

# Does Political Connection, Executive Character, and Audit Quality Affect the Tax Avoidance Practice? Evidence in Indonesia

1<sup>st</sup> Diah Amalia

Managerial Accounting Department  
Politeknik Negeri Batam  
Batam, Indonesia  
diahamalia@polibatam.ac.id

2<sup>nd</sup> Steven Ferdiansyah

Managerial Accounting Department  
Politeknik Negeri Batam  
Batam, Indonesia  
stevenferdx@gmail.com

**Abstract**—this study aims to know and find empirical evidence about the effect of political connection, executive characters, and audit quality on tax avoidance practice in Indonesia. This research uses secondary data with database collection technique using annual report of the manufacturing companies that are listed in Indonesian Stock Exchange (IDX) period 2013 – 2017. Using purposive sampling, this study obtained 51 companies which fulfill the criteria of 165 companies as total population, so the total observation for 5 years is 255 samples. The data examination in this study uses multiple regression analysis with data panel. Tax avoidance practice in this research proxied by Cash ETR. The results of this study indicate that variable political connection has significant positive effect on tax avoidance, which means that the average company uses their political connections to lower tax payments. Variable executive characters have no significant effect on tax avoidance, which means that the characters of executive not yet able to become a standard to determining tax avoidance practice. Variable audit quality indicated no significant effect on tax avoidance, which means KAP the big four who has a good quality hasn't been able to conclude the company not doing tax avoidance practice.

**Keywords**— Tax Avoidance Practice, Political Connection, Executive Character, Audit Quality.

## I. INTRODUCTION

The percentage of state revenue through taxes in Indonesia is very dominant than other revenue sources. The dominance of sources of state revenues through tax sector forces the government to roll out various policies to governing taxation in Indonesia. Policies regarding taxation made by the government is used as a benchmark in making tax payments. In fact, even though there are tax laws that regulate, there is a possibility that loopholes in cheating such as the practice of tax avoidance. Of course this causes the source of state revenue not work as it should.

Based on data from Kementerian Keuangan [33], Indonesia's tax ratio tends to be lower than neighboring countries in Southeast Asia Region. The low of tax ratio can be explained by the buoyancy indicator or comparisons between

the growth of tax revenues with the growth of Indonesia's economic which has decreased. Tax revenues in 2018 actually experienced a double digits growth compared to 2017 of 14,33% year on year (yoY). In terms of tax revenue performance in 2018, it is known that Direktorat Jendral Pajak (DJP) was able to collect 1.315,93 IDR trillion or 92,41% of the 1.424,00 IDR trillion targeted in APBN 2018 [34]. This shows that the performance of taxation in Indonesia has not yet reached the target of the determined by APBN or has experienced a shortfall of 108,07 IDR trillion.

The tax revenue realization deficit can be caused as a result of the tax avoidance practice. In line with the statement by [43] which states the tax revenue that doesn't reach the target is due to the low compliance of tax deposits, there are still many unrecorded transactions (underground economy), and tendency to do the tax avoidance practice. Revenue figures that do not meet the target are also supported by the low level of Indonesian taxpayer compliance ([www.pajak.go.id](http://www.pajak.go.id)). Avoiding tax payments is one form of non-compliance with taxpayers, so that the tax revenues are not optimal.

The complexity of the relevance between the interests of the government and tax payers, has triggered problems in non-compliance with taxation in Indonesia. In line with the statement by [27] who also mentioned that the practice of tax avoidance is a complicated issue, this is due to the fact that tax avoidance is an act that is permissible, but on the other hand the government doesn't want this practice. According to [40] also mentioned that the nature of tax avoidance are legal in the eyes of the law causes the tax authorities can't impose penalties to violators.

Disclosure the involvement of directors and commissioners in politics is not fully regulated in Indonesia laws besides the regulation of Politically Exposed Person (PEP) on financial services. This raises the suspicion that political connection can be a factor in tax avoidance. Research by [45] proves that there is an influence between political connections to tax avoidance, and the average of company uses their political connections to reduce tax payment through lobbying activity and looser supervision.

The role of an executive also influences company policies in carrying out the tax avoidance. The characters of an executive is divided into a risk taker and risk averse [1]. A risk taker more takes the risk to do tax avoidance, different with a risk averse who tends to avoid the risk of tax avoidance.

Research by [27] proves that the more an executive with a risk taker character, causing greater the tax avoidance practice.

Another factor suspected of having a role in tax avoidance is audit quality. Competent parties such as KAP the big four usually tend to present a better financial report audited results, so that the tax avoidance policies are difficult to do. That statement is in line with [18] which states that companies who uses KAP the big four in auditing financial statements have a higher level of difficulty in conduction aggressive tax policies.

