“The reciprocal effect of environmental, social, and governance (ESG) practices and tax aggressiveness in Indonesian and Malaysian companies”


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# THE RECIPROCAL EFFECT OF ENVIRONMENTAL, SOCIAL, AND GOVERNANCE (ESG) PRACTICES AND TAX AGGRESSIVENESS IN INDONESIAN AND MALAYSIAN COMPANIES

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## Abstract

This study highlights the complexity of the relationship between sustainability performance, environment, social and governance (ESG) reporting, and tax aggressiveness, which is a critical concern amidst the increasing demands for corporate social accountability. Companies in Indonesia and Malaysia, especially those in the non-financial sector, face increasing regulatory pressure to meet ESG standards. This study uses 263 Indonesian and 311 Malaysian companies as samples because both countries are prominent emerging markets in Southeast Asia with fast-growing economies, diverse industries, and abundant natural resources. However, aggressive tax avoidance remains a common strategy to maintain financial flexibility. This study aims to examine whether companies with high ESG performance tend to reduce tax avoidance practices or use it as a strategy to cover ESG costs. Through 2SLS regression analysis on 2012–2021 data, the results show that ESG performance has a significant positive effect on tax aggressiveness, where companies with high ESG performance also tend to engage in tax avoidance to cover ESG costs. Conversely, tax aggressiveness positively affects ESG performance because companies increase ESG engagement to reduce reputational risks from aggressive tax practices. The simultaneous test found a reciprocal relationship between the two variables with an $R^2$ value of 29.4% for tax aggressiveness and 63.1% for ESG performance. This study suggests stricter regulations to reduce tax avoidance in companies with high ESG performance and provides insights for policymakers in Southeast Asia.

**Keywords** ESG performance, tax aggressiveness, sustainability performance, Indonesia, Malaysia

**JEL Classification** Q56, H26, M41, M48

## INTRODUCTION

Attention to environmental, social, and governance (ESG) practices has continued to increase, especially in developing countries such as Indonesia and Malaysia. ESG has become an influential indicator in assessing a company's sustainability and social responsibility, and it now plays a major role in business reputation (Pamungkas et al., 2024). On the other hand, the practice of tax aggressiveness, which is a company's strategy to minimize tax liabilities, remains a major issue that reflects management efficiency while also giving rise to ethical and legal risks. The relationship between ESG and tax aggressiveness is interesting to study because both have the potential for reciprocal effects. Companies with high ESG performance tend to avoid tax aggressiveness practices to maintain transparency and social responsibility. Conversely, companies involved in tax aggressiveness can be considered to be neglecting their social responsibilities, which has the potential to damage their reputation and ESG performance. This com-

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plex relationship can be influenced by each country's institutional and regulatory contexts. Interestingly, few studies have examined this dynamic interaction in developing countries, thus opening up a space for exploration that can provide new insights into this relationship in a different context from developed countries.

Indonesia and Malaysia were chosen as research objects because of their characteristics as developing countries with similar economic structures but differences in tax and ESG regulations. Both countries have experienced significant developments in corporate sustainability reporting, with Indonesia requiring ESG reporting through the Financial Services Authority (OJK) since 2020, while Malaysia has previously implemented sustainability. In terms of taxation, Indonesia implements a self-reporting-based supervision system with a corporate tax rate of 25%, but the average effective tax rate (ETR) of companies is only 22% (Hasibuan & Khomsiyah, 2019), indicating high tax aggressiveness practices. In Malaysia, the average ETR of 24% (Wahab et al., 2017) also reflects similar practices, although this country offers more tax incentives. In addition, the combination of different regulations and the level of development of ESG and tax aggressiveness provides a unique basis for identifying institutional factors that influence the relationship between the two aspects.

This study is expected to provide in-depth insights into the relationship between ESG and tax aggressiveness in developing countries. Through this analysis, companies can understand how to balance tax efficiency with social responsibility, while policymakers can use these findings to design regulations that encourage sustainability without sacrificing tax compliance aspects.

## 1. LITERATURE REVIEW

This analysis uses the stakeholder theory. Stakeholders view tax aggressiveness as unethical and irresponsible behavior (Amidu et al., 2016). Through tax aggressiveness, companies shift their tax obligations onto other entities, such as the government and society, despite taxes being essential for funding infrastructure that indirectly supports the company's operations.

