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TAX AVOIDANCE AND FINANCIAL DISTRESS: A THREAT TO FIRM QUALITY?

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Abstract: Tax avoidance has become an ongoing issue because it has a negative social impact on a country. Unlike previous studies that examined the direct effects of tax avoidance, this study adds financial distress as a moderating variable. In this regard, this study aims to obtain empirical evidence regarding the effect of corporate tax avoidance on firm quality. This study focuses on the consumer cyclical sector and uses secondary data obtained from firms' financial reports. The analysis method used is moderated multiple linear regression analysis. The results show that tax avoidance has a significant negative effect on firm quality. Financial distress acts as a quasi-moderator, in which this condition strengthens the negative relationship between tax avoidance and firm quality, and has a positive effect on firm quality itself. Theoretically, this study enriches the tax avoidance literature by examining its impact on corporate quality, particularly in conditions of financial distress. Practically, the findings of this study also provide guidance for management to balance tax avoidance strategies with the internal conditions of the company.

Keywords: *consumer cyclicals sector, financial distress, firm quality, risk compensation theory, tax avoidance*

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1. Introduction

Tax ratio serves as a measure of how efficiently a country collects taxes by comparing total tax revenue relative to the total gross domestic product (GDP) (Hajawiyah et al., 2021), whereas tax buoyancy is a ratio that measures the change in tax revenue relative to the change in GDP, including discretionary changes made by a nation to its tax systems (Gupta et al., 2022). According to the annual report from the Directorate General of Taxes (Direktorat Jenderal Pajak, 2024), the tax ratio of Indonesia slightly decreased by 0.08% from 10.39% in 2022 to 10.31% in 2023, indicating that the tax revenue growth was slower than Indonesia's GDP growth. On the other hand, the tax buoyancy fell sharply from 2.04 in 2022 to 1.32 in 2023, indicating that the changes in tax revenue became less responsive to changes in Indonesia's GDP. Moreover, the Tax Justice Network (2023) revealed that Indonesia incurred a total tax loss of USD 2,806.3 million in 2023, equivalent to 0.27% of Indonesia's GDP and 19.01% of health expenditures. From a total tax loss of USD 2,806.3 million, 97.51% or USD 2,736.5 million is attributed to corporate tax abuse, whereas the remaining percentage is due to offshore wealth tax evasion. The data described above indicates tax non-compliance, which, as noted by Kumar et al. (2025), predominantly manifests through tax avoidance.

One of the tax collection systems adopted by Indonesia is the self-assessment system in which taxpayers are given full authority to assess, pay, and report the amount of taxes they owe to the state. However, this self-assessment system creates a potential loophole for taxpayers to take advantage of the grey area in the tax regulations, thus carrying out tax avoidance activities (Asyifanaya & Dewi, 2023). Furthermore, Indonesia has a comparatively high corporate tax rate, which may further motivate firms to avoid taxes, especially under a complicated tax system (Sutrisno et al., 2023). Tax avoidance activities carried out by taxpayers would directly reduce the amount of revenue received by the state, which this lower tax revenue would be disadvantageous for socioeconomically disadvantaged groups, eventually impeding social advancement (Bach et al., 2025; Dang & Tran, 2021; Gao et al., 2025).

Since tax avoidance is deemed detrimental, it is important to investigate how it affects the quality of firms, as such practices may undermine corporate transparency, weaken the trust of stakeholders, and potentially compromise long-term firm performance and reputation. Previous empirical studies have explored corporate tax avoidance and firm value or firm performance. For instance, research by Nebie & Cheng (2023) showed that the value of Taiwanese firms increases when firms engage in tax avoidance activities. Similarly, Khuong et al. (2020) found that higher corporate tax avoidance enhances firm accounting performance. However, they also found a negative relationship influenced by managers' self-motivation. On the contrary, corporate tax avoidance does not affect firm performance, specifically for the banking firms in Bangladesh, Pakistan, and Sri Lanka, as tax avoidance strategies are used by managers to accomplish their gains rather than prioritizing shareholders' value (Malik et al., 2025). Likewise, in the context of China, Chen et al. (2016) claimed that the lack of transparency in China's stock market provides opportunities for managers to use tax avoidance as a means of self-enrichment, thereby eroding shareholder value. Collectively, these studies establish the current state of knowledge on tax avoidance, yet the variability in findings underscores the need for further research.

