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Research Article / *Araştırma Makalesi*

DO COUNTRY-LEVEL GOVERNANCE AND ECONOMIC FREEDOM AFFECT TAX AVOIDANCE? EVIDENCE FROM TÜRKİYE

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ABSTRACT

This study intends to provide empirical evidence that country-level governance and economic freedom impact tax avoidance behavior in Türkiye, using a sample of yearly observations of 371 publicly listed companies over the 2006-2023 period. It is found that Turkish companies engage in tax avoidance less when country-level governance increases. On the other hand, the evidence shows that when the level of economic freedom in Türkiye increases, companies are more likely to avoid tax. This study highlights the importance of considering the influence of county-level factors on tax avoidance. In the context of Türkiye as an emerging economy, this study offers new evidence that links tax avoidance to economic freedom and governance at the country level. As a result, it fills a gap in the literature on Turkish companies' tax avoidance behavior. Policymakers and regulators may find the results helpful in enhancing the legal and economic environment for companies.

Keywords: *Tax avoidance, country-level governance, economic freedom, agency theory, panel data analysis*

JEL Classification: *G32, G38, M41, M48*

ÜLKE DÜZEYİNDE YÖNETİŞİM VE EKONOMİK ÖZGÜRLÜK VERGİDEN KAÇINMAYI ETKİLER Mİ? TÜRKİYE'DEN KANITLAR

ÖZET

Bu çalışma, 2006-2023 döneminde 371 halka açık şirketin yıllık gözlemlerini kullanarak, ülke düzeyindeki yönetişim ve ekonomik özgürlüğün Türkiye'deki vergi kaçınma davranışı üzerindeki etkisini ortaya koymayı amaçlamaktadır. Çalışmada, ülke düzeyindeki yönetişim arttığında Türk şirketlerinin vergiden kaçınma eğilimlerinin azaldığı tespit edilmiştir. Öte yandan, Türkiye'deki ekonomik özgürlük seviyesinin artmasıyla şirketlerin vergiden kaçınma davranışının yükseldiğine dair kanıtlar sunulmaktadır. Bu çalışma, vergi kaçınma üzerinde ülke düzeyindeki faktörlerin etkisinin dikkate alınmasının önemini vurgulamaktadır. Türkiye özelinde dikkate alındığında, çalışmada vergi kaçınma ekonomik özgürlük ve ülke düzeyinde yönetişim ile ilişkilendirilerek yeni kanıtlar sunulmasıyla literatürdeki boşluk da doldurulmaktadır. Politika yapıcılar ve düzenleyiciler, şirketler için yasal ve ekonomik ortamı iyileştirmede bu sonuçlardan yararlanabilirler.

Anahtar Kelimeler: *Vergiden kaçınma, ülke düzeyinde yönetişim, ekonomik özgürlük, vekalet teorisi, panel veri analizi*

JEL Sınıflandırması: *G32, G38, M41, M48*

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1. Introduction

In recent decades, it has been shown that a country's economic independence and a regulatory framework that prioritizes legal concerns, appropriate bureaucracy, and effective corruption control influence the financial and investment decisions of businesses. Economic growth and business development are significantly affected by country-level governance, especially when the key characteristics of good governance are considered, which include accountability and transparency in policy development, an efficient regulatory framework with clearly defined proprietary rights, and the assurance of predictable business transactions (Boţa-Avram et al., 2018). According to R. L. Porta et al. (1998), a country's financial markets' growth depends on the legal protections afforded to its investors. Investors are more eager to lend money to companies in countries where the law is well-enforced and protects them, which increases the liquidity and value of capital markets. Meanwhile, the economic freedom level of a country leads to a better operating environment for companies, improves their productivity, and strengthens companies' valuation and profitability (Liao, 2018). With good governance at the country level, by reducing bureaucracy in the corporate environment, continuously improving the solidity of the regulatory framework, and utilizing effective instruments to prevent corruption, economic freedom of countries will increase. Moreover, as companies fulfill their responsibilities in compliance with the legal regulations, economic growth will also be secured. When country-level governance and economic freedom are evaluated together, these two factors have been extensively addressed in previous studies. Prior studies show that firm value (Saona & San Martín, 2016; Shahriar et al., 2022), capital structure and investment decisions (Çam & Özer, 2022), profitability (Almaqtari et al., 2022), ethical behavior (Agyemang et al., 2015), cash management (Seifert & Gonenc, 2018), financial reporting quality (Bonetti et al., 2016), firm disclosure (Ernstberger & Grüning, 2013), tax avoidance (Zeng, 2019) and sustainable development goals of firms (Almaqtari et al., 2024) are directly influenced by country-level governance as an institutional determinant. Furthermore, empirical evidence also supported that effective tax rates (Fernández-Rodríguez et al., 2023), investment decisions (Le & Kim, 2020), bank profitability (Asteriou et al., 2021), and firm performance are determined by the economic freedom level of a country.

