The Effect of Tax Avoidance and Political Connection on Firm Value: Institutional Ownership as Moderating Variable

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Abstract

This research examined the effect of tax avoidance and political connection on firm value with institutional ownership as a moderating variable. It was motivated by many firms that have taken tax avoidance actions in the last period. Tax avoidance activities can reduce firm value from the public perspective. Furthermore, when a business commits a tax offense, it is considered to have violated the law. Tax avoidance activities are conducted to fulfill the interests of firm management instead of the shareholders, which may result in agency conflict. This conflict can be minimized by implementing corporate governance with institutional ownership mechanisms. The existence of institutional ownership can effectively oversee the management. Institutions can also evaluate management performance, reducing tax avoidance activities and controlling political connection between firms and the government. Therefore, firm value cannot be reduced in the long term from the public perspective.This research used secondary data from Manufacturing Firm Financial Reports during 2017-2019. Statistical analysis and hypothesis testing were performed using Smart-PLS software. The results showed that tax avoidance and political connection do not affect firm value. Furthermore, institutional ownership cannot moderate the relationship between tax avoidance and firm value. This research considered institutional ownership as part of corporate governance that can moderate the relationship between tax avoidance, political connection to firm value, and the relationship between tax avoidance and firm value. Meanwhile, institutional ownership could moderate the relationship between political connection to firm value.

Keywords: *Tax Avoidance, Political Connection, Firm Value, Institutional Ownership*

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1. INTRODUCTION

Management is expected to increase firm value from a public perspective because it is one of the principal considerations in assessing performance to provide welfare to stakeholders (Bandiyono & Murwaningsari, 2019). There is a tendency for potential investors to examine when the value becomes higher or tends to decrease. Firm value is something that is very important for investors because it is a market indicator to assess the company as a whole (Syamsudin et al., 2020). The increasing value is reflected in the ability to generate profits. There are many strategies, such as saving taxes to generate high profits at the end of the period (Handayani & Ibrani, 2020). Exploiting the weaknesses inthe tax law rules is a strategy carried out in savings. Additionally, this strategy is legal and permissible. Dyreng et al. (2008) stated that tax provisions encourage companies to reduce their tax burden, apart from that, unclear legal regulations mean that the government cannot impose sanctions when companies are indicated to be committing tax avoidance. The amount of profit earned can increase tax payments, and to overcome this, firm tends to avoid taxes. Tax avoidance is performed by reducing the information presented in financial reports, and this action can affect investors in making decisions (Oktaviani et al., 2019).

Desai and Dharmapala (2009) stated that tax avoidance affects firm value, which tends to be greater when company has high institutional ownership at 60%. Furthermore, tax avoidance actions taken by managers are only limited to fulfilling personal interests. Disclosure related to tax expenses can be reduced, which is the power of managers. The lack of transparency allows managers to conceal self-serving actions.

Hanlon and Slemrod (2009) stated that information arising from tax avoidance activities could reduce firm stock price. Retail firm with low effective taxes is the one most affected by the decline in stock price. Tax planning action is also needed to increase firm value but can be reduced by the avoidance activities in the future. This is supported by the ownership of the shares owned by the family to maintain its reputation.

Tax avoidance actions can reduce firm value in the public eye. The activities may often violate existing rules, and it is conducted to fulfill the management interests. Therefore, it is not merely to fulfill the interests, which creates conflicts between shareholders and management. It is necessary to have a corporate governance mechanism within firm to overcome this conflict. The corporate governance mechanism is institutional ownership, which is the shares owned by insurance, investment firm, banks, and pension funds. Furthermore, firm with high institutional ownership will carry out tight supervision of management. The research conducted by Desai and Dharmapala (2009) stated that tax avoidance affects value, with the effect tending to be greater with high institutional ownership.

Political connection arises when firm is attached in certain ways or try to establish relationships with politicians or the government (Purwoto, 2011). The benefits of political connection are the ease of obtaining loans with an extendable period. The government provides full support by giving guarantees to politically connected firms and lenders, as well as bailout funds when the parties experience a financial crisis (Faccio, 2006).

