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ESG Disclosure and Tax Avoidance: Evidence from Malaysia

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Abstract

Understanding the relationship between ESG disclosures and corporate tax strategies is crucial as companies are under growing pressure to be transparent about their environmental, social, and financial practices. This study investigates the relationship between Environmental, Social, and Governance (ESG) disclosure scores and tax avoidance among the 30 largest market-capitalized companies listed in Malaysia from 2017 to 2022. This study employed Ordinary Least Squares (OLS) regression to determine the relationship between the variables. Then, this study applied diagnostic checks for multicollinearity, heteroscedasticity, and serial correlation. The findings reveal a significant negative relationship between environmental disclosure scores and tax avoidance, indicating that companies with higher environmental transparency are less likely to engage in tax avoidance. Conversely, social disclosure scores show a significant positive relationship with tax avoidance, suggesting that socially transparent companies might still engage in tax-avoidance activities. Governance disclosure scores, however, do not show a statistically significant relationship with tax avoidance. These results reflected the complex dynamics between ESG practices and corporate tax strategies. Lastly, this study contributes to the literature by providing insights into the impact of ESG disclosures on tax avoidance in Malaysia. Future research is recommended to explore these dynamics in different sectors and regions, as well as to examine the role of regulatory frameworks in influencing the relationship between ESG practices and tax avoidance.

Keywords: ESG, Tax Avoidance, Malaysia.

Introduction

Sustainable development has become a paramount priority for organizations, driven by the adoption of sustainable development goals and Environmental, Social, and Governance (ESG) practices. These practices are crucial for ensuring long-term success and making positive contributions to the economy, environment, and society. The initial phase of the ESG

framework, known as the "just transition," is scheduled for 2024-2026. This phase focuses on raising awareness, offering training, and providing financial support to help companies initiate their ESG efforts (MITI, 2024). Key factors prompting Public Limited Companies (PLCs) to incorporate ESG reporting in their annual reports include company size, profitability, board characteristics, economic sustainability performance (ESP), financial leverage, the presence of external audit committee members, and the inclusion of female directors on the board (Hasnan et al., 2023).

As companies adopt ESG practices, an important area that needs attention is how they manage their taxes. Tax policies and practices are now being closely watched as part of a company's overall ESG performance, showing their commitment to ethical behaviour and corporate responsibility. Tax avoidance, therefore, is not just a financial tactic—it also connects with broader goals of sustainability and fairness. Tax avoidance exerts a considerable impact on both stakeholders and the company. For stakeholders (investors, employees, government and the general public) it erodes trust and raises ethical issues, which can lead to reputational harm and diminished investor confidence. For the company, tax avoidance can incur financial penalties, heightened regulatory scrutiny, and legal complications. It may also harm relationships with customers and partners who value corporate responsibility. Additionally, tax avoidance can jeopardize long-term sustainability by diverting funds from critical public services, ultimately affecting societal welfare and economic stability. Therefore, ethical tax practices are essential for preserving stakeholder trust and upholding corporate integrity.

Recent studies indicate that socially responsible corporations with robust ESG disclosures significantly mitigate tax avoidance, as observed in China (Jiang et al., 2024), Korea (Yoon et al., 2021), Indonesia (Nawangsari et al., 2022; Ermayda et al., 2023; Carolina et al., 2023) and Jordan (Haija, 2024). However, some findings from Indonesia suggest that ESG disclosure does not influence tax avoidance (Shafanur & Ratnasari, 2023). In Malaysia, there is a notable research gap in exploring the link between a company's ESG disclosure and its tax avoidance behaviors. Current academic literature primarily examines the correlation between ESG disclosure among Malaysian listed companies and their financial performance. Studies by (Jamal et al., 2021; Junius et al., 2020; Kengkathran, 2019; Lee et al., 2023; Jasni & Zulkifli, 2024) focus on how comprehensive ESG reporting influences financial outcomes.