There are differences in results and assumptions in several studies make researchers want to test further to find out the consistency of the result on the applications of different samples. This study uses the basis of research conducted by [15] which examines the influence of political connection, company characteristics, and audit quality on tax avoidance as measured by ETR in the banking sector listed on Indonesian Stock Exchange (IDX) period 2014 – 2016 with the number of samples is 39 companies.

This study has several differences from previous studies, including use of executive character variable that are thought to have a role in tax avoidance practice. Researcher also changed the measuring instrument to Cash Effective Tax Rate (Cash ETR) which represented the tax avoidance practice variable, because according to [16] Cash ETR is not affected by changes in estimates such as valuation allowance or tax cushion, and according to [43] referring to [11] that Cash ETR is often used as a proxy for tax avoidance and in accordance with tax regulations in Indonesia. This study uses manufacturing sector which listed on the Indonesian Stock Exchange (IDX) as the object of research, because that sector is the dominant sector on IDX. Time horizon in this research for 5 years using the latest year is 2013 – 2017. The problem that can be formulated in this study is to examine whether there are influences of political connection, executive characters, and audit quality on tax avoidance practice. In line with the formulations of the problem, the purpose of this study aims to know and find empirical evidence about the effect of political connection, executive characters, and audit quality on tax avoidance practice in Indonesia

## II. THEORY REVIEW, LITERATURE, AND HYPOTHESIS DEVELOPMENT

### A. Theoretical Review

#### 1) Agency Theory

The discussion of agency relations has been explained by [9] which states that a company is formed from a collection of contracts between two interested parties, namely the owners of economic resources as principal and managers of resources as agent. [45] indicates that the problem regarding agency appears when it's assumed that agents have an attitude that tends to follow their own desires (self-interest).

#### 2) Stewardship Theory

According to [8] this theory has been designed based on psychology and sociology for executives as stewards to be motivated to act in line with the wishes of principals. This theory further illustrates how a leader or steward isn't motivated by the goals of individualism. This is confirmed by

the statement of [5] which revealed executives weren't motivated by their personal desires.

#### 3) Positive Accounting Theory

The theory developed by [14] is a theory that describes how a manager predicts policies to be taken under certain conditions. Positive accounting theory also emphasizes the freedom to choose one alternative from several accounting policies with the aim of maximizing the value of the company. The freedom to choose makes a manager tend to take opportunistic actions. This theory describes 3 type of hypotheses that represent accounting policies, namely bonus plan, the debt covenants, and political cost.

#### 4) Stakeholder Theory

According to [13] stakeholder are groups or individuals who can influence each other by achieving certain goals. Stakeholder theory states that a company isn't an entity that only operates on the basis of its own interests, but must provide benefits to stakeholders. The company must strive to maintain good relations by meeting the needs and desires of stakeholders, especially for stakeholder who have strong power related to the availability of resources [29].

#### 5) Tax Avoidance Practice

Tax avoidance practice is all forms of activities that have an effect on tax liability, both allowed activities and special activities to reduce the tax expense [16]. The act of avoiding taxes made by the company, only intends to take advantage of legal weaknesses, therefore this doesn't violate applicable laws. This statement is in line with [40] which states that tax avoidance isn't a violation of law, but is an act of taking profits by understating of tax liability.

#### 6) Political Connection

Company that indicated there is a political connection is a company that utilizes a variety of ways, in order to have political or try to get closer to politicians and government [20]. The existence of political ties can be used to achieve certain goals by providing benefits to both parties [42]. Politically connected companies tend to be brave enough to take action to minimize their tax expense, considering the low risk of the company to be examined [2]. The political connection factor increasingly urging company management to find a way to improve its relationship with the leadership of the state or political party [3].

#### 7) Executive Character

When carrying out his duties as the head of the company, [1] mentions an executive has two characters namely risk taker and risk averse. Determination of executive character can be seen from corporate risk. When a company shows high risk, the executive who lead the company tend to be characterized by risk takers. Otherwise, when a company shows low risk, the executives who lead the company tend to be characterized by risk averse [31].

### **8) Audit Quality**

Audit quality is defined as all possibilities that can occur when the auditor doing audit the client's financial statement and find violations which then report them to the audited financial statements [7]. A company will trust the competent auditor in conducting the audit process in their financial statements. [35] explained that based on several references, when a company use the services of KAP the big four in auditing their financial statements, the result presented a higher level of quality.

