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by Boedi Hartadi Kuslina, Joni Joni

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The Interplay Between Political Connections, ESG, and Tax Avoidance: Insights from Indonesia

Boedi Hartadi Kuslina
Management Department- Universitas Kristen Maranatha
Jl. Suria Sumantri no.65 Bandung-40164, Indonesia
boedi.hartadi@eco.maranatha.edu

Joni Joni
Magister of Accounting – Universitas Kristen Maranatha
Jl. Suria Sumantri no.65 Bandung-40164, Indonesia
joni@eco.maranatha.edu

Abstract

This study investigates the impact of political connections on tax avoidance and the moderating role of Environmental, Social, and Governance (ESG) engagement in publicly listed firms in Indonesia. Tax avoidance remain a critical issue for firms in emerging economies such like Indonesia. Research on tax avoidance for political affiliated firms in Indonesia have varied results from positive to negative effect on tax avoidance, and no effect. The role of ESG in mitigating the relationship, however, remains underexplored. Using a dataset of 140 observation from Refinitiv (LSEG) between 2019 to 2023, this study employs Generalized Method of Moments (GMM) to test the hypotheses. The models include firm-specific controls such as firm size, leverage, and profitability, and account for industry and year fixed effects. The findings reveal that politically connected firms engage in greater tax avoidance, as indicated by the negative relationship between political connections and effective tax rates (ETR). However, ESG engagement significantly moderates this effect, reducing the extent of tax avoidance among politically connected firms. Additionally, firm size and profitability negatively affect ETR, suggesting that larger and more profitable firms are more likely to engage in tax planning. These results enrich governance theories and emphasize stronger ESG regulation and policy to enhance tax enforcement as a practical implication. Future research should explore sector-specific ESG impacts and evolving tax regulations.

Keywords: Tax avoidance, political connections, ESG, corporate governance, GMM

1 Introduction

Tax considered an important component for both government and companies. On the government side, tax is revenue to finance government expenditures such as infrastructure development, education, public goods and other things for social welfare. For companies, tax is a significant cost which has direct effect on profitability as well as for company's value. It consequently becoming burden for companies and shareholders that make a reason for companies to avoid (Chen at al., 2010). Companies did tax avoidance using flaw in the tax system hence they can plan reduction of tax they owed (Lim, 2011). Previous research showed importance of political connection related to tax avoidance. In China, political connection shield companies from tax enforcement (Lin et al., 2018) and CEO who has relation with local government official more likely to engage tax avoidance. Kim and Lee (2021) exhibited the same result in South Korea that CEO who are well related to politician adopt riskier strategic choice such as tax avoidance. Abdullah et al. (2022) found firms with actively engage tax aggressive strategies tend to perform better when they have board members with political connections in Pakistan.

Indonesia as an emerging economy, tax has been a crucial issue. Tax in Indonesia contributes 75% of Indonesia revenue (Putra, 2022). Tax avoidance issue becoming more important as low tax revenue ratio were occurred in Indonesia (10.4%) compared to world average (13.5%) (CNN Indonesia, 2023). Prior research showed varied result of regulatory environments and political affiliations have impact on corporate tax strategies in Indonesia. Abdul Wahab et al. (2024) found military-connected firms enjoy higher tax avoidance. Moreover, political connection also weakened relation of tax avoidance and tax enforcement (Firmansyah et al., 2022). Diningrum & Kurniawati (2024), however, presented different findings. They found that political connection in board of commissioner has negative effect on tax avoidance and no effect when political connection in board of directors. Indarto & Widarjo (2021) findings showed the same result when company had a high leverage situation. While Rudyanto et al. (2023) showed no significant effect of political connection with tax aggressiveness during Covid-19 pandemic and negative impact on more ethical companies. The findings, however, showed positive impact of political connection when the companies are less ethical.