As stated in a publication of the IMF and the OECD (Organization for Economic Cooperation and Development), after political stability and corruption, the general tax climate is the most vital criterion when choosing where to invest or do business in a country (IMF/OECD, 2017). Furthermore, the uncertainty around the tax burden on profit is the most significant tax indicator when making decisions about investments and locations. A free economy fosters a more favorable business climate, creates a fair market, and decreases asymmetric information and external finance costs. In countries with strong governance and high economic freedom, corporate governance practices will also be effective in the business environment. For this reason, managers will not be allowed to engage in opportunistic behavior, and agency conflicts will not arise. From the view of agency theory, tax avoidance behavior can also be seen as an action carried out by managers to gain individual benefits. Slemrod (2004) asserts that tax avoidance is also a reflection of the sense of obligation and responsibility that taxpayers have. It also shows how taxpayers perceive the tax system's fairness and how much they trust the political and governmental system. Considering this dilemma from the view of agency theory, the institutional, legal, political, and economic climate of a country influences the tax avoidance practices of companies.

The goal of the study is to investigate the function of country-level governance and economic freedom in shaping the tax avoidance behavior in Türkiye. Türkiye is considered as a country that has potential and an attractive market for investors and companies. For several years, it has had a stable statutory tax rate to attract new investments; in contrast, in the past 5 years, statutory tax rates have increased due to economic fluctuations, and significant changes have also occurred in the legal environment, which also affected the governance structure and economic freedom level of Türkiye. Therefore, the variability of such institutional determinants may influence the tax avoidance practice of companies operating and resident in Türkiye. Derived from a sample of 371 companies publicly listed on the Borsa Istanbul Stock Exchange (BIST), the findings demonstrate that country-level governance and economic freedom level significantly influence the tax avoidance behavior of companies in Türkiye. More importantly, when a strong country-level governance is present, it has been found that companies do not prefer tax avoidance. However, as the level of economic freedom rises, companies tend to adopt tax avoidance strategies.

This study is driven by the scarcity of research exploring the combined impact of country-level governance and economic freedom on tax avoidance behavior within a single country. During the literature review, it was determined that the influence of country-level governance and economic freedom on tax avoidance has been minimally explored and has not been addressed from the perspective of a single country. It adds to the recent studies on tax avoidance by analyzing not only the effect of country-level governance but also economic freedom level on tax avoidance for Turkish listed companies. It also investigates the company-level characteristics of tax avoidance for Turkish listed companies.

The study is outlined as follows: the existing literature was discussed, and the research hypotheses were developed in the second section. In the third section, the sample and the variables were described, and the methodology of the study was articulated. The primary findings and the outcomes of the robustness checks were shown in the fourth section. The main conclusions were summed up in Section 5.

2. Literature Overview and Hypotheses for Research

2.1. Definition of Tax Avoidance

Taxation plays a pivotal role in shaping corporate financial decisions, including risk management, organizational restructuring, and capital allocation (Desai & Dharmapala, 2006). Managers are motivated to adopt tax avoidance strategies in order to create a legitimate source of temporary funding (Richardson et al., 2015). Tax avoidance involves any actions that lowers the tax burden of companies (S. D. Dyreng et al., 2010) or can be described as a range of actions taken to lower tax obligations, from complete tax compliance to unlawful tax sheltering or tax evasion (Hanlon & Heitzman, 2010). Tax avoidance, unlike tax evasion, is a legitimate strategy to lower tax burden and distribute the savings to shareholders in order to boost the company's value. (Minh Ha et al., 2021). Tax avoidance constitutes a key element of companies' capital management strategies, including structuring of transactions or arrangements to capitalize on gaps in tax regulations within a specific jurisdiction (Ryan J. Wilson, 2009;

Lisowsky, 2010), or discrepancies in tax laws across jurisdictions (Atwood et al., 2012). In terms of capital management, tax avoidance enables companies to save funds, which can be used to finance investments, support operational activities, and ultimately increase firm value (Lisowsky, 2010).

Tax avoidance is a fundamental issue, as it directly alters government earnings, the funding and quality of governmental services, and perceptions of corporate ethics and fair treatment within the tax system. Effectively combating tax avoidance is critical to ensuring both the integrity and efficiency of tax systems while building public confidence in businesses and government institutions (Wongsinhirun et al., 2024). To support governmental operations, policymakers establish laws and require businesses to provide a share of the profits from their economic activities. These tax revenues represent a significant financial burden for companies, even though they are crucial to the development of the economy and public's access to goods and services (Nebie & Cheng, 2023). It is important to clarify that tax avoidance increases cash (Edwards et al., 2016) and enhances firms value by reallocating wealth from government to businesses (Armstrong et al., 2015). It can also impose significant costs, involving reputational penalties and penalties paid to tax authorities (Badertscher et al., 2013) and agency costs (Chen et al., 2014).

