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Political Connections, Blockholder Ownership, and Tax Avoidance: Evidence from Indonesia

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Abstract

We study the effect of political connections on tax avoidance, as well as the role of blockholder ownership in moderating the effect of political connections on tax avoidance. Using panel data of 102 companies listed on the Indonesia Stock Exchange during 2016–2019, we find evidence of the positive and significant effect of political connections on tax avoidance. Political connections' existence within the company could encourage tax avoidance. We also discover that blockholder ownership plays a role in weakening the effect of political connections on tax avoidance in Indonesia, a country with numerous companies having concentrated ownership. The higher the percentage of shares owned by the blockholder, the lower the level of tax avoidance, thus mitigating agency problem II related to entrenchment and expropriation of minority shareholders.

Keywords
agency problem II; political connections; blockholder; tax avoidance

I. Introduction

The self-assessment system has the risk of triggering tax avoidance or even tax evasion by taxpayers. In terms of the company, the self-assessment system tends to provide freedom ranging from the preparation of financial statements to tax reporting. The number of accounting measurement and estimating methods, as well as tax management schemes that could be selected, and grey areas, coupled with uncertain business conditions, certainly contribute to encouraging companies to avoid tax.

Tax avoidance is the effort to minimize tax payments by exploiting loopholes in tax regulations. According to data published by Cobham et al. (2020), Indonesia annually loses up to USD 4.86 billion, or equal to IDR 69.2 trillion (using Bank Indonesia's middle rate on 20/11/2020), due to tax avoidance. Of these, the amount of USD 4.78 billion or IDR 68 trillion came from tax avoidance by companies, with the remaining done by individuals. Following Faccio (2007), tax avoidance is inseparable from the influence of political connections owned by the company as one of the determinants of tax avoidance. In addition, Kim and Zhang (2016) and Ying et al. (2017) discovered that the company's political connections could be related to more aggressive tax avoidance. In the context of Indonesia, it is hard to deny that politics and business are interconnected.

The company's political connections may benefit the company but could have a negative impact on the economy of the country. In anticipation, the Indonesian government has issued regulations related to political connections because of the high risk. The Regulation of the Head of the Financial Transaction Reports and Analysis Center (PPATK) Number PER-02/1.02/PPATK/02/15 concerning the Category of Service Users with the Potential to Commit the Crime of Money Laundering is one of the most comprehensive. The government used the term "Politically Exposed Person" (PEP) to categorize parties that were considered political representations. Thus, the existence of PEP appointed as the board of

commissioners or board of directors is an illustration that the company is politically connected.

In recent years, studies have been conducted on the relationship between political connections and tax avoidance. Sudibyo and Jianfu (2016), Ferdiawan and Firmansyah (2017), likewise Kim and Zhang (2016) found that political connections positively affect tax avoidance. Conversely, Putra and Suhardianto (2020), Pranoto and Widagdo (2016), as well as Zhang et al. (2012) concluded that political connections negatively affect tax avoidance. We suspect that the inconsistency in the results is due to other variables interacting with them, one of which is ownership structure. According to Hanlon and Heitzman (2010), the ownership structure is one of the determinants of tax avoidance. The ownership structure is the internal corporate governance mechanism that could control the management (Lins & Warnock, 2004).

We add blockholder ownership, which is a proxy of ownership structure, as the moderating variable of political connections' effect on tax avoidance. From the Indonesian law perspective, blockholder ownership could be defined as ownership by the controlling shareholder that is not controlled by another party. The variable addition is based on the report of De La Cruz et al. (2019) that over 70% of companies in Indonesia have one controlling shareholder, known as the blockholder. Furthermore, according to agency theory, the controlling shareholder either could suppress (alignment effect) or even sharpen (entrenchment effect) agency problems that occur in the company (Setia-Atmaja et al., 2011).

Our paper contributes to the improvement of empirical studies on agency problem II regarding tax avoidance in Indonesia, which is still limited. Another contribution is the use of the Abnormal Book-Tax Difference (ABTD) method to measure tax avoidance, complementing previous research in Indonesia, which was dominated by Effective Tax Rate (ETR) methods.

