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Ownership Structure, Political Connection and Tax Avoidance

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Issues surrounding the influence of ownership structure on tax avoidance need to be carefully examined . Employing the agency theory in relation to tax avoidance, this research examines the effect of ownership structures as measured by managerial ownership, foreign ownership, public ownership, institutional ownership and political connection with the company undertaking tax avoidance. This study examines Indonesian companies listed on the Indonesian Stock Exchange between 2016-2018, which were selected based on purposive sampling. The research reveals that foreign and institutional ownership affect tax avoidance, while managerial ownership, public ownership, and political connections have no affect on tax avoidance. Surprisingly, testing using separate observations which consist of both connected and non-connected firms, found different results. For connected firms we found that only foreign ownership affects tax avoidance while for non-connected firms, we found that managerial ownership affects tax avoidance.

Keywords: *Tax avoidance, managerial ownership, public ownership, institutional ownership, foreign ownership, political connections*

Introduction

Tax avoidance has become a problem and has sparked a debate amongst practitioners and academics as although it is legal, and no law is violated, it is not to the government. Taxes incur a significant cost to the organisations (S. Chen, et. al. , 2010) and shareholders (Khan, Srinivasan, & Tan, 2017), take the firms' pre-tax earnings and reduce the company's earnings (Annuar, Salihu, & Obid, 2014), so that tax avoidance becomes important for shareholders, who expect the manager's actions to focus on maximising shareholder profits (Hanlon & Heitzman, 2010).

The Indonesian government requires taxpayers to report annual tax report (SPT) as a reporting and accountability tool for the calculations and payment of taxes that have been made. The level of tax compliance from taxpayers who submitted annual tax reports (SPT) in Indonesia was 62.96% in 2017 and 59.89% in 2018 (Dirjen, 2018; Dirjen, 2017). Based on this data, the percentage of tax compliance is still low and there is no improvement in the percentage of tax compliance in Indonesia. The low degree of tax compliance in Indonesia is one indication of tax avoidance practices (Rusydi & Martani, 2014).

Therefore, tax avoidance reflects agency problems (Hanlon & Heitzman, 2010). However, the control and segregation of ownership can cause company tax decisions reflecting the manager's personal interests (Hanlon & Heitzman, 2010).

Several research projects have shown the results of ownership structure and tax avoidance (see for instance, Badertscher, Katz, & Rego, 2013; Richardson, Wang, & Zhang, 2016; Bradshaw, Liao, & Ma, 2013). A study by Badertscher et al., (2013) found that companies with higher control and concentrations of ownership will avoid less income tax. The income tax rate is higher in State-Owned Enterprise (SEO) in China than in non SEOs, which is consistent with less tax avoidance (Bradshaw et al., 2014). Better performing ccompanies normally have a lower GAAP ETR, which then leads to more tax avoidance (Zevenbergen, 2018), companies that avoid taxes affect their market value (Z. Chen, Cheok, & Rasiah, 2016).

This indication makes tax avoidance interesting to investigate in Indonesia, which has a unique ownership structure. It tends to be concentrated with most companies belonging to a group of companies or larger part shareholders (Masripah, Diyanty, & Fitriasari, 2015). Ownership concentration in Indonesia tends to be extremely high with 80% of share ownership in a given firm (Rusmin, Evans, & Hossain, 2012). In addition to family and institutional ownership, in recent years foreign ownership of companies in Indonesia has increased. This indicated that the fundamentals of Indonesia's economy are still positive so that investors want to invest in Indonesia (Rachman, 2017). In this research paper we also test public ownership. There are still few studies that examine the influence of public ownership on tax avoidance.

Several studies in the Indonesian context have found that family ownership affects aggressive tax avoidance. Yet, both foreign and government ownership had no effects on aggressive tax avoidance (Rusydi & Martani, 2014). However, Aulia, (2016) found that family ownership had no effects on tax avoidance, while institutional and foreign ownership affected tax avoidance (Aulia, 2016; Saputra, Nadirsyah, & Hanifah (2017). Meanwhile, controlling shareholders had a negative effect on tax avoidance (Masripah et al., 2015).