A growing literature dempnstrates that tax avoidance behavior of companies is determined by both company-level factors and institutional factors. Based on the extensive literature, managerial ownership (Wongsinhirun et al., 2024), firm value (Nebie & Cheng, 2023), corporate governance (Desai & Dharmapala, 2006; Hasan et al., 2024; Wahab et al., 2017), audit committee characteristics (V. C. Dang & Nguyen, 2022), ownership structure (Badertscher et al., 2013; Richardson et al., 2016), family ownership (Gaaya et al., 2017), cost of equity (Goh et al., 2016), and financial distress (Richardson et al., 2015) have impact on tax avoidance practice of companies. The extent of existing research has also provided evidence that country-level factors like economic policy uncertainties (D. Dang et al., 2019; Nguyen & Nguyen, 2020; Shen et al., 2021), geopolitical risk (Athira & Ramesh, 2024), statutory tax rate (Atwood et al., 2012), country-level governance (Zeng, 2019) and economic freedom (Fernández-Rodríguez et al., 2023) affect tax avoidance behavior of companies.

2.2. Tax Avoidance and Country-Level Governance

Most research on tax avoidance have concentrated on the interaction of corporate governance and tax avoidance, which stems from the agency theory view of tax avoidance. Within the framework of corporate taxation, governance mechanisms aim to monitor and influence management behavior. For this reason, companies with various governance models may use various approaches to tax management (Wahab et al., 2017). As per the agency theory view of tax avoidance, in the absence of strong corporate governance, agency costs may occur and disrupt the balance of the costs and benefit analysis, which should be used when avoiding taxes. A company that participates in tax planning will consider the tradeoffs of tax avoidance. The benefits include saving cash on taxes and using cash saved to boost the firm value for shareholders (Nebie & Cheng, 2023). Moreover, agency conflicts may lead the manager to adopt an alternative degree of tax avoidance than the shareholders would like. The shareholders may favor a high degree of tax avoidance, which would increase cash flows, or a low degree of tax avoidance, which would reduce firm risk (Kovermann & Velte, 2019). The existence of additional governance systems will deter managers of well-governed companies from rent extraction obtained through tax avoidance practices. Managers of the poorly governed companies, conversely, will have the incentive to participate in tax avoidance as there would be no scrutiny or monitoring to prevent them from rent extraction (Desai & Dharmapala, 2006).

With regard to agency theory, management may perceive tax avoidance as a high-risk investment opportunity (Armstrong et al., 2015). Furthermore, Desai & Dharmapala (2006) assert that the information asymmetry between shareholders and managers may allow managers to act in ways that serve their own interests, such as taking advantage of tax regulations as a mechanism for managerial self-interest and causing agency costs. According to Çam & Özer (2022), corporate governance functions as a framework to reduce the agency costs. This implies that stronger corporate governance not only protects investors from management expropriation but also constrains managerial discretion. On the other hand, not only corporate-level, but also country-level governance may be associated with the tax avoidance behavior of companies. Managers of companies, which operate in a country with weak governance may engage in opportunistic activities such as tax avoidance and cause higher transaction and agency costs (Zeng, 2019). The impact of strong governance on companies is based on the premise that a country with balanced bureaucracy, strong legal adherence, and effective anti-corruption policies is expected to foster a business environment that reduces greed and dishonesty among managers (Agyemang et al., 2015). Bonetti et al. (2016) argue that country-level governance, which is described by Kaufmann et al. (2011), as the customs and establishments through which a country exercises its authority, is a reflection of a country's legislative framework, which includes security regulation, investor protection, and the efficiency enforcement. Additionally, Demirgüç-Kunt & Maksimovic (1999) suggest that a country's institutional environment, which supports monitoring and enforcing appropriate financial contracts, can help to mitigate agency costs. According to Doidge et al. (2007)'s findings, differences in a company's governance level can be attributed to a country's protection of investor's rights as well as its financial and economic development, rather than the company's characteristics. Since corporate governance serves to minimize agency conflicts by restricting managerial discretion and lowering the risk of governmental takeover, and because country-level governance may complement corporate governance, principal-agent conflicts between managers and shareholders are also likely to be reduced in well-governed countries. Desai et al. (2007) argue that a company's likelihood of being investigated by tax authorities, as well as the political and reputational consequences of tax avoidance, will increase in an institutional environment where government is efficient, corruption level is low, and legal enforcement is well-implemented. A company's likelihood of being sued by shareholders for engaging in tax avoidance operations will increase if shareholders' rights are strongly protected by the law. By giving managers more oversight and lowering their rent extraction, strong country governance, as an alternative to corporate governance, may discourage tax avoidance.

Many scholars have been investigating the linkage between tax avoidance and corporate governance; however, the effect of country-level governance on tax avoidance has not been extensively studied. The only empirical study that analyzes the influence of country-level governance on tax avoidance is performed by Zeng (2019). The aggregate findings demonstrate that companies based in countries with weak country-level governance avoid paying taxes due to a lack of improved government effectiveness and regulatory quality, stronger legal enforcement and control of corruption. Although not explicitly referred to as tax avoidance, some studies investigated the influence of country-level governance as an institutional determinant of effective tax rates. The effective tax rate is an indicator of the tax burden on a company, and if it is under the statutory tax rate of the country, then it can be interpreted that companies engage in tax avoidance and pay lower taxes than established by statutory tax rates. A study carried out by Fernández-Rodríguez et al. (2021) explored the institutional and business factors of effective tax rates in emerging economies, concentrated on BRIC and MINT countries. As a result of the study, they find that companies in countries with a greater government effectiveness, which is an indicator of country-level governance, participate in tax avoidance less. Moreover, the findings also suggest that regulatory quality and the rule of law lead to reduced tax burden on companies. In another study of Fernández-Rodríguez et al. (2023), covering a sample of 25.878 companies from G7 and BRIC countries, it was evidenced that indicators of country-level governance like regulatory quality, rule of law, and government effectiveness impact companies' tax burden in all countries, while corruption control, which is also an indicator of country-level governance, has an effect on the tax burden of companies only in emerging countries. Given the results of the limited number of studies, the hypothesis 1 is offered as follows:

H1: Overall country-level governance influences tax avoidance.