Tax aggressiveness involves manipulating the reduction of taxable income through various tax planning strategies, including tax evasion or other means (Frank et al., 2009). There is a concern that such practices may encourage opportunistic behavior by management without considering the company's long-term sustainability, as desired by shareholders (Minnick & Noga, 2010). ESG can potentially affect tax aggressiveness related to the systems and processes that companies implement for public welfare (Lanis & Richardson, 2012; Hajawiyah et al., 2022; Pranata et al., 2021).

Companies might see tax payments as harmful to societal welfare, as they could limit innovation, job creation, and economic growth. Profit-driven organizations are often seen as more efficient than governments in resource allocation. As a result, reducing tax obligations is likely to increase social benefits. Tax payments substitute CSR activities if tax-avoidant companies increase their CSR activities to cover up their opportunistic behavior. The effectiveness of sustainability activities can be measured by sustainability performance, and companies with good sustainability performance also have high effectiveness in sustainability activities.

ESG represents the company's level of awareness. Responsible ESG initiatives encourage greater regulatory compliance, discouraging companies from engaging in tax aggressiveness. However, previous studies examining the relationship between ESG and tax aggressiveness have yielded mixed findings. Some research suggests that ESG may reduce tax aggressiveness, indicating a negative correlation between the two. Corporate social responsibility (CSR) reduces tax aggressiveness, as demonstrated by the findings of Zeng (2021), Qodraturrasyid (2017), Karthikeyan and Jain (2017), Lanis and Richardson (2012, 2015), Hoi et al. (2013), and Shafer and Simmons (2008).

However, other studies have concluded that ESG positively affects tax aggressiveness (Mao, 2019;


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Marsdenia & Martani, 2018) and that ESG activities do not correlate with tax aggressiveness. Companies still engage in tax aggressiveness even though they have implemented ESG, especially countries that engage in transactions with tax haven countries (Rusydi & Siregar, 2014).

On the other hand, ESG is viewed as a means to evade tax obligations or disguise the opportunistic behavior of the company in evading taxes (Pratiwi & Djakman, 2017). ESG is inversely related to the effective tax rate (ETR) and directly associated with expenditures on tax lobbying, which positively influences tax avoidance (Davis et al., 2016). ESG and tax payments are substitutionary. Davis et al. (2016) also examined the simultaneous relations between ESG and tax aggressiveness with the 3SLS method. Socially responsible companies do not pay higher taxes than their counterparts, indicating that managers and stakeholders of these companies do not see tax payments as a complement to their ESG initiatives.

This difference in perspective motivates researchers to examine whether ESG and tax payments are complementary or substitution. If companies view tax payments in the same way as ESG activities, then they are complementary. Tax payments are positively related to ESG because companies are responsible to society, and ESG is used to maximize shareholder wealth (Garriga & Mele, 2004). Companies that consider ESG important will dedicate their resources to socially responsible activities.

Previous research has primarily examined the effect of sustainability performance on tax aggressiveness, resulting in negative, positive, or no influence. Several recent studies have shown the impact of tax aggressiveness on sustainability performance, which results in sustainability performance having a positive effect on tax aggressiveness. Based on these facts, examining the simultaneous relations between sustainability and tax aggressiveness is necessary to overcome endogeneity that can affect results if not tested.

This study examines the reciprocal relationship between sustainability performance and tax aggressiveness. Previous research only partially analyzed the relationship between sustainability performance and tax. This study also differs from prior research on using ESG rating as a proxy for measuring sustainability performance and testing the reciprocal relationship between sustainability performance and tax aggressiveness in Indonesia and Malaysia.

The object of this study is Indonesia and Malaysia, analyzing different research contexts compared with previous studies and enriching the literature to cause differences in sustainability performance and tax aggressiveness. The study employs corporate culture theory to test the effect of sustainability performance on tax aggressiveness and risk management theory to test the impact of tax aggressiveness on sustainability performance. This study was conducted with a quantitative approach using 2SLS regression to examine the relationship between sustainability performance and tax aggressiveness. This study sampled non-financial companies listed on the Indonesia Stock Exchange, covering the observation period from 2012 to 2021. The data sources consist of secondary data, including annual and sustainability reports.

This study addresses the previously identified research gap by examining the reciprocal relationship between sustainability performance and tax aggressiveness in Indonesia and Malaysia. Reputation is significant according to the legitimacy strategy. Companies are encouraged to voluntarily disclose information on ESG activities to relevant stakeholders to enhance legitimacy and preserve their reputation. This increased transparency is expected to lead to more prudent approaches regarding tax aggressiveness (Lanis & Richardson, 2012).