In addition to ownership structure, this research project also examines the political connection. Political connections owned by the company will affect tax avoidance. They have an important role in financial matters (Fisman, 2001). As a developing country, Indonesia has generally made political connections (Pranoto & Widagdo, 2016). Companies that have a political connection will gain benefit such as easy access to obtain loans from banks, ease of obtaining a contract/tender from the government (Aulia, 2016). Researchers found that political connections did not have an effect on tax avoidance (Aulia, 2016), but the political connections of the independent commissioner had a negative impact on tax aggressiveness (Pranoto & Widagdo, 2016).

Based on prior studies, this paper examines the effect of ownership structure (including managerial ownership, institutional ownership, public ownership, and foreign ownership) and political affiliation with tax avoidance. Ownership structure, especially foreign ownership and public ownership are still conducted to a limited extent in Indonesia. Furthermore, we separate samples to politically affiliated and non- affiliated companies. The findings of this study provide input to the government and companies associated with tax regulations, especially those concerning tax avoidance.

Literature Review

Agency Theory and Tax Avoidance

Based on previous research, this work uses agency theory (Slemrod, 2004; Crocker and Slemrod, 2005; Chen and Chu, 2005 in Hanlon & Heitzman (2010); (Chyz & White, 2014); (McGuire, Wang, & Wilson, 2014). Richardson et al., (2016) and Rusydi & Martani (2014) maintain that agency (agency framework) theories underly the research of tax avoidance.

Some experts have proposed several definitions of tax avoidance. Hanlon & Heitzman, (2010), for instance, define tax avoidance as an effort to reduce certain explicit taxes. Similarly, Dyreng, Hanlon, & Maydew (2008) describe it as any activity that aims to reduce some amount of company' cash effective tax rate over a period of time.

Tax avoidance has consequences. Corporate tax avoidance activity may be costly (Desai & Dharmapala, 2009). A potential consequence is tax authorities recognising the actions of the company and forcing the company to pay extra taxes, interest, and penalties that will affect cash flow and investor wealth reduction (Hanlon & Heitzman, 2010). In contrast, tax avoidance can also potentially gain benefit from cash savings obtained from avoiding taxes. These savings will increase the company's value and some company cash flow . Company shareholders will also receive more dividends and increased share value. Compensations obtained from effective tax management will also benefit the managers (Annuar et al., 2014).

Ownership Structure

One of the factors which has an important effect on tax avoidance is oownership structure (Hanlon & Heitzman, 2010). The structure of ownership refers to the degree of concentration of ownership. Separating ownership and control indicates that if tax avoidance is a useful activity, the owner will guarantee that managers make efficient tax decisions (Hanlon & Heitzman, 2010).

Several research projects have investigated the influence of ownership structure on tax avoidance (Badertscher et al., 2013; Richardson et al., 2016; Bradshaw et al., 2014). Controlling the owner is more likely to confiscate shareholders' wealth by utilising tax evasion (Richardson et al., 2016).

Tax Avoidance and Managerial Ownership

Managerial ownership is the proportion of the company's stocks owned by the manager, the council of commissioners and the company board of directors . Agency theory suggests that when managers do not own the company or a small number of shares in the company, their actions are impacted by personal interests, not to increase the value of organisation and the shareholder interests. Conversely, if managers have a part in the company, they tend to align their interests with those of the shareholders (Alzoubi, 2016).

Recent studies show that the determination of tax avoidance levels is significantly determined by individual executives (Dyreng, Hanlon, & Maydew, 2010). Companies with higher concentrations of ownership and control and more risk-averse managers avoid lower income taxes more than companies with fewer concentrations of ownership and control (Badertscher et al., 2013). Less tax avoidance will be experienced by mmanagers with extreme control rights (McGuire et al., 2014). Managerial ownership does not have any substantial relationship with tax avoidance (Jamei, 2017). Pramudito & Sari (2015) have found that managerial ownership negatively affects tax avoidance. Increasing numbers of company managerial shares will reduce company tax avoidance.