II. Literature Review and Research Hypotheses

2.1 Agency Theory

Agency theory explains the separation between ownership and control of a company. Jensen and Meckling (1976) define an agency relationship as a contract between one or more people (principal) to involve another person (agent) to perform work on behalf of the principal and involves delegation of decision-making authority to the agent. Here, the agency problem might arises is conflicts between management and shareholders as the owner. The most common solution is for the majority shareholder to have a controlling stake in the company (Desai & Dharmapala, 2008). However, the solution has the potential to cause conflicts between the controlling shareholder and minority shareholders. When the controlling shareholder uses control rights to obtain private benefits at the expense of minority shareholders, agency problem II arises (Villalonga & Amit, 2006).

The primary theory in this research is agency theory with agency problem II. The agency's perspective on tax avoidance shows that concentrated ownership creates more incentives to avoid tax (Desai & Dharmapala, 2008). Under Indonesian law, the controlling shareholder has absolute majority voting rights, allowing them to put pressure on management to take the actions they desire.

2.2 Political Cost Hypothesis

The political cost hypothesis refers to the effort to reduce political costs. Political costs include any costs incurred by the company as a result of political actions, such as taxes, antitrust, regulation, labor demands, and others (Watts & Zimmerman, 1978). In Indonesia, political costs are relatively large, hence avoided by the company (Kamila, 2014). Political costs, in terms of tax, arise from the conflict of interest between the company and the government that authorized wealth transfer based on tax regulations. Here, the company tends to take opportunist action by selecting accounting methods and tax management schemes that could minimize tax payments. The reduction of political costs is one of the factors that increase management prosperity (Watts & Zimmerman, 1978). The opportunist action is consistent with the statement of Hanlon and Heitzman (2010) which define tax avoidance broadly as an explicit tax reduction.

2.3 Tax Avoidance

Tax avoidance is generally described as the effort to minimize tax payments by exploiting loopholes in tax regulations. Such as Dyreng et al. (2008) define tax avoidance as anything that could reduce the company's tax payments by utilizing the grey area of tax regulations, thereof considered legal in the eyes of the law. Tax avoidance is different from tax evasion, which is the fraud that could lead to criminal sanctions.

Furthermore, OECD (2021) describes tax avoidance as the arrangement of a taxpayer's affairs that is intended to reduce his tax liability and that although the arrangement could be strictly legal, it is usually in contradiction with the intent of the law. Tax authorities around the world agreed tax avoidance is an unacceptable practice because has a direct impact on tax base erosion, which results in reduced a country's tax revenues.

2.4 Political Connections

Referring to experts' opinions, Budiardjo (2007) concluded that politics in a country is related to issues of power, decision-making, public policy, and allocation or distribution. This indicates that a country's politics are closely related to public policy, including policies to support the business world. In the business context, Indonesia is a country with high political influence (Fisman, 2001; Harymawan & Nowland, 2016). Faccio (2006) defines a company as politically connected if at least one of its large shareholders or one of its officials is a member of parliament, a minister, or closely related to top politicians or parties.

Indonesia already has regulations related to political connections because considered high risk. PPATK specifically defines PEP as a person who has or has had public authority, inter alia, the state organizer as intended in the laws and regulations governing the state organizers, and/or people who are registered or have been recorded as members of political parties that influence the policies and operations of political parties, both those of Indonesian nationality and foreign nationality. Parties associated with PEP are also considered high risk, ergo classified as PEP, including:

a. PEP's main family includes family members up to the second degree;
b. companies owned, managed, and/or controlled by PEP; and
c. parties who are generally and publicly known to have close relations with PEP;

Political connections in Indonesia are generally done by placing people who have government closeness into the company's organizational structure, both as commissioners and directors (Pranoto & Widagdo, 2016). Thus, the existence of PEP serving as the board of commissioners or board of directors shows the company has political connections.