Ethical behaviour of companies exhibited in some forms, one of them is in Environmental Social and Governance (ESG) implementation in the companies. Some studies argue that firms with strong ESG commitments (high ESG index) may engage in more responsible tax behaviour (Elgharbawy & Aladwey, 2025; Du & Li, 2024; Lanis & Richardson, 2015). Other studies, showed opposite results that ESG performance have positive relationship with tax avoidance (Davis et al. 2016; Col & Patel, 2019; Chandrasena et al., 2024). Firms would reduce tax avoidance when ESG index were low due to the risk of reputation and apply tax avoidance strategies when ESG performance are high. Some firms may manipulate through ESG practice to cover unethical practice such as tax avoidance. In Indonesia, most studies showed negative effect of ESG through Corporate Social Responsibility (CSR) on tax avoidance (Adiputra et al., 2019; Fitri & Munandar, 2018; Mulyani et al., 2017). It means that firms that engage more CSR activities tend to comply with tax regulation.

Given the ambiguity of political connection relationship on tax avoidance in Indonesia and most findings of ESG practice in Indonesia showed negative effect on tax avoidance. This study aims to investigating ESG function as a moderator factor between political connection and tax avoidance in Indonesian public companies listed in Indonesia Stock Exchange (IDX). The role of ESG is crucial in determining of tax avoidance aligns with global sustainability efforts. According to stakeholder theory, companies engage in ESG as moral obligation and social responsibility are also expected to demonstrate the same commitment to the government by accomplished to their tax obligation (Fallan & Fallan, 2019)

As far as researchers' knowledge, there is little attention has been given to observe how ESG affect relationship between political connection and tax avoidance. Incorporating ESG as moderator factor, this research offers a novel theoretical framework that integrates political ties, ethical and governance, and tax strategies in the Indonesian market.

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2 Literature Review

2.1 Tax Avoidance

Tax avoidance considered as strategic minimization of tax liabilities through shifting funds such as income shifting, profit allocation, and tax incentives from the government to the business legally (Khuong et al., 2020). Firms engage in tax avoidance to increase after tax profits, improve cash flow, and enhance shareholder value (Alkurdi & Mardini, 2020). Social obligation approach suggests companies to avoid tax avoidance strategies due to reputation cost for the company (Ortas & Gallego-Alvarez, 2020). In contrast, Hanlon & Slemrod (2009) found CSR disclosure reflected risk management function to support company's image and reputation. Hence, CSR practice thought as shield for irresponsible action such as tax avoidance. However, excessive tax avoidance can lead to reputational risks, regulatory inspection, and potential policy changes (Duhoon & Singh, 2023). Tax avoidance determine by some factors are governance mechanism, CSR practice, firm characteristics, and political connection (Duhoon & Singh, 2023). In emerging economies like Indonesia, tax avoiding is prevalent issue due to weak enforcement and regulatory gaps (Firmansyah et al., 2022).

2.2 Tax Avoidance and Political Connection

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Political connection significantly impacted firms' tax behaviour. It often allows firms to engage with aggressive tax planning such as tax avoidance that reduced risk of regulatory problems (Kim & Lee, 2021). Reasons for firms to have political connection are (1) protected against detection and legal action risks, and (2) access to important information and future regulation changes and legal enforcement (include tax regulation and enforcement) (Ajili & Khlif, 2020). Empirical studies obtained that political connection reduce effective tax rates (ETR) meaning higher tax avoidance (Firmansyah et al., 2022; Lin et al., 2018; Kim & Lee, 2021; Abdullah et al., 2022). In Indonesia, however, the results are varied. Firmansyah et al. (2022) and Abdul Wahab et al. (2024) found positive results of political connection relationship with tax avoidance. In contrast, there are negative and no effect between political connections and tax avoidance (Diningrum & Kurniawati, 2024; Indarto & Widarjo, 2021).

Although there is no clear consensus among findings in Indonesia, in general empirical studies showed negative relationship of political connection and ETR. Hence, the study proposed such hypothesis:

H1: There is negative relationship between political connection and effective tax rate (ETR).