H1: Managerial ownership affects tax avoidance

Foreign Ownership and Tax Avoidance

The increasing number of foreign ownership in Indonesian firms reveals that Indonesia's economic fundamentals are still positive and foreign investors want to invest their capital in Indonesia (Rachman, 2017). Foreign ownership is related to high levels of efficiency and profitability (D'souza, Megginson and Nash, 2001; Smith, Cin and Vodopivve, 1997, in Annuar et al., 2014), concentrating more on the reputation of the firms so they can change the company behaviour in operation (Rusydi & Martani, 2014). Foreign ownership tends not to invest in poorly governed firms, high insider control and countries with weak institutions, as they will burden foreign investors with information and monitoring cost (Leuz, Lins, & Warnock, 2009).

Several research projects have examined the effect of foreign ownership on tax avoidance in Indonesia, for instance, a study by Aulia (2016); Saputra et. al., (2017) and Annuar et al., (2014) in Malaysia. Rusydi & Martani (2014) did not find an effect of foreign ownership on tax avoidance.

H2: Foreign ownership affects tax avoidance

Public Ownership and Tax Avoidance

Public ownership is categorised as a public share (not affiliated with the company), each of which is no more than 5% ownership. It can be said that the public shareholder has minority power within the company (Santoso & Muid, 2014). The results of Santoso & Muid (2014) research show that public ownership affects tax avoidance (with α 10%).

Public companies are experiencing greater financial reporting pressures than private firms. The greater pressure on financial reporting causes managers to focus more on financial statements, which leads to reduced tax planning. Public ownership increases the accuracy of corporate financial statements because public ownership consists of numerous investors, financial analysts, and regulators (Badertscher, Katz, & Rego, 2009).

H3: Public ownership affects tax avoidance

Institutional Ownership and Tax Avoidance

Institutional ownership is the proportion of stock owned by an organisation. The organisation may consists of foundations, banks, insurance companies, investment companies, financial institutions, legal entities and other institutions. The presence of institutional ownership in the company means monitor managerial performance aggressively (Desai & Dharmapala, 2009). Institutional ownership plays an essential role in controlling management policies and can constitute a government mechanism (Alzoubi, 2016).

Institutional ownership has a positively effect on tax avoidance and corporate income (Khan et al., 2017; Saputra et al., 2017). Meanwhile, research in Indonesia has found that institutional ownership negatively affects tax avoidance (Aulia, 2016). However, this contradicts studies conducted by Winata (2014) and Damayanti & Susanto (2015) who found that tax avoidance is not affected by institutional ownership. A study by Jamei (2017) in the Iranian context has found that institutional ownership and tax avoidance are not significantly related.

H4: Institutional ownership affects tax avoidance

Political Affiliation and Tax Avoidance

Kim and Zhang (2016) state that ppolitical affiliation is one potential determinant of corporate tax assertiveness (Kim & Zhang, 2016). According to Faccio (2006), companies have political connection if one of the top officers of the company is: (a) a parliament member, (b) a minister or a governor, or (3) very closely linked to an important person in the government. Companies may be linked to parliament members for two potential reasons. First, because at least one of their top officers has become a member of national parliament. Second, due to at least one important stakeholder being a parliament member. An important stakeholder is defined as anyone who has direct or indirect control over the company because they owe at least 10% of shareholder votes.

In dealing with the risk of tax detection, it is a common practice for ppoliticians to try to protect their politically affiliated companies. By doing so, they can lower the possibility of being detected as taxpayers. Political connections can indeed help companies gain access to lawmakers. They can also have more complicated and aggressive tax planning because firms with political connections will have less capital market pressure for transparency and can reduce political cost (Kim & Zhang, 2016). The affiliated companies have higher leverage, pay fewer taxes, and have stronger market power (Faccio, 2010). This political connection has been found to be a common practice in countries with more serious levels of corruption (Faccio, 2006). Here, they imposee restrictions on foreign investments and countries with more transparent systems.