2.5 Blockholder Ownership

Blockholder is the major shareholder who has significant control rights (exceeding the threshold) and is not controlled by other parties (Claessens et al., 2002; Edmans, 2014; La Porta et al., 1999). Indonesian Financial Accounting Standards (PSAK) 65 stipulate that control is considered to exist if it has more than 50% of voting rights, either directly or indirectly, in a company. In the realm of public companies, the term "controller" refers to the Financial Services Authority (OJK) Regulation Number 9/POJK.04/2018. OJK defines the controlling shareholder as a party who directly or indirectly owns shares of a public company with more than 50% of all shares with fully paid voting rights; or could determine, directly or indirectly, in any way, the management and/or policies of the public company.

The calculation of the threshold for blockholder ownership in the OJK Regulation Number 9/POJK.04/2018 applies to non-financial business fields. There are different criteria for blockholder ownership thresholds for the banking, insurance, pension funds, financing, and guarantee industries as stipulated in OJK Regulation Number 4/POJK.05/2013, which is 25% or more of the number of shares issued and has voting rights.

2.6 Research Hypotheses

a. The Effect of Political Connections on Tax Avoidance

Previous studies have shown that the influence of political connections owned by the company could provide significant benefits, such as obtaining government subsidies (Johnson & Mitton, 2001), corporate bailout access (Faccio, 2006), ease of import permit (Mobarak & Purbasari, 2006), global financing access (Leuz & Oberholzer-Gee, 2006), legal protection (Li et al., 2008), banking preferences access (Claessens et al., 2008), government procurements (Goldman et al., 2009), better performance (Wu et al., 2012), low bank loan costs (Houston et al., 2014), ease of collecting deposits (Nys et al., 2014), low capital market pressure (Kim & Zhang, 2016), and others.

In terms of tax, Sudibyo and Jianfu (2016), Ferdiawan and Firmansyah (2017), and Kim and Zhang (2016) found companies with political connections enjoy tax benefits through tax avoidance. Sudibyo and Jianfu (2016) concluded that politically connected companies paid lower taxes. Ferdiawan and Firmansyah (2017) stated companies use their political connections to lower tax payments through lobbying or take advantage of looser supervision. Further, Kim and Zhang (2016) explain that politically connected companies are more aggressive in avoiding tax because of lower tax detection risk, better information regarding changes in regulations and tax law enforcement, and low political costs related to tax avoidance aggressiveness.

Based on the description of the benefits of having political connections in terms of tax, plus the fact that Indonesia is a politically influential country in the business context, it strengthens the positive correlation between the existence of political connections and tax avoidance. Accordingly, the first hypothesis is:

H_1 : Political Connections Have a Positive Effect on Tax Avoidance

b. Blockolder Ownership Moderates the Effect of Political Connections on Tax Avoidance

Research by Ying et al. (2017) showed the existence of political connections and concentrated ownership encourages the company to undertake aggressive tax avoidance. The primary idea underlying the relationship between concentrated ownership and tax avoidance is agency problems. The agency's perspective on tax avoidance shows that concentrated ownership leads to greater incentives to avoid tax (Desai & Dharmapala, 2008). Agency

theory explains that concentrated ownership would lead to two different views, viz., the alignment effect and the entrenchment effect.

In Indonesia, the controlling shareholder in public companies tends to make decisions that benefit their interests but could harm minority shareholders (OJK, 2014). If associated with the relationship of political connections to tax avoidance, the effect that could invigorate is the entrenchment effect. It means the controlling shareholder could exercise their voting rights to achieve the desired goals, including appointing the politically connected board of commissioners and directors. The greater the concentration of control rights, the greater the possibility for the majority shareholder to obtain private benefits (Shleifer & Vishny, 1997).