2.3 Tax Avoidance and ESG

The relationship between ESG practices and tax avoidance remain ambiguous. Some scholars argue that firms with strong ESG commitments employ in less tax avoidance due to ethical consideration and reputational concerns (Elgharbawy & Aladwey, 2025; Du & Li, 2024; Lanis & Richardson, 2015; Ortas & Gallego-Alvarez, 2020). ESG conscious firms may voluntarily pay higher taxes to demonstrate their commitment to corporate responsibility (Hoi et al., 2013). The findings were based on stakeholder theory that firms engage ESG activities for the benefit of their stakeholders. Tax regulator as public authorities should be seen as part of stakeholder, hence firms with strong ESG considered comply to tax regulation as part of their ESG activities.

Studies uses legitimacy and risk management theories explain different results compared to the one used stakeholders' theory. They found positive effect of ESG practice to tax avoidance (Davis et al. 2016; Col & Patel, 2019; Chandrasena et al., 2024). Companies might balance tax avoidance and ESG practice to manage their reputation. ESG actions and tax avoidance are principally view as risk-management strategy to enhance companies' reputation.

Indonesia practice of ESG mostly has negative association with tax avoidance or positive effect on ETR (Adiputra et al., 2019; Fitri & Munandar, 2018; Mulyani et al., 2017). The same findings showed by Rudyanto et al. (2023) that more ethical companies showed negative impact on tax aggressive during Covid-19 pandemic.

From the above discussion, the study proposed hypothesis:

H2: ESG performance has positive impact on ETR.

2.4 Moderating Effect of ESG on the Relationship Between Political Connections and Tax Avoidance

Recent studies imply that ESG plays a moderating role in relationship between political connections and tax avoidance. ESG reporting can act as a governance mechanism that constrains politically connected firms from doing in excessive tax avoidance through increasing transparency and accountability (Firmansyah et al., 2022). Moreover, Rudyanto et al. (2023) showed more ethical companies doing less tax avoidance although they had political connection in their boards. Firms that actively disclose ESG information may be more closely to be monitored by public, investors, and regulators. They, accordingly, less likely to apply tax avoidance aggressively. ESG reporting could function as an external pressure mechanism to enhance tax compliance (Kanagaretnam et al., 2018). However, ESG can also serve as a strategic tool for politically connected firms to justify tax-saving strategies while maintaining a responsible public image (Davis et al. 2016; Col & Patel, 2019; Chandrasena et al., 2024).

The dual role of ESG as both a constraint and an enabler of tax avoidance highlights the complexity of corporate tax behaviour in politically connected firms. Hence, the study propose hypothesis based on Firmansyah et al. (2022) and Rudyanto et al. (2023), as most Indonesia case on ESG has negative association with tax avoidance.

H3: ESG moderating positively on relationship between political connections and tax avoidance.

3 Data and Methods

This study utilizes secondary data obtained from publicly listed firms on the Indonesia Stock Exchange (IDX) between 2019 to 2023 using Refinitiv (LSEG) data base. The dataset consists of 140 observations across various industries and classified using the Global Industry Classification Standard (GICS). The financial and governance-related information including tax reports, political connections, is extracted from annual reports, sustainability reports, and financial statements. Firms with missing or incomplete disclosures were excluded using listwise deletion method, ensuring consistency in the analysis.

The dependent variable in the study is tax avoidance, measured using the effective tax rate (ETR) as a widely used to measure tax avoidance (Tang, 2020). ETR is calculated as the ratio of total tax expense to pre-tax income. A lower ETR indicates higher levels of tax avoidance. The main independent variable is political connection (PC), which number of political affiliations person from board members, commissioners, or top executives of the companies. Political affiliation is based on direct government roles, membership in political parties, or previous governmental positions.