Kim & Zhang (2016) have found that corporate political connections are more tax aggressive than non-affiliated firms. This ddiffers from a study by Zaitul & Ilona (2019) which found no significant difference in tax aggressiveness between politically affiliated and non-affiliated companies. Another study found that political affiliations have no effect on tax avoidance (Aulia, 2016); while political connections from independent boards have a negatively effect on tax aggression (Pranoto & Widagdo, 2016). State-Owned Enterprises (SOEs) have higher income tax rates than non-SOEs, consistent with less tax avoidance (Bradshaw et al., 2014). Political connections negatively aaffect tax avoidance practices. Companies whose greater part offers are owned by central or local government will have a low risk of tax avoidance (Tehupuring & Rossa, 2016).

H5: Political connections affect tax avoidance.

Methodology

Some companies listed on the Indonesian Stock Exchange (see this link: https://www.idx.co.id) between 2016-2018 were taken to be the population of this study. Based on purposive sampling, the final samples consists of 135 companies or 435 observations.

Tax avoidance (TA) is the ddependent variable and measured by Cash ETR (cash effective tax rate). To calculatee the tax rate, the following formula of CASH ETR was used (Dyreng et al., 2008):

$$CASH\ ETR = \frac{Cash\ tax\ Paid}{Pretax\ income -\ special\ item}$$

There are 5 independent variables in this research, namely managerial ownership, institutional ownership, public ownership, foreign ownership and political connection.

1. Managerial ownership (MAN) is the company shares belonging to company managers . who sit on the company board of commissioners and board of directors . Managerial ownership is measured using a dummy variable, which is value 1 if there is manager ownership and 0 otherwise.

2. Foreign ownership (FORG) is the quantity of the company shares owned by a foreign body, either individual, company or foreign government. Foreign ownership is measured by using dummy variables, which is value 1 if there is foreign ownership and 0 otherwise.

3. Public ownership (PUB). Public ownership represents the power of society's effect on the company. Public ownership consists of shares owned by the community (not affiliated with the company.)

$$PUB = \frac{Total\ ownership\ of\ public\ shares}{Total\ shares\ outstanding} x\ 100\%$$

4. Institutional ownership (INS) is the proportion of the company shares owned by an institution.

$$INST = \frac{Number\ of\ Institutional\ Shareholdings}{Total\ shares\ outstanding} x\ 100\%$$

5. Political connection (CON). The company has a political connection if one of the company owners, board of directors or board of commissioners has served or is a government official, military officer or parliament member during the period of study. The political connection is measured by dummy variable, 1 if the companies meet one of the criteria above and 0 otherwise.

This study tests the hypotheses by using multiple linear regressions.

$$\mathbf{TA_{it}} = \alpha + \beta_1 \mathbf{MAN_{it}} + \beta_2 \mathbf{FORG_{it}} + \beta_3 \mathbf{PUB_{it}} + \beta_4 \mathbf{INS_{it}} + \beta_5 \mathbf{CON_{it}} + \varepsilon_{it}$$

Notes:

Y	= *Tax Avoidance*
α	= Constant
β1 - β5	= Regression coefficient
MAN	= Managerial Ownership
FORG	= Foreign Ownership
PUB	= Public Ownership
INS	= Institutional Ownership
CON	= Political Connection
ε	= Error

Results and Findings

Descriptive Statistic

This study aims to investigate ownership control, political connection, and tax avoidance. The study samples consist of 145 companies listed on IDX between 2016-2018, except banks, insurance and financial investment or 435 observations. A test was also conducted for politically affiliated firms and non-affiliated firms. It has been found that there are 183 observations for affiliated firms and 252 observations for non-politically affiliated firms. The following Table 1 shows descriptive statistics of the study samples.

