

# POLITICAL CONNECTIONS, STATE OWNED ENTERPRISES AND TAX AVOIDANCE : AN EVIDENCE FROM INDONESIA

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## Abstract

This study investigated the relationship between political connections and tax avoidance behaviour in Indonesian listed-firms in 2007-2013 year period. Some firms created links to government for obtaining benefits in various variables such import licensing, taxes, and supply-funds. We have manually managed to identify politically connected-firms from the annual reports and measure tax avoidance by using Cash Effective Tax Rate (CETR) as the proxy. Our observation indicated that politically connected-firms paid lower corporate income tax than non-politically connected-firms. Our study also examined how the status of State Owned Enterprise (SOE) correlates to tax avoidance. Firms hiring politically connected independent commissioners (INDCOM) in this study were more likely to show tax avoidance behavior. However, we have no strong evidence to prove our proposition regarding the type of political connections.

**Keywords:** Political Connections; State Owned Enterprises; Tax Avoidance; Corporate Income Tax; Cash Effective Tax Rate.

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## 1. INTRODUCTION

**Corporate income tax is one of the primary concerns of both firms and the government. Firms are always trying to manage tax efficiently to reduce their expenses. On the other side, the government is responsible to optimize state revenues from tax. A study showed that one-fourth of US listed firms are able to maintain long-run cash effective tax rates below 20 percent (Dyreg et.al, 2008). Some other empirical researches have showed how firms were able to efficiently manage their tax (Siegfried, 1974; Porcano, 1986; Rego, 2003; Slemrod, 2004; Crocker and Slemrod, 2005; Dyreg et.al, 2008).**

This paper studies tax avoidance, one of the most significant aspects in tax management, which is also the focus in the area of accounting. See Sticney & Mc Gee, 1982; Zimmerman, 1983; Gupta & Newberry, 1997; Shackelford and Shevlin, 2001; Desai and Dharmapala, 2006 ;Chen et.al, 2010; Mc Guire et.al, 2014.

How political connections and tax avoidance are related is the focus of this study; the outcome of this study will be a significant contribution to tax literature. Faccio (2010) believes that politically connected-firms have higher leverage, pay lower taxes, and have stronger market power than non-politically connected-firms. The study of Wu et.al (2012) showed how hiring politically connected manager is a convenient and effective channel for private firms to create links to the government.

When they hire such manager, it will be beneficial to the firms in terms of lower taxes and private taxes information.

We here focus on Indonesia, a country where the institutional environment is weak (Leuz & Gee, 2006; Sudibyo et.al, 2013). Corruption is a serious issue in Indonesia (as well as other Asian Countries, according to the survey held by Transparency International, 2013). Despite its corruption issue, Indonesia's economic growth is considerably high. World Bank (2011) has named Indonesia as 10 of 12 countries with the largest economic growth as indicated by Gross Domestic Product (GDP). This shows that tax is one of the potentials to improve state revenue; thus, it must be significantly optimized. This year, Indonesian Tax Authority has established their tax ratio, aiming the increase from 12% to 14% (Directorate General of Taxes, 2015).

We here provided empirical evidence on tax avoidance behavior from firms listed at Indonesian Stock Exchange from 2007-2013 periods. The purpose of our study is to examine the effect of politically connected-firms toward tax avoidance behavior. The recent coordinating Minister on Economy of Indonesia argued that the position of board of directors or commissioners at state-owned enterprise (SOE) for politicians or former of politicians is a tradition in Indonesia (Kompas, 2015). This is supported by some literatures on political connections in Indonesia (Fisman, 2001; Leuz & Gee, 2006; Mobarak & Purbasari, 2006; Nys et.al, 2015).

## 2. LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

### 2.1. Political Connections

Stigler (1971) argued that public resources and powers could be used to improve the economic status of economic groups (such as industries and occupations), which he referred as the demand for regulation. Supply of regulation was characterized by political processes which allow relatively small groups to obtain such regulation. Theory of economic regulation here, is central to determine who will receive the benefits or burdens of regulation, what regulation is in effect, and the effects of the regulation upon the allocation of the resources. Here, bureaucrats tend to use their position by providing rights to businessman for product licensing (Krueger, 1974), or tax benefit (Quinn & Shapiro, 1991; Williams & Collins, 1997; Young et.al, 2001; Richter et.al, 2009).