This study aims to explore the relationship between ESG disclosure scores and tax avoidance behaviors among public listed companies in Malaysia. It seeks to determine how the level of ESG transparency affects corporate tax planning strategies and to assess whether higher ESG scores are associated with reduced tax avoidance practices. The significance of this study lies in its potential to provide valuable insights into the interaction between ESG disclosure and tax avoidance among Malaysian listed companies. As ESG practices become increasingly important worldwide, understanding their influence on tax behaviour is crucial for stakeholders such as policymakers, regulators, investors, and the public. The findings could emphasize the role of transparent ESG reporting in mitigating tax avoidance, thereby fostering ethical business practices and strengthening corporate governance. For policymakers and regulators, the results could aid in developing guidelines that promote responsible tax behaviour and ESG compliance. Investors may benefit from a clearer

understanding of the risks and opportunities related to companies' ESG disclosures and tax strategies.

Literature Review

There are three relevant theories to be used in this study, which include stakeholder theory, agency theory, and legitimacy theory.

Stakeholder Theory

Stakeholder theory in corporate governance posits that businesses hold responsibilities not only to their shareholders but also to a wide range of stakeholders, including employees, customers, suppliers, and the broader community. Companies with robust ESG disclosures and performance are more inclined to adopt responsible tax practices that align with the interests of these stakeholders rather than engaging in aggressive tax avoidance strategies. (Teja, 2024.; Yoon et al., 2021).

Agency Theory

Agency theory suggests that managerial decisions regarding tax avoidance are often driven by self-interest (Desai & Dharmapala, 2006). Managers, acting as agents, frequently aim to maximize business profits to secure higher compensation from principals (Mukhtaruddin et al., 2024). Enhanced internal control quality and stringent external oversight can deter opportunistic tax avoidance by management and major shareholders by reducing financial constraints, improving internal controls, and reinforcing external supervision (Jiang et al., 2024).

Legitimacy Theory

Legitimacy theory provides a framework encouraging organizations to adopt and enhance voluntary social and environmental disclosures. This practice helps firms fulfill their social contracts, thereby securing recognition of their objectives and ensuring survival in a volatile environment (Schiopoiu & Popa, 2013). To maintain legitimacy, companies must strengthen their social ties and adhere to relevant regulations, facilitating smooth business operations (Shafanur & Ratnasari, 2023; Mukhtaruddin et al., 2024).

ESG Disclosure

Economic, social, and governance (ESG) concepts are widely utilized in the literature to evaluate corporate sustainability. Studies suggest that religious affiliations can positively impact corporate performance, with Islamic firms excelling in environmental and social aspects, although not necessarily in governance. Furthermore, larger governing bodies and a higher number of independent directors positively influence ESG disclosures, while the impact of women on boards and the CEO can vary (Ahmad et al., 2024).

Contradicting these findings, a European study revealed a positive correlation between a board’s focus on corporate social responsibility (CSR), its CSR strategy, and the utilization of the Global Reporting Initiative (GRI) with ESG disclosure scores. This research indicates that boards with a strong CSR focus and those employing the GRI can help companies disclose high-quality ESG information, enhancing transparency and stakeholder satisfaction. Additionally, having more women on the board can lead to higher ESG disclosure scores by introducing new sustainability-focused ideas (Helfaya et al., 2023).

In Malaysia, research on the presence of women on boards and the competitive advantages of firms influences ESG disclosures. Findings show that board diversity significantly impacts ESG disclosures; however, in large, competitive firms dominated by male board members, the effectiveness of women's roles appears diminished. Future research should explore factors driving ESG adoption, as certain types of firms are more likely to increase both ESG disclosures and the presence of women on boards (Wan et al., 2023).

Another Malaysian study revealed a positive relationship between firm performance and ESG disclosure. The conclusions indicate that ESG disclosure enhances firm performance, even after accounting for competitive advantage. Interestingly, firms with a competitive advantage tend to disclose less ESG-related information, but for those that do disclose more, performance improves. Conversely, for firms without a competitive advantage, increased ESG disclosure tends to reduce performance. The study recommends reassessing the extent of ESG disclosure and the financial incentives for firms with high ESG scores, as these scores are linked to greater competitive advantage (Mohammad & Wasiuzzaman, 2021).