Unlike prior research that investigated the direct effect of corporate tax avoidance on firm value or firm performance, this study adopts the term 'firm quality' rather than 'firm value' or 'firm performance' as it better reflects a firm's operational efficiency and capacity to generate sustainable returns from its assets. Unlike firm value, which is driven by market perceptions, or firm performance, which may emphasize short-term profitability, the concept of 'firm quality' captures the fundamental strength, efficiency, and stability of a firm, as evidenced by its ability to consistently deliver asset-based returns. In addition, although prior research has considered various moderating variables, financial distresss has primarily been treated as a determinant of tax avoidance rather than as a contextual factor that may influence its consequences (Stanley & Widianingsih, 2025). This leaves a gap in understanding how the effectiveness and implications of tax avoidance strategies may vary under different financial conditions. Thus, this study also extends the analysis by exploring the potential moderating role of financial distress in this relationship, as distressed firms may be more incentivized to engage in tax avoidance strategies to preserve liquidity. However, such behaviour may either bolster firm quality by enhancing operational stability or undermine it through regulatory and reputational risks. Based on the explanation above, this research aims to obtain empirical evidence on the effect of corporate tax avoidance on firm quality, moderated by financial distress in the consumer cyclical sector of Indonesia. Theoretically, this research enhances tax avoidance literature by examining how it affects firm quality, especially under the conditions of financial distress. Practically, the findings of this study also guide management to strike a

balance between tax avoidance strategies and the condition of the firm itself, and how it would affect the quality of the firm in the eyes of its stakeholders.

Risk Compensation Theory

Risk compensation is a behavioural and psychological theory that explains how individuals adjust their behaviour when they perceive an increase in safety, often due to regulatory measures or design improvements (Levy & Miller, 2000). A well-known study on risk compensation is by Peltzman (1975), who found that automobile safety regulations did not reduce highway fatality rates because drivers offset the added safety by engaging in riskier driving behaviours. Whereas Peltzman (1975) viewed risk compensation through an economic lens, Wilde (1982) approached it from a psychological standpoint, suggesting that risk-taking is an inherent aspect of human behaviour. According to Wilde (1982), individuals tend to engage in riskier behaviours to raise the level of risk back to their preferred threshold, and conversely, they may act more cautiously when the perceived risk falls below their desired level.

Extending the logic behind risk compensation to firms, firms may pursue tax avoidance strategies to improve their financial performance, such as liquidity and profitability, to offset, for example, the risk of earnings volatility. However, under financial distress, firms may face greater risk and uncertainty. The firm may perceive the risk associated with tax avoidance as more acceptable or even necessary, given the perceived urgency of survival. This distorted perception may lead to more extreme tax avoidance behaviour, not because the actual risk is lower, but because the tolerance for risk increases under financial distress.

Firm Quality

In this study, firm quality refers to a firm's ability to generate consistent and efficient profits from its assets, an attribute widely viewed in prior literature as a marker of long-term financial health and operational efficiency. Consistent with previous research by Cheng & Tzeng (2011) which argued that one of the financial ratios of firm quality is earnings-to-total-assets, since the fundamental basis of a firm's existence lies in its capacity to derive earnings from its asset base. Profitability is also one of the core components in Fama's Five Factor Model, where firms with robust profitability are characterized as 'higher-quality' firms (Fama & French, 2015). Furthermore, empirical evidence has also shown that perceptions of firm quality were more strongly influenced by prior financial performance than by subsequent performance (McGuire et al., 1990). Aside from this, overall perceptions of firm quality were driven more by firm financial performance, including return-on-assets, than evaluations of management quality (McGuire et al., 1990).