Table 1: Descriptive Statistics of Research Variables

	Min	Max	Mean	Std
Panel A: Full Sample (N=435)				
TA	.000	.805	.23307	.14876
MAN	.00	1.00	.51	.500
FORG	.00	1.00	.46	.499
PUB	.570	70.600	27.2969	14.56996
INS	6.460	99.430	64.3640	17.81619
CON	0	1	.42	.494
Panel B: Connected Firm (N=183)				
TA	.01	.74	.2313	.15143
MAN	.00	1.00	.4286	.49624
FORG	.00	1.00	.4121	.49357
PUB	3.19	67.68	30.4991	14.95800
INS	6.46	96.62	61.4685	18.64206
Panel C: Non-Connected Firm (N = 252)				
TA	.00	.80	.2344	.14739
MAN	.00	1.00	.5754	.49527
FORG	.00	1.00	.5040	.50098
PUB	.57	70.60	25.0391	13.90825
INS	12.43	99.43	66.3927	16.94262

Minimum, maximum and mean ownership structure, political affiliation and tax avoidance for full sample are as follows: Mean for tax avoidance was 0.233. Managerial ownership, foreign ownership and political connection were measured by the dummy variable. The mean for managerial ownership was 0.51; foreign ownership of 0.46 and political connection of 0.42. Public ownership has minimum 0.57%, maximum 70.6% and mean 27.3%. Institutional ownership has a minimum of 6.46% and a maximum of 99.43% and a mean of 64.4%. Based on this data, there are companies that are almost entirely governed by institutional ownership (99.43%). This means that for full samples, institutional ownership has a larger percentage than public ownership.

For separate observations, that is politically connected firms, it was found that the mean for tax avoidance is 0.231; managerial ownership is 0.43; and foreign ownership is 0.41. Public ownership has a minimum of 3.19%, a maximum of 67.68% and a mean of 30.5%. Institutional ownership has a minimum of 6.46%, a maximum of 96.62% and a mean of 61.47%. For non-affiliated firms, it was found that mean tax avoidance was 0.234; for managerial ownership 0.58 and foreign ownership 0.50. Public ownership has a minimum of 0.57%, a maximum of

70.60% and a mean of 25.04%. Institutional ownership has a minimum of 12.43%, a maximum of 99.43% and a mean of 66.39%.

As a result, for affiliated and non-affiliated firms, institutional ownership also has a larger percentage than public ownership. Based on this data, institutional ownership also has the largest block holder in Indonesia. Indonesian companies have the highest concentration of control rights. Ownership concentration in Indonesia tends to be extremely high with 80% of share ownership in a given firm (Rusmin et al., 2012). The mean value of tax avoidance in affiliated and non- affiliated firms is almost same, that is 0.231 and 0.234. Therefore, there is no difference between affiliated firms and non- affiliated firms regarding tax avoidance.

Empirical Analysis

This research consists of two step . First, we study the effect of ownership structure and political connection on tax avoidance for a full sample. Second, we separate observations into connected and non-connected firms, and then we conduct the same test. Table 2 shows the results of the hypothesis.

Table 2: Results of Hypothesis Test

	Panel A: Full sample		Panel B: Connected Firm		Panel C: Non Connected Firm	
	Beta	t-stat	Beta	t-stat	Beta	t-stat
Constant	-.071	-1.958	.184	2.935	.356	4.354
MAN	.024	.639	.032	1.300	-.053	-2.028***
FORG	.120	3.242***	.108	4.299***	-.004	-.171
PUB	-.065	-1.275	-.001	-1.447	.001	.658
INS	-.094	-1.884*	.001	.793	-.001	-1.552
CON	.006	.154				
Adj R^2	.024		.115		.018	
F-Stat	3.156***		7.290***		2.214*	
N	435		183		252	

*** Sig α 1%
** Sig α 5%
* Sig α 10%

Panel A of Table 2 shows that ownership structure as measured by managerial ownership and public ownership, and political connection does not have a statistically significant eaffect on tax avoidance. However, tax avoidance is statistically and significantly affected by fforeign and institutional ownership. The results of this study do not support hypotheses 1, 3 and 5, but advocate hypotheses 2 and 4.

This study did not prove that managerial and public ownership affects tax avoidance concerning ownership structure. It supports Jamei (2017) who found that managerial ownership did not significantly affect tax avoidance. The research does not support McGuire et al., (2014) who found that managers with extreme control rights will encounter significantly less tax avoidance and Dyreng et al., (2010) who found that the level of tax avoidance is significantly determined by individual managers.