Additionally, a study on ESG in Malaysia posits that environmental, social, and governance performance each have varying impacts on financial performance depending on sector risk levels. In high-risk sectors, governance performance strongly correlates with improved financial returns, while social initiatives have mixed effects. In medium-risk sectors, social performance shows a positive relationship with financial returns, although other ESG factors vary in impact. In low-risk sectors, connections between ESG factors and financial performance are minimal, with some ESG elements even showing negative correlations (Jasni & Zulkifli, 2024).

Tax Avoidance

A study examining the relationship between ESG performance and corporate tax avoidance in China applied agency theory and utilized data from A-share listed non-financial companies from 2009 to 2021. This research suggests that management's self-interest drives the decision to avoid corporate taxes. The findings indicate that strong ESG performance significantly reduces corporate tax avoidance through three primary mechanisms: alleviating financing constraints, improving the quality of internal controls, and increasing external oversight. This effect is particularly pronounced in firms located in regions with less developed FinTech, higher agency costs, and lower audit quality. The study emphasizes the importance of enhancing ESG performance to curb tax avoidance and recommends collaboration between the government and businesses to improve ESG practices and transparency (Jiang et al., 2024).

In Egypt, a study explored the interplay between tax avoidance, corporate social responsibility (CSR), and firm value, utilizing legitimacy theory to explain the dynamics. The research suggests that companies engaging in tax avoidance often increase CSR disclosures to maintain legitimacy. It finds a positive association between tax avoidance, CSR, and firm value, indicating that these strategies can boost a company's financial performance and reputation. However, the study also notes that socially responsible companies are less inclined to pursue aggressive tax avoidance behaviors (Abd-Elmageed & Abo, 2021).

In Malaysia, research investigated the influence of CEO authority on tax evasion practices within firms listed on Bursa Malaysia's Main Market from 2009 to 2019. Preliminary results reveal an inverse relationship between CEO authority and tax evasion indicators (ETRB and ETRC), suggesting that more powerful CEOs are more likely to engage in tax avoidance. Additionally, the study found that board gender diversity amplifies the positive impact of CEO authority on tax evasion, indicating that a higher proportion of female board members enhances a CEO's effectiveness in tax evasion. The research, however, does not delve into the underlying reasons for tax evasion (Hooy & Phua, 2024).

Another recent study in Malaysia highlighted the significant influence of leverage and company size on tax avoidance, with firms having higher leverage and larger sizes being more prone to tax avoidance strategies. In contrast, audit quality did not show a significant effect on tax avoidance (Hadaming & Apollo, 2023).

A study examining the determinants of tax avoidance among 260 listed companies in Malaysia found that firms with higher return on assets and sales growth tend to engage less in tax avoidance. Conversely, companies with higher leverage are more likely to engage in tax avoidance practices. The study also noted that variables such as firm size, capital intensity, and inventory intensity did not have a statistically significant impact on tax avoidance activities among the companies studied (Abdul et al., 2021).

ESG Disclosure and Tax Avoidance

In the domain of corporate finance and sustainability, numerous studies have examined the relationship between Environmental, Social, and Governance (ESG) disclosure and tax avoidance across various countries.

A study conducted in Korea identified a negative correlation between the ESG ratings of Korean firms and tax avoidance, suggesting that companies with strong Corporate Social Responsibility (CSR) performance are less likely to manipulate taxable profits. This aligns with the corporate culture theory, which posits that socially responsible firms are less inclined to evade tax responsibilities by manipulating profits (Yoon et al., 2021).

Research on Chinese listed companies found that robust ESG performance can mitigate tax avoidance by enhancing internal controls and external supervision. The study indicates that ESG performance helps align the company's interests with those of its stakeholders, promoting more responsible tax practices. According to agency theory, management's decision to avoid taxes is driven by self-interest. By strengthening corporate governance through improved internal controls and external oversight, ESG performance reduces the likelihood of tax avoidance. Moreover, ESG performance helps decrease information asymmetry between the company and its stakeholders, enabling better monitoring of the company's tax practices and making aggressive tax avoidance strategies more difficult to execute (Jiang et al., 2024).

