Conference Paper

Tax Aggressiveness and Politically Connected Company

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Abstract

This study investigates the tax aggressiveness in politically connected companies. Based on the relation-based system, politically connected companies tend to be more tax aggressiveness due to its benefit of being a tax aggressiveness. Using 625 companies-years observations, we reveal that politically connected companies listed in Indonesia Stock Exchange are likely to be more aggressive in tax. Applying the independent t test, however, there is no significant difference between politically connected companies and non-connected companies. The finding also indicate that the profitability is higher for politically connected companies rather than non-connected. Contract to profitability, politically connected companies' leverage is lower than non-connected. This study has theoretical and practical implications and they discuss in detail in this article.

Keywords: Tax Aggressiveness, politically connected companies, Indonesia

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1. Background of the Study

The term of tax aggressiveness often refers to the tax avoidance (Hanlon & Shane, 2010) and it is part of tax planning. Tax aggressiveness is viewed as a activity of value maximization that shifts the wealth from the state to the company shareholders (Kim, Li, & Zhang, 2011). Definition of Tax aggressiveness has been provided by many experts. For example, (Hanlon & Shane, 2010) provide us with definition of tax aggressiveness as behavior of tax planning that being at more aggressiveness end of the description. Managerial decisions were planned merely to keep down corporate taxes through activities of tax aggressiveness (Lanis & Richardson, 2011). However, corporate tax aggressiveness carry the significant disadvantage and merits for society, management, and stockholders (Lanis & Richardson, 2011). The primary benefit of tax aggressiveness make company's shares more attractive and positive news to the capital market (Hanlon & Slemrod, 2009).

However, (Hanlon & Slemrod, 2009) add that the disadvantage of tax aggressiveness are the potential for tax fine and penalties, implementation cost, reputational cost, and political cost. Corporate tax aggressiveness may generate agency problems due to the unaligned interest of managers and stockholders regarding to tax risk (Wahab, Ariff, Marzuki, & Sanusi, 2017). Further, (Wahab et al., 2017) argue that the stockholders want manager or directors will take actions on benefit of them and one way to do it is by focusing on profit maximatition through reducing the tax liabilities.

There are a bundle of previous studies on corporate tax aggressiveness (Adhikari, Derashid, & Zhang, 2006; Chen, Chen, Cheng, & Shevlin, 2010; Hanlon & Slemrod, 2009; Kim & Zhang, 2016; Lanis & Richardson, 2011, 2012; Richardson, Taylor, & Lanis, 2016; Sánchez-Marín, Portillo-Navarro, & Clavel, 2016; Wahab et al., 2017; Yuan, McIver, & Burrow, 2012). (Adhikari et al., 2006) examine the relationship between effective tax rates and political connections in developing economies (Malaysia) and conclude that politically connected companies pay tax at significantly lower effective rates (more tax aggresiveness) compared to other company. Moreever, (Chen et al., 2010) investigate the tax aggressiveness between family and non-family company and found that family companies are less tax aggressiveness compared to non-family companies. Further, (Hanlon & Slemrod, 2009) carry out a study of stock price reaction to news about corporate tax aggressiveness and conclude that a company's stock price declines when there is news about its involvement in tax shelters. Thereafter, (Kim & Zhang, 2016) investigate the relationship between political connected companies and tax aggressiveness using U.S companies and conclude that the politically connected companies are more tax aggressiveness than no connected companies. Thus, (Lanis & Richardson, 2012a) examine the relationship between corporate social responsibility and corporate tax aggressiveness using 408 Australian listed companies and found that more socially responsible companies are likely to be less tax aggressiveness. In addition, (Richardson et al., 2016) investigate the effect of women on Board of Directors on corporate tax aggressiveness using the Australia's companies and found that women on Board is likely to reduce the likelihood of tax aggressiveness. (Sánchez-Marín et al., 2016) analyses the tax aggressiveness among family firms and conclude that family ownership influence the tax aggressiveness in different ways. (Wahab et al., 2017) examine the relationship between politically connected companies and tax aggressiveness in Malaysia and conclude that politically connected companies are more tax aggressiveness. Finally, (Yuan et al., 2012) investigate the tax aggressiveness post new Enterprise Income Tax Law and found that corporate tax aggressiveness has reduced as a result of the 2008 Enterprise Income Tax reform.

