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Research Article

The Effect of Changes in Tax Rates on Capital Structure

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Abstract: This research aims to analyze the impact of changes in tax rates on corporate capital structure by highlighting how tax rate fluctuations affect financing decisions, particularly the balance between debt and equity. Using a literature review approach, the research examines various sources to identify patterns in the relationship between tax rates and capital structure, considering internal factors such as profitability, firm size, and access to external financing. The findings indicate that companies with high profitability and better access to funding are more flexible in adjusting their capital structure, while smaller or less profitable firms are more vulnerable to tax rate changes. This study contributes by offering a more holistic understanding of how tax policies influence financing decisions and emphasizes the importance of effective tax management strategies and stable tax policies. These findings have significant implications for policymakers and future research in developing relevant analytical models and strategies in the context of ever-evolving tax regulations.

Keywords: tax rate, capital structure, debt, profitability, tax shield

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1. Introduction

Capital structure is one of the fundamental aspects in corporate financial decision-making. It reflects how a company finances its operations and investments through a combination of equity and debt. According to Riyanto (2001), as cited in Fitria Sugma Sugestiara and Pujo Gunarso (2021), capital structure is the balance between external and internal capital used to fund a company's operations. Choosing the right capital structure is crucial to ensuring business continuity and company growth. One external factor that can influence capital structure is the tax policy implemented by the government. Changes in tax rates can directly impact a company's financial strategies, particularly in terms of debt and equity usage.

Several studies have found that changes in tax rates can affect the proportion of debt and equity in a company's capital structure. Research by Fitria Sugma Sugestiara and Pujo Gunarso (2021) shows that tax rates have a negative effect on capital structure, with a significance level above 0.05. This finding indicates that an increase in tax rates can reduce a company's tendency to use debt as a primary source of funding. As tax rates rise, the interest expense that companies must bear also increases, leading them to be more cautious in taking on debt and more likely to rely on internal financing to avoid greater financial pressure.

Moreover, a study by Yahya Shidiq et al. (2022) found that the impact of tax rate changes on capital structure is not always significant and depends on moderating factors such as profitability and company size. Highly profitable companies tend to be more flexible in adjusting their capital structure, while companies with limited capital are more dependent on external financing. This aligns with the Trade-off Theory, which states that companies seek a balance between the tax benefits of debt and the increased bankruptcy costs that come with excessive debt use. Therefore, a deeper understanding of the effects of tax rate changes is important for corporate financial decision-making.

Other factors influencing the relationship between tax rates and capital structure include dividend policies and macroeconomic conditions. Dividend policy determines how much profit is retained for internal financing compared to seeking external funds through debt or new equity issuance. Fluctuations in interest rates and government fiscal policies can also amplify or weaken the impact of tax rate changes on capital structure. When interest rates rise along with tax rates, companies tend to reduce debt usage and prefer equity financing to avoid heightened financial pressure.

In the context of Indonesia's economy, changes in tax policy often play a key role in shaping corporate financial strategies. Certain industrial sectors, such as manufacturing and banking, heavily rely on debt for their operations. The manufacturing sector generally requires substantial capital investment, often funded through long-term loans. Therefore, significant changes in tax rates can influence investment decisions and funding strategies in this sector. Meanwhile, the banking sector faces different challenges as tax changes can impact their operating costs and profit margins, thus affecting their financing strategies.

In addition to industrial sectors, company size also influences the impact of tax rate changes on capital structure. Large companies with broader access to funding sources are generally more capable of adjusting their capital structure in response to tax policy changes compared to smaller firms with more limited financing options. Small firms facing increased tax rates may be more inclined to increase debt usage to cope with higher tax burdens, while larger firms may rely more on equity as a funding source.

The impact of tax rate changes on capital structure should also be viewed from a long-term perspective. Unstable or frequently changing tax policies can create uncertainty for companies in designing their financial strategies. This uncertainty may hinder investment decisions and slow down economic growth. Furthermore, tax rate changes not supported by complementary regulations can make companies more vulnerable to market fluctuations and external pressures.