The study also examines ESG performance as independent variable, which is measured using ESG score from Refinitiv (LSEG) database. To investigate the moderating role of ESG in the relationship between political connections and tax avoidance, an interaction term PC x ESG is included in the regression model.

Several control variables are used to enhance the robustness of analysis. Firm size (SIZE) is measured as the logarithm of total assets. Leverage (LEV) is calculated as the ratio of total debt to total assets, reflecting a firm's capital structure. Return on assets (ROA) indicate of firm profitability (Lin et al., 2018). Additionally, industry (IND) and year (YEAR) were included to control for sectoral differences and time-specific variations.

To examine the relationship between political connections, ESG performance, and tax avoidance, the study employs the Generalized Method of Moments (GMM) estimation technique. GMM is utilized to address potential endogeneity concerns, which may arise due to reverse causality or omitted variable bias. The regression model is specified as follows:

$$ETR_{i,t} = \beta_0 + \beta_1 PC_{i,t} + \beta_2 ESG_{i,t} + \beta_3 (PCxESG)_{i,t} + \beta_4 SIZE_{i,t} + \beta_5 LEV_{i,t} + \beta_6 ROA_{i,t} + + \gamma IND + \delta YEAR + \epsilon_{i,t}$$

where represents the Effective Tax Rate for firm i in year t, denotes political connection status, captures ESG disclosure scores, and is the interaction term to assess the moderating role of ESG. Control variables include firm size, leverage, and profitability, while industry and year fixed effects account for sectoral and temporal influences.

4 Findings and Discussions

4.1 Descriptive Statistics and Person Correlation Test

Table 1 summarizes the key statistics of variables in this study. The ETR has a mean of 0.285 with high variability (SD = 0.395), indicating differences in tax burdens across firms. Some firms report zero taxes, while others have ETRs exceeding 4. It possibly due to penalties or tax adjustments excess from regulation or tax planning of the firms. While PC shows that 36.1% of firms have political ties, with values ranging from 0 to 2 persons in the firms. ESG scores average 49.41 (SD = 18.58), showing significant variation in sustainability engagement among firms. The variation might indicate inconsistent adoption of sustainability practices as a strategic tool or reflect differences in industry requirements or investor expectations. Among control variables, SIZE averages 24.83 (SD = 2.06), while LEV and ROA show considerable dispersion (ROA ranging from 0.45% to 68.55%). These variations suggest potential differences in firms' tax strategies.

Table 1. Descriptive Statistics

Variabel	**N**	**Mean**	**Std. Deviasi**	**Min**	**Max**
ETR	140	0.285	0.395	0	4.400
PC	140	0.361	0.410	0	2
ESG	140	49.406	18.579	12.59	86.67
SIZE	140	24.826	2.056	20.99	32.668
LEV	140	0.179	0.168	0	0.706
ROA	140	10.857	10.561	0.45	68.55

Table 2 presents the Pearson correlation test, which examines the relationships between ETR, PC, ESG, and key financial variables. The results indicate that the correlations among the study's variables are generally low, suggesting no serious multicollinearity concerns. The strongest correlation is observed between SIZE and LEV (0.536, $p < 0.001$), indicating that larger firms tend to have higher debt levels. Additionally, LEV is negatively correlated with ROA (0.299, $p < 0.001$), suggesting that highly leveraged firms exhibit lower profitability. ESG is positively correlated with firm size (0.205, $p < 0.05$) and profitability (0.195, $p < 0.05$), implying that larger and more profitable firms tend to engage in sustainability initiatives. However, ESG does not show a significant correlation with ETR (0.017, $p > 0.10$), indicating that ESG performance is not directly linked to tax avoidance strategies.