According to Kim and Zhang (2016), the benefit of political connection is that the capital market does not pressure firms to be transparent. This provides an opportunity to reduce political costs arising from tax planning activities. The connection also provides easy access to the central government, which is common in countries with high levels of corruption. Even though corruption is very detrimental economically and to the country's development, this does not apply to political connection considered beneficial by many firms (Faccio, 2006).

Political connection emerges from relationships between top managers, employees, shareholders, and politicians with current and past political activities. They are formed from campaign activities and agreements with legislators to achieve certain goals (Bianchi and Viana, 2014). Politically connected firms have ties or seek closeness with politicians or the government (Purwoto, 2011). Wang et al. (2018) stated that there is a decrease in the equity value when the public knows the firm has a political relationship with dismissed officials. Sharma et al. (2020) found a significant positive effect of political connection on Chinese firms' decisions to enter export markets and subsequent performance. The research also found that there were significant differences based on ownership type. Meanwhile, politically connected firms have higher managerial ownership and make them vulnerable to bad governance practices (Ang et al., 2013)

Institutional ownership in the firm can create a control mechanism, and the value is increased when it is politically connected with the government. This convenience should be controlled and monitored to prevent abuse. Institutional ownership controls political connection in the long run, which does not reduce firm value. The motivation for carrying out this research is the increasing number of cases of tax evasion which have been prosecuted by the Directorate General of Taxes, including cases of Asian Agri, Indofood, Bumi

Resource, Adaro, Indosat, which of course will reduce the value of the company in the eyes of the public in the long term.

2. LITERATURE REVIEW

2.1. Agency theory

Principal delegates authority and responsibility to agents to run the company. Of course, as the party running the company, the agent has far more information than the principal and this condition will be utilized by the agent to maximize his interests. Information asymmetry will arise when there is an imbalance in information acquisition. To reduce information asymmetry, it will generate agency costs, which require a financial reporting mechanism (Morris, 1987 in Afriansyah, 2020). In the financial reporting submitted there is an agency problem, management has an interest in the amount of bonuses received through the large profits earned while shareholders want relatively small tax payments through low profits. To bridge these two interests, aggressive tax avoidance is needed (Rusydi & Dwi Martani, 2014). In the traditional view, shareholder value will increase along with tax avoidance by management (Desai and Dharmapala, 2006). However, tax avoidance is not without cost. Direct costs include implementation costs, loss of reputation and potential penalties, etc. Agency theorists argue that tax avoidance activities are also related to corporate governance issues (Chen et al, 2014)

2.2. Tax Avoidance and Firm Value

Tax avoidance can increase value by transferring potential State wealth to shareholders. However, this activity is at the legal level to minimize the tax burden to be paid. The smaller the tax burden, the higher the opportunity to achieve profit.

Desai and Dharmapala (2009) stated that the tax avoidance effect on firm value is greater, with high institutional ownership at 60%. Managers take opportunistic actions by avoiding taxes for their benefit. They can reduce the disclosure level related to the tax burden, and lack of transparency conceals actions to promote self-interest.

Hanlon and Slemrod (2009) explained that existing information from tax avoidance activities could reduce stock prices. The decline in share prices was more pronounced for retail firm and those with lower effective rates. Furthermore, tax planning action is also needed to increase firm value. There may be an increase in the beginning, but tax avoidance activities can reduce the value in the future. This is supported by the share ownership owned by the family to maintain the firm reputation.

H1: Tax avoidance affects firm value.

2.3. Political Connection and Firm Value

Political connection arises when a firm with a certain method tries to make close ties with politicians or the government (Purwoto, 2011). Political majorities affect economic activity, elected politicians implement industrial and fiscal policies, and have power over public expenditures and the design of institutions (Coulomb, R., & Sangnier, M., 2014). The firm benefits from the convenience of obtaining a loan with an extendable term when it is well-connected. This is because the lender also receives direct economic support where the firm is connected, and there is assurance that the politically connected borrower and the lender will be provided with bailout funds during a financial crisis (Faccio, 2006).