To address these challenges, companies need sound tax management strategies to optimize their capital structure. One such strategy is diversifying funding sources to reduce dependency on a single form of financing. Additionally, the government can offer tax incentives to companies investing in strategic sectors or implementing sound financial policies. Through this approach, the negative impacts of tax rate changes can be minimized, and economic stability can be better maintained.

By understanding the relationship between tax rates and capital structure, companies can design financial strategies that are more adaptive to changes in tax policy. The government also needs to consider the impact of tax policy on corporate financial stability and on the industrial sector as a whole. In the long run, well-designed tax policies can not only increase state revenue but also create a conducive business climate for economic growth. Therefore, further studies are needed to evaluate the factors that can strengthen or weaken the influence of tax rate changes on corporate capital structure under various economic conditions.

2. Preliminaries or Related Work or Literature Review

This literature review examines the impact of tax rate changes on corporate capital structure, emphasizing that the effect is not uniform across all companies but depends on various internal and external factors. While some studies suggest that corporate income tax rates do not significantly affect capital structure, other factors such as firm size, liquidity, and financial flexibility often play a more dominant role. Larger firms tend to manage the effects of tax changes more effectively due to better access to capital and strategic financial planning, whereas small and medium-sized enterprises (SMEs) are more vulnerable due to limited funding options and tax planning capabilities. Additionally, dividend policy, interest rate fluctuations, and macroeconomic stability influence capital structure decisions, as higher interest rates or economic uncertainty may shift firms' preferences from debt to equity financing. Industry characteristics also matter—capital-intensive sectors are more sensitive to tax policy than service-based industries. Given these complexities, further research is needed to explore how different sectors and firm sizes adapt their capital structures in response to evolving tax policies and economic conditions.

The Effect of Tax Rates on Capital Structure

Several studies suggest that the impact of changes in tax rates on capital structure is not universal, but rather depends on various internal and external factors of a company. For example, research by Adhilla and Siti Rahmi (2024) shows that corporate income tax rates do not have a significant effect on capital structure, while other factors such as company size and liquidity have a greater influence. This indicates that companies with more stable and flexible capital structures tend to be less affected by tax changes compared to those heavily reliant on debt. However, for companies with a higher proportion of debt, changes in tax rates can directly impact their financial burden, forcing them to adjust their funding strategies to reduce tax pressure.

Additionally, some studies have found that larger companies with broader access to financing tend to be better equipped to manage the impact of tax changes compared to smaller companies. Larger firms are better able to optimize their capital structure by balancing the use of debt and equity, so the impact of tax rate changes is less significant. In contrast, small businesses that rely on debt as their primary source of funding are more affected by changes in tax policy, especially if they lack sufficient alternative financing. Therefore, the scale of the company becomes an important factor in determining how tax rate changes influence capital structure decisions.

Furthermore, external factors such as macroeconomic conditions, monetary policy, and government regulations can also moderate the impact of tax rate changes on a company's capital structure. In a stable economic environment, companies tend to be more confident in taking on debt, even when tax rates rise. However, in uncertain economic conditions, an increase in tax rates can exacerbate uncertainty and make companies more cautious in making financing decisions. Hence, understanding the various factors that influence the relationship between tax rates and capital structure is crucial in helping companies adopt more adaptive and responsive financial strategies to changing tax policies.

Differences in Impact Based on Company Size

Moreover, there are differing findings regarding whether tax rates affect large or small companies more significantly in determining their capital structures. Some studies find that larger companies are more capable of managing the impact of changes in tax rates than smaller companies, which have limited access to financing. This is confirmed by research conducted by Fitria Sugma Sugestiara and Pujo Gunarso (2021), which found that company size has a significant effect on capital structure, whereas tax rates do not have a significant impact.