This study fails to prove that the existence of public ownership will increase the accuracy of the company's financial statements because public ownership consists of numerous investors, financial analysts and regulators (B. Badertscher et al., 2009). Greater pressure on financial reporting causes managers to focus more on financial statements, which leads to reduced tax planning that will ultimately lower tax avoidance. This indicates that there is still no visible power of public company ownership , most likely because public shareholders usually have minority ownership.

On the contrary, this study reveals that foreign ownership has a positive effect on cash ETR. The results obtained are similar to Aulia (2016) and Saputra et al., (2017) who have found the positive effects of foreign ownership on tax avoidance in Indonesia; and Annuar et al., (2014) in Malaysia. However, the findings differ from Rusydi & Martani (2014)'s research who did not find any effect of foreign ownership on tax avoidance.

The research has also found that institutional ownership negatively affects cash ETR. Institutional ownership has made an effective contribution to monitoring managerial policies (Alzoubi, 2016). It usually makes a significant investment in the firm and needs to protect its investment (Siagian, 2011). Institutional ownership with a larger shareholder has a potential ability to monitor every decision that can affect company performance (Saputra et al., 2017). Aulia (2016) found that institutional ownership negatively affects tax avoidance. This result differs from the studies by Khan et al., (2017); Saputra et al., (2017) which found t positive effects of institutional ownership on corporate income tax avoidance.

The study did not find that political affiliations affect tax avoidance. However, political connections have indeed benefited companies in accessing debt financing/bank loan, lower taxes and easy access to government contracts (Aulia, 2016) and provide protection to affiliated firms. The affiliation can also help companies gain access to legislators, less capital market pressure for transparency and can reduce political cost (Kim & Zhang, 2016). This result consistent with Aulia (2016) who found that political connections have no effect on tax avoidance in Indonesia, but differs from Kim & Zhang (2016), Pranoto & Widagdo (2016)'s findings who found that political connection affects tax aggressiveness.

Through this research, we are also testing for separate observations for affiliated and non-affiliated firms (Table 2, Panel B and C). Panel B of Table 2 shows the result for affiliated firms. Different from full samples, we found that only foreign ownership affects tax avoidance. It is associated with high levels of profitability and efficiency (D'souza, Megginson and Nash, 2001; Smith, Cin and Vodopivve, 1997). Annuar et al., (2014) focus on company reputation so they can change the behaviour of the company in operation (Rusydi & Martani, 2014). Meanwhile, managerial ownership, public ownership and institutional ownership have no eeffect on tax avoidance.

Panel C of Table 2 describes the result for non-affiliated firms. It has been found that managerial ownership affects tax avoidance. The level of tax avoidance is greatly determined by iindividual managers (Dyreng et al., 2010). This result is consistent with the results of a study by Pramudito and Sari (2015) who reveal that managerial ownership has a negative effect on tax avoidance. Yet, it varies from a study by Jamei (2017), revealing that managerial ownership does not have any significant relationship with tax avoidance. This result shows that public , foreign and institutional ownership do not influence tax avoidance.

Conclusion, Limitations, and Suggestions

This study investigates ownership control, political connection and tax avoidance. For ownership structure, managerial ownership, foreign ownership, public ownership, and institutional ownership have been investigated. A test has also been conducted for politically affiliated and non-affiliated firms. Tax avoidance was measured by cash ETR. For a full sample, this study failed to prove that managerial ownership, public ownership and political connections affect tax avoidance. However, it found that foreign and institutional ownership affect tax avoidance. The absence of influence of managerial ownership and political connections can also be attributed to the measurement of these variables using dummy variables with similar outcomes. Public ownership can be caused by a small percentage of ownership (minority interest).

A test using a separate observation, including politically affiliated and non-affiliated firms found different results. It found that only foreign ownership affects tax avoidance in the case of affiliated firms. On the contrary, managerial ownership was found to have an eaffect on tax avoidance in the case of non-affiliated firms.

It is suggested that subsequent studies use different proxies for the measurement of these variables. It is also recommended to use different proxies to measure tax avoidance. Hanlon & Heitzman (2010) found that there are other measuring tools for tax avoidance such as GAAP ETR, Long Run effective tax rate and others.

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