2.3. Tax Avoidance and Economic Freedom

Economic freedom encompasses a nation's legislative framework, rule of law, monetary system, and governmental action, all of which are correlated with the advancement of the financial market in a country (R. La Porta et al., 2002). It eliminates challenges and restrictions in the financial and economic markets, which encourages companies to invest more. When a fair market for different economic players is established, asymmetric information also decreases, and as a result, the cost of external financing decreases (Le & Kim, 2020). Liao (2018) argues that economic freedom reflects a country's openness and ability to respond to external resources, which can encourage the spread of technology and creativity. Blau (2017) points out that combined with a focus on property rights, economic freedom lowers regulatory uncertainties and encourages free trade.

As suggested by Alabede (2018), there could be a connection between economic freedom and a country's tax revenue, as economic freedom fosters growth, which in turn influences tax revenue as part of economic development, specifically a positive association between tax revenue and "property rights freedom", "freedom from corruption", and "investment freedom", which are aspects of economic freedom, can be exerted. Fernández-Rodríguez et al. (2021) utilize data belonging to emerging economies, to evaluate the determinants of effective tax rates and find evidence that economic freedom has a weak positive influence on tax burden of companies. Given this argument, companies' tax avoidance behavior can be directly determined by the economic freedom level of a country. Greater economic freedom will create a more efficient operating environment for companies, and strong economic growth will enhance companies' financial performance and facilitate their access to external resources; therefore, companies will not engage in tax avoidance in order to save cash from tax. On the other hand, in another study of Fernández-Rodríguez et al. (2023) which investigated the determinants of ETR in BRIC and G7 countries, the findings reveal that a higher economic freedom level results in a reduced tax burden for companies only in BRIC countries. Hence, the second hypothesis is proposed below:

H2: Economic freedom influences tax avoidance.

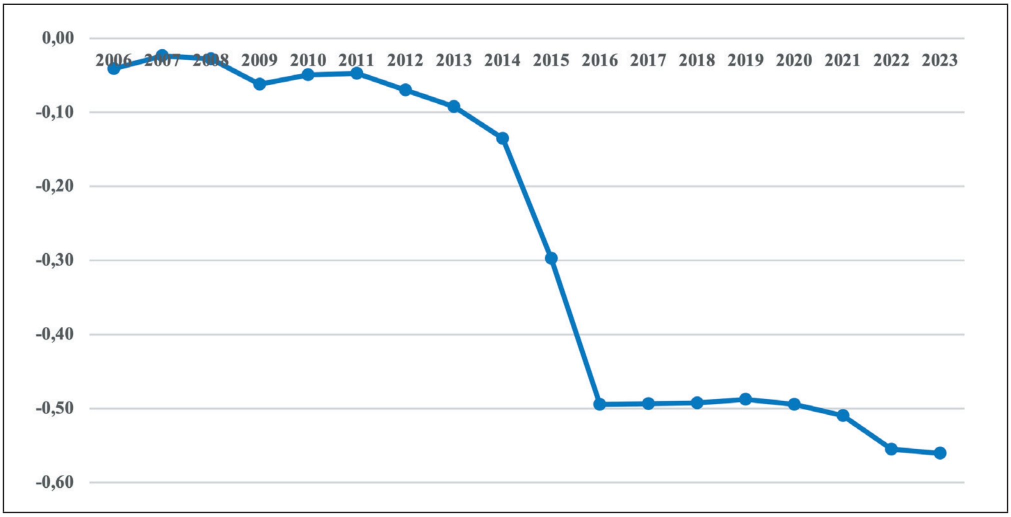
3. Variables Employed and Methodology

The sample consists of 371 non-financial and non-utility companies listed on the BIST with data over the 2006-2023 period. The financial data was obtained from Thomson-Reuters DataStream. Companies included in this study are those that have at least four consecutive time series observations from 2006 to 2023. Following the past studies (Fernández-Rodríguez et al., 2021; Nebie & Cheng, 2023; Nguyen & Nguyen, 2020; Zeng, 2019), observations of firm-year with negative pretax income were eliminated from the sample. All continuous variables are winsorized at the 1st and 99th percentile values to address the potential effect of outliers.