In Indonesia, a study of LQ companies listed on the Indonesia Stock Exchange found a positive relationship between ESG activities and tax avoidance. This suggests that companies might use ESG initiatives to justify lower tax payments under the guise of social responsibility. According to legitimacy theory, companies may leverage ESG activities to enhance their social

legitimacy, masking their engagement in tax avoidance. The findings indicate that firms with robust ESG activities are more likely to engage in tax avoidance, using ESG as a tool to justify their actions and reduce scrutiny from stakeholders and regulators. The researchers argue that insufficient regulatory oversight on ESG disclosures can lead to companies misrepresenting their true tax-related activities (Mukhtaruddin et al., 2024).

Existing research underscores the link between strong ESG commitments and ethical practices, particularly regarding tax compliance. For instance, a recent study in Indonesia found that higher Bloomberg ESG disclosure scores are positively correlated with deferred tax assets relative to deferred tax liabilities. This suggests that companies with substantial ESG disclosures engage more deeply with indirect stakeholders and demonstrate a commitment to societal goals beyond immediate financial benefits (Teja, 2024). Additionally, research in the same region identified a significant negative relationship between ESG performance and tax avoidance, indicating that firms dedicated to ESG principles are more likely to adopt transparent and ethical tax management practices (Hashfi, 2024).

Stakeholder Theory provides a theoretical framework for understanding this relationship. According to this theory, companies with strong ESG disclosures are better equipped to address the expectations of a diverse range of stakeholders, including employees, customers, suppliers, and local communities. By focusing on the interests of these stakeholders, such companies are more inclined to implement responsible tax practices that align with their commitment to ethical business conduct (Yoon et al., 2021).

Companies that demonstrate lower levels of tax avoidance through their ESG disclosures often benefit from enhanced reputational advantages, greater access to capital, and improved long-term financial performance. As stakeholders increasingly prefer transparent and responsible businesses, such firms may gain a competitive edge in the market. However, it is important to be cautious of "greenwashing," where companies may exaggerate or misrepresent their ESG practices to appear more responsible than they are. This could undermine the perceived validity of the relationship between ESG disclosure and responsible tax behaviour (Menicacci & Simoni, 2024). Recognizing and addressing these challenges will lead to a more accurate assessment and understanding of the connection between ESG commitments and tax responsibilities.

Based on the review, this study hypothesizes the following:

Hypothesis 1: Companies with higher levels of environmental disclosure score have lower levels of tax avoidance.

Hypothesis 2: Companies with higher levels of social disclosure score have lower levels of tax avoidance.

Hypothesis 3: Companies with higher levels of governance disclosure score have lower levels of tax avoidance.

Data and Methodology

This study examines the relationship between ESG disclosure score and tax avoidance among the 30 largest market capitalization listed companies in Malaysia. The sample period for the data spanned from 2017 to 2022. The independent variables are the environment disclosure scores, social disclosure scores, and governance disclosure scores. Whereas the dependent variable is the book-tax difference (*proxy for tax avoidance*). The data are gathered from Bloomberg terminal.

Then, this study employs Ordinary Least Squares (OLS) regression analysis to analyze the relationship. To ensure the robustness and validity of the regression results, several diagnostic checks are performed. Firstly, multicollinearity is assessed to determine whether the independent variables are highly correlated with each other, which could distort the regression estimates. Secondly, heteroscedasticity is checked to ensure that the variance of the errors remains constant across all observations, thereby validating the assumption of homoscedasticity in the regression model. Thirdly, serial correlation is investigated to detect any autocorrelation in the residuals, which could indicate that the error terms are not independent over time.

The regression model is as below:

$$Tax_{i,t} = \beta_o + \beta_1 E_{i,t} + \beta_1 S_{i,t} + \beta_1 G_{i,t}$$

Where $Tax_{i,t}$ refers to Box Tax Difference (Proxy of Tax Avoidance), $E_{i,t}$ refers to Environmental Disclosure Score, $S_{i,t}$ refers to Social Disclosure Score, and $G_{i,t}$ refers to Governance Disclosure Score.