According to (Kim and Zhang, 2016), political connection benefits included low pressure from capital markets to conduct transparency and reduce costs related to tax planning activities through tax aggressiveness. Furthermore, it assists firm in accessing the central government and will be more visible in countries with high levels of corruption. Even though corruption is detrimental to the economy and growth rate, the same is not true for political connection, which are considered beneficial (Faccio, 2006).

Dewanti (2019) and Tangke (2019) states that political connections have no effect on firm value. However, firm value will be affected in the form of a decrease in equity, when officials with political connections are removed from office (Wang et al., 2018). There was also a significant positive effect of political connection on Chinese firms' decisions to enter export markets and subsequent performance (Sharma et al., 2019). This research found significant differences based on the type of firm ownership. Politically connected firm haves' higher managerial ownership and tend to be smaller. Therefore, it is more vulnerable to poorer governance practices (Ang et al., 2013).

H2: Political connection affects firm value

2.4. Institutional Ownership Moderated Tax Avoidance and Firm Value

Tax avoidance actions can reduce firm value from the public perspective. Its activities often violate existing rules to fulfill the interests of firm management. It also creates conflict between shareholders and management. To overcome this conflict, it is necessary to have a corporate governance mechanism. One of the corporate governance mechanisms is institutional ownership. Desai and Dharmapala (2009) stated that the effect of tax avoidance is greater in firm with high institutional ownership. Institutional ownership is seen as a party that has the ability to supervise management (Wahyudi et al, 2020). Research conducted by Hanum & Zulaikha (2013) explains that institutional investors have a role in determining policies related to effective tax rates, institutional investors will supervise management so that in making profits they must comply with applicable regulations.

Wahab & Holland (2012) tax planning can reduce company value, in accordance with agency theory where there is information asymmetry that tax planning actions can result in moral hazard, Desai and Dharmapala (2006) argue that when there is information asymmetry between managers and shareholders in connection with planning taxes, this can motivate managers to act in their own interests resulting in a negative relationship between tax planning and firm value. Chen et al (2014) state that tax avoidance behavior can increase agency costs and reduce company value but this negative reaction can be reduced by information transparency.

H3: Institutional ownership moderates the relationship between tax avoidance and firm value

2.5. Institutional Ownership Moderated Political Connection and Firm Value

Institutional ownership creates a control mechanism, and when a firm is connected politically with the government, it can increase its value because of the ease of facilities and regulations. The role is to control the political connection in the long term, and it does not reduce firm value from the public perspective. Companies with political connections will be braver in making efforts to minimize the tax burden because the risk of being audited is lower and will not even be subject to inspection by a tax audit agency (Chaney et al, 2011; Kim and Zhang, 2016). Political connections are often used to take advantage of taxes by using proximity to the government to obtain preferential treatment from the government in tax matters such as avoiding tax audits (Adhikari, 2006; Richter et al., 2009; Brown et al., 2014 in Pranoto and Widagdo, 2016; Kim and Zhang, 2016). Companies with political connections are able to carry out more aggressive tax planning because of protection from the government which has an impact on reducing the transparency of financial reports.

Opacity in financial reports has negative impacts on companies, such as high capital requirements due to a lack of investors or the risk of audits. However, companies with political connections do not seem to care about the consequences, one of which is because their political connections are able to reduce or even eliminate the negative consequences (Chaney et al. 2011; Kim and Zhang, 2016). The existence of institutional ownership in the company will create a control mechanism. When a company is politically connected with the government, it will increase the value of the company because of the ease of facilities and regulations. Of course, this facility must be controlled and supervised because otherwise it could be misused. The role of institutional ownership is to control the company's political connections so that in the long term these connections do not reduce the company's value in the eyes of the public. Lin and Fu (2017) state that information asymmetry and agency problems will be reduced when institutional investors actively monitor the company's business so that company performance will increase

H4: Institutional ownership moderates the relationship between political connection and firm value