- **Measurement of tax avoidance:** Tax avoidance is considered as a company's tax burden, in accordance with S. Dyreng & Maydew (2008). Hanlon & Heitzman (2010) used the effective tax rate (ETR) to measure tax avoidance. ETR is calculated by dividing the entire tax expense by the pretax income. As argued by S. Dyreng & Maydew (2008), ETR is predicated on the idea that managers are aware that effective tax avoidance activities can lower tax expenses. Since lower ETRs indicate higher levels of tax avoidance, ETR can be considered as an inverse function of tax avoidance (Hanlon & Heitzman, 2010; S. Dyreng & Maydew, 2008). For this study, annual ETRs greater than one were adjusted to one, while negative annual ETRs were adjusted to zero (Zeng, 2019).
- **Measurement of country-level governance:** The first explanatory variable of the study is country-level governance (CLG). The Worldbank's Worldwide Governance Indicators database, which is based on Kaufmann et al. (2011), was used to capture Türkiye's overall CLG. Annual updates are made to the governance indicators, which are collected for more than 200 countries and territories from 31 distinct data sources. CLG is measured on the basis of six governance indicators, which include "Voice and Accountability", "Political Stability and Absence of Violence", "Government Effectiveness", "Regulatory Quality", "Rule of Law", and "Control of Corruption". These indicators vary from -2.5 to + 2.5. Higher values of these indicators indicate strong governance, whereas lower values indicate weak governance (https://www.worldbank.org/en/publication/worldwide-governance-indicators).

Following Seifert & Gonenc (2018), the average of these six governance indicators is used to determine Türkiye's overall CLG score for a given year. This score encompasses various attributes that are expected to promote an environment supportive of strong governance. Figure 1 presents the change in Türkiye's overall CLG scores between 2006 and 2023.

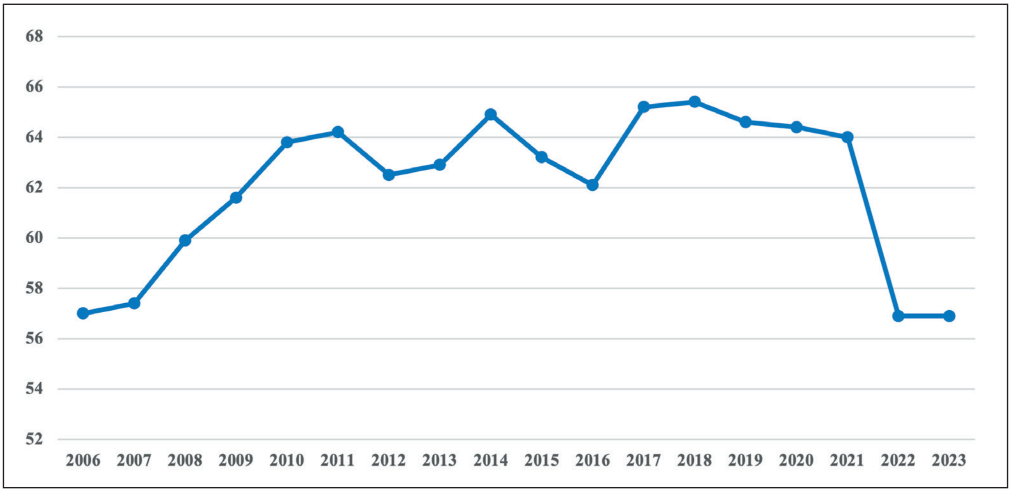
Figure 1: Overall Country-Level Governance Scores of Türkiye



As shown in Figure 1, Türkiye's overall CLG score has decreased between 2006 and 2023. Initially ranging from 0 to -0.10, the governance level has experienced the most significant changes starting in 2014 and reached its lowest score in 2023. When considering Türkiye's legal and economic development together, particularly with the economic fluctuations in recent years, the legal steps taken in areas such as accountability and transparency have not been fully implemented, making Türkiye one of the countries with weak country-level governance.

- **Measurement of economic freedom:** The second explanatory variable is economic freedom level. The Index of Economic Freedom, which is frequently used in the literature (Alabede, 2018; Asteriou et al., 2021; Fernández-Rodríguez et al., 2023) and developed by the Heritage Foundation, was utilized to analyze the impact of economic freedom (EF). The "Rule of Law", "Government Size", "Regulatory Efficiency" and "Open Markets" are the four facets of the Index of Economic Freedom. The index evaluates circumstances in these four areas, calculating 12 distinct aspects of economic freedom, each of which is ranked from 0 to 100. These specific aspects are "property rights, judicial effectiveness and government effectiveness under the rule of law", "tax burden, government spending and fiscal health under government size", "business freedom, labor freedom, and monetary freedom under regulatory efficiency", and "trade freedom, investment freedom and financial freedom under open markets". To generate an overall EF score for each country, scores on these 12 aspects are computed from a variety of sub-variables, then evenly weighted and averaged (https://www.heritage.org/index/). The EF scores for Türkiye throughout the study period is presented in Figure 2.

Figure 2: Overall Economic Freedom Scores of Türkiye



Source: Author's work.

As presented in the above figure, Türkiye has experienced continuous fluctuations in terms of economic freedom, with both upward and downward changes. While Türkiye reached its highest level of economic freedom in 2018, by 2023, the country's economic freedom level had returned to the level it was at in 2006. As stated by Heritage Foundation, countries with an economic freedom score between 60 and 69.9 are classified as moderately free, while those with a score between 50 and 59.9 are classified as mostly unfree (Fernández-Rodríguez et al., 2021). Until 2021, Türkiye was classified as moderately economically free, but after 2021, it has been classified as a mostly unfree country in terms of economic freedom.