Large companies generally have better financial flexibility than small companies. They have more funding options, such as issuing new shares, bonds, or obtaining loans from financial institutions at more competitive interest rates. This enables them to more easily adjust their capital structure without relying too heavily on debt when facing tax rate changes. In contrast, small companies with limited access to funding sources are more vulnerable to tax rate changes due to their constraints in obtaining low-cost capital to support their operations and business expansion.

In addition to access to financing, managerial capacity and financial strategies also play a role in determining how companies respond to tax rate changes. Large firms tend to have more skilled financial teams and greater resources to perform efficient tax planning. They can implement tax diversification strategies, such as utilizing available tax incentives or adjusting their dividend policies and capital structures for optimal outcomes. On the other hand, small firms often face limitations in tax planning and are more directly affected by tax rate changes without having many alternative mitigation strategies.

External factors such as macroeconomic conditions and government policies also influence how large and small companies adjust their capital structures in response to tax rate changes. In stable economic conditions, companies of various sizes may be more willing to take risks by increasing their debt. However, in times of economic uncertainty or drastic tax policy changes, small companies are more likely to experience financial pressure than large companies with stronger capital reserves. Therefore, the varying impact of tax rate changes based on company size is important to consider when designing tax policies that are not only effective in increasing state revenue but also do not hinder overall business sector growth.

Other Factors Affecting Capital Structure

Differences in capital structure are influenced not only by tax rates but also by the dividend policies adopted by companies. Dividend policy determines how much profit is retained and used as internal funding compared to seeking external financing through debt or new share issuance. Companies with more conservative dividend policies tend to have more stable capital structures because they rely on retained earnings to finance business expansion. Thus, the higher the dividends distributed, the less capital is available for internal funding, making companies more likely to seek external financing to support their growth.

In addition to dividend policy, interest rate fluctuations also play a role in influencing a company's capital structure. When interest rates rise, borrowing costs increase, which may prompt companies to reduce their use of debt and rely more on equity-based financing. In such conditions, companies are more selective in making investment decisions, as higher capital costs can reduce the net return generated from investment projects. Conversely, in low-interest-rate environments, companies are more inclined to increase debt usage due to cheaper financing costs. In the long run, decisions regarding the use of debt under different interest rate conditions will significantly determine the stability of a company's capital structure.

Economic stability is also an important factor in determining a company's capital structure. In a stable economic environment, companies are more confident in taking on debt for business expansion due to better growth prospects and strong market demand. However, in uncertain economic conditions, companies tend to be more cautious in financing decisions and prefer to maintain more conservative capital structures to reduce excessive financial risk. Factors such as inflation, exchange rate fluctuations, and monetary policy can also influence a company's decisions in choosing between debt- or equity-based financing, as these factors contribute to uncertainty in capital costs and business profit projections.

Influence of Industry Sector and Macroeconomic Conditions

Despite the various perspectives on the relationship between tax rates and capital structure, it is important to recognize that the impact of tax rate changes may vary by industry sector. Companies operating in capital-intensive industries such as manufacturing and construction tend to be more sensitive to tax rate changes because they require significant funding for fixed asset investment. Higher tax rates can increase their operational costs and reduce incentives for business expansion. In these sectors, capital structure decisions are heavily influenced by government policies related to tax incentives, investment subsidies, and access to low-interest debt financing.

In contrast, companies in the service sector may be more flexible in adjusting their capital structure due to lower investment needs. The service sector tends to rely more on equity financing compared to manufacturing industries that are more dependent on debt. With relatively lower operational costs and greater flexibility in adjusting cost structures, service sector companies are often less affected by tax increases. They are more capable of adjusting their financial strategies by raising service prices or cutting non-essential expenses to offset additional tax burdens.