Based on previous research above, the studies investigate the tax aggressiveness in politically connected companies are still limited (Adhikari et al., 2006; C. Kim & Zhang, 2016; Wahab et al., 2017). (Wahab et al., 2017) argue that there is limited evidence in how the level of tax aggressiveness in politically connected companies, especially in Malaysia. All three studies were conducted in Anglo Saxon countries (Malaysia and US). Therefore, there is lack of such studies conducted in Continental Europe counties, such as Indonesia. Even though, there are few studies investigating the politically connected companies in Indonesia, the studies focused on audit report lag and loan interest rate (Habib & Muhammadi, 2018; Harymawan, 2017). In addition, study investigating the tax aggressiveness using Indonesia's data has been done (see for example, Prawira, 2017) but not grouped companies into politically connected companies and non connected companies. Therefore, this study examines the tax aggressiveness between politically connected companies and non-connected companies using Indonesia's companies. Thus, this study could enrich the literature of tax aggressiveness and politically connected companies because it is conducted in unique business environment. Indonesia business environment is characterized by two-tiers Board system (Darmadi, 2013; Zaitul & Ilona, 2018), largest economy in Southeast Asia and the 16th-largest in the world (Darmadi, 2016). Indonesia is also categorized as weak corporate governance external mechanism, such as low investor protection (La Porta, Lopez-De-Silanes, & Shleifer, 1999). This study aims to determine any difference of tax aggressiveness and company's characteristics between politically connected companies and non-connected companies. Beside, this study also determines whether politically connected companies more tax aggressiveness. This paper is organized as follow: the first session discusses about background of the study. The second session is about theoretical aspect and followed by methodology in the third session. Fourth session discuss the result and discussion and finally the conclusion and recommendation session in the fifth session.

2. Tax Aggresiveness and Politically Connected Companies

Tax aggressiveness may be favoured by investors where it transfers value from the government to the firm and it advance shareholder's interests (Desai & Dharmapala 2009). However, this value transfer may be twisted and create the agency problems (Desai & Dharmapala, 2009). (Yuan et al., 2012) argue that based on the agency framework, the activity of tax aggresiveness may yield from a stimulus for managers to make use of the tax function to release private rents and upgrade their personal utility at the damage of stockholders' interest. In fact, (Wahab et al., 2017) support (Yuan et al., 2012)'s contention and state that it can lead to corporate tax decision that reflect private interests of the directors rather than the stockholders. Therefore, there is a need to run the corporate governance mechanism to reduce the agency problem. For example, (Yuan et al., 2012) suggest that it is neccessary to make stronger the external and internal corporate governance mechanisms. (Hanlon & Slemrod, 2009) argue that tax aggresiveness may have a positive and negative impact on company value. If this activities could reduce the tax liabilities, it would become a positive news to the market. However, comporate tax aggresiveness is deemed by Internal Revenues Service (IRS) and the tax courts to be noncomplience, it creates a negative news to the market. This condition bring company to be labelled as "poor corporate citizen"(Hanlon & Slemrod, 2009).

The previous evidence of tax aggresiveness in politcally connected companies show that politically connected companies are likely to be more tax aggresiveness (Adhikari et al., 2006; Kim & Zhang, 2016; Wahab et al., 2017). (Adhikari et al., 2006) argue that the reason why polically connected companies tends to be more tax aggresiveness is that Malaysia government uderpine selected companies for overlapping policy and personal reasons. Further, there is significant differences between companies of developing (i.e., relationship-based) capitilism and companies of developed (i.e., market-based) capitalism (Adhikari et al., 2006). In addition, (Kim & Zhang, 2016) conclude that more tax aggresiveness of politically connected companies in US due to better information regarding tax regulation and enforcement, lower detection risk, lower political costs of aggresive tax planning, lower capital market pressure for transparancy, and greater risk-taking tendencies. (Wahab et al., 2017) validate the finding of (Adhikari et al., 2006), who argue that overlapping policy between public and personal dimensions of political connections encourage the good turn served to connected companies in the fashion of corporate tax relief and possible tax–free bailouts. A relationship-based system is used by East Asian countries and it brings about a self-governing system of imminent connection among government, banks, politicians and other stakeholders (Rajan & Zingales, 1998). Based on the system used in Indonesia, it may be expected that politically connected companies of Indonesia tends to be more tax aggresive compared to non connected companies. Therefore, the hypothesis is developed as follow.

H1: Politically connected companies in Indonesia is likely to be more tax aggresive compared to non connected companies

3. Methodlogy

To test the hypothesis, this study use the manufacturing companies listed in Indonesia Stock Exchange (IDX). the final sample of this study is 125 companies or 625 companies-years observation. Data were collected from financial reports which gathered through IDX website. Politically connected companies were identified by see the name of company which followed by *Persero*. Tax aggressiveness is measured by cash ETR (Minnick & Noga, 2010) and which defined as cash tax paid divided by pre-tax book income before special items (Dyreng, Hanlon, & Maydew, 2010). Besides, this study also uses the profitability and leverage. Profitability is measured by Return on Asset (ROA) (Carpenter & Fredrickson, 2001; Erhardt, Werbel, & Shrader, 2003; Haleblian & Finikelstein, 1993; Jackling & Johl, 2009). Level of leverage indicate the agency problems in term of monitoring cost and how companies choose to finance the operations (Hutchinson & Gul, 2004). In addition, leverage is measured by ratio of total debt to total assets (Erickson, Park, Reising, & Shin, 2005; Foong & Idris, 2012; Mak & Kusnadi, 2005; Short & Keasey, 1999). Independent t test is used to see any difference in means between politically connected companies and non-connected companies (Wahab et al., 2017).