- **Control variables:** Based on prior studies (Adhikari et al., 2006; Delgado et al., 2014; Derashid & Zhang, 2003; Fernández-Rodríguez et al., 2023; Panda & Nanda, 2021; Richardson & Lanis, 2007), company-level control variables such as firm size (natural logarithm of total assets), profitability (pretax income to total assets), leverage (total debt to total assets), capital intensity (gross property, plant, and equipment to total assets), and inventory intensity (inventory to total assets) of the companies were used.

To estimate the influence of country-level governance and economic freedom on tax avoidance and test the hypothesis generated in Section 2, the following model was drawn up.

$$ETR_{it} = \beta_0 + \beta_1 CLG_{it} + \beta_2 EF_{it} + \beta_3 SIZE_{it} + \beta_4 LEV_{it} + \beta_5 ROA_{it} + \beta_6 CAPINT_{it} + \beta_7 INVINT_{it} + \mathrm{YEAR} + \varepsilon_t \quad (1)$$

In this model, tax avoidance is the dependent variable, defined as ETR. The explanatory variables are overall CLG and overall EF. Regarding the control variable, SIZE is firm size, LEV is leverage, ROA is profitability, CAPINT is capital intensity, and INVINT is inventory intensity. Additionally, year dummies are incorporated into the model to account for potential year-specific effects.

4. Empirical Findings

4.1. Univariate Findings

Table 1 displays an overview of descriptive statistics for all variables.

Table 1: Descriptive Statistics

	N	Std. Dev.	Mean	min	max	p25	p75
ETR	4899	0.193	0.148	0	1	0	0.215
CLG	4899	0.218	-0.322	-0.561	-0.023	-0.495	-0.07
EF	4899	3.043	62.163	56.9	65.4	59.9	64.4
SIZE	4899	0.879	8.667	6.565	11.491	8.035	9.254
LEV	4899	0.209	0.224	0	1.512	0.042	0.352
ROA	4899	0.118	0.042	-1.062	0.521	-0.004	0.095
CAPINT	4899	0.213	0.304	0	0.982	0.134	0.447
INVINT	4899	0.120	0.144	0	0.655	0.048	0.213

Source: Author's work.

Compared to the highest statutory rate in Türkiye between 2006-2023, which is 25%, the average ETR is only 15%. The average ETR being lower than the statutory tax rate supports the existence of tax avoidance behavior of Turkish companies. The findings reveal that the overall CLG varies from -0.56 at its lowest to -0.02 at its highest, with a mean of -0.32. In this context, it can be argued that Türkiye is characterized by weak country-level governance. With regard to EF, the results report that EF has a mean value of 62 (minimum 57, maximum 65), and according to this result Türkiye can be classified as a moderately free country throughout the study period (Fernández-Rodríguez et al., 2021). Concerning control variables, the findings exhibit that on average firm size is 8.7, with a minimum of 6.6. and a maximum of 11.4. The average leverage is 22.4%, signifying that Turkish companies are not highly leveraged. The mean value of profitability is 4.2% with a standard deviation of 11.8%, which indicates that sample companies do not have high profitability. Finally, capital intensity and inventory intensity have mean values of 30.4% and 14.4%, respectively.

The findings in Table 2 demonstrate that all dependent variables except country-level governance and inventory intensity have statistically significant correlations with ETR. Economic freedom, leverage, and capital intensity exhibit statistically significant and negative correlation with ETR. However, firm size and profitability have a statistically significant and positive correlation with ETR. The findings also indicate that country-level governance has significant correlations with all company-level characteristics. Moreover, economic freedom is negatively correlated with firm size and capital intensity but positively correlated with leverage.

Table 2: Correlation Results

Variables	ETR	CLG	EF	SIZE	LEV	ROA	CAPINT	INVINT
ETR	1.000							
CLG	0.013	1.000						
EF	-0.064***	-0.018	1.000					
SIZE	0.048***	-0.247***	-0.228***	1.000				
LEV	-0.117***	-0.034**	0.134***	-0.059***	1.000			
ROA	0.140***	-0.085***	-0.005	0.096***	-0.336***	1.000		
CAPINT	-0.062***	0.062***	-0.083***	-0.005	0.140***	-0.127***	1.000	
INVINT	0.021	0.029**	-0.022	-0.015	0.067***	-0.034**	-0.107***	1.000
*** $p<0.01$, ** $p<0.05$, * $p<0.1$								

Source: Author's work.

Table 2 shows that country-level governance has a positive but insignificant association with ETR as the proxy of tax avoidance, indicating that H1 is not supported. However, economic freedom demonstrates a significant negative correlation with ETR as the proxy of tax avoidance, offering initial evidence in support of H2.

To control for the existence of significant multicollinearity issues in the study, the variance inflation factors (VIFs) for each independent variable were calculated. According to Hair, et al. (2010) there should not be any serious multicollinearity concerns if the VIFs are less than 10. The average VIF value is 1.104, which is below 10 and highlights that multicollinearity is not present in this study.