Furthermore, a country's macroeconomic conditions also play a role in determining how companies adjust their capital structure. In a stable economy with supportive fiscal policies, companies are more encouraged to make financing decisions. For example, when low-interest policies are implemented to stimulate investment, companies are more inclined to take on loans and increase their capital to scale up their business. However, in uncertain economic conditions or during a recession, companies tend to be more cautious and reduce debt usage to avoid greater bankruptcy risk. Therefore, capital structure decisions are not solely dependent on tax rates, but also require a comprehensive analysis of macroeconomic conditions and prevailing industry trends.

The Need for Further Research

Therefore, further research is needed to understand the specific factors that can strengthen or weaken the influence of tax rate changes on a company's capital structure under various economic conditions. Factors such as tax regulations, a company's access to financial markets, and the business strategies employed are important elements that need to be analyzed more deeply. In various previous studies, it was found that the impact of tax rate changes on capital structure can vary depending on market conditions and prevailing economic policies. Hence, future research that highlights the relationship between tax policy and capital structure decisions across different industry sectors would be highly beneficial in providing a more comprehensive understanding.

In addition, it is important to further explore how companies of various scales and sectors adjust their capital structures in response to changes in tax rates. Research focusing on small and medium-sized enterprises (SMEs) can provide insight into the challenges they face compared to larger companies with broader access to financial instruments. By using both quantitative and qualitative approaches, future studies can identify adaptation patterns employed by companies in response to dynamic tax policies. This research will benefit not only academics and financial practitioners but also policymakers in designing more effective and sustainable tax regulations.

3. Proposed Method

This study uses a systematic literature review approach through meta-analysis of various scientific journals that examine the relationship between tax rates and capital structure. By comparing past research findings and analyzing moderating variables such as firm size, profitability, and financial policies, the study aims to provide a more integrated understanding. This method helps identify patterns and inconsistencies in previous research and offers clearer insights into the factors influencing capital structure changes due to tax policy.

The research focuses on companies affected by changes in tax rates, using samples from journals and publications across various industries. By including multiple sectors such as manufacturing, financial services, and technology, the study explores whether the tax impact is consistent or varies by industry. The sample selection considers relevance, publication quality, and completeness of capital structure data. It also includes international studies to enrich the analysis with different tax systems and financial regulations.

The main variables analyzed are tax rates (independent variable) and capital structure (dependent variable), with moderating variables such as firm size, profitability, and financial policies. These moderating factors help explain how different types of companies respond to tax changes. Larger firms may have more financing options, while more profitable firms might rely on internal funding. Financial strategies like dividend policies also influence how firms adjust their debt and equity composition.

Data analysis compares findings from previous studies using the Trade-off Theory and Pecking Order Theory. The Trade-off Theory suggests firms balance tax savings from debt with financial risk, while the Pecking Order Theory states firms prefer internal funding first. By applying these frameworks, the study assesses whether companies follow traditional capital structure behavior or take alternative approaches in response to tax changes. The goal is to offer practical insights for financial decision-making and contribute to the academic understanding of tax effects on capital structure.

4. Results and Discussion

Changes in tax rates have been regulated through the Minister of Finance Regulation Number 237/PMK.010/2020, which governs tax treatment across various economic sectors. Based on the studies reviewed in this research, changes in tax rates have varying impacts on corporate capital structures, depending on the industry sector and the company's financial condition. Companies with high profitability tend to be more flexible in adjusting their capital structure compared to those with limited funding. A stronger capital structure allows companies to better adapt to tax policy changes without facing significant financial pressure.

In addition, Government Regulation Number 30 of 2020 emphasizes that adjustments to tax rates must consider sustainability and economic stability. This policy is a key factor in determining corporate financing strategies, especially during periods of economic fluctuation. Several studies indicate that companies in the manufacturing sector are more sensitive to changes in tax rates than those in the service sector, which generally have more flexible cost structures. Companies with high levels of debt tend to be more affected by this policy, as changes in tax rates can increase their financial burden.