### **B. Literature Review**

The result of research by [40] found a positive effect of political connection variables on tax avoidance practice in non-financial companies. The results of the study were proven again by [37] in property and real estate companies and [45] in manufacturing companies who both found political connection had a positive effect on tax avoidance. Different with research conducted by [39] and [15] in the banking sector, political connection have a negative effect on tax avoidance. Other results that prove the political connection doesn't affecting on tax avoidance practice by [25] the object of research in all sectors of the company in Indonesia.

The research about the effect of executive character on tax avoidance has been carried out by [27] in the manufacturing sector who found a positive influenced. The same results proved by [36] in the mining sector that finds executive character has a positive effect on tax avoidance. Different directions are shown in the [44], [40], and [12] who found negative effects of executive character on tax avoidance. The results that show no influence of executive character on tax avoidance have been proved by [31] and [26].

[24] in their research on manufacturing companies proved that audit quality has a positive influence on tax avoidance. These results contradict by [41] who found a negative effect of audit quality on tax avoidance at mining companies. The results that prove audit quality isn't influence to tax avoidance practice were shown in several studies, like [39], [15], and [31].

### **C. Hypothesis Development**

#### **1) Effect of Political Connection on Tax Avoidance Practice**

Disclosure the involvement of directors and commissioners in politics is not fully regulated in Indonesia laws besides the regulation of Politically Exposed Person (PEP) on financial services. This causes some politically connected companies indirectly get some special treatment and benefits. In line with the statement of [15] and [40] which states that companies will get special treatment when having political connections, such as easy to obtain a capital loan and the risk of a low tax audit. These indications cause companies to be more aggressive in implementing tax planning, so that financial report transparency decreases.

Politically connected companies will use special relationships with government to carry out the tax avoidance. That allegation was supported by [10] who stated that

politically connected companies tend to pay lower taxes. The results of research that supports the researcher's allegation have been carried out by [40], [37], and [45] who found a positive effect on political connection to tax avoidance. Based on researcher's expectations and the description, the first hypothesis in this study is:

H<sub>1</sub>: There is a positive effect of political connections on tax avoidance practice.

#### **2) Effect of Executive Character on Tax Avoidance Practice**

An executive basically has different characters. The difference from executive character will be reflected in company policy making, including the tax avoidance practice. According to [1], it mentions that executives have two different characters, namely a risk taker and a risk averse. The risk taker will use their courage to take more risk in tax avoidance practice, while a risk averse will avoid taking these risks. The executive character will be seen from the risk of the company.

Executive who dare to take a large risk will be expected able to use his character to carry out the tax avoidance actions. The results of research that supports the researcher's allegation have been proven by [27] and [36] who found executive character had a positive effect on tax avoidance practice. Based on researcher's expectations and the description, the second hypothesis in this study is:

H<sub>2</sub>: There is a positive effect of executive characters on tax avoidance practice.

#### **3) Effect of Audit Quality on Tax Avoidance Practice**

[15] stated in their research that the audit process really requires professionalism, accountability, and high integrity or transparency. Transparency is an important component in audit quality. To obtain high quality audited financial statements, the company tends to use competent auditors from trusted public accountant like KAP the big four. [35] in their research mentioned that audited annual reports by KAP the big four auditors would present higher quality results than KAP non the big four.

KAP the big four gets a good reputation from the public because audited financial reports have a high credibility, so researchers suspect that companies uses the service of KAP the big four when auditing financial report will reduce tax avoidance practice. The result of research supporting researcher's allegation have been carried out by [41] who found a negative effect on audit quality as measured by KAP the big four against to tax avoidance. Based on researcher's expectations and the description, the third hypothesis in this study is:

H<sub>3</sub>: There is a negative effect of audit quality on tax avoidance practice.

Based on theory review, literature review, and hypothesis development that have been explained, the research model can be seen in Fig. 1:

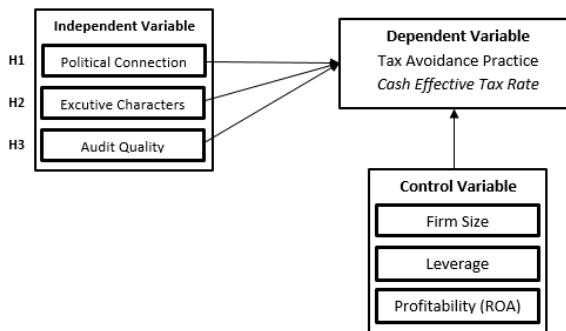


Fig. 1. Research Model  
Source: Authors, 2019

### III. RESEARCH METHOD

#### A. Population and Sample

This study uses secondary data by collecting and analyzing audited annual report data of companies listed on the IDX in 2013 – 2017 from idx.co.id. The population of this research is manufacturing companies which listed on the IDX such as basic chemical industries, various industries, and consumer goods industries. The sampling technique is use probability sampling with purposive sampling method.