ESG activities and fulfilling tax obligations are often viewed as significant expenses for companies, leading many to engage in ESG as a strategy for tax avoidance to reduce tax expenses (Rusydi & Siregar, 2014). Firms that do such actions are deemed irresponsible toward society (Lanis & Richardson, 2012). In contrast, firms that actively participate in environmental activities are regarded as responsible and have better ethics, which helps them maintain a positive reputation (Shafer & Simmons, 2008).

According to the theory of corporate culture, firm actions should embody the principles of ethical conduct (Col & Patel, 2019), which leads to a negative correlation between ESG and tax aggressiveness. Companies are expected to refrain from engaging in activities that could negatively affect society. Companies align themselves with socially responsible practices by implementing ESG initiatives to benefit stakeholders, including the government. Consequently, tax aggressiveness is perceived as incompatible with ESG, and firms committed to social responsibility typically exhibit lower tax aggressiveness.

ESG activities can succeed in business through acceptance in the community (Lanis & Richardson, 2012). The company has an indirect contribution to society through taxes paid. ESG activities and fulfillment of tax obligations must be carried out simultaneously as a legitimacy strategy so that the company is accepted by the community (legitimacy theory).

This study uses risk management theory to examine the effect of tax aggressiveness on sustainability performance. The company aims to increase ESG activities to minimize reputational risks because of aggressive tax minimization practices. Tax avoidance has a positive effect on ESG. Companies manage reputational risks linked to unethical corporate actions, such as tax avoidance, and seek to maximize shareholder value by enhancing their ESG efforts to strengthen their public image. ESG-focused firms are likely to carefully assess the potential risk of damaging the legitimacy they have established through ESG initiatives when engaging in opportunistic practices like tax aggressiveness. Therefore, companies that have built legitimacy through ESG activities will consider the risks generated by tax aggressiveness practices, one of which, if exposed, will damage the legitimacy of the society.

When stakeholders discover the aggressiveness of corporate taxes, community legitimacy will decrease, thus disrupting the firm's activities and sustainability. Companies use ESG to minimize the risk of declining legitimacy because tax minimization practices are primarily related to public perceptions and expectations.

Some studies examine the effect of tax aggressiveness on environmental, social, and governance practices. Pratiwi and Djakman (2017) discovered that firms involved in tax aggressiveness tend to have a broader ESG disclosure to uphold the legitimacy of their operational activities and mask their opportunistic behavior. Companies that actively violate tax regulations generate more ESG disclosures to cover up their opportunistic behavior (Lanis & Richardson, 2013). ESG disclosures are used to cover up their opportunist actions and maintain legitimacy for society and the environment. The firm's legitimacy will be threatened when the public realizes that firms avoid tax, which can disrupt the company's operational activities.

Tax avoidance is positively correlated with ESG rating. Corporate tax reduces ESG behavior, and tax aggressiveness positively affects ESG (Gandullia & Piserà, 2020). ESG could be seen as an investment in intangible assets. If companies believe that ESG is one of the investment choices, then the minimization of tax can affect ESG investments as they affect other investment decisions (Gandullia & Piserà, 2020).

Taxes majorly influence a company's investment decisions, and taxes affect incentives to accumulate capital and invest in innovation (Gandullia & Piserà, 2020). The government should lower tax rates to encourage companies to do ESG (Gandullia & Piserà, 2020). The government should provide tax incentives through tax credits on R&D investment.

Col and Patel (2019) tested tax aggressiveness to ESG. Companies that engage in aggressive tax avoidance by establishing offshore entities in tax-heaven countries increase their ESG ratings (Sikka, 2010; Davis et al., 2016). Companies that claim to be socially responsible are also actively involved in tax avoidance.

Tax aggressiveness positively affects ESG disclosure. As unethical actions of a company become more frequent, such as tax evasion, the level of ESG disclosure will increase. ESG can represent an excellent reputation to firms' stakeholders (Hoi et al., 2013). Tax aggressiveness practices can damage reputation. This indicates that companies use ESG disclosures to manage risk and cover up irresponsible behaviors such as tax evasion. This will result in ESG having a positive effect on tax avoidance.


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Companies can utilize ESG disclosures to establish a positive reputation for stakeholder accountability, mitigating the risk of unethical behaviors like tax avoidance. Companies that actively practice tax avoidance will disclose higher ESG to maintain public legitimacy for the firm's activities. The broader ESG disclosure will minimize the risk of tax avoidance practices and maintain the firm's reputation. Opportunistic companies may leverage ESG as a risk management approach in response to tax avoidance.

