The Effect of Corporate Political Connections on Tax Aggressiveness: Evidence in Indonesia

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Abstract. This study examines whether corporate political connections influence tax aggressiveness in state-owned enterprises and private-owned enterprises in Indonesia. The observation period is 2015 to 2017. The population taken is a state-owned enterprise and a non-financial sector private sector business entity with 327 companies with a period of 3 years. Then the determination of the sample using purposive sampling method, used a sample of 148 companies. This research use panel data as a research method. The results of this study indicate that the existence of political connections in state-owned enterprises and private-owned enterprises has a significant positive effect on tax aggressiveness.

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Introduction

Political connections often occur in developing countries where political connections are made by placing parties that have closeness with the government, so that the government has connections to the company's organizational structure, whether commissioners or directors (Fisman, 2001). In Indonesia, this often occurs especially in State-Owned Enterprises (SOEs), namely by conducting a number of filling and turnover of state-owned commissioners from volunteers, coalitions, as well as from members of political parties to assume positions as State-Owned Enterprises commissioners. The purpose of the existence of political connections one of which is an act of tax avoidance by companies by minimizing the tax burden within limits that do not violate regulations, because tax is one of the factors of profit reduction. The amount of the tax as we know it depends on the amount of income. The higher the level income earned, the greater the tax that must be paid. Therefore, companies need proper tax planning so that companies pay takes correctly and efficiently. The one way to do this is by carrying out tax aggressiveness. In this study will look at how the influence of companies both State-Owned Enterprises and Private-Owned Business are politically connected with the government towards their tax aggressiveness actions.

Tax aggressiveness is part of tax planning which aims to reduce the value of taxable profits that are still in accordance with tax regulations (Frank *et al.*, 2009). Tax aggressiveness refers to how tax avoidance is legal and safe because it does not conflict with tax regulations and discloses full information to tax authorities. The methods and techniques used are likely to exploit the weaknesses contained in the tax laws and regulations themselves and do not violate tax laws. Companies that make political connections, in general, often carry out tax aggressiveness. This was done by the company in order to have a lower risk of detection because politicians also provide protection to companies that are connected with it so that the risk of tax avoidance can be lower. Then the company can have better information about changes to tax regulations in the future. The impact that is also felt is the low pressure from the capital market to carry out transparency and the potential to reduce political costs related to tax planning activities through tax

aggressiveness. Not only that, political connections also benefit companies to gain access to the central government (Kim *et al.*, 2016).

Theoretical Thinking Framework and Hypothesis Formulation

There are two sides that connect political connections with tax agreements (Kim *et al.*, 2016). The first is the political connection made by SOEs is to lobby with the government to avoid tax audits, submission of tax penalties and other actions classified as tax evasion or tax aggressiveness. Political connections made will have a good influence on tax aggressiveness called Political Favoritism Effect.

Secondly, the government has the authority to establish and evaluate the executive parties in State-Owned Enterprises, both the board of commissioners and the board of directors. Awards were also given to SOEs that contributed to the payment of high taxes. This phenomenon has also occurred in Indonesia. This proves that the government plays a dominant role in political connections so that it gives a bad influence on tax aggressive action so that it is called the Bureaucratic Incentive Effect.
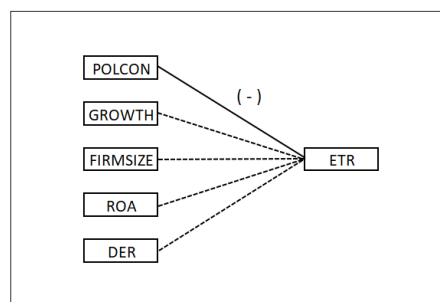

Fig. 1. Hypothesis Formulation

The Effect of Political Connections on Tax Aggressiveness

According to Zhang *et al.* (2012) and Kim *et al.* (2016), political connections can have a positive or negative impact on tax aggressiveness. The positive impact of political connections is getting preferential treatment from the government in terms of taxation such as avoiding tax audits. Political connections also have a negative effect on tax aggressiveness. In

state-owned enterprises, the executive members both the board of commissioners and the board of directors are determined and evaluated by the government. Although there are a number of considerations in evaluating, one of the government's considerations is the company's contribution to state revenues through tax payments. This will make the board of commissioners and directors retained or given promotional rights to the company. Larger state-owned enterprises to reinforce their political legitimacy and be able to play a deeper role in managing the company so that the company can contribute more to state revenues.

