

Political connection as a double-edged sword: the case of tax aggressiveness practice during the COVID-19 pandemic

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Abstract

Purpose – This research aims to examine the association between political connection and tax aggressiveness during the COVID-19 pandemic and the role of business ethics in the association between political connection and tax aggressiveness.

Design/methodology/approach – This study employs a multiple regression method for 147 manufacturing firms listed on the Indonesia Stock Exchange during the pandemic era.

Findings – Political connection has no association with tax aggressiveness. However, political connection has a negative (positive) association with tax aggressiveness in more (less) ethical firms. The results are robust after controlling for year-fixed effects, endogeneity issues and other tax aggressiveness measurements.

Originality/value – Political connection is often cited as the driver of unethical business, including tax aggressiveness. However, this paper claims and finds that political connection is a double-edged sword. Ethical firms use political connection to reduce their tax aggressiveness, and vice versa. Previous research has paid little attention to this topic. This paper also uses COVID-19 as a natural experiment to highlight the importance of corporate social responsibility activities as business ethics.

Keywords Political connection, Tax aggressiveness, CSR activities, COVID-19

Paper type Research paper

1. Introduction

The sustainable development agenda has been severely threatened by the advent of the COVID-19 pandemic. These challenges demand that governments raise more tax revenue to spend. In this context, tax aggressiveness is the most damaging action a company can pursue in terms of a country's economy. Since developing countries depend on tax revenues to meet public spending needs (Bird, 2008), there is an urgent need to identify the factors affecting tax aggressiveness in developing countries.

During the COVID-19 era, Indonesia, as a developing country, focused on the tax aggressiveness pursued by high-net-worth individuals (HNWI) and their companies (Nugroho, 2022) as there is tremendous tax loss from HNWI and their companies. The real factor driving tax aggressiveness by HNWI is their political connections (Sindhunata, 2016; Lukas and Arndt, 2020). Previous research has established that HNWI oppose higher income taxes (Lukas and Arndt, 2020) and political connection weakens the effectiveness of tax enforcement (Lin *et al.*, 2018). Studies have supported the phenomenon by finding a positive association between political connection and tax aggressiveness (Kim and Zhang, 2016; Wahab *et al.*, 2017; Kim and Lee, 2021).



Other recent studies, however, have reported contrasting results. Based on agency theory, politically connected firms are less tax aggressive as they are more prudent in their decision-making, notably those linked to the taxation regulation as they are more visible to the public (Jian *et al.*, 2012; Iswari *et al.*, 2019; Fasita *et al.*, 2022). These contrasting results therefore infer that the association between political connection and tax aggressiveness is moderated by other factors, leading this paper to contend that business ethics is one of the most influential factors in the association.

The objective of this paper is to investigate the association between political connection and tax aggressiveness and the role of business ethics, i.e. corporate social responsibility (CSR) activities, in this association during the pandemic era. CSR activities can serve as a proxy for firms' business ethics and have been used interchangeably with business ethics in previous studies (Matten and Moon, 2004; Manuel and Herron, 2020). It is hypothesized that politically connected firms with high CSR activities have lower tax aggressiveness while politically connected firms with low CSR activities have higher tax aggressiveness.

The results do not support the first hypothesis. No association was found between political connection and tax aggressiveness during the COVID-19 pandemic. This was due to the conflicting association between political connection and tax aggressiveness among politically connected firms, which depends on business ethics. As a notion, this is supported by the result of the second hypothesis, whereby political connection was found to have a negative (positive) association with tax aggressiveness in a subsample with high (low) CSR activities.

Theoretically, this research contributes in two ways. First, it adds to the literature on political connection and tax aggressiveness; this remains scarce and has only increased slowly since Kim and Zhang (2016). Second, this research fills a gap in the association between political connection and tax aggressiveness as the previous researches found competing results (Wahab *et al.*, 2017; Kim and Lee, 2021; Fasita *et al.*, 2022). The research also adds business ethics as a moderating variable of the association between political connection and tax aggressiveness which has not been used by other researches (Kim and Zhang, 2016; Iswari *et al.*, 2019).

Practically, this research also contributes in two ways. First, COVID-19 pandemic has offered a natural experiment through which to distinguish ethical CSR and greenwashing CSR, which is appropriate to consider CSR activities as business ethics. Second, this research contributes by demonstrating how business ethics alter the association between political connection and tax aggressiveness.