Davis et al. (2016) concluded that ESG is inversely associated with tax expenses and positively correlated with tax lobbying expenditures, facilitating tax avoidance. They concluded that spending on ESG and tax payments are substitutive. Davis et al. (2016) employed the 3SLS method to examine the relationship between ESG and tax aggressiveness. Their study determined that socially responsible companies do not incur higher tax payments than others, indicating that managers and stakeholders of these companies do not perceive tax payments as complementary to ESG activities.

The company engages in ESG activities to mitigate the negative image associated with tax minimization. The advantages of ESG initiatives are partly influenced by the degree of tax aggressiveness, while the costs of tax aggressiveness are related to the extent of ESG activities. There is a positive relationship between ESG and tax avoidance and a positive impact of tax avoidance on ESG (Davis et al., 2016). The firms' ESG performance shows their sustainability performance.

This study aims to test sustainability performance and tax aggressiveness reciprocally to check the influence of both, previously studied separately. Existing research only examines the effect of sustainability performance on tax aggressiveness and the impact of tax aggressiveness on sustainability performance separately. This study combines the two to test whether sustainability performance and tax aggressiveness have a simultaneous or reciprocal relationship. Simultaneous relationship testing is also valuable for checking whether endogeneity is present. The hypotheses are as follows:

*H1:* *Sustainability performance negatively affects tax aggressiveness.*

*H2:* *Tax aggressiveness positively affects sustainability performance.*

*H3:* *There is a reciprocal relationship between sustainability performance and tax aggressiveness.*

## 2. METHOD

This study used a quantitative approach with 2SLS regression to test the reciprocal relations between sustainability performance and tax aggressiveness. Panel data regression was also conducted to investigate the effect of sustainability performance on tax aggressiveness and tax aggressiveness on sustainability performance individually.

This study used a sample of non-financial companies listed on the Indonesia Stock Exchange (IDX) and Bursa Malaysia (Malaysia Stock Exchange/MYX) during 2012–2021. Purposive sampling is used to eliminate data that do not match the criteria. The non-financial sector is chosen due to its significant environmental and social impact, especially in industries like manufacturing, agriculture, energy, and mining, which often face intense scrutiny regarding their ESG practices. These industries tend to have a larger carbon footprint and are more directly involved with local communities, making ESG performance critical. Simultaneously, they also have greater opportunities for aggressive tax strategies, such as using capital investment incentives and transfer pricing, making them ideal for examining the relationship between sustainability and tax avoidance.

This study sampled 263 Indonesian and 311 Malaysian companies. Companies in Indonesia and Malaysia are selected as samples in this study because both nations are prominent emerging markets in Southeast Asia with fast-growing economies. Their industries are diverse, spanning sectors like agriculture (e.g., palm oil in Malaysia and forestry in Indonesia), manufacturing, and mining, each with unique ESG challenges and tax scrutiny. Additionally, their abundant natural resources position companies in these countries as key players in tackling global environmental issues such as deforestation, carbon emissions, and biodiversity loss. Social and governance concerns, including labor practices, further highlight the importance of examining their ESG performance.

Choosing Malaysia and Indonesia provides a comparative analysis of how different regulatory environments shape corporate behavior. Malaysia has a more developed regulatory framework for ESG, with Bursa Malaysia requiring public companies to disclose their sustainability initiatives. This allows the study to investigate whether stricter regulations correlate with reduced tax aggressiveness among companies with strong ESG performance. Conversely, Indonesia faces greater challenges in integrating ESG, particularly in high-impact sectors such as palm oil, mining, and energy. While Indonesia has initiatives like environmental laws and REDD+ protocols, ESG implementation remains inconsistent, providing a unique opportunity to explore whether firms with better ESG ratings in Indonesia also engage in less aggressive tax practices.

The study employs legitimacy theory to explain how companies might avoid tax aggressiveness to maintain social legitimacy through stronger ESG commitments while also considering the trade-off theory, which posits that companies may prioritize short-term tax savings over long-term ESG investments. By comparing companies in two countries with differing regulations and cultural attitudes, this paper aims to assess how these factors influence the relationship between ESG performance and tax aggressiveness. In Malaysia, stricter governance and transparency might deter tax avoidance, while in Indonesia, the regulatory environment and corporate culture may still tolerate higher levels of tax aggressiveness despite ESG claims.