Based on the descriptions above, coupled with the report, over 70% of companies in Indonesia have one controlling shareholder. This indicates the strong role of blockholder ownership in tax avoidance through political connections. Thus, the second hypothesis is:

H_2 : Blockholder Ownership Plays a Role in Strengthening the Effect of Political Connections on Tax Avoidance

III. Research Method

3.1 Sample Selection and Data Collection

The research was conducted by taking the population of the listed companies on the Indonesia Stock Exchange from 2016 to 2019. The sample selection used the purposive sampling technique, with the criteria including public companies that (1) publish complete financial reports for 2015–2019; (2) outside the sectors of financial, property and real estate, and construction; (3) using the January–December financial year; (4) direct blockholder ownership throughout the research period; (5) present financial reports using IDR currency; and (6) gross turnover up to IDR 50 billion. Outliers are eliminated using the z-score method, which declares data as outliers if the results of the regression analysis produce a residual z-score value of > 2.58 or < -2.58. The outcome was 102 public companies, with a final sample of 297 observations.

We collected data from the financial statements and annual reports of public companies published through the official website of the Indonesia Stock Exchange, the composition of political party management uploaded on the general election of 2019 publication portal, as well as other related sources.

3.2 Operational Definition of Variables

a. Tax Avoidance (Y)

Tax avoidance is measured by the ABTD method, the residual value from the regression results of the Book-Tax Difference (BTD) equation model, referring to the research of Tang and Firth (2012). The regression equation model to find BTD is as follows:

$$BTD_{it} = \alpha + \beta_1 \Delta INV_{it} + \beta_2 \Delta REV_{it} + \beta_3 TL_{it} + \beta_4 TLU_{it} + \beta_5 BTD_{it-1} + \varepsilon_{it} \quad \text{..... (1)}$$

BTD_{it} : The difference between taxable income and accounting income for company i in year t divided by total assets in year t

ΔINV_{it} : The change in gross fixed assets and intangible assets from year t-1 to year t divided by total assets in year t

$\Delta REVit$: The change in sales and operating income from year t-1 to year t divided by total assets in year t

TL_{it} : Net operating loss in year t divided by total assets in year t

TLU_{it} : Fiscal loss compensation in year t, measured by a dummy variable, coded as 1 if using loss compensation and 0 if not using loss compensation, divided by total assets in year t

BTD_{it-1} : BTD of company i in year t-1 divided by total assets in year t

ε_{it} : ABTD of company i in year t

To fulfill the equation, the BTD_{it-1} or the previous year's BTD variable is needed, which could be calculated by the following formula in the research of Hanlon and Heitzman (2010):

BTD = Pretax book income - (CTE / Statutory ETR) - ΔNOL ..... (2)

Pretax book income : Earnings before tax
CTE : Tax expense
Statutory ETR : Effective tax rate by law
ΔNOL : The change in net operating loss from year t-1 to year t

A large positive ABTD is the result of aggressive tax reporting (Tang & Firth, 2012).

b. Political Connections (X_1)

The illustration of the company as politically connected applies the existence of PEP according to the classification in the Regulation of the Head of PPATK Number PER-02/1.02/PPATK/02/15. The measurement of political connections employed a dummy variable, coded as 1 if the company's board of commissioners or board of directors is included in the PEP category and 0 if it is not.

c. Blockholder Ownership (X_2)

The threshold of control rights for the blockholder or controlling shareholder in the non-financial sector in Indonesia, as regulated by OJK Regulation No. 9/POJK.04/2018, is more than 50% of all shares with fully paid voting rights. Following the rule, the company with over 50% share ownership is categorized as the blockholder's company. The percentage of shares owned by the blockholder in the blockholder-categorized company is used in the research to calculate blockholder ownership.

d. Empirical Model

The following equation model was used to test the role of blockholder ownership in moderating the effect of political connections on tax avoidance:

$$Y = \alpha + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_1*X_2 + \varepsilon_t \quad \text{..... (3)}$$

IV. Results and Discussion

4.1 Descriptive Statistics

Table 1. Descriptive Statistics

Variable	N	Mean	Standard Deviation	Min	Max
TAXVOID	297	-0.012	0.016	-0.046	0.026
POL	297	0.660	0.475	0	1
BLOCK	297	0.691	0.135	0.501	0.975
BLOCKPOL	297	0.449	0.340	0	0.975