Some literatures on political connections in Indonesia has shown the significant role of the connection to the economy (Fisman, 2001), the relationship to global financing (Leuz & Gee, 2006), the effect on import licenses decisions (Mobarak & Purbasari, 2006), the indirect costs of financial distress (Wijantini, 2007) and the ability to collect formal deposit insurance (Nys et.al, 2015).

### 2.2. Tax Avoidance

Tax literatures define tax avoidance in many different way; we here take the definitions broadly that it is the reduction of explicit taxes (Dyregang et. Al, 2008; Hanlon and Heitzman, 2010). Most literatures on tax avoidance emphasize on the determinants of tax avoidance, such as firm value (Chen et.al, 2014), firm size (Zimmerman, 1983; Porcano, 1986; Gupta & Newberry, 1997), firms ownership (Shackelford & Shevlin, 2001; Chen, et.al, 2010), foreign-operations firm (Stickney & McGee,

1982; Rego, 2003; Atwood et.al, 2012), and leverage (Gupta & Newberry, 1997).

However, studies with empirical evidence on relationship between political connections and tax avoidance are still scarce (Adhikari, 2006; Faccio, 2010; Wu et.al, 2012). Therefore, our study aims to examine the effect of political connections toward tax avoidance. We believe political connections will be beneficial to the firms in terms of gaining more information about tax regulation and favorable tax treatment. We will prove this hypothesis in our paper.

Firms which have political connections are divided into private firms and state-owned enterprise (SOE). That state-owned enterprise have more stable connections with tax authorities positively correlates to tax managing skills; much better than private firms. Therefore we present the following hypothesis:

H 1: Politically connected pay lower taxes than non politically connected-firms.

H 2: SOE able to manage taxes better than private politically connected-firms.

## 3. RESEARCH METHOD

### 3.1. Data

To minimize bias caused by different tax regulations on each sectors, our study here focuses on manufacturing firms listed at Indonesian Stock Exchange from 2007 to 2013 periods. We retrieved our data from OSIRIS Database for pre-tax income, and then we manually collected cash tax paid data from financial statement, and categorized the politically connected firms from their annual reports.

We eliminated several firms which do not comply to the following criteria: no business activities/ missing data, net operating loss (NOL) carry-forward, negative cash tax paid and cash ETR more than one. Finally, our sample consists of 52 manufactured firms, with 364 firm-year observation (Table 1).

Table 1. Sample selection

<i>All manufacturing firms listed in Indonesian Stock Exchange</i>	171
<i>Less :</i>	
<i>Firms missing data for one or two years</i>	(32)
<i>Firms with net operating loss carry-forward</i>	(82)
<i>Firms with negative cash tax paid</i>	(45)
<i>Firms with cash ETR more than one</i>	(12)
<i>Final sample (number of firms)</i>	52
<i>Final sample (firm years)</i>	364

### 3.2. Measure of Political Connections (POL)

A company is defined as politically connected firm when at least one of its shareholders (anyone controlling at least 10% of voting shares), and one of its top officers (board of commissioners/ directors) is a political party member, a parliament member, a government official (including military officer), a former of parliament member and/or a former of government official (military officer). We also define state-owned enterprises as politically connected firms.

The procedure of the categorization is as follow: first, we collected the name of

commissioners, directors and owners from firms' financial statements. Second, we determine their political backgrounds by investigating individuals' biographies from firms' annual reports. Finally, we collected additional data from various websites to check the information established at the second step.

POL is a dummy variable that equals one when a firm has political connections, and zero when otherwise. In this study, we classified 26 firms as politically connected-firms, and 25 firms with no political connections (NONPOL). NONPOL is also a dummy variable which equals one when it is non

politically-connected firm, and zero when it is otherwise.

For politically connected-firms, we follow Nys et.al (2015), where the categorization falls into three different categories based on what is politically connected. The classification is as follow: firms, which at least one of their directors or at least one

of their controlling shareholders is politically connected (DIR); firms, which at least one of their commissioners is politically connected (COM); and firms, which at least one of their independent commissioners is politically connected (INDCOM).