The dependent variable in model 1 is tax aggressiveness, while the dependent variable in model 2 is sustainability performance. Tax aggressiveness is proxied by ETR, while sustainability performance is measured by ESG rating obtained from the Thomson Reuters Database. Environmental, social, and governance (ESG) aspects are indicators of a company that include issues of ethics, corporate governance, and sustainability. This study uses ESG data from Thomson Reuters Eikon. ESG score is a metric score that contains the overall value of a company's sustainability performance. ESG scores consist of three pillars: (1) environmental pillar, (2) social pillar, and (3) government pillar.

This study uses the effective tax rate (ETR) to measure corporate tax aggressiveness. The ETR represents the tax rate applied to each unit of a company's currency and is determined based on the taxpayer's income. It is calculated by dividing taxes paid by pretax income, with a lower ETR indicating higher tax aggressiveness. ETR proxies are among the most widely used measures in research concerning tax aggressiveness. This study used GAAP ETR with the numerator of tax burden.

$$ETR_{i,t} = \frac{CTE_{i,t}}{AI_{i,t}}, \tag{1}$$

where $ETR_{i,t}$ – Effective Tax Rate, $CTE_{i,t}$ – Current Tax Expense, $AI_{i,t}$ – Accounting Income.

The variables controlled for in analyzing the relationship between ESG and tax aggressiveness are leverage, firm size, capital intensity, profitability,

**Table 1.** Definition and operationalization of the variables

| Variable | Definition |
|---|---|
| $TaxAg_{i,t}$ | Tax aggressiveness: measured by ETR |
| $ESG_{i,t}$ | Sustainability performance: measured by ESG rating |
| $LEV_{i,t}$ | Leverage: total debt divided by total assets |
| $SIZE_{i,t}$ | Company size: the natural logarithm of total assets |
| $CAPINT_{i,t}$ | Capital intensity: fixed assets divided by the total assets |
| $ROA_{i,t}$ | Return on assets: net profit after tax divided by total assets |
| $MBV_{i,t}$ | The ratio of market value to book value of a company's equity |
| $INVINT_{i,t}$ | Inventory intensity: Inventory ownership (inventory divided by the company's total assets) |
| $CGOV_{i,t}$ | Country governance is a control variable of governance in each country. It is measured by the Worldwide Governance Indicators (WGI) issued by the World Bank |


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market-to-book value, and inventory intensity. Previous studies have shown that these factors influence tax aggressiveness and are incorporated as control variables in the analysis. Table 1 provides the definitions and operationalization of the variables.

The equations used in research models are as follows:

$$TaxAg_{i,t} = \alpha + \beta_1 ESG_{,t} + \beta_2 LEV_{i,t} + \beta_3 SIZE_{i,t} + \beta_4 CAPINT_{i,t} + \beta_5 ROA_{i,t} + \beta_6 CGOV_{i,t} + \beta_7 INVINT_{i,t} + \varepsilon_{i,t}. \quad (2)$$

$$ESG_{i,t} = \alpha + \beta_1 TaxAg_{,t} + \beta_2 LEV_{i,t} + \beta_3 SIZE_{i,t} + \beta_4 CAPINT_{i,t} + \beta_5 ROA_{i,t} + \beta_6 CGOV_{i,t} + \beta_7 MBV_{i,t} + \varepsilon_{i,t}. \quad (3)$$

# 3. RESULTS AND DISCUSSION

This study used 263 Indonesian companies and 311 Malaysian companies as representative samples. The sampling was carried out using a purposive technique, with the criteria shown in Table 2. Table 3 shows descriptive statistical analysis.

Table 3 shows that the average ESG value is 0.462. A high ESG value indicates that the company is more committed to environmental, social, and governance practices. Companies with high ESG values will be more attractive to investors who prioritize sustainability. The average tax aggressiveness value of –0.251 indicates the company's tendency to implement an aggressive tax strategy. This indicates tax avoidance practices, which can affect state revenues and public welfare. An aggressive tax strategy can increase short-term profitability but has the potential to pose long-term legal and reputational risks.

Control variables used in this study are leverage, with an average of 0.256, indicating that most companies have a low to medium debt-to-asset ratio. In comparison, the average company size is 7.797, with a standard deviation of 1.361. A larger company size can support the stability and resilience of the company but can also pose challenges related to efficiency. The capital intensity ratio, with an average value of 0.710, indicates a large investment in fixed assets. The average ROA value of 9.290 indicates a relatively high level of profitability, indicating the company's operational efficiency in generating profits. The high average MBV ratio of 6.690 indicates