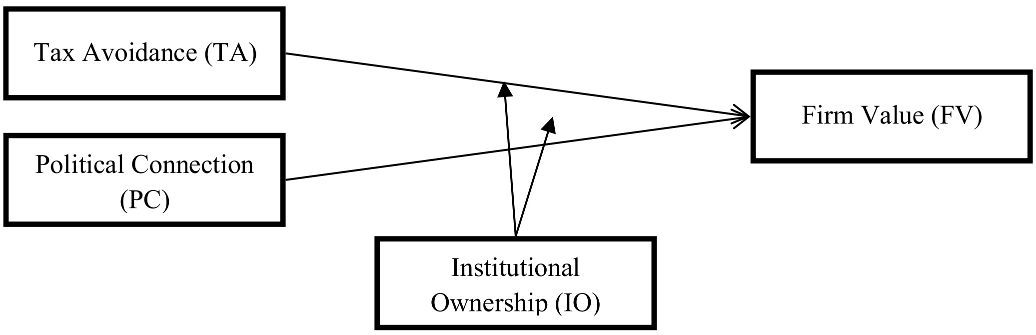

Figure 1. Research Model

3. RESEARCH METHODS

3.1 Sample and Data

The samples used in this research were manufacturing companies listed on the Indonesia Stock Exchange for the 2017-2019 period using purposive sampling criteria to obtain a research sample of 65 samples with 3 years of observation. Manufacturing company data was obtained from company financial reports originating from the official website of the Indonesia Stock Exchange (www.idx.co.id).

3.2 Research operational variables

This research systematically tested the independent, dependent and moderating variables as follows:

3.2.1 Dependent Variable

Firm Value (FV)

According to Tobin et al (1976) and Copeland (2005), firm value is the prospective price buyers pay when the firm is sold and measured using the Tobins'q-ratio. A q-ratio above one means the asset investment is very attractive. However, when the q-ratio is below one, investment in assets is not attractive.

3.2.2 Independent Variable

Tax Avoidance (TA) is a lawful and secure endeavor for taxpayers because it does not violate applicable laws, and the methods and strategies employed tend to exploit the Act's vulnerabilities. The Tax Laws and Regulations are to minimize the amount owed (Pohan, 2013). The higher the CurrentETR value, the smaller the tax avoidance.

Political connection refers to firm relations or attempts to establish close ties with politicians or the government (Purwoto, 2011). Tri Wulandari & Rahardja (2012) stated that the criteria include the board of directors and commissioners holding multiple positions as politicians affiliated with political parties.

1. The board of directors and commissioners hold multiple positions as politicians affiliated with political parties.
2. The board of directors and commissioners hold multiple positions as government officials.
3. The board of directors and commissioners hold multiple positions as military officials.
4. The board of directors and commissioners are former government or military officials.
5. The firm owner or shareholder is a politician or government official.

Political connection is identified by cross-checking the composition and profile of the board of directors and commissioners with politicians from political parties, government officials including ministers, vice ministers, parliament members, regents, mayors, governors, high-ranking military officials, former government officials, and former military officials (Aulia, 2016).

3.2.3 Moderating Variable

This research used institutional ownership as a moderating variable, such as insurance firms, banks, pension funds, and investment firm.

In this research, data analysis uses the Partial Least Square (PLS) approach. PLS is a component or variant-based Structural Equation Modeling (SEM) model. PLS (Partial Least Square) is a variant-based structural equation analysis (SEM) that can simultaneously test the measurement and structural models with the regression equation as follows.

$$\boxed{\mathbf{y = \alpha + \beta1X1 + \beta2X2 + \beta3X1{*}Z + \beta3X1{*}Z + \varepsilon}}$$

Where:
y = Firm Value
x1 = Tax Avoidance
x2 = Political Connection
z = Institutional Ownership

Table 1. Research Instrument

Variables	Instrument
Firm Value (FV)	Tobins'q-ratio: q = (MVS+ MVD) /RVA where: MVS = Market value of all outstanding stock. MVD= Market value of all debt. RVA = Replacement value of all production capacity.
Tax Avoidance (TA)	$\text{CurrentETR} = \frac{\mathit{Current\ Tax\ Expense}}{\text{pretax income}}$