4.2. Multivariate Findings and Robustness Checks

The current study employs three types of panel data techniques; "pooled ordinary least squares model", "fixed-effect model", and "random-effect model" to control for the possible unobserved heterogeneities among companies. With regard to the technique to be used for the estimation, F-test and Breusch-Pagan Langrange Multiplier tests were performed. Since the null hypothesis regarding the absence of individual effects is rejected at the significance level of 1%, both of these tests demonstrate the existence of individual effects. As a result, the "fixed-effect (FE) model" or "random-effect (RE) models" are more suitable than the "pooled ordinary least square (POLS) model". The study applied the Hausman test to determine whether the FE or RE model is the most suited for the analysis. The test outcomes revealed that the FE model is the best suited choice for the data. After confirming the validity of the FE model, diagnostic tests for heteroscedasticity, autocorrelation, and serial correlation were conducted. Since these issues were identified, Driscoll and Kraay's (1998) robust standard error estimator was applied to address them.

Table 3 provides the regression findings from all three models: POLS, FE and RE, where Column 2 displays the findings of the initial model.

Table 3: Regression Results

	POLS	FE	RE
CLG	0.0254*	0.0388**	0.0315**
	(0.0130)	(0.0157)	(0.0128)
EF	-0.00324***	-0.00239***	-0.00286***
	(0.000934)	(0.000837)	(0.000897)
SIZE	0.00427*	0.00669**	0.00571***
	(0.00221)	(0.00314)	(0.00213)
LEV	-0.0600***	-0.112***	-0.0821***
	(0.0142)	(0.0175)	(0.0174)
ROA	0.184***	0.117***	0.142***
	(0.0247)	(0.0299)	(0.0262)
CAPINT	-0.0383***	-0.00448	-0.0212
	(0.0131)	(0.0271)	(0.0176)
INVINT	0.0367	-0.0820**	0.00384
	(0.0230)	(0.0408)	(0.0308)
Constant	YES	YES	YES
Year	YES	YES	YES
Observations	4,899	4,899	4,899
Prob>F	0.000	0.000	
Prob>chi2			0.000
Hausman		0.000	
R-squared	0.031	0.025	0.029
Robust standard errors in parentheses			
**** p<0.01, ** p<0.05, * p<0.1*			

Source: Author’s work.

According to the findings displayed in Table 3, the association of CLG and ETR is significantly positive at the 5% level. In other words, consistent with Zeng (2019), as the country-level governance improves, companies are less inclined to avoid tax. This finding reveals that a high level of governance at the country level may lead to greater demands for transparency and accountability, which in turn restrict companies’ tax avoidance activities. Additionally, a strong legal environment is likely to support the development of the economic environment, potentially eliminating the need for companies to participate in tax avoidance. Moreover, the findings also indicate that companies resident in Türkiye prefer to avoid taxes more when the level of economic freedom increases. Fernández-Rodríguez et al. (2023) find a significant negative association between economic freedom and tax burden of BRIC countries, indicating that companies in BRIC countries participate in tax avoidance activities more when the level of economic freedom is higher. As stated by Egger & Winner (2004), an economically free environment fosters a more favorable business climate, which permits the government to impose higher taxes. In this case, the argument that countries with increasing economic freedom have the right to demand higher taxes may lead companies to become more inclined to avoid taxes. The findings confirm the study's H1 and H2, that country-level governance and economic freedom impact tax avoidance in Türkiye. At the company level, firm size is positively related to ETR, suggesting that larger companies do not prefer to engage in tax avoidance, which is in line with previous studies (Delgado et al., 2014; Fernández-Rodríguez et al., 2021; Kim & Zhang, 2016; Omer et al., 1993). Political cost theory (Plesko, 2003; Zimmerman, 1983) suggests that profitable and larger companies are more likely to be scrutinized politically than less profitable and smaller companies. Therefore, larger companies have a higher tax burden due to increased governmental control. Regarding the carryable leverage, a positive association with tax avoidance is found and reveals that high-leveraged companies avoid taxes more, reflecting the findings of Plesko (2003), Liu & Cao (2007), Richardson & Lanis (2007) and Delgado et al. (2014). This result aligns with the approach that financial expenses lower the tax burden of the companies. Consistent with Plesko, (2003), Richardson & Lanis (2007) and Zeng, (2019), profitability is positively associated with ETR, implying that companies with higher profitability engage in tax avoidance less. As regards inventory intensity, there is a positive interaction between tax avoidance and inventory intensity, implying that companies with higher inventory avoid taxes more, which also provides contradictory results with the previous literature (Adhikari et al., 2006; Zeng, 2019). However, the association between capital intensity and tax avoidance is positive but insignificant, aligned with the studies of Liu & Cao (2007).

To ensure that the main results persist, the regression is reestimated using an alternative measure for tax avoidance. For the robustness check, book-tax difference (BTD) is utilized to measure the tax avoidance. The total difference between pretax income and taxable income is how first Manzon, Jr. & Plesko (2005) first calculated BTD. It is the company's pretax income less its expected taxable income, scaled by total assets. The expected taxable income is estimated by dividing the current tax expense by the statutory tax rate (Ryan J. Wilson, 2009). It can be suggested that greater BTD values reflect a higher degree of tax avoidance. Since the tax rate applied to taxable income is not obvious, observations of firm-year with a negative pretax income have been eliminated (Zeng, 2019).

