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# Do Profitability, Leverage, and Political Connections Affect Tax Avoidance? Evidence from Consumer Cyclical Sector Companies

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**Abstract**

**Purpose** – This study empirically examines the effect of profitability, leverage, and political connections on tax avoidance.

**Design/methodology/approach** – A total of 55 companies from the Consumer Cyclical sector on the Indonesia Stock Exchange were selected by purposive sampling. The analysis technique used is multiple linear regression analysis.

**Findings** – The results show that profitability positively affects tax avoidance. By contrast, leverage and political connections did not affect the tax avoidance of consumer cyclical sector companies listed on the Indonesia Stock Exchange.

**Originality/value** – The object of this research differs from that of previous studies, namely, consumer cyclical sector companies listed on the Indonesia Stock Exchange.

**Research limitations/implications** – The limitation of this study is its relatively small sample size. The research implication is the role of the government or regulator in supervising and implementing effective tax rules to minimize tax avoidance practices.

**Keywords:** profitability, leverage, political connections, and tax avoidance

**Article Type:** Research Paper.

## Introduction

This study examines whether profitability, leverage, and political connections affect tax avoidance. Taxes have made a significant contribution to Indonesia's development. For this reason, an active role and awareness of taxpayers is needed to make tax payments to the state, following applicable laws and regulations. Optimizing tax revenue continues to be carried out by the government, even though this is contrary to the interests of taxpayers (Setyaningrum & Suryarini, 2016). One important source of state tax revenue is corporate income tax. Companies are corporate taxpayers who are trusted by the state as the largest tax contributor to tax revenues. However, not a few perceive taxes as a burden because they can reduce the net profit obtained (Lee & Kao, 2018). In addition, management tries to avoid taxes to protect its interests, such as by increasing bonuses and compensation (Armstrong et al., 2015). Business entities dominate as much as 80% in conducting tax avoidance in Indonesia compared to individual taxpayers. This is a severe issue that the government must address (Himawan, 2017).

Tax avoidance is a problem that deserves attention because it is a form of active resistance that takes advantage of regulatory loopholes but is considered not to violate tax laws. Tax avoidance is a step that being used by several companies to reduce the tax burden that must be paid. This practice harms the state because state revenue is not optimal and ineffective (Mahdiana & Amin, 2020). Based on the publication of the International Center for Policy and Research (ICPR) and the International Center for Taxation and Development (ICTD) database, Indonesia is ranked 11th out of 30 countries in terms of the level of tax avoidance by the amount of tax not paid to the state is estimated at US$ 6.48 billion per year (Cobham & Janský, 2018). Meanwhile, the Tax Justice Network announced that due to this tax avoidance, Indonesia suffered losses of up to US$ 4.86 billion per year, equivalent to Rp. 68.7 billion. Of the tax revenue target in 2020, it is estimated that tax avoidance can reach around 5% (Suryo, 2020).

Many factors, including company profitability, can influence tax avoidance. Profitability is a company's ability to measure profits within a certain period. If a company's profitability increases, its operational activities are good. Previous research by Dewi & Noviari (2017) stated that profitability is a determining factor in the level of tax avoidance because the higher the level of profitability in a company, the higher the level of tax avoidance carried out. Return on assets (ROA) is a proxy for profitability. ROA relates to net profit generated by the company and the imposition of income tax for corporate taxpayers. Praditasari & Setiawan (2017) state that companies that generate high ROA increase their income tax. It is because the profit generated by the company is the basis for imposing an income tax. Thus, the company will avoid increasing the tax burden paid by implementing tax avoidance.