Political Connection (PC)	Research on political connection is measured using a dummy variable by giving: a. Value 1, when firm fulfills one of the 5 political connection criteria. b. Value 0, otherwise.
Institutional Ownership (IO)	Institutional Ownership = $\frac{\textit{The}\ \text{number of shares owned by the institution}}{\textit{Total outstanding shares}}$

4. RESEARCH RESULTS

After carrying out a selection process for the sample based on the purposive sampling technique, a sample of 65 manufacturing companies was obtained, and combining research data for 3 years in one analysis, the number of observations in the research was 195 observations.

4.1 Descriptive Statistics

Table 2. Descriptive Statistics
Political Connection

Variables	Valid	Frequency	Percent
(1)	(2)	(3)	(4)
Political Connection	0	81	41.5
	1	114	58.5
	Total	195	100.0

Table 3. Descriptive Statistics

Variables	Min	Max	Mean	Std. Deviation
(1)	(2)	(3)	(4)	(5)
Tax Avoidance (TA)	0.001	10.171	0.35702	0.811921
Institutional Ownership (IO)	0.012	0.930	0.47148	0.288214
Firm Value (FV)	0.006	18.660	0.37098	2.292332

Data source: SPSS output, 2022

The descriptive analysis provided an overview of data, including the minimum, maximum, mean, and standard deviation used. This includes tax avoidance and political connection as independent variables, firm value as a dependent variable, and institutional ownership as moderating variable.

Descriptive Statistics Table 3 above describes the results of descriptive statistics from 195 sample company observation data. The company value as measured by the Tobin's q value shows an average value of 37,098, this means that potential investors rate the companies in the research sample tend to be low. The average tax avoidance value of 35.7% indicates that on average the sample company's observation data generally pays corporate income tax of 35.7% of profit before tax. Shares owned by institutions are 47.14%, this means that the companies in the research sample have high institutional ownership. Most of the sample companies' observation data are politically close to government officials, as many as 114 observation data or 58.5% have political connections, while those without political connections are 81 observation data or in other words 41.5%.

4.2 Structural Model Evaluation

This examination includes the significance of the path relationship and R Square (R^2) to determine the evaluation results of the structural model. The R^2 aims to obtain the effect magnitude of the independent variable on the dependent, as shown in the following table.

Table 3. R-Square

	R Square	R Square Adjusted
Firm Value (FV)	0.035	0.009

Source: Output SmartPLS, 2022

R^2 of 0.035 means that the variability of firm value can be explained by tax avoidance and political connection as well as institutional ownership as a moderating variable. Meanwhile, the remaining 96.5% is due to other reasons outside the model.

Table 4. Path Coefficient

	Original Sample	Standard Deviation	T Statistics	P Values
Institutional Ownership -> Firm Value	0.060	0.056	1.068	0.286
IO*PC -> Firm Value	-0.116	0.036	3.243	0.001**

IO*TA -> Firm Value	-0.009	0.160	0.054	0.957
Political Connection -> Firm Value	-0.125	0.064	1.963	0.050*
Tax Avoidance -> Firm Value	0.040	0.252	0.157	0.875

* Sig < 10%, ** Sig< 5%

Based on the table above, the results can be used to answer the hypotheses by looking at the T-Statistics and P-Value. Therefore, it can be seen that only one hypothesis is accepted, namely institutional ownership can moderate the relationship between political connection and firm value, while the others are rejected.

5. DISCUSSIONS

5.1 Effect of Tax Avoidance on Firm Value

The calculation results above showed that **Hypothesis 1 is rejected** where tax avoidance does not affect firm value. Tax avoidance is not the only consideration of the stakeholders toward firm. It is at a legal level and allowed by law, where there are many stakeholder considerations to decide the best relationship. Firm can be seen as a whole, specifically the information regarding future business plans. The results of this research are in line with research conducted by Simarmata et al (2014) that long-term tax avoidance does not have a significant effect on company value and there is no increase in company value after long-term tax avoidance practices.