To investigate impact of SOE to tax avoidance behavior, we also examine the model below:

$$CETR_{i,t} = \alpha_0 + \alpha_1 SOE_{i,t} + \alpha_2 DIR_{i,t} + \alpha_3 COM_{i,t} + \alpha_4 INDCOM_{i,t} + \varepsilon_{i,t} \quad (1)$$

### 3.3. Measure of Tax Avoidance

Tax avoidance is measured by using Cash Effective Tax Rate (Cash ETR). We calculated a firm's total cash taxes paid over a five-year period and divided that by the sum of its total pretax income over the same five-year period (Dyrenge et.al, 2008). Cash tax paid by the firms can be obtained in the financial statements at the statement of cash flows. The benefit of using cash tax is to avoid tax accrual effects present in the current tax expense.

We divided our observation periods into 3 groups (2007-2009 periods, 2010-2013 periods, and 2007-2013) since the government decreased the tariff of corporate income taxes to 25 % at 2010<sup>1</sup>. For robustness check, we examined the impact of political connections toward tax avoidance in those periods.

## 4. RESULTS

We here examined the influence of political connections to tax avoidance behavior. The mean of cash effective tax rate (CETR) between politically

connected-firms (POL) and non politically connected firms (NONPOL) were compared. Table 2 describes mean comparison of cash effective tax rate. During overall period, non politically connected-firms (NONPOL) has higher mean than politically connected-firms (POL), at 0.3493 and 0.2872, respectively. It indicates that politically connected-firms pay lower taxes than non-politically connected-firms.

The comparison of cash effective tax rate (CETR) on separate periods yields consistent results. For robustness check, we compare cash effective tax rate in 2007-2009 periods (CETR3) and 2010-2013 periods (CETR7). The results show that politically connected-firms have lower CETR in both periods than non politically connected-firms (Table 2). That there is no influence of difference of corporate income tax tariff is evidential in our study.

From table 2, we investigate the average of cash effective tax rate (CETR) which are paid by politically connected-firms is 28,72%. On the other side, non politically connected-firms pay higher at 34,93%. The average of CETR3 is higher than CETR 7 as the tariff was different at of the two periods.

**Table 2.** T-test results

	POL (n=26)		NONPOL (n=25)		t-Test
	Mean	Median	Mean	Median	
CETR3	0.3135	0.3086	0.4077	0.3157	0.000***
CETR7	0.2675	0.2603	0.3054	0.2667	0.000***
CETR	0.2872	0.2746	0.3493	0.2782	0.000***

POL is political connected-firms. NONPOL is non politically connected-firms. CETR is cash effective tax rates. CETR3, CETR7, CETR are calculated by summing cash tax paid over 2007-2009 periods, 2010-2013 periods, and total periods, respectively, and dividing by pretax income summed over 2007-2009 periods, 2010-2013 periods, and total periods, respectively. \*, \*\*, and \*\*\* indicate significance at the 10%, 5% and 1% levels, respectively.

To examine the impact of state owned enterprise to tax avoidance behaviour, we conducted ordinary least square (OLS) regression for testing our model (Table 3). The results show that the status of state owned enterprise (SOE) affect their cash tax paid in overall periods at 10% level of significance. It denotes that state-owned enterprises have the ability to manage their tax better than private firms.

**Table 3.** OLS Regression results

	POLCETR3	POLCETR7	POLCETR
SOE	1.983 (0.051)*	0.548 (0.585)	1.859 (0.065)*
DIR	-0.598 (0.552)	-0.220 (0.827)	-0.791 (0.430)
COM	-1.398 (0.166)	0.562 (0.575)	-0.594 (0.553)
INDCOM	-1.254 (0.214)	1.463 (0.147)	0.076 (0.940)
Observations	78 firm-years	104 firm-years	182 firm-years

This table reports the OLS regression results of cash effective tax rates on political connected-firms. POLCETR3 is cash effective tax rates of politically

connected-firms in 2007-2009 periods. POLCETR7 is cash effective tax rates of political connected-firms in 2010-2013 periods. POLCETR is cash effective tax

rates of political connected-firms in 2007-2013 periods. SOE is the dummy variable for firms which equal 1 if a firm belong to government, and zero otherwise. DIR is the dummy for directors which equal 1 if politically connected, and zero otherwise. COM is the dummy variable for members of board of commissioners which equal 1 if politically

connected, and zero otherwise. INDCOM is the dummy variable for independent commissioners which equal 1 if politically connected, and zero otherwise. The values in parentheses are *p*-values. \*\*, and \*\*\* indicate significance at the 10%, 5%, and 1% levels, respectively.