Results and Discussion

This section discusses the results obtained throughout the study.

Table 1
Descriptive Statistics for the Variables

Variable	Observations	Mean	Standard Deviation	Min	Max
Tax	180	613.48	685.44	-647.70	3896.10
E	180	32.67	14.21	0.91	72.30
S	180	33.90	10.82	10.19	62.12
G	180	85.86	5.68	71.79	96.12

Table 2
Result of OLS Regression and Diagnostic Checking

Variable	Coefficient	p-value
E	-14.129	0.001
S	13.419	0.028
G	2.055	0.844
Multicollinearity	*VIF* E: 1.39 S: 1.73 G: 1.41	
Heteroscedasticity	*Breusch–Pagan* 17.37	0.000
Serial Correlation	*Wooldridge test* 43.375	0.000

Table 2 shows the result of OLS regression analysis and diagnostic checking. The environmental score (E) shows a significant and negative relationship with tax avoidance. In contrast, the social score (S) has a significant and positive relationship with tax avoidance. However, the governance score (G) did not show a significant relationship with tax avoidance. Besides that, Variance Inflation Factor (VIF) values for the independent variables are below the threshold of 10. These values suggest that there is no multicollinearity issue. The result for the Breusch–Pagan test for heteroscedasticity indicated the presence of heteroscedasticity, while the Wooldridge test for serial correlation confirmed the presence of serial correlation in the residuals. Both heteroscedasticity and serial correlation violate key assumptions of OLS regression, potentially leading to biased or inefficient estimates. To address these issues, this applied the Feasible Generalized Least Squares (FGLS) to improve the reliability of the model's estimates.

Table 3
Result of FGLS Regression

Variable	Coefficient	p-value
E	-14.129	0.001
S	13.419	0.025
G	2.055	0.842

The result of FGLS shows that the relationship between the independent variables and the dependent variable remains consistent with the result of OLS. The consistency of these coefficients between the OLS and FGLS models suggests that the relationships identified in the original OLS regression are robust. However, the FGLS model offers greater confidence in these results because it corrects for the issues of heteroscedasticity and serial correlation, which were present in the OLS model. This correction makes the FGLS estimates more reliable and trustworthy, especially when interpreting the significance and magnitude of the relationships between the variables.

Conclusion

This study aimed to examine the relationship between Environmental, Social, and Governance (ESG) factors and the tax avoidance of 30 listed companies in Malaysia. The findings revealed that the environmental score (E) has a significant negative impact on tax avoidance while the social score (S) has a significant positive impact on tax avoidance. However, the governance score (G) did not show a statistically significant relationship with tax avoidance.

This study recommends that companies should strengthen their social initiatives to improve social responsibility and reduce tax avoidance. Socially responsible actions may reflect ethical business practices, including more transparent and compliant tax behaviour. However, companies should be careful in implementing their environmental strategies to ensure these efforts do not unintentionally lead to increased tax avoidance. Additionally, companies should review their governance practices, even though this study did not find a direct impact, as good governance is still crucial for overall corporate integrity and compliance. For policymakers, these findings emphasize the importance of promoting and rewarding social responsibility in companies, which may encourage more ethical tax practices. They should also make sure that environmental regulations and incentives do not unintentionally create loopholes that encourage tax avoidance.

There are several limitations in this study. First, the analysis is limited to the top 30 listed companies in Malaysia, which may not be representative of the broader market or other regions. Second, the study focuses on a specific sample period from 2017 to 2022. These results may not capture the long-term impacts of ESG practices on financial performance. Third, the study assumes linear relationships between ESG factors and tax avoidance, which may oversimplify the complex interactions between these variables. Finally, the analysis is limited by the availability and quality of ESG data, which can vary between companies and may affect the accuracy of the findings. Future research could address these limitations by expanding the sample size, exploring different regions and industries, and considering non-linear models or alternative methodologies to capture the dynamic nature of ESG impacts on financial performance.

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