The government also gives appreciation in the form of awards given to companies both State-Owned Enterprises and Private-Owned Business Entities that contribute greatly to the state through high tax payments (Kim *et al.*, 2016). Seeing this phenomenon, both companies that are state-owned enterprises and privately-owned business entities will compete with each other with other companies in order to be able to make a major contribution to the country through high tax payments.

The existence of political connections will also make the company obtain special treatment, such as the ease of obtaining capital loans and the risk of low tax audits, thus making the company more aggressive in implementing tax avoidance which results in decreased financial report transparency. In addition, companies that have political connections with the government in power are proven to have a significantly high level of tax avoidance when compared to companies that have no political connections (Kim *et al.*, 2016). Based on the explanation above, the research hypothesis is as follows:

H_1 = political connection has a negative effect on tax aggressiveness.

Research Methods

Population and Research Samples

The population in this study is a state-owned enterprise and a non-financial sector private enterprise (banking, insurance, securities and leasing). This is because it is difficult to get a regression component to get ETR values from companies in the financial industry (especially banks).

Then, it is focused on state-owned enterprises and private-owned business entities that go public, assuming that state-owned enterprises and private-owned enterprises that go public have required reporting of financial and annual reports to the public, making it easier for researchers to identify. From this population, the sample was taken by using purposive sampling method according to the type and criteria needed. The criteria specified in the sampling are as follows:

1.   The company of a state-owned enterprise and a private-owned business entity in the non-financial sector listed on the Indonesia Stock Exchange in 2015 - 2017.
2.   Companies that are not delisted during the observation period.
3.   No loss during the observation period.

Research Variable

The dependent variable in this study is tax aggressiveness which is measured using effective tax rates (ETR). ETR is measured by 2 proxies, namely Current ETR and ETR Cash.

1.   Current ETR, is used to see the ETR value of the company for the current tax burden.

$$\text{CURRENT ETR} = \frac{\text{Tax Expense-Deffered Tax Expenses}}{\text{EBIT}}$$

2.   ETR Cash, reflects the company's ability to pay a small amount of cash taxes per currency from EBIT.

$$\text{CASH ETR} = \frac{\text{Cash Taxes Paid}}{\text{EBIT}}$$

The independent variable in this study is political connections through the board of commissioners or directors, measured by dummy variables. Value 1 if there is a board of commissioners or directors whose members are former presidential candidates, members of the people's legislature, serving as chairman / member of a political party, government officials, and as military officials both active and non-active (Adhikari *et al.*, 2006).

The control variable used in this study is profit growth as measured by Ln EBIT, company size measured through Ln total assets, Return on Assets and Debt Equity Ratio.

Analysis Model

The analysis model in this study is to use two models:

1st Model (Cash ETR)

$CashETR_{i.t} = α + β_1 POLCON_{i.t} + β_2 GROWTH_{i.t} + β_3 FIRMSIZE_{i.t} + β_4 ROA_{i.t} + β_5 DER_{i.t} + ε_{i,t}$

2nd Model (Current ETR)

$CurrentETR_{i.t} = α + β_1 POLCON_{i.t} + β_2 GROWTH_{i.t} + β_3 FIRMSIZE_{i.t} + β_4 ROA_{i.t} + β_5 DER_{i.t} + ε_{i,t}$

Explanations :

$CashETR_{i.t}$	=	Cash *Effective tax rate* company i in year t
$CurrentETR_{i.t}$	=	Current *Effective tax rate* company i in year t
$POLCON_{i.t}$	=	D*ummy variable*, Polcon company i in year t
$GROWTH_{i.t}$	=	Ln EBIT company i in year t
$FIRMSIZE_{i.t}$	=	Ln total asset company i in year t
$ROA_{i.t}$	=	*Return of Asset* company i in year t
$DER_{i.t}$	=	*Debt Equity Ratio* company i in year t
$ε_{i,t}$	=	*Error*

Results and Discussion

Description of Research Object

Table 1
Research Object

Criteria		Total
State-owned enterprises and private sector non-financial sector companies listed on the Indonesia Stock Exchange in 2015 - 2017.	327 Companies x 3 years	981
Companies that are not delisted during the observation period.	327 Companies x 3 years	981