4. Result and Discussion

As mention above, this study aims to investigate whether politically connected companies is more tax aggressive compared to non-connected companies. Using 625 company-years observation, the means, standard deviation, minimal and maximal values are demonstrated in Table 1. Means value of tax aggressiveness is 0.23 which is lower than finding of (Dyreng et al., 2010). Thus, it implies that Indonesia companies is more tax aggressiveness. Regarding to company's ability to earn the profit (profitability), average value of company profitability is 5.52% with minimal and maximal value are -55% and 260% respectively. In addition, leverage means value is 52.77% which imply that 0.5277 of assets are financed by debt and the rest is funded by equities.

Table 1: Descriptive Statistics of Research Variables.

	Mean	Std	Min	Max
Panel A. Corporate TA				
Tax Aggressiveness	0.23	0.71	-7.68	5.8
Panel B. Company's Characteristics				
Profitability	5.52	15.21	-55	260
Leverage	52.77	46.36	-56	506

Table 2 show the means and means difference between politically connected companies and non-connected companies. Means value of tax aggressiveness for politically connected companies (0.21) is lower compared to non-connected companies (0.23). this finding imply that politically connected companies is more tax aggressiveness compared to non-connected companies. This findings confirm the finding of previous studies (Adhikari et al., 2006; C. Kim & Zhang, 2016; Wahab et al., 2017) which conclude that politically connected companies are more tax aggressiveness. However, the means difference is not significant at 5%.

Table 2: Means and Means difference Polcon vs. Non Connected.

	Polcon	Non-Polcon	Means difference
Panel A. Corporate TA			
Tax Aggressiveness	0.21	0.23	-0.02(-0.13)
Panel B. Company's Characteristics			
Profitability	6.27	5.48	0.01(0.52)
Leverage	38.79	53.35	-0.15(-1.54)

Further, the means value of profitability is higher for politically connected companies (6.27%) rather than non-connected companies (5.48%). There is possible explanation for higher profitability of politically connected companies. Politically connected companies tend to have a better information regarding tax regulation and enforcement, lower political cost, and lower capital market pressure for transparency (C. Kim & Zhang, 2016). All above benefits will create the good profitability position. For example, better information will yield low tax cost and therefore increase the net income and finally result higher return on asset. However, the difference is not significant. Further, leverage is lower for politically connected companies (38.79%) compared to non-connected companies (53.35%). This result may be explained by fact that politically connected companies has a limited capabilities to expand (Wahab, Zain, & Rahman, 2015). In this context, Indonesia's political connection companies fail to take advantage of taking debt as main sources of fund to finance the company's asset. The study periods (2012-2016) is a period of better economic condition which characterized by low interest rate, including low cost of debt. Well-managed companies would take this opportunity to expand by using the debt capital to finance the expanding activities. However, politically connected companies fail to do so.

5. Conclusion and Recommendation

Tax aggressiveness among politically connected companies have been attracting an academics and practitioners recently. Politically connected companies are likely to be more tax aggressiveness in US and Malaysia. However, tax aggressiveness of politically connected companies are unknown in Indonesia. In addition, it is expected that politically connected companies in Indonesia tend to more tax aggressiveness as well. Using manufacturing companies listed in Indonesia Stock Exchange, it can be concluded that tax aggressiveness of politically connected companies are more tax aggressiveness compared to non-connected companies. However, the means difference is not significant at 5%. Besides, this study also reveals that profitability is higher for politically connected companies. However, the company leverage is lower for politically connected companies. This study has theoretical and practical implication. Theoretically, this study contributes to political economy discipline in the sense that by design, there is a transfer of wealth from the state to shareholders. Relation-based economy creates the opportunities for politically connected companies to reduce the tax liabilities due to having a better information, and lower political cost of aggressive tax planning. Practically, politically connected companies should not gain the competitive advantage through relation-based economy because this relation-based economy is temporary. A number of important limitations need to be considered. First, this study is descriptive in nature. Second, this article uses one sector (manufacturing sector). Finally, this paper only uses three variables. Therefore, it is recommended that further research be undertaken in the following areas. First, future researcher can advance this study by testing the effect of politically connected companies on tax aggressiveness. Second, next research can emphasize by adding more sector as research object, such as main sector, or service and trading sector. Finally, next analysis also can be done by adding other variables, such as corporate governance concepts.

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