**Table 2.** Sample selection criteria

| Criterion | Number of Samples | | |
|---|---|---|---|
| | Indonesia | Malaysia | Total |
| Non-financial company listed on IDX/MYX | 756 | 950 | 1.706 |
| Companies with final tax | (210) | (222) | (432) |
| After industry elimination | 546 | 728 | 1.274 |
| **Firm-year=samples per year * 10** | **5.460** | **7.280** | **12.740** |
| Companies that do not have an ESG score | (5.165) | (6.852) | (12.017) |
| Incomplete company data | (32) | (117) | (149) |
| **Total number of analysis units** | **263** | **311** | **574** |

**Table 3.** Descriptive statistics

| Variable | Mean | Std. Dev. | Min | Max |
|---|---|---|---|---|
| ESG | 0.462 | 0.194 | 0.030 | 0.892 |
| TaxAg | – 0.251 | – 0.128 | – 0.001 | – 0.992 |
| Lev | 0.256 | 0.177 | – | 0.800 |
| Size | 7.797 | 1.361 | 2.140 | 10.718 |
| Capint | 0.710 | 0.435 | 0.013 | 2.846 |
| ROA | 9.290 | 9.297 | – 11.960 | 62.121 |
| MBV | 6.690 | 17.274 | – | 274.821 |
| Invint | 0.095 | 0.117 | – | 0.693 |
| Cgov | 0.104 | 0.314 | – 0.382 | 0.476 |

that the market values the company higher than its book value. The average investment intensity of 0.095 indicates that the company allocates a small portion of its assets for investment. Moreover, the average corporate governance value of 0.104 indicates a diverse level of corporate governance among the samples.

This study partially examines the impact of each independent on the dependent variable. The test was carried out by examining the value of the variable significance at the significance level of 0.05 (5%). The partial test results of multiple linear regression equations are presented in Table 4 for model 1.

**Table 4.** Multiple regression results for model 1

| Dependent: TaxAg | Coef. | P>z |
|---|---|---|
| ESG | 0.065 | 0.094* |
| Lev | –0.269 | 0.001*** |
| size | 0.033 | 0.077* |
| Capint | –0.064 | 0.031** |
| Roa | 0.002 | 0.073* |
| CGV | 0.014 | 0.408 |
| invent | 0.039 | 0.415 |

*Note:* ***significance at 1%, **significance at 5%, *significance at 10%.

Based on Table 4, sustainability performance significantly positively affects tax aggressiveness. This suggests that the first research hypothesis is not supported (significant but in different directions). Sustainability performance has yet to be proven to minimize the company's tax aggressiveness. Companies that have high sustainability performance also have high tax aggressiveness. The positive influence of sustainability performance on tax aggressiveness may occur because companies consider that the company's ESG activities require costs, so the company carries out tax aggressiveness activities to make savings. The company will choose ESG activities that can be charged according to taxes. ESG activities and tax payments are substitutionary, meaning that when companies incur high costs to carry out ESG activities with evidence of increased ESG performance, the company will minimize tax payments by doing tax aggressiveness. The results of this study support Davis et al. (2016), who concluded that socially responsible companies do not pay higher taxes than other companies.

This study aligns with the findings of Rusydi and Siregar (2014). Companies regarded ESG activities and tax obligations as significant expenses. As a result, many organizations engage in ESG to pursue aggressive tax strategies to minimize their tax liabilities. These results do not support corporate culture theory or earlier studies by Lanis and Richardson (2012), Hoi et al. (2013), and Qodraturrasyid (2017), which indicate that sustainability performance influences tax aggressiveness. The control variables affecting model 1 include leverage, size, capital intensity, and return on assets (ROA).

Sustainability reporting and tax aggressiveness are grounded in the principle that companies committed to transparency and ethical practices are less likely to engage in aggressive tax strategies. Sustainability reporting, which involves the disclosure of environmental, social, and governance (ESG) practices, exposes companies to greater scrutiny from stakeholders such as governments, investors, and the public. As firms enhance transparency through sustainability reports, they are under pressure to align their tax practices with the broader ethical standards they promote. Engaging in tax aggressiveness would contradict the responsible image projected by sustainability reporting, potentially leading to reputational damage and stakeholder backlash.

According to Lanis and Richardson (2013), companies that disclose sustainability initiatives tend to refrain from tax avoidance because such strategies undermine their credibility. Furthermore, Hoi et al. (2013) suggest that companies with firm sustainability profiles often adopt ethical tax management approaches, reducing their likelihood of aggressive tax planning. By maintaining a commitment to ethical and transparent practices, firms minimize reputational risk and avoid conflicting with the principles of corporate responsibility emphasized in sustainability reports. Consequently, companies that publish comprehensive sustainability reports typically avoid aggressive tax strategies, instead aligning their financial practices with the broader social and ethical expectations set by their sustainability commitments.