In running a business, companies need additional capital. However, getting capital is not always easy because of competition between companies. To obtain this capital, companies use leverage, namely loans or debt, to increase company profits. When a company has debt, it will affect the reduction of taxes because an interest expense is charged to the company due to its debt. This leverage can also influence a company to avoid taxes (Barli, 2018). Another factor is political connections. The existence of political connections forged by a company can provide various benefits for the company. The advantage is that if a company needs loan funds, it can get a loan quickly (Firth et al., 2009) and has a low tax audit rate. Strong political connections make companies not afraid to commit tax avoidance because they are considered less likely to be caught by the government. The results of previous research by Ferdiawan & Firmansyah (2017) and Munawaro & Ramdany (2019) show that political connections affect the potential for tax avoidance. In contrast, Lestari, Pratomo, & Asalam (2019) found no effect between political connections and tax avoidance.

Several previous studies have examined tax avoidance, but the results are varied and show inconsistency, so it still requires further study. In contrast to previous research, this study examines profitability, leverage, and political connections associated with tax avoidance in a sector that is rarely researched, namely cyclical consumers listed on the Indonesia Stock Exchange (IDX). This sector was chosen because competition is a tough industry, and its growth depends on economic cycles, thus enabling companies to avoid taxes to reduce their operating costs. This research contributes to the literature linking tax avoidance with profitability, leverage, and political connections.

## Literature Review

### *Agency Theory*

Agency theory explains the contractual relationship between the principal and the agent (Jensen & Meckling, 1976). The principal (shareholder) authorizes the agent (manager) to conduct activities on behalf of the principal as a decision-making tool. Relationships caused by differences in interests between principals and agents often pose a risk of moral hazard. The principal wants company managers to do work that can develop and maximize shareholder wealth. Conversely, managers in a company often do work that does not maximize prosperity for shareholders but maximizes their prosperity. As a party that knows more about the company's state, managers must fulfill their obligations to report their information to the company's owner. However, managers sometimes do not report the company's condition to the principal. Managers try to address the company's shortcomings and maintain performance to have a good reputation.

Differences in interests between managers and company owners affect managers' actions, which can trigger agency problems. These different interests affect various matters related to corporate relationships, including corporate decisions to manage corporate taxes. Indonesia has implemented a tax self-assessment system that allows taxpayers, especially corporate taxpayers, to calculate and report the amount of tax on their own. The smaller the profit or income earned by the company, the lower the tax that the company must pay. It can encourage the practice of tax avoidance. On the government side, taxes are a very potential source of income to influence and increase state revenues.

The two sides between the government and company management conflict because the government, as the principal, wants maximum tax revenue. In contrast, as an agent, the company wants the minimum possible tax payments to the state. To avoid spending much money on it, companies make tax payments to a minimum by carrying out tax avoidance. The coercive characteristics of taxes cause taxpayers, especially corporate taxpayers, to legally practice tax avoidance which is deemed not to violate the law. According to Arnold and McIntyre (1995), tax avoidance still complies with laws and regulations. This effort is carried out by looking for loopholes or uncertainties in tax provisions so that companies can use them to reduce the amount of tax paid. A company considers that paying a large tax burden will reduce its profits.

### *The Effect of Profitability on Tax Avoidance*

Profitability is an illustration to see the company's performance in generating profits through its resources. Often this profitability ratio is used for decision-making in the company's operations management, both investors and creditors. One measure that can be used to see profitability is the return on assets (ROA). ROA calculates the value of net income to the total assets owned by the company. The higher the ROA value, the better the company's profit level. According to Darmadi and Zulaikha (2013), taxes paid by companies will usually be lower for companies with high levels of efficiency and income. The company has taken advantage of the advantages obtained with tax incentives and other tax reductions. Large tax payments can reduce the profits earned by the company. Agency theory will encourage agents to create large profits. Increased company profits allow companies to avoid paying increased tax burdens. Several previous studies have proven that there is a positive effect between profitability and tax avoidance (Dewi & Noviari, 2017; Prapitasari & Safrida, 2019; Yulyanah & Kusumastuti, 2019; Marsahala, Arieftiara & Lastiningsih (2020). So that the hypothesis can be formulated in this study, namely:

*H1: profitability has a positive effect on tax avoidance*

### *The Effect of Leverage on Tax Avoidance*

The use of debt within a company can cause several costs, such as fixed expenses, namely interest expenses. Interest costs incurred as a result of debt are tax deductible. However, not all interest expenses can be charged according to the rules set by the tax authorities. Using leverage in a company also requires several considerations because if a company has too much leverage, the greater the risk and interest expense charged to the company, which can trigger bankruptcy because the profits the company earns are lower than the debt it has. Leverage can be high if the company's total assets are less than the total assets of its creditors. Therefore, the leverage ratio can measure whether a company is healthy.

Debt to equity ratio (DER) is often used in measuring leverage. DER is a ratio describing a company's ability to pay off the existing debt using the company's capital. Leverage is the relationship between total assets and common stock capital or the use of debt to increase a company's profits. According to Richardson and Lanis (2007), companies can rely on leverage to run company operations rather than financing from equity. By relying on leverage, the company has a lower Effective Tax Rate (ETR) value. The higher the leverage, the smaller the tax burden that the company will pay or bear because there is a greater debt interest expense incentive, so the use of debt influences the tendency to increase tax avoidance. Sinaga & Suardikha (2019) and Ayuningtyas & Sujana (2018) have proven that leverage positively affects tax avoidance. So that the hypothesis can be formulated in this study, namely:

*H2: Leverage has a positive effect on tax avoidance*

### *The Effect of Political Connection on Tax Avoidance*

The success of business activities is inseparable from political influence. Companies with political connections also have specific ways to connect or establish special relationships with politicians or the government. Faccio (2006) states that a company can be said to have political connections if at least one of its shareholders is a member of parliament, a minister, or a close relationship with a political figure or party. With political connections, companies have special treatment, such as easy access to capital and a low risk of tax audits. According to Faccio (2006), the notion of political connection has the following characteristics: one of the main shareholders or company leaders is a member of parliament, a minister, or someone close to politicians (leading political figures). Political connections give companies special privileges or treatment, such as easy access to loan capital and low risk of tax audits. Companies with political connections tend to have a high level of tax avoidance compared to similar companies that do not have political connections (Kim & Zhang, 2015). Thus, the hypothesis can be formulated in this study:

*H3: political connection has a positive effect on tax avoidance.*

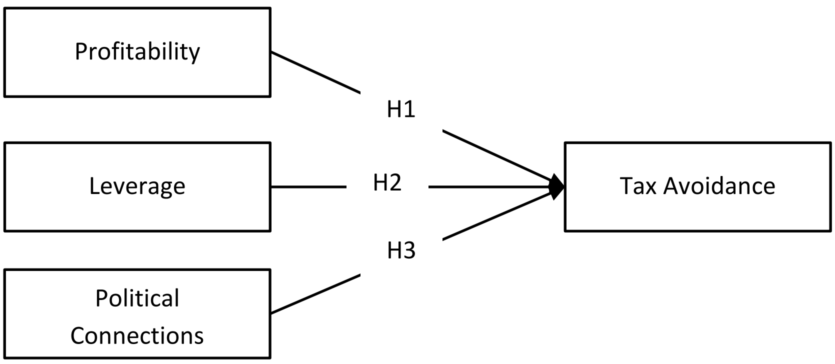


**Figure 1**. The conceptual framework

Based on the theory described earlier and previous research, the conceptual framework depicted in Figure 1 can help to understand the relationship between the independent and dependent variables more easily. This conceptual framework becomes a reference, flow, and research basis for testing hypotheses.

## Methods

This research uses quantitative because it is an objective approach. The objects in this study are companies in the cyclical consumer sector that are listed on the Indonesia Stock Exchange during 2018-2020 period. Financial reports are accessed through the Indonesia Stock Exchange (IDX) official website for collecting secondary data for this study. Nonprobability sampling with the purposive sampling method was used to choose the sample for this study. Table 1 presents the sample selection criteria. Further, multiple regression analysis was utilized to analyzed the effect of the independent variables on the dependent variable of this study. Table 2 defines and measures the variables used in the studies.

