

# Political Connections and Tax Avoidance

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## Political Connections and Tax Avoidance

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### <sup>2</sup>**Abstrak**

**Tujuan** - Penelitian ini bertujuan untuk menemukan bukti empirik apakah koneksi politik berpengaruh terhadap penghindaran pajak.

**Desain/Methodologi/Pendekatan** - Metode penelitian yang digunakan adalah metode penelitian kuantitatif dari data laporan tahunan dan laporan keuangan perusahaan sektor konsumsi primer yang terdaftar di BEI (Bursa Efek Indonesia) tahun 2019-2021. Metode pengambilan sampel yang digunakan yaitu metode pengambilan sampel secara non probabilitas berupa purposive sampling. Penelitian ini menggunakan regresi data panel yang diolah menggunakan Eviews 12.

**Temuan** - Hasil penelitian menunjukkan bahwa koneksi politik berpengaruh terhadap penghindaran pajak.

**Keterbatasan/Implikasi Penelitian** – Investor yang ingin berinvestasi pada suatu perusahaan dapat memilih untuk berinvestasi pada perusahaan yang memiliki koneksi politik karena minimnya praktik penghindaran pajak yang dilakukan pada perusahaan tersebut.

**Kata Kunci:** Pajak, Koneksi Politik, dan Penghindaran Pajak

### **Abstract**

**Purpose** - This study aims to find empirical evidence whether political connections affect tax avoidance.

**Design/methodology/approach** - The research method used is a quantitative research method from annual reports and financial statements of primary consumption sector companies listed on the IDX (Indonesia Stock Exchange) for 2019-2021. The sampling method used is a non-158

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probability sampling method (purposive sampling). This study used regression panel data processed using Eviews 12.

**Findings** - the results showed that political connections affect tax avoidance.

**Research limitations/implications** – Investors who wish to invest in a company may choose to invest in companies with political connections due to the minimal tax avoidance practices carried out in such companies.

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**Keywords:** Tax, Political Connections, and Tax Avoidance

## Introduction

One source of state income is taxes. It is the largest source of state income for carrying out national development aimed at improving people's lives. According to Undang-Undang No 16 Tahun 2019, taxes are contributions required by the state from individuals or entities that are coercive in nature and used for the needs of the state and the prosperity of the Indonesian people. The Ministry of Finance sets the tax revenue target every year with the aim of achieving it, as tax is the largest source of state income.

The government aims to optimize tax revenues, which can often conflict with taxpayers. These companies try to minimize their tax burden to maximize profits, but they must still comply with all applicable tax regulations. To achieve this, one can engage in tax avoidance practices that aim to reduce the tax burden without violating established tax provisions (Mardiasmo, 2018). This activity is carried out by individual taxpayers and also corporate taxpayers (Anderson & Ismail, 2023).

The Indonesian government is continuously implementing new regulations to prevent tax avoidance practices in the country. This is due to the fact that many taxpayers in Indonesia still engage in such practices. For instance, some taxpayers report business profits that are significantly lower than those of similar companies, or even report an unreasonable fiscal loss despite making commercial sales for five years and reporting a fiscal loss for three consecutive years. To prevent tax avoidance practices in Indonesia,

the government issued regulation PP 55/2022 (Redaksi DDTC News, 2023).

The optimal tax ratio for a country to sustainably finance various development projects is 15%. However, as of 2022, Indonesia's tax ratio is only 10.41%, indicating that the country has not yet reached its ideal tax ratio. This also suggests that tax avoidance is still prevalent in Indonesia, resulting in suboptimal state income from taxation (CNBC Indonesia, 2023; Siswanto, 2022).

Zhang (2012) explains that in China, the government awards corporate taxpayers who pay the highest taxes. This award can lead to media attention and a positive image for corporate executives with political connections. As a result, these executives are encouraged to make maximum contributions in paying large taxes to the state.

In Indonesia, there are also awards for the highest taxpayers, similar to those in China. In 2020, Telkomsel, a State-Owned Enterprise (BUMN) operating in the field of Information and Communication Technology (ICT) services and telecommunications networks, received an award and appreciation from the Directorate General of Taxes for being the largest tax contributor at the Tax Service Office. In 2020, Telkomsel was one of the four large taxpayers for state companies/BUMN in the service sector and large individual taxpayers. Its national tax contribution grew by 1.3 percent compared to 2019 (Tommy, 2021). Telkomsel's receipt of this award will enhance its reputation and motivate the company to continue making maximum contributions to the state's tax revenue.

Companies with executives who have political connections may receive benefits from the government. In return, the company may have an obligation to comply with government policies, such as paying taxes to support existing policies. <sup>17</sup>

The motivation for this research is to investigate the influence or impact of political connections on tax avoidance in Indonesia. Previous studies have found inconsistent results.