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**Table 5.** Multiple regression results for model 2

| Dependent: ESG | Coef. | P>z |
|---|---|---|
| TaxAg | 0.046 | 0.097* |
| Lev | –0.077 | 0.130 |
| size | –0.083 | 0.000*** |
| Capint | –0.088 | 0.002*** |
| Roa | 0.002 | 0.015** |
| CGV | –0.321 | 0.000*** |
| MBV | –0.000 | 0.369 |

*Note:* ***significance at 1%, **significance at 5%, *significance at 10%.

Table 5 tests model 2. Tax aggressiveness has a significant positive effect on sustainability performance. This suggests that the second research hypothesis is supported. The research results support risk management theory, which states that companies increase ESG activities to minimize reputational risks arising from the company's tax aggressiveness practices. The risk of decreasing legitimacy due to tax aggressiveness practices can be minimized with the company's ESG activities. Companies that actively violate tax regulations generate more ESG disclosures to cover up their opportunistic behavior (Lanis & Richardson, 2013).

This finding is in line with Davis et al. (2016) and Pratiwi and Djakman (2017). When tax avoidance is perceived as irresponsible, when the action is detected, the public will perceive that the company is not responsible. This perception can threaten the company's sustainability because it can damage the legitimacy built. Thus, the company will carry out better ESG activities to signal its excellent attention and responsibility to the environment and surrounding communities. This will restore the company's reputation. The influential control variables are firms' size, capital intensity, profitability, and governance.

Tax aggressiveness is often viewed as a company's effort to minimize tax liabilities through aggressive tax planning or avoidance, either within legal boundaries or beyond. Although such practices are typically perceived negatively by the public and government, companies engaged in tax aggressiveness might increase their involvement in sustainability reporting to manage public and regulatory perceptions.

Huseynov and Klamm (2012) indicate that companies prone to aggressive tax practices are often more active in publishing sustainability reports to project an image of social responsibility. Sustainability reporting enhances corporate legitimacy in the eyes of the public and stakeholders. In this context, sustainability reporting acts as a legitimate strategy that balances the potential negative impact of aggressive tax practices.

Similarly, Kim et al. (2011) concluded that companies with high tax aggressiveness often disclose more environmental, social, and governance (ESG) activities in their impression management. By disclosing sustainability efforts, these companies aim to divert attention from tax authorities and appease other stakeholders who may be critical of their tax practices. This suggests a positive relationship where companies involved in aggressive tax strategies tend to increase sustainability reporting to counterbalance negative perceptions.

Furthermore, Lanis and Richardson (2013) support this view, showing that companies engaged in tax aggressiveness have incentives to intensify environmental disclosure or sustainability reporting. This is done to build legitimacy in the eyes of the public and create a positive corporate image, thus obscuring their aggressive tax behavior.

Additionally, Hoi et al. (2013) identified that higher sustainability reporting by companies with aggressive tax behavior is a means to mitigate reputational risk. In other words, companies are motivated to invest more in sustainability reporting to maintain positive relationships with the public and regulators, even while engaging in tax aggressiveness behind the scenes.

Companies that engage in tax avoidance or aggressive tax strategies use sustainability reports to maintain a positive public image. By enhancing sustainability reporting, companies can improve public perception and minimize the negative impact of their aggressive tax strategies. Previous research (Jatiningrum et al., 2024; Kim et al., 2011; Lanis & Richardson, 2013; Hoi et al., 2013) has demonstrated this link, where tax aggressiveness is often accompanied by more extensive sustainability reporting as a form of reputational compensation.

Based on the simultaneity test conducted, there is a simultaneous relationship between sustainability performance and tax aggressiveness. Sustainability performance has a positive effect on tax aggressiveness, and tax aggressiveness positively impacts sustainability performance. The test results together can be seen from the *F* statistical test, which shows Prob *F* for model 1 and model 2 of 0.0000 or less than alpha 0.05 so that the variation of independent variables can explain the variation of the dependent variable. The *R* square (*R2*) in model 1 (Dependent TaxAg) and model 2 (Dependent ESG) was 29.4% and 63.1%, respectively.

Companies that improve their ESG performance, particularly in governance, are more likely to adopt tax strategies that are effective but moderate. These firms may use legitimate tax planning to optimize financial stability while ensuring their ESG commitments remain intact. By efficiently managing taxes, companies can allocate resources to sustainability initiatives and social responsibility without risking reputational harm due to aggressive tax practices.