Definition of Variables:

TAXVOID	=	tax avoidance
POL	=	political connections
BLOCK	=	blockholder ownership
BLOCKPOL	=	blockholder ownership in moderating the effect of political connections on tax avoidance

The mean score of TAXVOID as measured by the ABTD method is -0.012, indicating that public companies in Indonesia do not evade tax in general. Using a dummy variable, POL reveals that approximately 66% of Indonesian public companies have political connections. According to BLOCK, public companies in Indonesia that are included in the blockholder-categorized companies have a mean of 69.1% control rights, with a minimum control of 50.1%. BLOCKPOL averages 44.9%, indicating that blockholder ownership plays a significant role in moderating the effect of political connections on tax avoidance.

4.2 Panel Method Test Results

The panel method test, which includes the Chow, Hausman, and LM tests, is used to select the best panel data regression model while also ensuring that the data is properly processed and the results are valid.

Table 2. Panel Method Test Results

Test	Prob.	Selected Model	Best Selected Model
Chow Test	0.000	Fixed Effect	Random Effect
LM Test	0.000	Random Effect	
Hausman Test	0.847	Random Effect	

The Random Effect Model (REM) was selected as the best model. Because it is estimated using the Generalized Least Square method, the econometric test, or classical assumptions test, actually does not need to be performed in REM. Problems or violations of classical assumptions in REM should be confirmed by running the xtgls command in the Stata program. The command's output is used as research results analysis data. However, the econometric test results are still presented to demonstrate the fulfillment of assumptions in the regression model.

4.3 Econometric Test Results

The econometric test is applied to meet the criteria for the best linear unbiased estimate (BLUE) by testing for multicollinearity, heteroscedasticity, and autocorrelation. The Pearson correlation multicollinearity test resulted in a value of less than 0.8, so there was no multicollinearity.

Table 3. Multicollinearity Test Results

Variable	BLOCK	POL
BLOCK	1	
POL	-0.102	1

Due to modified Wald test results, it is possible to conclude that the REM heteroscedasticity test is unnecessary. It was confirmed then by running the xtgls command in Stata, which produced Prob>chi2 values greater than 0.05, implying that it meets the homoscedasticity assumption.

Table 4. Heteroscedasticity Test Results

Heteroscedasticity Test	**Prob>chi2**	**Conclusion**
Modified Wald Test	-	REM eliminates heteroscedasticity
xtgls	0.085	Homoscedasticity

The Woolridge test for autocorrelation revealed that the Prob>F value was below 0.05, indicating that no autocorrelation existed.

Table 5. Autocorrelation Test Results

Autocorrelation Test	**Prob>F**	**Conclusion**
Wooldridge Test	0.001	No autocorrelation

Based on the overall results of the econometric test, the regression model has met the econometric criteria.

4.4 Interaction Test Results and Hypotheses Testing

Table 6. Interaction Test Results

Variable	**Coefficient**	**z-stat**	**p-value**
POL	0.025	2.44	0.015**
BLOCK	0.022	1.89	0.058
BLOCKPOL	-0.037	-2.55	0.011**
_cons	-0.027	-3.28	0.001
Dependent Variable = Tax Avoidance (TAXVOID)			
N		297	
R^2		0.017	
Wald chi2 statistic		0.085	