This study focuses on Indonesia, for three reasons. First, politicians intervene more in business activities when institutional constraints are weak as in Indonesia (Sudibyo and Jianfu, 2016). Second, Faccio *et al.* (2016) identified Indonesia as having one of the highest rates of politically connected companies. Third, tax revenue is most important for emerging countries such as Indonesia (Bird, 2008).

2. Literature review

2.1 Stakeholder theory, business ethics and CSR

Stakeholder theory is one of the underlying theories of CSR. CSR reflects the sense of corporate responsibility over the concerns of stakeholders related to human existence to contemporaries, future generations and nature (Becker, 2012). Stakeholder theory extends the manager's roles and responsibilities beyond profit maximization to include the interests and claims of non-shareholding stakeholder groups to get competitive advantage which creates economic value.

Focusing on the interest of stakeholders (CSR) characterizes good business ethics (Reynolds *et al.*, 2006). Matten and Moon (2004) argued that CSR is an umbrella term for a

broad set of synonyms and overlapping concepts that reflect both business and society relations and business ethics. In line with Becker (2012), Balmer *et al.* (2007) argued that CSR comprises corporates' ethical identity, which is formed relationally within a community of business and social exchange. Jiménez *et al.* (2021) stated that CSR is a code of conduct that guides a company's ethical conduct. Evans *et al.* (2006) also portrayed CSR education as ethical education in higher institutions.

However, there are several concerns about using CSR as business ethics. First, CSR activities are now mandatory activities (Government of the Republic of Indonesia, 2007; Taneja *et al.*, 2022). Garavan and McGuire (2010) argued that the central concept of ethics is a moral reflection concerning business behavior and not necessarily within a regulatory legal framework. Second, CSR activities can be used as greenwashing activities (i.e. organizations misrepresent themselves as engaging in earth-friendly behaviors) (Mitchell and Ramey, 2011).

COVID-19 has reduced the possibility of companies engaging in many CSR activities solely to comply with the regulation or enhance their reputation (i.e. CSR as greenwashing activities) using the number of CSR activities. In constrained economic times, firms can choose to withdraw their socially responsible activities or maintain, or even expand, them to meet heightened stakeholder needs. True ethics decisions entail identifying the right action to take among competing alternatives (Trevino and Nelson, 2017). It is argued that firms prioritizing CSR (characterized by large number of CSR activities) during the COVID-19 period have used CSR ethically (Miller *et al.*, 2022). In addition, there is no regulation concerning the number of CSR activities. Recent paper has employed CSR activities as proxies of business ethics, especially during the COVID-19 pandemic (Miller *et al.*, 2022).

2.2 Political connection in Indonesia

The characteristics of political connection in Indonesia differ from those in other countries. First, the military plays a significant role in Indonesian politics and economy (Harymawan, 2018). This can bring different results to tax aggressiveness as military personnel are known for their good leadership, discipline and good organizational skills (Harymawan, 2018). Second, Indonesia has a presidential and democratic multiparty system, where the president is elected by the people through general elections. Each new presidential election produces a new political coalition formed among the parties (Nasih *et al.*, 2020). In the context of this phenomenon, there is a high probability that political connections would not provide stable benefits to those who own them. Third, Indonesian companies operate with two tiers of boards. In this dual-board system, all listed firms are required to have a separate Board of Directors (BOD), responsible for daily operations, and a Board of Commissioners (BOC), responsible for supervising and monitoring the BOD. BOC ethics is therefore one of the defining factors influencing the association between political connection and tax aggressiveness.

Scholars have increasingly recognized that the institutional setting significantly influences the role of political connection (Nasih *et al.*, 2020). To date, however, research has tended to focus on the role of political connection within a single-board-system setting (Kim and Zhang, 2016; Wahab *et al.*, 2017). Analyzing the role of political connection in a two-tier board system thus provides an insight into how the BOD–BOC coalition influences the effect of political connection.

2.3 Political connection, tax aggressiveness and business ethics

Companies derive various benefits from having ties with the government which leads them to be more tax aggressive. First, politically connected firms have lower risk of detection for tax sheltering activities. According to the grabbing hand theory, government officials may

therefore treat the tax planning activities of connected firms with added caution to defend themselves against future accusations (Kim and Zhang, 2016) as bureaucrats are controlled by politically connected firms (Iswari *et al.*, 2019). Next, politically connected firms obtain better information about tax policies and can thus better explore time-series differences in tax laws or tax enforcement using complex tax strategies. They can also be more aggressive in their tax planning as they require less legitimacy from stakeholders (Hasan *et al.*, 2014; Balakrishnan *et al.*, 2019). Political connections may reduce the political costs of being tax aggressive (e.g. the loss of a government contract). Lastly, political connections may be associated with a higher degree of tax aggressiveness since firms can afford more risky investments. Scholars have found a positive association between political connections and tax aggressiveness (Kim and Zhang, 2016; Wahab *et al.*, 2017; Lin *et al.*, 2018).