On the other hand, firms that adopt more efficient tax strategies, such as leveraging legitimate tax incentives for environmental and social investments, can enhance their ESG performance. For instance, tax breaks for renewable energy investments or philanthropic activities can boost a company's environmental (E) and social (S) contributions. In this way, companies can benefit financially from strategic tax management while strengthening their ESG credentials.

ESG and tax aggressiveness are two important aspects that influence each other in a reciprocal manner. ESG refers to a company's commitment to operate in an ethical and socially responsible way. At the same time, tax aggressiveness involves strategies that firms use to minimize their tax liabilities, often pushing the boundaries of legal and regulatory frameworks. A reciprocal relationship between these two concepts arises because companies engaged in ESG may experience external pressure to be transparent and ethical in all areas, including tax practices. Firms with strong ESG programs might avoid aggressive tax strategies to maintain a reputation for integrity and social responsibility. Conversely, companies involved in tax aggressiveness may use ESG initiatives to offset negative perceptions or to distract stakeholders from questionable tax behavior. However, in some cases, ESG may also be used as a legitimizing tool to justify tax-saving actions as efforts to allocate resources for social good. This complex interplay shows that ESG and tax aggressiveness can either reinforce ethical conduct or create opportunities for strategic manipulation, depending on the firm's objectives and the regulatory environment.

Over the long term, companies with strong ESG performance and prudent tax management can build better relationships with stakeholders, including tax regulators and local communities. These companies are also less likely to face fines or legal issues related to taxes, allowing them to focus more on sustainability and social responsibility efforts. This creates a mutually reinforcing cycle where strong ESG reduces tax risks, and sound tax strategies support ESG initiatives.

The implementation of ESG and tax aggressiveness plays a significant role in enhancing a company's value. ESG initiatives, when aligned with a company's mission, can boost its reputation, build stronger relationships with stakeholders, and increase customer loyalty, all of which contribute to long-term profitability. By demonstrating a commitment to ethical practices and social well-being, companies can attract socially conscious investors and reduce risks related to regulatory scrutiny or public backlash. On the other hand, when managed carefully, tax aggressiveness can reduce a company's tax burden, leading to increased cash flow and financial resources that can be reinvested in growth initiatives or returned to shareholders. However, it is crucial for companies to strike a balance, as excessive tax aggressiveness may harm their reputation or attract legal consequences. Therefore, integrating responsible tax strategies with a robust ESG framework not only safeguards the company's ethical standing but also maximizes financial performance, ultimately enhancing overall firm value.

This study contributes to the understanding of how regulatory frameworks, corporate culture,


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and business structure influence the interplay between ESG and tax strategies. By examining two countries with distinct economic and social contexts, the paper identifies regional differences in ESG and tax practices, evaluates the effectiveness of sustainability regulations in curbing tax avoidance, and provides policy recommendations for regulators in both countries. Ultimately, this study offers critical insights into corporate governance, social responsibility, and fiscal management in developing economies within Southeast Asia.

## CONCLUSION

This study aimed to analyze the reciprocal relationship between sustainability performance (ESG) and tax aggressiveness among non-financial companies in Indonesia and Malaysia. The findings reveal that high ESG performance does not necessarily reduce corporate tax aggressiveness; companies with strong ESG profiles may use aggressive tax strategies to offset the costs associated with sustainability initiatives. Conversely, companies involved in tax aggressiveness tend to increase ESG disclosures as a means of protecting their reputation and minimizing potential reputational risks. Therefore, ESG and tax aggressiveness are interrelated, each influencing the other and serving as strategies to bolster legitimacy in the eyes of the public and stakeholders. These results suggest the need for stricter regulations to ensure that companies pursuing ESG do not excessively employ aggressive tax strategies and highlight the importance of governance in integrating tax compliance with sustainability commitments.

Based on these findings, future research is encouraged to expand the analysis by examining additional factors that may moderate the relationship between ESG performance and tax aggressiveness, such as corporate culture and regulatory compliance levels across different countries. Additionally, using data from other industrial sectors or extending the study to other ASEAN countries could offer deeper insights into how geographical and economic contexts influence ESG dynamics and tax strategies. Future studies might also consider alternative proxies for measuring tax aggressiveness, such as book-tax differences (BTD), and explore the individual dimensions of ESG (environmental, social, or governance) to determine which aspects most significantly impact tax avoidance strategies. Further research in this area could provide more targeted recommendations for policymakers in designing regulations that encourage ESG commitment without compromising tax compliance.

## AUTHOR CONTRIBUTIONS

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