**Table 1**. Sample selection criteria

| Criteria | Amount |
|---|---|
| Population: Consumer Cyclical sector companies listed on the Indonesia Stock Exchange | 128 |
| Criteria: | |
| Companies listed above in 2019 | (39) |
| Companies that do not include expense income tax payments | (7) |
| Report losses on an ongoing basis | (9) |
| Does not issue successive financial reports | (18) |
| Number of samples | 55 |
| Number of observations (55×3 = 165 samples) | |

**Table 2**. Variable Operational Definitions

| Variable | Variable Definitions | Measurement | Scale |
|---|---|---|---|
| Dependent Variable | | | |
| Tax avoidance | Efforts to minimize the amount of tax by looking for weaknesses in tax provisions (Barr, James, & Prest, 1977). | $CETR = \frac{\text{Cash tax paid}}{\text{Pre-tax income}}$ (Riko, 2017) | Ratio |
| Independent Variable | | | |
| Profitability | The ratio used to measure a company's ability to earn profits by using its resources (Marsahala, Arieftiara, & Lastiningsih, 2020) | $ROA = \frac{\text{Earning after tax}}{\text{Total assets}}$ (Ubaidillah, 2022) | Ratio |
| Leverage | The ratio to measure the ability of short-term or long-term debt used by the company (Hery, 2015) | $DER = \frac{\text{Total debt}}{\text{Total equity}}$ (Aulia & Mahpudin, 2020) | Ratio |
| Political connections | Companies have the special privilege of forging relationships with people who have roles in government. At least one shareholder is a member of parliament, a minister, or has a close relationship with a political party (Faccio, 2006). | 0 = No company has political connections<br>1 = The company has political connections | Dummy |

*Source: Processed by the authors*

## Results

### *Descriptive Statistics*

Table 3 presents the results of the descriptive statistical analysis. It shows that the overall standard deviation is greater than the mean, meaning that the variation in the data used is large or diverse. Leverage shows the highest average of 0.572, and profitability has the lowest average of 0.054. The maximum value is again obtained from leverage and the lowest from political connections. Meanwhile, the minimum value indicates that leverage and political connections have a greater positive value than profitability and tax avoidance.

**Table 3**. Descriptive Statistics

| Descriptive Statistics | | | | | |
|---|---|---|---|---|---|
| | N | Minimum | Maximum | Means | Std. Deviation |
| PROF | 165 | -0.173 | 2.157 | 0.054 | 0.199 |
| Lev | 165 | 0.000 | 8,836 | 0.572 | 0.923 |
| KP | 165 | 0 | 1 | 0.14 | 0.347 |
| TA | 165 | -1.77 | 8,488 | 0.485 | 1,242 |
| Valid N (listwise) | 165 | | | | |

*Source: data processed*

### *Hypothesis Testing*

The classical assumption test was carried out in this study. However, the normality test using the one-sample Kolmogorov-Smirnov showed that the data were not normally distributed. These data then transformed by eliminating outliers' extreme data (Ghozali, 2009). After transformation and re-testing, the results show that the data is normally distributed. Table 4 shows the results of the t-test after transformation.

**Table 4**. T- test Results after Transformation

| Coefficients[a] | | | | | | |
|---|---|---|---|---|---|---|
| Model | | Unstandardized Coefficients | | Standardized Coefficients | T | Sig. |
| | | B | Std. Error | Beta | | |
| 1 | (Constant) | 85,478 | 66,800 | | 1,280 | 0,204 |
| | Prof | 750,344 | 325,919 | 0,230 | 2,302 | 0,023 |
| | Lev | -162,029 | 130,728 | -0,127 | -1,239 | 0,218 |
| | PC | -44,289 | 62,119 | -0,070 | -0,713 | 0,478 |
| a. Dependent Variable: Transform_Y | | | | | | |