**Table 4.** Correlation matrix

	<i>POLCETR</i>	<i>SOE</i>	<i>DIR</i>	<i>COM</i>	<i>INDCOM</i>
<i>POLCETR</i>	1				
<i>SOE</i>	0.06	1			
<i>DIR</i>	0.069	0.083	1		
<i>COM</i>	0.046	-0.093	-0.210***	1	
<i>INDCOM</i>	-0.050	0.397***	-0.397	-0.490***	1

The table reports Pearson correlation matrix of the variables. *POLCETR* is cash effective tax rates of political connected-firms. *SOE* is the dummy variable for state-owned enterprises. *DIR* is the dummy for firms with political connected-director. *COM* is the dummy for political connected-commissioners. *INDCOM* is the dummy for political connected-independent commissioners. \*\*, and \*\*\* indicate significance at the 10%, 5% and 1% levels.

However, in this study, we have no strong evidence to support our proposition regarding the type of political connections. The observation of firms where the directors are politically connected-directors (*DIR*), and firms where the directors have political connections on their commissioners (*COM*), seem to show negative impact upon their ability to manage tax.

Firms hiring politically connected-independent commissioners (*INDCOM*) are more likely to perform tax avoidance. Table 3 reports the regression results of *INDCOM*; it shows positive impact of *INDCOM* to *CETR*, but the relationship is weak with *p*-values at 0.076. We also presented the correlation analysis of each variable at table 4.

## 5. CONCLUSION

Our study has provided empirical evidence on tax avoidance behaviour in Indonesia. Under the framework of previous studies concerning political connections in Indonesia (Fisman, 2001; Leuz & McGee, 2006; Mobarak & Purbasari, 2006; Wijantini, 2007; Nys et.al, 2015), we have managed to expose the effect of political connections regarding tax avoidance behaviour in Indonesia.

Our findings are consistent to tax avoidance definition by Dyreng et.al (2008) and conceptual terms proposed by Hanlon & Heitzman (2010), as the reduction of explicit taxes. Consequently, firms which are indicated to avoid taxes in this study might be defined by different means. The avoidance might be driven by their tax managing skills, tax planning, tax aggressiveness, tax evasion and tax sheltering.

Our study has described that tax avoidance behavior by politically connected-firms during 2007-2013 periods in Indonesia. Previous literatures described that political connection gives more benefits regarding import licensing (Mobarak & Purbasari, 2006), supply of funds and inviting deposits (Nys et.al, 2015). In this study, we have provided another evidence on the correlation

between political connections and tax avoidance behavior.

Politically connected-firms tend to pay lower taxes as compared to non politically connected-firms during observation periods. This supports prior works on political connections and tax literatures (Adhikari, 2006; Faccio, 2010). In this study, political connections play an important role on cash tax paid by firms. It suggests that the economy of developing countries tend to be relationship-based rather than market-based (Adhikari, 2006).

For Indonesian Directorate General of Taxes, this study is a valuable contribution to tax collecting activities by describing how politically connected-firms enjoy tax benefit in Indonesia as compared to others. Proper policies designed by these findings might optimize state revenues from corporate income tax in upcoming years, and in turn, help the directorate in achieving its target.

Control variables and other determinants of tax avoidance are details to improve in further study. Firm size and firm performance are some of the variables to consider, as well as other tax avoidance determinants such as family-ownership shareholder, foreign-operation, high-leverage and dual-listings firms.

1. Tariff of corporate income tax at Indonesia was 28% until 2009, and then it changed to 25% in 2010.

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