#### B. Operational Variables and Measurement

##### 1) Tax Avoidance Practice

Cash ETR is the value of tax payments made by the company in cash for the earnings before the company's tax [18]. Cash ETR formula refers to [16] as follows: Cash ETR = Cash Tax Paid / Pre-Tax Income.

##### 2) Political Connection

Independent variable of political connection can be explained using dummy variables. If the company is indicated have a political connection, then get a score of 1 and company that isn't indicated have a political connection, the get a score of 0. [6] provide provisions that companies will be indicated having political connection if board commissioners and directors: (1) double position as a politician affiliated with political party; (2) double position as a government officials; (3) double position as military officials; (4) former government officials or former military officials.

##### 3) Executive Character

Determination independent variable of executive character can be seen from the corporate risk of a company [17]. Corporate risk can be measured by standard deviation of EBITDA (earnings before interest, taxes, depreciation, and amortization) divided by the total asset of the company. Standard deviation of corporate risk formula refers to [17] as follows: Risk = Standard Deviation EBITDA / Total Asset.

##### 4) Audit Quality

The measurement of audit quality can use a dummy variable by looking at the KAP the big four services used by the company. If the company uses the services of KAP the big four in auditing their financial reports, it will give a score as 1,

while companies that uses services other than KAP the big four are given score as 0.

#### 5) Firm Size

The size of the company also affects the productivity of the company which seen by the profits generated, so that indirectly can influence the level of company tax payments [30]. Firm size formula refers to [16] as follows: Firm Size = Ln. Total Asset.

#### 6) Leverage

[30] and [21] adding leverage policy related to the amount of debt that will cause interest expense, this expense is used as a component to reduce the company's net profit so that tax payments will also decrease. The existence of leverage can encourage companies to intentionally in debt to reduce the tax expense [32]. Leverage formula refers to [4] as follows: Leverage= Total Liability / Total Asset.

#### 7) Profitability

According to [37], when a company able to manage income and payment of its tax expense, that company is considered to earn a profit so the company doesn't practice the tax avoidance. Return on Asset (ROA) formula refers to [4] as follows: ROA = Earning After Tax / Total Asset.

#### C. Data Processing and Analysis Techniques

This study is use the Eviews 9 statistical application to do data processing. The panel data regression equation model formed in this study as follows:

$$CETR_{it} = \alpha + \beta_1 POLCON_{it} + \beta_2 RISK_{it} + \beta_3 QUALITY_{it} + \beta_4 SIZE_{it} + \beta_5 LEV_{it} + \beta_6 PROFIT_{it} + \varepsilon \quad (1)$$

### IV. RESULTS AND DISCUSSION

#### A. The Results of Determining Estimation Model

According to [19] there are 3 estimation models of panel data, such as common effects, fixed effects, and random effects. Based on that test, the best estimation model in this research is common effect model.

#### B. The Results of Classic Assumption Test

Based on multicollinearity test which refers to [22] and heteroscedasticity test which refers to [28], it can be concluded that the data used in this study didn't experience the classic assumptions test problems.

#### C. The Results of Hypothesis Test

##### 1) The Result of Data Panel Regression

The result of data panel regression using common effect as the best model can be seen in Table III as follows:

TABLE I. THE RESULT OF DATA PANEL REGRESSION

Variabel	Coefisien	t-Hitung	Prob.
C	0.476558	0.597542	0.5507
POLCON (H1)	0.305472	2.811663	0.0053
RISK (H2)	2.272350	1.390853	0.1655
QUALITY (H3)	-0.138246	-0.986299	0.3249

SIZE	-0.011712	-0.303138	0.7620
LEV	0.599287	1.898389	0.0588
PROFIT	-1.681819	-2.536569	0.0118
R-squared			0.086447
Adj R-squared			0.064345
N			255
Alpha significance level of 5%			

Source: Data processed by Eviews 9, 2019.

In accordance with the regression results in table I, the equation model of data panel regression is:

$$\begin{aligned} \text{CETR}_{it} = & 0,476558 + 0,305472 \text{POLCON}_{it} + \\ & 2,272350 \text{RISK}_{it} - 0,138246 \text{QUALITY}_{it} - \\ & 0,011712 \text{SIZE}_{it} + 0,599287 \text{LEV}_{it} - \\ & 0,681819 \text{PROFIT}_{it} \end{aligned} \quad (1)$$

### 2) The Result of Coefficient Determination

The adjusted R-squared value in table III shows that political connection, executive character, audit quality, company size, leverage, and profitability are only able to explain the tax avoidance practice (CETR) of 6,4% while 93,6% is explained by other variables.