Previous research <sup>1</sup> has found conflicting results regarding the relationship between political connections and tax avoidance. Some studies have found no influence or relationship (Dharma & Ardiana, 2016; Fatharani, 2012; Hijriani et al., 2017; Lestari & Putri, 2017; Purwanti & Sugiyarti, 2017), while others suggest a positive relationship (Asadanie & Venusita, 2020; Butje & Tjondro, 2014; Fajri & Rusydi, 2019; Hardianti, 2014). The research findings indicate that political connections have a negative relationship with tax avoidance (Adhikari et al., 2006; Mulyani et al., 2014; Pranoto & Widagdo, 2016; Tehupuring & Rossa, 2016).

The purpose of this research is to determine whether there is empirical evidence of a relationship between political connections and tax avoidance. Previous studies have produced varying results on this topic. <sup>8</sup>

Conducting this research aims to enhance the understanding of how political connections relate to tax avoidance. Additionally, it may serve as a factor for investors seeking to invest in politically connected companies.

## <sup>10</sup> Literature Review and Hypothesis

Agency theory explains the relationship between the owner (principal) and other individuals (agents) within a company. The principal, who is typically a stakeholder or shareholder, is responsible for reviewing information, while the agents, who are typically company management, make

decisions and carry out tasks assigned by the principal. The information reviewer, acting as the principal, must provide the agent with a variety of options to make the best decision in the principal's interest. This theory acknowledges that the principal and agent have differing interests. The principal's objective is to achieve good performance and maximum profits for the company, while the agent's objective is to improve their own welfare. When company management fulfills the owner's interests, such as increasing profits, their own welfare is also achieved. This can be accomplished through rewards such as compensation, bonuses, or incentives for achievements made by the company management (Jensen & Meckling, 1976). Under pressure from the principal to achieve good performance and maximize profits, the agent may resort to tax avoidance practices to minimize the company's tax burden and increase profits.

However, social exchange theory explains that relationships between individuals are viewed from an economic perspective. The sacrifices (costs) given are compared with the benefits obtained to determine the continuation or end of a relationship. In this context, sacrifice (cost) has a negative element, and benefit has a positive element. If the benefits obtained outweigh the sacrifices made, the relationship between individuals will continue, and vice versa. This theory is based on the concepts of individual interests and interdependence. Interdependence means that the benefits received by one person are influenced by the efforts of another person, resulting in interdependence between the two parties involved (West & Turner, 2008). A reciprocal relationship may emerge between the government and companies in business matters. The government may provide benefits or incentives for companies, and in return, companies may comply with existing government policies, such as paying taxes to the state.

1 Zhang (2012) found a positive relationship between political connections and tax avoidance in his research conducted in China. This relationship can be explained by the political favoritism effect, where political connections have a higher influence on the practice of tax avoidance. Executives with strong political connections in their companies can lobby the government and tax agencies in China to avoid tax audits, minimize fines, or engage in tax avoidance practices. This can lead to unfair advantages and undermine the integrity of the tax system.

The second effect is the bureaucratic incentive effect, which explains the negative relationship between political connections and tax avoidance. This effect means that the existence of political connections has a lower impact on the practice of tax avoidance. The government evaluates executives with political connections in a company, whether they are commissioners or members of the board of directors, which reduces the likelihood of tax avoidance. This evaluation considers several factors, including the tax contributions made to the state. In China, the government awards corporations that pay the highest taxes, as is also the case in Indonesia. This achievement is expected to receive media attention and create a positive image for executives with political connections within the company. It will also serve as motivation to make maximum contributions towards paying taxes to the state. Shleifer and Vishny (1994) argue that a positive image is crucial for executives in a company, as it can help them and the company maintain positive value from shareholders even in difficult times. Therefore, it is important for executives to cultivate a positive image.

Businesses and governments have a reciprocal relationship. Companies with political connections receive external resources and other benefits provided by the government, such as expedited permits for setting up factories. However, companies have an obligation to comply with

government policies, including paying taxes to the state and establishing good relations with the government. This is not done without a cost. To maintain objectivity, it is important to avoid subjective evaluations unless clearly marked as such.

Based on the information provided, a hypothesis can be formulated:

H1: political connections have an influence on tax avoidance.

## Research Method

The study employs a quantitative research method to test the hypothesis and examine the relationship between political connections and tax avoidance. A data collection strategy was employed using an archive strategy sourced from secondary data and data collected from databases containing annual and financial reports of primary consumption sector companies (consumer non-cyclicals) listed on the BEI (Indonesian Stock Exchange) for the years 2019-2021. The research focuses on the primary consumption sector companies (consumer non-cyclicals) listed on the BEI (Indonesian Stock Exchange) as the unit of analysis. Cross-sectional and time-series studies were conducted for the years 2019-2021.