Criteria		Total
No loss during the observation period.	148 companies x 3 years	444
Total number of samples (N_{i.t})		**444**

Source: Data processed, 2019

Selecting of The Best Model Data Regression Panel

Table 2
Model Selection

Description	Test		Score	Conclusion
1st Model Cash ETR	Chow Test	Cross Section Chi Square (Stat)	220.457.623	RE Model
		Prob	0.0001	
	Hausman Test	Cross Section Random (Chi-Sq Stat)	17.710.999	
		Prob	0.0702	
2nd Model Current ETR	Chow Test	Cross Section Chi Square (Stat)	412.923.141	RE Model
		Prob	0	
	Hausman Test	Cross Section Random (Chi-Sq Stat)	4.157.740	
		Prob	0.3851	

Source: Data processed, 2019

The chosen model is Random Effect Model, so there is no need to do a classic assumption test (Baltagi, 2008; Ekananda, 2016).

Conclusion of Panel Data Regression Results and Hypothesis Tests

Table 3
Conclusion of Regression Test & Hypothesis Test Results

Variabel		CashETR (Y_1)	Current ETR (Y_2)	Conclusion
Intercept	Coef	-2.548583	-0.083655	
	t-Stat	-2.973983***	-0.509617	
Polcon		0.314691	0.060453	H_1 Rejected
		2.513100**	2.410677**	

Variabel	CashETR (Y_1)	Current ETR (Y_2)	Conclusion
Growth	-0.781419 -11.01662***	-0.087817 -7.904104***	
Firmsize	0.80411 9.980476***	0.090258 6.932141***	
ROA	3.485481 6.236553***	0.273667 3.091199***	
DER	-0.113061 -2.812690***	0.004551 0.609609*	
Adj R Square	0.229079	0.163153	
F Statistic	27.32741***	18.27365***	
*** Sig & Prob < 0,01			
** Sig & Prob < 0,05			
* Sig & Prob < 0,1			

Source: Data processed, 2019

Results and Discussion

The effect of political connection variables on tax aggressiveness

Political connections through the relationship of commissioners and directors show significant results with a positive effect on tax aggressiveness. Then the hypothesis in this study is rejected. These results contradict Zhang *et al.* (2012) which show that political connections negatively affect tax aggressiveness, but the results of this study also support the results of previous studies (Adhikari *et al.*, 2006) which show that political connections have a positive effect against tax aggressiveness. According to Adhikari *et al.* (2006) and Kim *et al.* (2016), stated that the existence of a connection with the government was able to have a negative impact on tax aggressiveness. In state-owned enterprises, the good executive members of the board of commissioners and directors want to maintain their position as board of commissioners and directors of the state-owned enterprises, or they want to be given promotion rights to larger state-owned enterprises reinforce its political legitimacy. Then the next reason is that the government also gives appreciation in the form of awards given to state-owned enterprises and private-owned enterprises that contribute greatly to the country through high tax payments (Kim *et al.*, 2016).

Our result support the previous research that has been done by Adhikari *et al.* (2006) also provides results that political connections have a significantly positive effect on ETR. Their results show that companies do not always use political connections to avoid taxation, but can be used to obtain capital assistance and various funding benefits. The advantage that can be obtained by companies that have political connections is that loans can be obtained more easily.

The effect of control variables on tax aggressiveness

All control variables used in this study significantly influence tax aggressiveness.

Conclusion

Based on data analysis and discussion that has been done, it can be concluded that the results of panel data regression prove that statistically, political connections through the relationship of commissioners / directors significantly positively influence tax aggressiveness. This evidence that existence of a connection with the government was able to have a negative impact on tax aggressiveness. The board of commissioners and directors want to maintain their position as board of commissioners and directors of the state-owned enterprises, or they want to be given promotion rights to larger state-owned enterprises reinforce its political legitimacy. Then, the government also gives appreciation in the form of awards given to state-owned enterprises and private-owned enterprises that contribute greatly to the country through high tax payments.

A limitation of this study is the use of ETR as a proxy for tax aggressiveness. The BTD (Book Tax Difference) is also a proxy for measuring the tax aggressiveness. BTD is the gap between pre-tax profit reported in the financial statements issued by the company (book income-commercial income) and taxable profit reported to the taxation apparatus. Suggestions for further research are expected to use BTD or both (ETR and BTD) as a proxy for measurement of tax aggressiveness variable.

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