Table 2. The Pearson Correlation Test

	(1)	(2)	(3)	(4)	(5)	(6)
(1) ETR						
(2) PC	-0.123					
(3) ESG	0.017	0.012				
(4) SIZE	-0.086	0.128	0.205**			
(5) LEV	0.098	0.010	0.007	0.536***		
(6) ROA	-0.092	0.120	0.195**	-0.113	-0.299***	

Note: ** $p < 0.05$; *** $p < 0.01$

4.2 Regression and General Moment Method Test Result

This study uses ordinary least square (OLS) regression and the general moment method (GMM) to cater potential endogeneity problem. The result from both estimations presented and compared to evaluate the robustness of the finding. Table 3 presents the OLS regression results. PC exhibit a significant negative effect on ETR (-0.182, $p < 0.05$ in Model 1), hence H1 is accepted. The result indicates politically connected firms tend to engage in higher tax avoidance. When ESG and its interaction term (PC × ESG) are included in Model 2, the coefficient for PC remains significant but weaker (-0.067, $p < 0.05$), while ESG itself does not show a significant effect on ETR. The result showed that H2 is rejected, mean there is no significant effect of ESG alone on ETR. Interestingly, the interaction term PC × ESG is positive and weakly significant (0.001, $p < 0.10$) (H3 is accepted), suggesting that ESG engagement may mitigate tax avoidance practices among politically connected firms. The control variables reveal that SIZE and ROA are negatively related to ETR, implying that larger and more profitable firms engage in tax planning strategies. Whereas LEV is positively associated with ETR (0.831, $p < 0.05$), indicating that highly leveraged firms tend to have higher tax payment. Model 2 shows improved explanatory power ($R^2 = 0.3181$, Adj $R^2 = 0.2167$), suggesting that the inclusion of ESG enhances model fit. Small value Variance Inflation Factor (VIF) for Model 1 and 2 (1.60 and 2.86) indicates there is no multicollinearity concern in both models.

Table 3. The OLS Results of Tax Avoidance Relations to Other Independent Variables

	ETR	
Variables	Model 1	Model 2
PC	-0.182**(-2.05)	-0.067**(-1.99)
ESG		-0.000(-0.14)
PC*ESG		0.001*(1.79)
SIZE	-0.115*(-1.84)	-0.011*(-1.94)
LEV	0.831**(2.14)	0.055(1.22)
ROA	0.001(0.07)	-0.002***(-2.70)
IND	*Included*	*Included*
YEAR	*Included*	*Included*
Average VIF	1.60	2.86
R^2	0.1887	0.3181
Adj R^2	0.0831	0.2167
F	1.79	3.14
Prob > F	0.0400	0.0001
N	140	140

Note: $^{*}p < 0.1$; $^{**}p < 0.05$; $^{***}p < 0.01$

To address endogeneity concerns and robustness, Table 4 presents the GMM estimation results. The findings confirm the negative association between PC and ETR, with a significant coefficient of -0.067 ($p < 0.05$ in Model 2) indicating H1 is accepted. The result support the argument that politically connected firms engage in tax avoidance. ESG result is consistently (with OLS) does not showed significant effect (rejected H2). However, the interaction term PC × ESG becomes more significant (0.001, $p < 0.05$) in different direction (accept H3). The result revealed that ESG engagement plays a strong moderating role on ETR although it has no significant effect on ETR. SIZE becomes statistically significant (-0.011, $p < 0.05$) when ESG interaction included, reinforcing the idea that larger firms engage in structured tax planning through ESG. Furthermore, ROA becomes significantly negative (-0.001, $p < 0.01$) when ESG interaction incorporated in the model. This result confirming that more profitable firms are more likely to engage in tax avoidance strategies when company have political ties and ESG practices.

These findings align with previous studies on tax avoidance and political connections. The negative relationship between PC and ETR is consistent with prior research suggesting that politically connected firms leverage their influence to reduce tax burdens (Firmansyah et al., 2022; Lin et al., 2018; Kim & Lee, 2021; Abdullah et al., 2022; Abul Wahab et al., 2024). Furthermore, the significant moderating role of ESG aligns with research indicating that strong corporate governance and sustainability practices can control aggressive tax planning such as tax avoidance (Elgharbawy & Aladwey, 2025; Du & Li, 2024Lanis & Richardson, 2015; Ortas

& Gallego-Alvarez, 2020). ESG disclosure regulate (Firmansyah et al., 2022) and pressure (Kanagaretnam et al., 2018) for companies to do excessive tax avoidance. This might a strategic tool for politically connected firms to maintain public image (Davis et al. 2016; Col & Patel, 2019; Chandrasena et al., 2024). Probably, this also indicating that ethical consideration might limit tax avoidance through political connection (Rudyanto et al., 2023).