This research focuses on the population of 117 primary consumption sector companies (consumer non-cyclicals) listed on the BEI (Indonesian Stock Exchange) between 2019 and 2021. The population was selected to investigate and uncover the most recent issues that have arisen between 2020 and 2022. However, due to data collection limitations from annual reports, which only exist until 2021, the researcher opted to use data from the annual report for the last three years, which are 2019-2021. However, due to data collection limitations from annual reports, which only exist until 2021, the researcher opted to use data from the annual report for the last three years, which are 2019-2021.

However, due to data collection limitations from annual reports, which only exist until 2021, the researcher opted to use data from the annual report for the last three years, which are 2019-2021. The researchers selected the primary consumption sector, specifically consumer non-cyclicals, as the population for their study. This sector provides goods and services for daily basic needs and is known to be resilient even during economic downturns, such as the recent COVID-19 pandemic (Ramadhani, 2022). A non-probability sampling method, specifically purposive sampling, was used to obtain a sample of 33 companies with 99 annual and financial reports (Mustakini, 2018). The obtained samples are listed below:

**Table 1**  
**Sample Determination**

No	Criteria of Sample	Companies	Financial Statements
1	Primary consumption companies listed on the Indonesian Stock Exchange	117	351
2	Companies that have not submitted consecutive annual reports from 2019-2021.	-42	-126
3	Annual financial reports of primary consumer companies are not released in rupiah.	-2	-6
4	Companies in the primary consumption sector that did not achieve consecutive profits between 2019 and 2021.	-2	-6
5	Primary consumer companies that release financial reports with an adverse audit opinion or decline	-29	-87

	to provide an opinion.		
6	Companies that primarily consume goods or services and do not have tax payment data.	-5	-15
7	Companies that have a negative tax burden on primary consumption.	-2	-6
8	Outlier data	-2	-6
	<b>Samples</b>	<b>33</b>	<b>99</b>

**Operational Definition of Variables**  
**Independent Variable**

The independent variable (X) in this research is political connections. A dummy variable is used to measure political connections. A value of 1 is assigned if the company is known to have political connections, and 0 is assigned if it does not have political connections. A political connection within a company is established if any of its executives, including directors, supervisors, senior officials such as the CEO, president, vice president, chairman, or secretary, have been or are members of ministries, state institutions, parliament, or political parties. It is important to note that this definition excludes subjective evaluations unless they are clearly marked as such. According to Reimsbach et al. (2018), a company is considered to have political connections if one of its executives is a current or former member of the military. It is important to maintain objectivity and avoid subjective evaluations.

**Dependent Variable**

This research considers tax avoidance as the dependent variable (Y). To measure tax avoidance by a company, CETR (Cash Effective Tax Rate) is used as it is a reliable indicator (Chen et al., 2010).

$$CETR = \frac{\text{Tax Paid}}{\text{Income before Tax}}$$

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A higher CETR percentage indicates a low level of tax avoidance practices, while a lower CETR percentage indicates a high level of tax avoidance practices.

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**Control Variable**

- The control variables used in this study are:
1. Profitability. Return on Assets (ROA) as a measure of profitability by comparing profit before tax to total assets for the year concerned (Husnan, 2002).
  2. Company size. Company size variables are measured using the natural logarithm of total assets (Taylor & Richardson, 2012).

The research was analyzed using panel data regression. The stages of panel data regression analysis begin with estimating the panel data regression model, which consists of the Common Effect Model, Fixed Effect Model, and Random Effect Model. These models are then tested using the Chow Test, Hausman Test, and Lagrange Multiplier Test. Next, classical assumptions were tested, including the Normality Test, Multicollinearity Test, Heteroscedasticity Test, and Autocorrelation Test. Finally, a feasibility test of the panel data regression model is conducted, which includes hypothesis testing and coefficient of determination. The hypothesis test comprises two tests: the F-test and the t-test.

The regression equation obtained is presented below.

$$CETR = \alpha_0 + \beta_1 KP + \beta_2 ROA + \beta_3 SIZE + \varepsilon$$

- $CETR$  = Cash Effective Tax Rate
- $\alpha_0$  = Constanta
- $\beta_1 KP$  = Political Connection
- $\beta_2 ROA$  = Return on Asset
- $\beta_3 SIZE$  = Size
- $\varepsilon$  = Error

## Results and Discussion

### Estimation of Panel Data Regression Models

To estimate panel data, researchers used the Chow Test and Hausman Test to determine the best panel data regression model, choosing between the Common Effects Model and the Fixed Effects Model (Ghozali & Ratmono, 2017). Based on the results of these tests, it was concluded that the Fixed Effect Model is the best panel data regression model for this research and that model has passed the classical assumption test.