On the other hand, political connections may also be associated with lower tax aggressiveness. Agency theory posits that as politically connected firms are owned by the government and directed or supervised by parties linked to the government, they will pursue the same goal, which is increasing tax revenue. Previous studies have found that politically connected directors have a stronger social orientation, including less tax aggressiveness (Yang and Tang, 2020; Wang *et al.*, 2021). In addition, the government also dictates the career prospects of directors or commissioners in politically connected firms. Since tax revenue helps the government to achieve social objectives, directors or commissioners receive positive publicity and enjoy greater promotion opportunities if the firms they run pay more tax (Jian *et al.*, 2012).

At times of disaster, previous studies have found that political connection serves as a tool to hinder government policy (Kubinec *et al.*, 2021). The government has also provided greater amounts of disaster relief to regions with wider political connections (Higuchi *et al.*, 2019). However, it has also been established that political connections can enhance the positive effects of disasters and CSR performance (He *et al.*, 2022). As such, firms are motivated to increase their CSR activities during the critical time of a disaster, either due to pressure from the government or their willingness to establish a better relationship with the government. Political connection has been proved to increase corporate sustainability performance as it provides more resources to engage in CSR activities (Najaf and Najaf, 2021). Therefore, it is hypothesized as follows:

H1. Political connection is associated with tax aggressiveness during the COVID-19 pandemic.

Although previous studies have found that political connection is positively associated with tax aggressiveness (Wahab *et al.*, 2017; Wang and You, 2022), researchers in Indonesia have reported mixed findings (Iswari *et al.*, 2019; Fasita *et al.*, 2022). The mixed results are due to firms' business ethics.

Prior studies have also found that the association between political connection and unethical business practice depends on a firm's morals. Habib *et al.* (2017), for example, found that politically connected firms are less likely to appoint a Big 4 auditor if they wish to cover up related party transaction related tunneling activities by providing financial statements that fail to reflect their true economic performance. On the other hand, politically connected insiders who refrain from self-dealing would prefer a higher quality of financial reporting and, hence, appoint a Big 4 auditor (Guedhami *et al.*, 2014).

Stakeholder theory contends that tax aggressiveness is not about firms' characteristics or monitoring (Gribnau, 2015) but rather concerns the focus on stakeholders and their business ethics. Previous study has used corporate governance to moderate the association between political connection and tax aggressiveness (Wahab *et al.*, 2017), asserting that corporate governance provides internal and external monitoring to reduce tax aggressiveness. However, there is a flaw in this argument; that is, tax aggressiveness depends more on firms'

moral and business ethics than monitoring (Gribnau, 2015; Lin *et al.*, 2018). As a consequence, no prior evidence has been found to suggest that corporate governance mitigates the influence of political connections in promoting tax aggressiveness.

Therefore, we propose the following hypothesis:

- H2.* Political connection has a positive (negative) association with tax aggressiveness in less (more) ethical firms during the COVID-19 pandemic.

3. Research methods

This research used manufacturing firms listed on the Indonesia Stock Exchange that published an annual report during the pandemic period (2019–2021). Manufacturing firms were selected for three reasons. First, the manufacturing industry is not subject to any special tax treatment. Second, it has a large but not excessive environmental impact. Given that CSR activities vary across industries (Rudyanto, 2019), this research chose to focus on only one industry. Third, manufacturing firms were paragons in terms of state tax revenue.

The following criteria were imposed for the sample selection. First, firms with a negative profit before tax were eliminated as they have less incentive to undertake aggressive tax evasion (Kubick *et al.*, 2015). Second, firms with a negative effective tax rate (ETR) were also eliminated, along with those that had more than one ETR (Davis *et al.*, 2016). Third, there should have been no missing data for any of the variables used in the study. Finally, all firms were removed whose fiscal year did not end in December and that used USD in their financial statements. After applying these selection criteria, the research obtained 147 firm-years as the main sample.

Tax aggressiveness comprises all forms of reduction of taxable income through tax planning, both legal and illegal (Hanlon and Heitzman, 2010). Tax aggressiveness was proxied by the current ETR, which is the current tax expense divided by pretax income. This paper also used cash ETR and book-tax difference and the results are statistically the same.