The effect of tax rate changes on capital structure depends not only on profitability levels but also on the company's access to funding sources. Companies with greater access to capital markets are more capable of adjusting their capital structure without heavily relying on debt. In contrast, companies with limited capital are more affected by tax changes and tend to depend more on external financing.

The findings of this study indicate that well-designed tax policies can help companies establish a more optimal capital structure. Therefore, regulators should consider the long-term effects of tax rate changes to avoid instability in corporate financing decisions. Proper strategies in tax policy implementation will ensure a balance between tax incentives and business sustainability across various industrial sectors.

Furthermore, the government may consider tax incentive schemes to encourage companies in optimizing their capital structure, so that tax policies can be applied more effectively without hindering business sector growth. Appropriate incentives, such as reduced tax rates for specific industries or tax relief policies for companies investing in strategic sectors, can help businesses remain competitive and maintain balance in their capital structure.

5. Comparison

This study has several limitations, primarily concerning data coverage, as it relies solely on literature review without direct empirical analysis. The conclusions drawn are conceptual in nature, based on previous research, rather than on company-specific financial data. Therefore, future studies are encouraged to incorporate corporate financial data to strengthen and validate the findings. Moreover, this study focuses solely on tax rate changes, without taking into account other tax policies such as investment incentives or tax reductions for specific sectors. These factors may significantly influence corporate capital structure and should be explored further. Another limitation lies in the absence of industry-specific analysis, as each industry has unique characteristics in adjusting its capital structure to tax changes. Future research could delve more deeply into how certain industries respond to tax rate changes for more applicable insights for policymakers and business practitioners.

Tax rate changes can have direct and indirect effects on companies, which are considered the tax subjects in this context. These entities are obligated to pay corporate income tax and other business-related taxes in accordance with government regulations. A change in the corporate income tax rate, for instance, can affect the amount of net income available for reinvestment or operational financing, potentially leading companies with lower profit margins to rely more on debt financing. This aligns with the Trade-off Theory, which suggests that companies aim to balance the tax advantages of debt with the risk of financial distress. Similarly, objects of taxation—such as income and value-added taxes—can affect product pricing, profitability, and, in turn, influence a firm's capital structure. Tax increases raise production costs, reduce profitability, and may increase dependence on debt. Conversely, a tax cut like the corporate income tax reduction from 25% to 22% under the Omnibus Law can increase post-tax profits, allowing firms to expand or return value to shareholders more readily.

The impact of tax rate changes on capital structure must be viewed through fundamental tax principles, such as neutrality, efficiency, certainty, and flexibility. Ideally, tax policy should not distort financing decisions, but in practice, tax hikes often lead firms to adjust their debt-to-equity ratios in favor of debt, due to interest deductibility. The efficiency principle also highlights the need for tax systems to avoid discouraging investment or burdening decision-making processes. Frequent or unpredictable changes in tax policy can hinder firms' ability to plan long-term financing strategies. To mitigate these challenges, companies must adopt proactive strategies such as effective tax planning, capital structure adjustments, and diversification of funding sources. In parallel, the government can support businesses by providing a stable tax environment, simplifying administration, and offering targeted tax incentives. These efforts can collectively help firms maintain financial stability, reduce tax burdens, and remain competitive amid shifting tax regimes.

6. Conclusions

The results of the study indicate that changes in tax rates can affect the company's capital structure decisions. Increasing tax rates tend to encourage companies to increase the use of debt to reduce the tax burden, while decreasing tax rates provide greater flexibility in determining the composition of funding. However, the impact of changes in tax rates is not universal. Factors such as company size, profitability level, and macroeconomic conditions also determine how companies respond to changes in tax policy. Companies with better access to funding tend to be more flexible in managing their capital structure than smaller companies or those with financial constraints. Therefore, an effective tax policy must consider its impact on the company's capital structure as a whole. The government is expected to design policies that are not only oriented towards increasing tax revenues but also pay attention to the stability and development of the business world.

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