**Table 2**  
**Fixed Effect Model**

Variable	Coefficient	t-Statistic	Prob.
C	-11.78934	-1.061268	0.2926
KP_X1	0.631452	2.717666	0.0085
ROA_X2	-1.222812	-3.431161	0.0011
SIZE_X3	2.292422	1.115529	0.2689
R-squared		0.533281	
Adjusted R-squared		0.273993	
S.E. of regression		0.188619	
Sum squared resid		2.241362	
Log likelihood		47.03287	
F-statistic		2.056713	
Prob(F-statistic)		0.006328	

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The panel data regression equation can be obtained from the output of the Fixed Effect Model panel data regression model shown above.

$$CETR\_Y = -11.79 + 0.63*KP\_X1 - 1.22*ROA\_X2 + 2.29*SIZE\_X3 + e$$

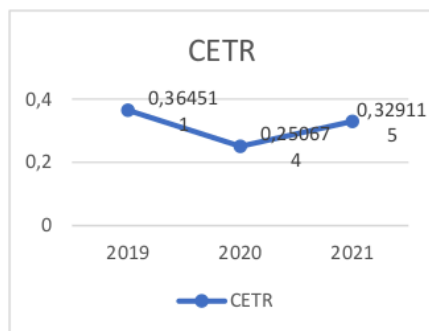
2  
The F-test results indicate that the panel data regression equation is correct, as the Prob(F-statistic) value of 0.006328 is less than 0.05 (see Table 7). The three independent

variables (political connections, profitability, and company size) can predict the dependent variable, tax avoidance (Ghozali & Ratmono, 2017).

The t-test results for each variable in the research are presented below:

- a. Variable X1, political connections, has a positive effect on variable Y, indicating that hypothesis 1 (H1) is accepted. This is demonstrated by the t-statistic value of the political connection variable (X1) 2.717666, which is greater than the t-table value of 1.984723186, and the probability value of 0.0085, which is less than 0.05.
- b. Control variable X2, profitability, has a negative effect on variable Y, namely CETR, indicating that hypothesis 1 (H1) is accepted. The t-statistic value of the profitability variable (X2) is -3.431161, which is less than the value in the t table (1.984723186), and the Prob value is 0.0011, which is less than 0.05.
- c. Control variable X3, company size, has no effect on variable Y (CETR), which means that hypothesis 1 (H1) is rejected. The t-statistic value of the company size variable (X3) is 1.115529, which is less than the value in the t table (1.984723186), and the value of Prob is 0.2689, which is greater than 0.05.

## Discussion



**Figure 1**  
**Average CETR 2019-2021**  
**Source: research data**

Figure 1 displays the average CETR data for 2019-2021 from 99 financial reports of 33 sample companies in this study. The average CETR in 2020 and 2021 is lower compared to that of 2019, indicating an increase in tax avoidance practices by primary consumption sector companies listed on the Indonesia Stock Exchange (BEI). The Indonesian government continuously creates new regulations to prevent tax avoidance practices in the country. PP 55/2022 was recently introduced for this purpose.

Based on the test results, it is evident that hypothesis 1 (H1) is supported, indicating that political connections have an impact on tax avoidance. The t-test also confirms that political connections have a positive effect on CETR. This implies that companies with political connections tend to have a higher Cash Effective Tax Rate. If a company's Cash Effective Tax Rate is higher, it indicates that the company has taken fewer tax avoidance actions.

The test results from this research are in line with the bureaucratic incentive effect which supports that the presence of political connections in a company will minimize tax avoidance. The bureaucratic incentive effect describes the relationship between political connections and tax avoidance. The government evaluates executives with political connections, such as commissioners or board members, based on their company's tax contributions to the state. This evaluation may benefit company executives with political connections by enhancing their public image. However, it is important to note that the award should not be the sole reason for minimizing tax avoidance. The focus should be on maintaining a positive reputation through ethical business practices.

The research findings align with social exchange theory, specifically regarding the reciprocal relationship between the government and companies in business. Companies with political connections receive benefits from those connections and, in return, comply with



government policies, such as minimizing tax avoidance and paying taxes for the country. In addition, this study supports the findings of Adhikari et al. (2006), Mulyani et al. (2014), Pranoto & Widagdo (2016), and Tehupuring & Rossa (2016) that political connections have a negative relationship with tax avoidance.

## Conclusion And Recommendation

### Conclusions

The research findings confirm the acceptance of hypothesis 1 (H1) that political connections have an impact on tax avoidance. The research concludes that political connections have a positive effect on CETR. This means that companies with political connections tend to have a higher Cash Effective Tax Rate, indicating minimal tax avoidance actions. Politically connected companies may comply with existing government policies, such as paying taxes to the state.

### Suggestions

This research has two implications of the findings. The first is theoretical, providing readers with a better understanding of the political connections that describe the practice of tax avoidance. Secondly, there are practical implications. Investors who wish to invest in a company may choose to invest in companies with political connections due to the minimal tax avoidance practices carried out in such companies.

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