CSR activities were proxied by content analysis from Sembiring (2005). Sembiring (2005) added checklists on community development which is crucial during the COVID-19 pandemic (Raimo *et al.*, 2021) in the Indonesian context (Susanto *et al.*, 2022). As some studies have referred to earnings management as an unethical business practice, this study performs and also does additional test by splitting the samples according to the mean value of earnings management (Belgasm-Hussain and Hussain, 2023). The results are statistically the same.

Firms were classified as having political connections if they fulfilled one of the criteria outlined by Kim and Zhang (2016), that is, one of the majority shareholders or BOC/BOD members belonged or belongs to a political group or holds a title such as president, minister or legislative; or is the chairman of a party caucus or presidential or governor election campaign; or holds an influential position in governance; or is an employee of a government or military agency.

As in previous research, this study used profitability (ROA), firm size, leverage, growth and capital expenditure as control variables to reflect firm characteristics (Lin *et al.*, 2018; Wang and You, 2022). The data were divided into two subsamples according to the CSR mean value. The empirical model for each subsample is as follows:

$$\text{TAX}_{it} = \beta_0 + \beta_1 \text{PCON}_{it} + \beta_2 \text{PROF}_{it} + \beta_3 \text{SIZE}_{it} + \beta_4 \text{LEV}_{it} + \beta_5 \text{GROWTH}_{it} + \beta_6 \text{CAPEX}_{it} + \varepsilon$$

where *i* and *t* indicate the firm and time, respectively; TAX denotes the level of tax aggressiveness; PCON denotes political connection; PROF denotes return on asset; SIZE

denotes firm size; LEV denotes leverage; GROWTH denotes sales growth; CAPEX denotes capital expenditure and ε denotes error.

4. Results

4.1 Descriptive statistics

Table 1 shows the descriptive statistics of the research variables. Except for 2019, the income tax rate during the COVID-19 pandemic was 22%. Public companies that have a minimum listing requirement of 40% and other specific conditions are eligible for a 3% cutoff from the standard corporate income tax rate, resulting in 19% (Acclime Indonesia, 2022). The 0.26 mean value of tax indicates that firms are paying more than they should.

Table 1 also reveals a low level of CSR activities, at only 0.433 on average. Further analysis shows that the most common CSR activities among firms relate to products (0.48), followed by the environment (0.47), community development (0.38) and labor (0.37). This result was to be expected given that the sample comprises manufacturing firms. However, it does indicate that manufacturing firms in Indonesia do not prioritize community development, despite the COVID-19 pandemic highlighting its importance. Fewer firms have political connections compared to their counterparts (95 vs. 52).

4.2 Pearson correlation and univariate tests

The sample was divided into two subsamples based on the mean value of CSR. We named the subsample with CSR values above the samples' mean value as the more ethical subsample and the one containing their counterparts as the less ethical subsample. The Pearson correlation tests (Table 2) show a no correlation between political connections and tax aggressiveness in the two subsamples. A univariate test of difference in means was carried out (untabulated) and the result supported Pearson correlation test result ($p:0.6891$). The correlation coefficients between the key variables of interest are low, indicating that multicollinearity is not likely to affect our regression results.

4.3 Multivariate tests

This paper uses Driscoll–Kraay Standard Errors for panel regression as there are autocorrelation and heteroscedasticity problems (Hoechle, 2007). Table 3 shows the multivariate test results of the main analysis. They reveal no association between political connections and tax aggressiveness during the COVID-19 pandemic. Two factors may explain the results. First, the level of tax aggressiveness in the sample is low. Second,

Variable	Obs	Mean	Std. dev.	Min	Max
TAX	147	0.26	0.127	0.002	0.959
CSR	147	0.433	0.148	0.141	0.808
PCON	147	0.354	0.48	0	1
PROF	147	0.092	0.109	0.001	0.921
SIZE	147	28.804	1.531	25.955	32.726
LEV	147	0.823	0.839	0.102	5.443
GROWTH	147	0.038	0.2	-1	0.859
CAPEX	147	0.383	0.178	0.024	0.781

Note(s): TAX denotes level of tax aggressiveness; CSR denotes CSR activities; PCON denotes political connection; PROF denotes return on asset; SIZE denotes firm size; LEV denotes leverage; GROWTH denotes sales growth; CAPEX denotes capital expenditure

Source(s): Authors' own work

Table 1.
Descriptive statistics

conflicting attitudes toward tax ethics may exist among the politically connected firms. To prove the second factor, this paper extends to the second hypothesis. As hypothesized, political connection has a negative (positive) association with the level of tax aggressiveness at more (less) ethical firms. The findings show that the association between political connection and tax aggressiveness depends on business ethics. This paper also used fixed effect model and the results are statistically the same. To control for potential endogeneity issues, this paper employs Heckman's two-stage model and first-order lag of political connection. The results (untabulated) are statistically the same.