To estimate the influence of country-level governance and economic freedom on tax avoidance, the following model is developed.

$$BTD_{it} = \beta_0 + \beta_1 CLG_{it} + \beta_2 EF_{it} + \beta_3 SIZE_{it} + \beta_4 LEV_{it} + \beta_5 ROA_{it} + \beta_6 CAPINT_{it} + \beta_7 INVINT_{it} + \mathrm{YEAR} + \varepsilon_t \qquad (2)$$

Table 4 displays the empirical findings on the association of tax avoidance with country-level governance and economic freedom. The findings of the F-test, Breusch-Pagan Langrange Multiplier test, and Hausman test indicate that the FE model is the best fit for the study.

Table 4: Robustness Results

	POLS	FE	RE
CLG	-0.0277***	-0.0224***	-0.0247***
	(0.00416)	(0.00610)	(0.00394)
EF	0.000377	0.000872**	0.000702**
	(0.000299)	(0.000375)	(0.000275)
SIZE	-0.00243***	-0.00170*	-0.00189***
	(0.000707)	(0.000919)	(0.000651)
LEV	0.0164***	0.0644***	0.0479***
	(0.00431)	(0.0202)	(0.00545)
ROA	-0.0155***	-0.0120***	-0.0132***
	(0.00150)	(0.00347)	(0.00142)
CAPINT	0.0229***	0.0367***	0.0284***
	(0.00422)	(0.0101)	(0.00600)
INVINT	0.0596***	0.0420**	0.0497***
	(0.00737)	(0.0170)	(0.0106)
Constant	YES	YES	YES
Year	YES	YES	YES
Observations	4,899	4,899	4,899
Prob>F	0.000	0.000	
Prob>chi2			0.000
Hausman		0.000	
R-squared	0.034	0.056	0.081
Robust standard errors in parentheses			
**** p<0.01, ** p<0.05, * p<0.1*			

Source: Author's work.

The results of the analysis suggest that country-level governance is negatively associated with tax avoidance, and economic freedom is positively related to tax avoidance. This implies that companies resident in Türkiye avoid taxes less; when the level of governance in Türkiye strengthens and when economic freedom increases, companies prefer greater involvement in tax avoidance. Considering the outcomes of the main regression, a significant negative relationship between firm size and tax avoidance was observed. Consistent with the literature, increased profitability is associated with reduced tax avoidance. The findings also reveal that higher leverage, higher capital intensity, and higher inventory intensity are linked to greater tax avoidance.

5. Conclusion

In recent years, tax avoidance has become more significant for both public policy and academic research. The earlier research on this topic analyzed the role of company-level characteristics on tax avoidance practice of companies. Since corporate tax compliance is crucial for any country, one way that it might be consistently implemented in companies is by making sure that every economy has strong governance and greater economic freedom. However, few or no studies examine how external factors (such as economic freedom and the country-level governance) interact with the tax avoidance practice of companies.

In this study, it was attempted to fill this gap by hypothesizing that economic freedom and country-level governance impact tax avoidance practice of 371 Turkish companies from 2006 to 2023. The findings indicate that country-level governance and tax avoidance behavior have a significant and negative relationship, which implies that companies are less likely to participate in tax avoidance when the country-level governance increases. It can be argued that strong country-level governance enhances tax compliance of companies in Türkiye, leads to a decrease in managers' engagement in opportunistic behavior, reduces information asymmetry, and prevents agency conflicts. Furthermore, this study provides evidence that when the economic freedom level increases, companies prefer to avoid taxes more. According to this result, it can be suggested that the increase in economic freedom creates more opportunities for companies alongside economic growth, and companies may seek to take greater advantage of these opportunities. As economic freedom increases, companies tend to avoid more taxes to generate more cash, take better advantage of investment opportunities, and raise their firm values.

The findings of the study may be of interest to policymakers and regulators. Strengthening governance structures can further mitigate tax avoidance, protect shareholders' rights, and raise investor confidence, thereby supporting sustainable economic development. More importantly, it should be stated that companies do not need to engage in tax avoidance when the economic freedom level increases and that they will be supported to take advantage of investment opportunities.

Finally, this study is constrained by some limitations. In this study, since only publicly traded companies were included, the results cannot be generalized. To make the findings more generalizable to Türkiye, including small and medium-sized enterprises could contribute to obtaining different results. On the other hand, the overall scores of country-level governance and economic freedom were used as explanatory variables. If scores related to sub-indicators were included instead of the overall scores, different interpretations and arguments could be obtained for each indicator. In order to fully comprehend how the interplay between political and economic freedom may affect tax avoidance, political freedom in addition to economic freedom can be included in future studies. In addition to country-level governance, corporate governance could also be considered, sectoral differences can be included, and comparisons with other countries in terms of similar economic development could also be taken into account.

Conflict of Interest

The author declare that there is no conflict of interest.

Ethics Approval

No specific ethical approval was necessary for the study.

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