Tax Avoidance

The definition of tax avoidance is very broad, in which tax avoidance represents a gradation of tax-saving methods where bond investments are at the perfectly legal end, whereas 'non-compliance', 'aggressiveness', 'evasion', and 'sheltering' fall at the opposite end (Hanlon & Heitzman, 2010). In opposition, according to Dyreng et al. (2008), tax avoidance refers to strategies that lower the long-term cash effective tax rate of the firm. Other researchers have also defined the concept of tax avoidance. Khelil & Khlif (2023) outline tax avoidance as a managerial effort to reduce tax costs. Mocanu et al. (2021) specify that tax avoidance is only possible when the law is porous because this allows taxpayers to escape taxes by legal means through existing loopholes. By the same token, Ngah et al.

(2022) describe tax avoidance as a series of legal schemes assembled to lawfully minimize tax payments. Likewise, Xu (2024) pinpoints tax avoidance as the practice of taxpayers using legal loopholes within tax laws to minimize their tax liabilities. Corporate tax avoidance is also the practice of firms retaining cash within the company that would otherwise be contributed to the government (Koay & Sapiei, 2024). Summarizing the definitions of tax avoidance from prior research, in this course of research, tax avoidance is characterized as the legal practice of utilizing strategies and gaps within the tax law to lessen the amount of tax liability without violating the boundaries of tax laws.

Financial Distress

Zhao et al. (2024) categorize corporate financial distress definitions into 2 types: abnormal financial conditions and stock exchanges' criteria. Financial distress in abnormal conditions refers to the situation in which a firm faces financial difficulties, such as having high debt levels. As defined by stock exchanges' criteria, financial distress may be in the form of special treatment and delisting. In the context of China, Yuan et al. (2022) characterize firms with potential financial distress when they are classified under 'special treatment' by the China Securities Regulatory Commission. Several researchers adopt either one of the types of financial distress definitions or incorporate both. For example, Yousaf et al. (2020) define financial distress in which firms are listed as special treatment (ST) companies that have negative profit during the year or declining earnings for two years, have an interest coverage ratio below one, and have decreasing or negative net income. In a narrower context, Zmijewski (1984) defines financial distress as filing for bankruptcy; Altman et al. (2019) define financial distress as when a firm experiences cash flow constraints needed to fulfill its debt obligations. According to Isayas (2021), financial distress arises when a firm fails to honor its debt responsibilities to loan providers. More specifically, financial distress happens when firms experience the incapacity to meet debt payments, which may lead to bankruptcy, liquidation, and even asset forfeiture (Farooq et al., 2023). In this study, financial distress denotes the situation in which a firm experiences financial challenges in fulfilling debt obligations due to weakening financial performance, with the potential to cause bankruptcy.

Hypotheses Development

Firms often engage in tax avoidance as a strategy to reduce cash outflow and improve short-term performance (Guo et al., 2023). From a traditional finance perspective, while such practices may improve short-term financial performance, they also introduce hidden costs and behavioural distortions that affect a firm's long-term quality. The risk compensation theory suggests that when a firm's perceived risk is low, firms may respond by taking on greater risks elsewhere to maintain their preferred level of risk. In the corporate setting, tax avoidance may unintentionally trigger riskier behaviours, such as weakening internal controls and reducing financial transparency (C. S. A. Cheng et al., 2022). These compensatory behaviours can undermine long-term performance and stakeholder trust over time. Therefore, tax avoidance, while financially beneficial in the short term, may paradoxically harm overall firm quality. The hidden costs associated with reduced transparency, increased agency problems, and elevated risks may outweigh the immediate financial gains, which in turn, erode the fundamental attributes that define firm quality, including operational efficiency, stability, and sustainability. Therefore, based on the explanation, the first hypothesis is as follows:

H_1: Corporate tax avoidance has a significant and negative effect on firm quality.