*** signifikan at α level = 1%
** signifikan at α level = 5%
* signifikan at α level = 10%

The regression equation model is as follows:

$$TAXVOID = -0.027 + 0.025\ POL + 0.022\ BLOCK - 0.037\ BLOCK*POL \quad .... \ (4)$$

a. Hypothesis 1 (H_1) Testing

The first hypothesis (H1) states that political connections have a positive effect on tax avoidance. With a p-value less than 0.05 and a positive regression coefficient of political connections' effect on tax avoidance, it might be asserted that political connections have a positive and significant effect on tax avoidance. In other words, the existence of political connections could encourage corporate tax avoidance. The findings agree with those of Sudibyo and Jianfu (2016), Ferdiawan and Firmansyah (2017), and Kim and Zhang (2016). Tax benefits through tax avoidance can be obtained through political connections within the company, such as paying lower taxes (Sudibyo & Jianfu, 2016), lower tax payments through lobbying or taking advantage of looser supervision (Ferdiawan & Firmansyah, 2017), lower tax detection risk, better information regarding changes in regulations and tax law enforcement, and low political costs related to tax avoidance aggressiveness (Kim & Zhang, 2016). The findings support hypothesis 1.

The uncertain conditions faced by the company in its operations occasioned the appointment of politically connected parties to positions on the board of commissioners or board of directors. Especially since the company avoids Indonesia's relatively high political costs (Kamila, 2014). The reduction of political costs is one of the factors that increase management prosperity (Watts & Zimmerman, 1978).

b. Hypothesis 2 (H_2) Testing

The second hypothesis (H2) contends that blockholder ownership plays a role in strengthening the effect of political connections on tax avoidance. The p-value is less than 0.05, and the negative regression coefficient indicates that blockholder ownership plays a role in weakening the effect of political connections on tax avoidance. To put it another way, the higher the percentage of shares owned by the blockholder, the lower the level of tax avoidance, thereby mitigating agency problem II, which is related to entrenchment and expropriation of minority shareholders by the blockholder.

Politically connected boards of commissioners or boards of directors may have other goals, such as maximizing bonuses, which can sometimes lead to excessive risk-taking at the expense of the company's long-term interests. They couldn't do much, however, because they are under the control of the blockholder, who has voting rights to control the company's strategic policies. In this case, blockholder ownership performs a supervisory function related to company management in order to achieve good corporate governance.

This study demonstrates that the blockholder, as the majority shareholder, is not proven to exploit company resources and expropriate minority shareholders in order to gain private benefits through tax avoidance. It does not support the statement by Shleifer and Vishny (1997) that the greater the concentration of control rights, the greater the possibility for the majority shareholder to obtain private benefits

V. Conclusion

According to the findings, political connections affect tax avoidance positively and significantly. Political connections' existence within the company could encourage tax avoidance. It indicates that the politically connected company tends to obtain tax benefits through tax avoidance to reduce political costs. The findings also show that blockholder ownership, as a moderating variable, plays a role in weakening the effect of political connections on tax avoidance. The higher the percentage of shares owned by the blockholder, the lower the level of tax avoidance, thereby mitigating agency problem II, which is related to entrenchment and expropriation of minority shareholders by the blockholder. It implies that the blockholder and minority shareholders are more concerned with long-term results and are working to increase the company's value in the future.

The research's implications for regulators could be material for evaluating tax policies and increasing oversight of politically connected companies. Moreover, the ABTD method generates significant results, suggesting it could be used as an alternative method of measuring tax avoidance by academics in Indonesia. Hereinafter, investors could use the research findings to make investment decisions involving companies with political connections and/or blockholder ownership.

The research has limitations that must be considered, so the interpretation of the research findings must be done carefully. There are blockholder-categorized companies that are not included in the sample because the percentage of share ownership in each layer of the ownership structure is not shown in the annual report if the public company is controlled by the blockholder indirectly. New research could use the OSIRIS, ORIANA, Dun & Bradstreet, or OneSource Global Business Browser databases to trace. Because the research's measurement of tax avoidance is limited to the ABTD method, it is suggested that forthcoming research combine tax avoidance measurement methods to determine the most effective results in describing tax avoidance. The research uses a dummy variable to measure political connections, and future research could apply to broader aspects of political connections, such as political campaign contributions, to better represent the realm of social and political science. As the research is limited to one independent variable and one moderator variable, continued research could include control variables that affect tax avoidance, such as company size, foreign activities, or corporate governance effectiveness.

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