Political connection has a positive association with tax aggressiveness in less ethical firms. Politically connected firms have a lower expected cost of tax sheltering, face less market pressure for transparency, and do not suffer the risk of losing legitimacy from stakeholders (Kim and Zhang, 2016). Less ethical firms enjoy the benefit of political connection to engage in rent-seeking activities, i.e. tax avoidance. Another possible explanation is that less ethical firms pay more attention to their shareholders than other stakeholders (Jian et al., 2012). As the payment of tax equates to a transfer of wealth from shareholders to other stakeholders, less ethical firms choose to reduce their tax burden to increase their accounting tax figure. This finding supports the grabbing hand theory and previous studies (Wahab et al., 2017; Wang and You, 2022).

In contrast, political connection has a negative association with tax aggressiveness in the more ethical subsample. Political connection is a critical type of personal experience that positively affects social orientation (Fernández-Gago et al., 2018). Ideally, someone runs for political membership to contribute to society. Since government aims to promote social welfare, this ideology is likely to guide that individual's value orientation (Wang et al., 2021). If a politically connected director runs a business, the business will focus on social welfare. As tax aggressiveness can reduce social welfare, politically connected firms are associated with less tax aggressiveness. In addition, according to agency theory, government owner-management promotes communication and cooperation within the firm and guards against opportunism, sparing them the need to closely monitor the management or the expense of pay

Table 2.
Pearson correlation tests of more ethical subsample

Variables	(1)	(2)
(1) TAX	1.000	1.000
(2) PCON	0.167	-0.123
(3) PROF	-0.075	-0.187
(4) SIZE	0.027	-0.108
(5) LEV	-0.021	0.122
(6) GROWTH	-0.291	0.078
(7) CAPEX	0.014	-0.109

Source(s): Authors' own work

Table 3.
Multivariate tests: more ethical vs. less ethical firms

Variable	Baseline		More ethical		Less ethical	
	Obs	Coef	Obs	Coef	Obs	Coef
CONS	147	0.297**	70	0.332***	77	0.257***
PCON	147	0.013	70	0.053***	77	-0.031**
<i>F</i> test		17.98		7.5		7.46
Prob > <i>F</i>		0.001		0.001		0.001
Adjusted <i>R</i> Square		0.0360		0.1322		0.1122

Source(s): Authors' own work

incentives (Schulze *et al.*, 2001). Since the government wishes to increase tax revenue, the government owner-management relationship can reduce corporate tax aggressiveness. Previous studies have found that politically connected firms are more likely to make major philanthropic donations at the same time as holding a stronger sense of the responsibility for doing so (Li *et al.*, 2015; Yang and Tang, 2020).

5. Conclusion

COVID-19 exemplifies the role of CSR activities as proof of business ethics. This paper argues and proves that the association between political connection and tax aggressiveness depends on the level of CSR activities. These insights have implications for informing governments and political parties in their decision-making. To revive the Indonesian economy in the post-pandemic era, governments and political parties should push politically connected firms to increase their business ethics and pay tax fairly. In this way, as in the theme of Indonesia's 77th anniversary of Independence Day in 2022 – “Recovering Faster, Rising Stronger” – the economy can recover and be even stronger than before the pandemic.

Although this study has shed light on the role of business ethics in the association between political connection and tax aggressiveness, it also has some limitations. First, this study did not separate more aggressive (worse business ethics) and less aggressive tax avoidance due to the limited sample size (Balakrishnan *et al.*, 2019). Future researchers may thus wish to focus on more aggressive tax avoidance. Second, this study has focused only on an emerging country. Future researchers could thus extend the analysis to developed countries and compare the results with developing countries. Third, this study employed only five control variables due to the limited data used. However, this introduced the possibility of omitted variable bias. It may thus be better to include more data in the analysis to increase the number of control variables. Finally, it would be relevant to use the quality of CSR activities, rather than the quantity, as a proxy of business ethics.

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