While tax avoidance may negatively affect firm quality on its own, its impact may not be uniform across all firms. One important contextual factor that can shape this impact is financial distress. Firms experiencing financial distress often face intense pressure to meet obligations (Lee & Thong, 2023). In such situations, tax avoidance may be viewed not just as a financial strategy but as a survival mechanism. However, under conditions of distress, corporate decision-making often becomes short-term oriented, and the firm's tolerance threshold for risk may increase. This behavioural shift suggests that when firms are financially distressed, the perceived benefits of avoiding taxes may outweigh the perceived risks, prompting management to engage in more aggressive tax strategies. This compensatory behaviour can intensify the negative consequences of tax avoidance, where the same tax avoidance behaviour may have a more damaging effect since the negative effects of tax avoidance are more likely to be amplified under financial distress. Based on the explanation above, the second hypothesis is as follows:
H_2: Financial distress moderates the effect of corporate tax avoidance on firm quality.

2. Research Method

Population, Sample, and Data

This quantitative research aims to obtain empirical evidence on the effect of corporate tax avoidance on firm quality, moderated by financial distress. This research focuses on the consumer cyclical sector from 2019 to 2023, as global and economic conditions during this time frame may affect the state of firms in this sector. Secondary data are obtained from firms' financial reports available on the Indonesian Stock Exchange (IDX) website or the firm's official website. The population of this study is 154 firms in the consumer cyclical sector in Indonesia. To determine the final sample, the purposive sampling technique is employed, with the criteria outlined in Table 1. An initial observation of 770 is obtained by multiplying the number of firms in the consumer cyclical sector (154 firms) by the time frame (5 years). Effective tax rate (ETR) values are restricted between 0 and 1 to prevent distortion in ETR interpretation (Stanley & Widianingsih, 2024).

Table 1. Research Observations

Criteria	Observations
The firm is listed on IDX (2019-2023).	770
The firm did not publish financial reports.	(158)
The firm's financial report is stated in a currency other than the Indonesian Rupiah.	(58)
The firm recorded a loss and did not report any tax payments.	(280)
ETR < 1 or ETR > 1	(17)
Final observations	257

Variables and Measurements

The dependent variable, firm quality, is proxied by the return-on-assets (ROA). ROA is used because it captures how efficiently a firm generates profits relative to the assets it controls. A firm with a relatively high ROA is generally seen as better managed and has a stronger operational efficiency than other firms. A high ROA also reflects effective cost control, efficient asset utilization, and durable competitive advantages, all of which are traits

of a high-quality firm. Empirical evidence has also shown that firms that are quality-certified show higher ROA than those that are not certified. ROA is measured using the formula below:

$$ROA = \frac{Net\ Income}{Total\ Assets}$$

The independent variable, tax avoidance, is proxied by the cash effective tax rate (CETR). However, it has been argued that using pre-tax income as the denominator can be problematic for firms reporting income that is close to zero, which causes large fluctuations in tax rates (Edwards et al., 2016). Therefore, this study used total assets as the denominator, which has also been used in prior literature (Mindzak & Zeng, 2020; Wang et al., 2024). Since ETR and tax avoidance have inverse interpretations, all ETR values are multiplied by -1 to facilitate the convenience of statistical readings. CETR is measured using the formula below:

$$CETR = \frac{Cash\ Paid\ for\ Taxes}{Total\ Assets}$$

The moderating variable, financial distress, is proxied by the Altman Z"-Score. This modified version of the Altman Z is chosen because it excludes the sales-to-total assets variable, which may vary across industries, and is more suitable for the context of emerging markets, such as Indonesia, as it outperforms earlier models in classification accuracy (Alcalde et al., 2022; Srebro et al., 2021). The Z"-Score has 3 values of interpretations: 1.) a Z"-Score greater than 5.85 suggests that the firm is not in the distressed zone; 2.) a Z"-Score between 3.75 and 5.85 suggests that the firm is in the gray zone; and 3.) a Z"-Score below 3.75 suggests that the firm is in the distressed zone. From this, it can be deduced that the Z"-Score values and financial distress interpretations are inversely related; therefore, all Z"-Score values are multiplied by -1 to easily comprehend statistical results. The Altman Z"-Score is shown in the following equation below:

$$Z" - Score = 3.25 + 6.56\frac{Working\ Capital}{Total\ Assets} + 3.26\frac{Retained\ Earnings}{Total\ Assets} + 6.72\frac{Earnings\ Before\ Interest\ and\ Taxes}{Total\ Assets} + 1.05\frac{Total\ Equity}{Total\ Liabilities}$$

The control variable, firm size, is proxied by the natural logarithm of total assets. Previous studies have proved a negative effect of firm size on tax avoidance since larger firms tend to refrain from reducing their taxes extensively to avoid a damaged reputation in the market (Hasan et al., 2021; Khlifi et al., 2025; Toumi et al., 2022).

$$Firm\ size = \ln(total\ assets)$$

Method of Analysis

This study employs a three-equation approach of moderated regression analysis by Sharma et al. (1981). Based on this approach of moderated regression analysis, there are four types of moderator variables (Sharma et al., 1981). If the interaction term is not significant,

then the variable is considered to be another independent predictor. On the contrary, the variable is a pure moderator if the interaction term is significant. However, suppose both the interaction term and the variable are significant. In that case, it is considered a quasi-moderator, as it both directly predicts the dependent variable and moderates the relationship between the independent and dependent variables. Lastly, if neither the interaction term nor the variable is significant, then the variable has no role. The equations for this research are shown below:

$$FQ = \alpha + \beta_1 TAX + \beta_2 SIZE + \varepsilon \quad (1)$$
$$FQ = \alpha + \beta_1 TAX + \beta_2 FDS + \beta_3 SIZE + \varepsilon \quad (2)$$
$$FQ = \alpha + \beta_1 TAX + \beta_2 FDS + \beta_3 TAX * FDS + \beta_4 SIZE + \varepsilon \quad (3)$$

Where FQ is firm quality, TAX is tax avoidance, FDS is financial distress, SIZE is firm size, TAX*FDS is the interaction term, α is the constant, β is the coefficient, and ε is the error term.

Classical assumption tests for this moderated regression analysis include normality, multicollinearity, and heteroscedasticity tests. Normality is tested using the Skewness-Kurtosis Test, in which the residual errors are not normally distributed if the p-value is below 0.05. To resolve this, outliers are removed. Multicollinearity is tested using the Variance Inflation Factor (VIF), in which there are no symptoms of multicollinearity if the mean VIF value is below 10. Heteroscedasticity is tested using the Breusch-Pagan/Cook-Weisberg Test, in which symptoms of heteroscedasticity occur if the p-value is below 0.05; robust standard errors are employed to solve heteroscedasticity issues.

3. Results and Discussion

3.1. Results

Descriptive Statistics

Table 2 shows the descriptive statistics of all the variables used in this study, with a total of 232 observations, after eliminating 25 outliers to ensure normality requirements are met. FQ with a mean value of 5.02% and a relatively large standard deviation of 3.98% indicates that not all firms in the consumer cyclical sector are high-quality. This is further supported by the minimum value of -1.10% which shows that no profits can be generated from the assets owned. TAX with a mean value of 1.81% and a relatively large standard deviation of 1.65% indicates that most firms pay a relatively low amount for taxes relative to their total assets. FDS with a mean value of 13.67 demonstrates that, on an average level, the firms in the consumer cyclical are not financially distressed, as this value is greater than the critical value of 5.85. SIZE, expressed in trillion IDR, shows that the firms in the sector have an average total asset of 5.42 trillion.