Table 4. GMM Result Test

	ETR	
Variable	Model 1	Model 2
PC	-0.182*(-1.82)	-0.067**(-2.41)
ESG		-0.000(-0.17)
PC*ESG		0.001**(2.08)
SIZE	-0.115(-0.96)	-0.011**(-2.15)
LEV	0.832(1.45)	0.055(1.34)
ROA	0.001(0.11)	-0.001***(-3.08)
b0	2.870(1.02)	0.521***(3.99)

Note: * $p < 0.1$; ** $p < 0.05$; *** $p < 0.01$

Moreover, the findings from control variables exhibit setting of model. Significant role of ESG on political connection and tax avoidance are more likely in larger and profitable firms. The reduced impact of leverage in the GMM model suggests that once endogeneity is controlled for, debt financing may not play as central a role in tax planning as initially observed in the OLS model.

The implications of these findings extend beyond regulatory considerations. From a corporate governance perspective, firms with political ties may face increased examination from investors and stakeholders who demand higher levels of tax transparency and ESG commitment. This suggests that politically connected firms should not only focus on compliance but also on enhancing their ESG reporting to mitigate reputational risks associated with tax avoidance (Elgharbawy & Aladwey, 2025; Du & Li, 2024). Additionally, firms with strong ESG practices may benefit from improved public perception, greater investor confidence, and potential incentives from regulators, further reinforcing the business for more responsible tax behaviour and be more ethical (Rudyanto et al., 2023).

Moreover, the results highlight the dual role of ESG in tax avoidance strategies. Negative sign of ESG effect on ETR (although not significant) indicates firms may leverage ESG engagement as a tool for mechanism to divert attention from tax planning activities. However, at the same time ESG has positive moderating role in control tax avoidance. This reinforces the need for stronger regulatory oversight on ESG disclosures to ensure that sustainability initiatives genuinely reflect ethical corporate behaviour rather than being exploited as a tax avoidance strategy (Rudyanto et al., 2023).

5 Conclusions and Limitation

This study examines the relationship between tax avoidance, political connections, and ESG performance of publicly listed firms in Indonesia. The study provides empirical evidence that political connections are strongly associated with higher tax avoidance**,** as firms with political ties tend to lower their effective tax rates. However, the findings also indicate that ESG engagement plays a moderating role**,** alleviating the extent of politically connected firms engage in tax avoidance. Interestingly, although ESG perform stronger than political connection in tax avoidance, it has a positive but not significant effect on tax avoidance motives among the firms.

The findings have important policy and managerial implications. For regulators and policymakers, the study suggests the need for stronger ESG disclosure regulations to ensure that sustainability commitments are not merely symbolic but actively discourage aggressive tax strategies. Furthermore, tax authorities should implement prudent monitoring of politically connected firms to prevent undue tax advantages.

For corporate governance literature, the results highlight the importance of ESG integration in tax strategy for political affiliated firms**.** The findings enrich stakeholder theory as well as legitimacy and risk management theory. Affiliated firms probably integrate ESG as part of risk management to avoid bad reputation caused by tax avoidance practice. At the same time, however, might a genuine ethical behaviour of the firms.

Findings would encourage future research through exploring sectoral differences in examining the variables. Industry-specific examination may provide deeper insight into how different governance structures shape corporate tax strategies. Furthermore, longitudinal studies could investigate how changes in political regime and ESG policies impact tax behaviour over time.

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