### 3) The Result of Partial Hypothesis Test

#### a) Effect of Political Connection on Tax Avoidance Practice

Based on table III with the common effect data panel regression model, the probability value of political connection (POLCON) is 0,0053 which smaller than the significance level of 0,05 ( $0,0053 < 0,05$ ) and the coefficient is 0,305472 with positive direction. The result of this test concludes that political connection variable have a positive and significant effect on tax avoidance practice, so  $H_1$  is supported. The positive influence in this study can be interpreted that companies that have political connections will increase tax avoidance. Reduce tax costs is to practice tax avoidance. Companies that have political connections indicate that there is a special relationship between the company and the government. This special relationship serves as an opportunity for the company to lobbying. The efforts of companies with political connections to lobby are aimed at influencing the government to launch tax avoidance methods used by companies so that the tax costs paid can be lower. In addition, lobbying efforts can reduce punishment if the methods used by companies in avoiding taxes are contrary to tax regulations. Therefore, companies indicated to have political connections must be clever in utilizing their special relationships in order to get the opportunity to practice tax avoidance.

#### b) Effect of Executive Character on Tax Avoidance Practice

Based on table III with the common effect data panel regression model, the probability value of executive character (RISK) is 0,1655 which higher than the significance level of 0,05 ( $0,1655 > 0,05$ ) and the coefficient is 2,272350 with positive direction. The result of this test conclude that executive character variable have a positive and no significant effect on tax avoidance practice, so  $H_2$  is not supported.

#### c) Effect of Audit Quality on Tax Avoidance Practice

Based on table III with the common effect data panel regression model, the probability value of audit quality (QUALITY) is 0,3249 which higher than the significance level of 0,05 ( $0,3249 > 0,05$ ) and the coefficient is -0,138246 with negative direction. The result of this test conclude that audit quality variable have a negative and no significant effect on tax avoidance practice, so  $H_3$  is not supported.

## V. CONCLUSIONS, LIMITATIONS, AND SUGGESTIONS

### A. Conclusions

Based on the results of the test, some conclusions can be drawn, such as: (1) Political connections have a positive and significant effect on tax avoidance practice, so that indicating there are relationship between politically connected companies with the tax avoidance actions which taken by them. These results prove that politically connected companies have the opportunity to carry out the tax avoidance through their special relationships with the government. One of the opportunities that can be utilized by companies indicated by political connection is to make lobbying efforts. This effort aims to launch a tax avoidance method that is used or minimizes punishment when the method is against the rules of the government; (2) Executive character doesn't affect the tax avoidance practice which indicates that the character of a leader who is brave enough to take risks can't be used a benchmark in making decisions related to government. This result is reinforced by the theory of stewardship, which considers the executive as a person who can be trusted in carrying out the duties and responsibilities in accordance with the rules set by the government as well as in paying taxes. One form of trust given by the government to steward (company) is by calculation the tax expense in a self-assessment. Remember there is sense of trust, the steward must make every effort to avoid opportunistic behavior such as reducing his tax expense; (3) Audit quality as measured by KAP the big four has no effect on tax avoidance practice. This result indicates KAP the big four which generally good quality has not been able to minimize and detect tax avoidance actions. The company's decision to conduct tax avoidance is only influenced by the company's internal management decisions, so that the auditor as an external party can't influence that decision. When a company carrying out the tax avoidance, an auditor who conducts an auditing process can't directly decide that the company is cheated. This becomes more complicated considering that the practice of tax avoidance is still legal in the eyes of the law, so the auditors of the KAP the big four can't influence the internal decisions in using the tax avoidance method while not violating the rules.

### B. Suggestions

Based on limitations, there are suggestions that can be considered for further research, such as: (1) Increase the number of observation samples, not only using the manufacturing company sector, but using all sectors of the company on the IDX; (2) Increase the number of periods, so

that can produce more sample quantities and can represent previous years; (3) Can use another proxies besides Cash ETR which represent tax avoidance variable such as Current ETR, GAAP ETR, and Book Tax Difference; (4) Indicates that the company has political connections not only from the board of commissioners and directors, but also from the company audit committee; (5) Add proxies that represent audit quality variable such as audit tenure and audit fees; (6) Adding other research variables that are through to influence the tax avoidance practice such as good corporate governance, corporate social responsibility, transfer pricing transactions, and executive-related variables such as executive incentives and executive share ownership.

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