Table 2. Descriptive Statistics

Variable	Mean	Std. Dev.	Min	Max
FQ	0.0501985	0.0398096	-0.01102	0.205562
TAX	0.0180825	0.0165255	0.000022	0.074223
FDS	13.6683	48.4106	1.15343	726.082
SIZE	5.42	7.75	0.037	36

Classical Assumptions Test

Table 3 shows the results of the classical assumptions for each equation in moderated regression analysis. The results revealed that there are no issues for normality and multicollinearity test, as their values are below 0.05 and 10, respectively. However, since the p-values from the Breusch-Pagan/Cook-Weisberg Test are below 0.05 for all three equations, the robust standard errors are applied to resolve heteroscedasticity issues.

Table 3. Classical Assumptions Test

Description	Equation 1	Equation 2	Equation 3
Skewness/Kurtosis Test	0.0706	0.0709	0.1023
Mean VIF	1.05	1.04	2.37
Breusch-Pagan/Cook-Weisberg Test	0.0000	0.0000	0.0000

Moderated Regression Analysis

Table 4 shows the results from the moderated regression analysis after it has been remedied with robust standard errors to resolve heteroscedasticity issues. The model is feasible to use since the F-test showed a significant value. As shown in Equation 3, the results demonstrated that TAX has a significant negative effect on FQ; therefore, H_1 is accepted. Furthermore, the results also demonstrated that FDS acts as a quasi-moderator since it affects FQ and moderates the effect of TAX on FQ. From this, it can be determined that H_2 is accepted. When FDS acts as another predictor of FQ, the results showed that it has a significant and positive effect on FQ. However, in the interaction term, FDS strengthens the negative effect of TAX on FQ, indicating that TAX further harms FQ when the firm itself is experiencing financial distress. From this, it can be determined that H_2 is accepted. The R-squared value of 0.6054 indicates that the model can explain FQ by 60.54%, with the remaining explained by other variables not covered in this study.

Table 4. Hypothesis Testing

Description	Equation 1 FQ	Equation 2 FQ	Equation 3 FQ
TAX	-1.862806*** (0.000)	-1.861719*** (0.000)	-1.369385*** (0.000)
SIZE	-0.0006585 (0.512)	-0.0006682 (0.508)	-0.0003925 (0.692)
FDS		5.93e-06 (0.741)	0.0000397*** (0.000)
TAX*FDS			0.043187** (0.011)
Constant	0.0351526 (0.214)	0.0355278 (0.212)	0.0289805 (0.300)
Prob > F	0.0000***	0.0000***	0.0000***
R-squared	0.5895	0.5896	0.6054

*Notes: robust p-values in parentheses, ***p < 0.01, **p < 0.05, *p < 0.1*

3.2. Discussion

Accepting H1, the findings of this study showed that tax avoidance has a significant negative effect on firm quality. This finding suggests that firms engaging in higher levels of tax avoidance tend to exhibit lower levels of firm quality. One possible explanation for this is

that aggressive tax strategies reflect short-term opportunistic behaviour that deteriorates long-term firm performance and erodes stakeholder trust. Investors and other stakeholders may perceive such firms as less trustworthy, leading to reputational damage and reduced market confidence. As mentioned by Velte (2023) and I. Hasan et al. (2022), both foreign and sustainable institutional investors are not in favour of tax avoidance practices since these practices result in higher information asymmetry, managerial opportunistic behaviour, and agency conflicts. Corporate tax avoidance may also be a sign of weak corporate governance within the firm, where managers themselves employ strategies that enable them to achieve their gains, such as higher bonuses or compensation, at the expense of the firm's long-term performance (Koay & Sapiei, 2025). Such behaviour reflects managerial opportunism and may increase agency costs, both of which are detrimental to firm quality. In this sense, the risk compensation theory supports the idea that the perceived 'gain' from tax avoidance is not neutral. It may result in behavioural distortions within the firm that lead to excessive risk-taking, which, in turn, negatively impacts firm quality.