This result is not in line with Hanlon and Slemrod (2009) that a firm needs to take tax planning actions to increase its value. The value will increase at the beginning of the actions and decrease in the future. Desai and Dharmapala (2009) stated that tax avoidance affects firm value, while a lack of transparency causes managers to take opportunistic actions. These actions impact reducing the tax expense that firm should pay to achieve maximum profits. Research by Arfiansyah (2020) states that shareholders positively assess tax avoidance actions carried out by management, because by managing taxes to keep them minimal, it will ultimately increase shareholder welfare. Wahab and Holland (2012) state that there is a negative relationship between tax planning and firm value, shareholders' concerns about the impact of moral hazard in the tax sector or the impact of other tax planning actions, namely audits by the tax authority.

5.2 Effect of Political Connection on Firm Value

Based on the calculation results, **Hypothesis 2 is accepted** Companies that have political ties will get many benefits that can be used to increase firm value (Purwoto, 2011). Politicians who sit in government can make policies that can provide protection for shareholders and stakeholders

Research conducted by Wang et al. (2018) that it affects firm value, where the equity value in the politically connected firm decreases when the related officials are dismissed. The company's stock price tends to rise when the company is politically connected (Bandiyono, 2019)

Ang et al. (2013) reported that politically connected firm has higher managerial ownership, making them more vulnerable to bad governance practices. Furthermore, loans can be easily obtained within an extendable period when a firm is connected with the government. This is because the lender also receives direct economic support where firm is connected. There are guarantees that the borrower and the lender will be provided with bailout funds during a financial crisis (Faccio, 2006). This result is not in line with Tangke (2019) stated that political connection has no significant positive effect on firm value.

5.3 Institutional Ownership in Moderating the Relationship between Tax Avoidance on Firm Value

Based on the calculation, **Hypothesis 3 is rejected** since institutional ownership cannot moderate the relationship between tax avoidance and firm value. Institutional ownership cannot prevent companies from committing tax avoidance. Institutional parties cannot supervise properly so that companies continue to carry out tax avoidance, and if this is allowed, in the long term it will reduce the firm value in the eyes of the public. In contrast, Desai and Dharmapala (2009) found that the effect of tax avoidance is greater in firm with high institutional ownership.

5.4 Institutional Ownership Moderates the Relationship between Political Connection to Firm Value

The calculation above showed that **Hypothesis 4 is accepted** since institutional ownership can moderate the relationship between political connection and firm value. Furthermore, the existence creates a control mechanism, and when a firm is connected politically, its value will be increased because of the ease of facilities and regulations. This facility should be controlled and monitored to hinder any abuse. The role of institutional ownership is to control the political connection owned by firm. In the long term, the relationship does not diminish the public's estimation of firm value.

6. CONCLUSIONS, LIMITATIONS & SUGGESTIONS

Based on the test results, evidence was obtained that hypothesis 1 is rejected, there was no increase in company value after long-term tax avoidance practices were carried out. Hypothesis 2 is accepted Policies drawn up by politicians sitting in government can provide many benefits for companies so that they can increase firm value. Hypothesis 3 is rejected, the high institutional ownership cannot prevent tax avoidance activities which will later decrease firm value. Meanwhile, Hypothesis 4 is accepted, share ownership owned by institutions will create a control mechanism and when a firm is connected politically with the government, the value will be increased because of the ease of facilities and regulations. The facility should be controlled and monitored to hinder any abuse.

This research has several limitations in identifying political connection variables with limited information in financial reports. Future research is expected to add other variables, including information transparency and the Corporate Governance index, as moderating variables. Meanwhile, suggestions for using these variables are based on the argument that the negative relationship between tax avoidance and firm value is weakened by proper management. Information transparency can reduce agency conflicts (Armstrong et al., 2010) by adjusting market value and cash flows through changes in management decision-making (Lambert et al., 2007).

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