfer pricing does not affect tax avoidance.

This study has limitations that can be used as a reference for future researchers to obtain more accurate results. The study used only banking sector companies listed on the Indonesia Stock Exchange (IDX) for 2015–2019. The purposive selection method yielded only 17 samples of companies that could be used as research objects. It is intended that banking firms and non-bank financial institutions will be able to contribute more to the research in the future.

The independent variables used are only foreign ownership, executive incentives, and transfer pricing as mediating. The effect of the adjusted R-squared of the three variables is only 37.88%, which means that many other possible variables still play a role in transfer pricing and tax avoidance. There are still many other corporate governance variables, such as managerial ownership, institutional ownership, the composition of independent commissioners, and audit quality, which can be assessed as independent variables in subsequent research.

Studying tax avoidance in Indonesia has essential ramifications for fiscal policy and legal structures. The discoveries can potentially impact revenue generation, distribution of funds, and overall economic stability by necessitating modifications to current regulations. Possible measures to rectify recognized deficiencies in the tax system may involve introducing legal changes, such as reinforcing enforcement mechanisms. Such research may result in heightened transparency, stricter reporting obligations, and enhanced international cooperation to address cross-border tax evasion. Indonesian businesses may be required to modify their tax planning tactics, while the investment environment as a whole could gain from a tax system that is more transparent and equitable. Overall, this study can stimulate favourable transformations in Indonesia's economic terrain.

The findings of this research provide broad contributions and have broad implications. Regulators can utilize these findings to formulate policies that address tax avoidance in the banking sector, promote financial transparency, and encourage ethical business practices. This has the potential to shape the fiscal landscape, giving regulators a tool to raise revenue and ensuring that financial institutions make a fair contribution to public finances. Investors, armed with the knowledge gained from this research, can make informed decisions by considering the tax-related risks associated with foreign ownership and executive incentives when evaluating banking stocks. This not only supports wise investment strategies but also contributes to financial market stability.

At the industry level, this study emphasizes the need for banking companies to reassess policies regarding foreign ownership structures and executive incentive programs. This reassessment is critical to optimizing tax practices, aligning with financial and ethical standards, and ensuring the long-term sustainability of banking institutions. This optimization not only makes a positive contribution to fiscal health but also supports ethical and responsible financial behavior in the industry. In the context of the existing literature, although acknowledging its limitations, this research provides significant added value by revealing the specific impact of foreign ownership, executive incentives, and transfer pricing on tax avoidance in banking. In the future, this research could explore additional corporate governance factors and introduce control or moderating variables to enrich further our understanding of the complex dynamics between transfer pricing and tax avoidance in the banking industry.

Author Contributions: Conceptualization, N.B.Z.; investigation, V.R.P.; data collection, V.R.P.; writing—original draft, R.A.; supervision, J.S.; project administration, F.G. All authors have read and agreed to the published version of the manuscript.

Funding: This research received no external funding.

Data Availability Statement: Data used in this study are available upon request.

Acknowledgments: The authors thank the support from the Accounting Research Institute HICoE of Universiti Teknologi MARA.

Conflicts of Interest: The authors declare no conflicts of interest.

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Source details

Journal of Risk and Financial Management

Open Access

Scopus coverage years: from 2019 to 2023

Publisher: Multidisciplinary Digital Publishing Institute (MDPI)

ISSN: 1911-8066 E-ISSN: 1911-8074

Subject area: Business, Management and Accounting: Business, Management and Accounting (miscellaneous)

Economics, Econometrics and Finance: Economics and Econometrics

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Journal of Risk and Financial Management • *Open Access* • Volume 17, Issue 1 • January 2024 • Article number 26

Document type
Article • *Gold Open Access*

Source type
Journal

ISSN
19118074

DOI
10.3390/jrfm17010026

Tax Tightrope: The Perils of Foreign Ownership, Executive Incentives and Transfer Pricing in Indonesian Banking

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Abstract

Despite being a crucial source of funding for the government, tax revenue collection in Indonesia has yet to reach its ideal and satisfying level for the economy. Therefore, this study explores the impact of executive incentives, foreign ownership, and transfer pricing on tax avoidance. The conventional banks of Indonesia that were listed on the Indonesia Stock Exchange (IDX) between 2015 and 2019 are the subject of this study. This study employed a purposive selection technique, with a final sample of 17 banks chosen after screening to ensure they met the requirements of having foreign ownership and not

having suffered losses during the study year. The results of this study show that while CEO incentives harm tax avoidance, foreign ownership has a beneficial effect. Furthermore, tax avoidance is not significantly impacted by transfer pricing. The findings of this investigation open the door for accountable authorities in the economy. © 2024 by the authors.

Author keywords

executive incentive; foreign ownership; tax avoidance; transfer pricing

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(2022) *International Journal of Multidisciplinary Research and Analysis*, 5, pp. 3188-3197.