Accepting H2, the findings of this study also showed that financial distress strengthens the negative effect of tax avoidance on firm quality. Additionally, financial distress itself also has a significant positive effect on firm quality. When firms are under financial distress, they may rely more heavily on aggressive tax avoidance strategies as a short-term measure to alleviate financial pressure and preserve cash flow. However, rather than improving firm performance, this strategy may backfire. Financially distressed firms often already suffer from strained resources and reduced strategic flexibility (Altman et al., 2019). Engaging in tax avoidance under such conditions may further erode transparency, increase regulatory scrutiny, and signal desperation to stakeholders, all of which can damage credibility and worsen firm quality. From the perspective of the risk compensation theory, this interaction can be interpreted as a behavioural adjustment mechanism. During times of financial distress, the firm may regard tax avoidance as a reasonable strategy to overcome financial distress, as survival becomes a perceived immediate priority. Nonetheless, this does not necessarily mean that the actual risk is lower; rather, it signifies that the risk tolerance threshold is greater under financial distress. As a result, these firms may overcompensate by engaging in riskier tax avoidance tactics that ultimately accelerate the worsening of firm quality.

Since the results show that financial distress acts as a quasi-moderator, it means that it can have an effect on firm quality itself. Based on the descriptive statistics as shown in Table 2, since the mean Z''-Score is above 5.85, it implies that the firms examined in this study are financially healthy. This raises an important nuance in which the positive effect of financial distress is not being driven by distress, but rather by variations in financial pressure within a relatively healthy sample. Firms that are still fundamentally sound but experiencing mild to moderate financial strain may respond by adopting more disciplined management practices. These may include tighter cost control, careful investment decisions, operational streamlining, as well as enhanced governance, all of which can improve firm quality. This supports the idea that a certain and mediocre level of distress can be beneficial, as it reduces slack and forces firms to focus on long-term sustainability.

This study offers both theoretical and practical implications. Theoretically, this research enhances tax avoidance literature by examining how it affects firm quality, especially in times of financial distress. This adds a nuanced perspective to prior research, which often treated tax avoidance as a standalone determinant of firm outcomes. By demonstrating that financial distress can intensify the adverse effects of tax avoidance, this study provides deeper insights into how internal financial conditions shape the consequences of corporate tax

behaviour. Further, the incorporation of the risk compensation theory as an explanatory framework expands the theoretical lens used in corporate finance research by linking behavioural responses to perceived reductions in risk. Practically, the findings offer valuable guidance for corporate decision-makers. While tax avoidance may appear beneficial in the short term by reducing tax expenses, the evidence suggests that such strategies, particularly under conditions of financial distress, can be damaging to overall firm quality. Management should therefore exercise caution when implementing tax avoidance strategies, especially when the firm is facing distress. Instead of relying on aggressive tax strategies, firms are encouraged to prioritize long-term value creation and stakeholder trust.

4. Conclusion

This research aims to obtain empirical evidence on the effect of tax avoidance on firm quality, moderated by financial distress. The results revealed that tax avoidance has a significant negative effect on firm quality, indicating that tax avoidance practices used by the firm harm firm quality as perceived by the market. Moderation analysis also showed that this negative effect is greater when the firm is experiencing financial distress. In addition, it is also found that financial distress itself has a significant positive effect on firm quality when it acts as another predictor.

In light of these conclusions, this study is not without limitations, along with opportunities for future research. First, this research was not able to specifically select firms that are under conditions of financial distress based on the critical value of the Z”-Score because the limited sample size could constrain the feasibility of employing the analysis technique. Aside from this, this research was unable to determine whether conforming tax avoidance could have also affected firm quality, as CETR only reflects non-conforming tax avoidance and does not reflect conforming tax avoidance. Correspondingly, future research could explore more than one sector so that the sample size of financially distressed firms would be sufficient. Future research could also use other proxies that would reflect both non-conforming and conforming tax avoidance.

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