*Source: data processed*

Based on Table 4, profitability has a positive regression coefficient value of 750,344 and a significance value of 0.023, less than 0.05. It means that profitability has a positive effect on tax avoidance. Thus, the first hypothesis is supported. Leverage has a negative regression coefficient value of -160.029 and a significant value of 0.218, greater than 0.05. Thus, leverage does not significantly affect tax avoidance, and H2 is unsupported. The political connection has a negative coefficient value of -44,289 and a significance value of 0.478, greater than 0.05. Thus, political connections have no significant effect on tax avoidance. This result implies that H3 is unsupported. The coefficient of determination was determined using Negelkerke's R Square.

Table 5 shows the results of the coefficient of determination at the adjusted r-square value of 0.057 (5.7%). This indicates that tax avoidance (CETR) as the dependent variable can be explained using independent variables, namely profitability, leverage, and political connections of 0.057 (5.7%), and the remaining 0.943 (94.3%) is explained using other factors outside this study.

**Table 5**. Determinant Coefficient Test Results (R2)

| Summary models | | | | |
|---|---|---|---|---|
| Model | R | R Square | Adjusted R Square | Std. Error of the Estimate |
| 1 | 0,291a | 0,085 | 0,057 | 244.01374 |

a. Predictors: (Constant), KP, PRO, LEV

## Discussion

### *The Effect of Profitability on Tax Avoidance*

Based on the partial statistical test or t-test, a significance value of 0.023 < α = 0.05 is obtained. Likewise, H1 is supported. This shows that profitability proxied by ROA positively affects tax avoidance in cyclical consumer sector companies in 2018-2020. If the company's ROA increases, the company's profit also increases. The company successfully manages company activities to generate profits by using the assets owned by the company. Profit is the amount of tax that the company must pay. Increased profits will impact the amount of tax that must be paid and also increase following the amount of profit generated, so it is more likely that the company will do tax avoidance to reduce the tax burden.

This result is in line with agency theory, where the difference in interests between the principal and the agent encourages the agent to avoid taxes so that the profit generated is optimal. The company assesses that if it does not do tax avoidance, it will impact paying higher taxes so that the profit generated decreases. Meanwhile, the principal wants corporate governance and management to run well. This research is in line with the research of Dewi & Noviari (2017), Prapitasari & Safrida (2019); Yulyanah & Kusumastuti (2019); Marsahala, Arieftiara & Lastiningsih (2020); Safiinatunnajah & Setiyawati (2022). However, this research contradicts the research of Masrurroch, Nurlaela, and Fajri (2021) and Nugrahitha & Suprasto (2018).

### *The Effect of Leverage on Tax Avoidance*

The partial test results show a significant leverage value of 0.218 > α = 0.05. Thus, H2 is not supported. These results indicate that the size of the leverage does not affect the practice of tax avoidance in companies, and the results do not support agency theory. Debt will cause the company to have a high debt ratio, and the interest expense that must be paid will be even greater. However, this does not make the company tax avoidance. The company prioritizes the good image or name built so far and maintains good relations with creditors. In addition, the company also considers the future risks and impacts that will be faced if tax avoidance is carried out. This research aligns Wahyuni, Aditya, & Indarti (2019). However, these results contradict the research of Sinaga & Suardikha (2019) and Ayuningtyas & Sujana (2018), which state that leverage has a positive effect on tax avoidance.

Another reason is because the company has a low leverage ratio so leverage has no effect on tax avoidance, companies prefer to use their own capital. The company's operational funding sources are shared into two, first is internal financing, namely own capital and financing from external, those originating from loans such as debt to banks. Companies prefer to use capital than using resources funding from debt, so it can be concluded that the company does not depend on debt to finance its operations.

### *The Effect of Political Connections on Tax Avoidance*

The results of the partial statistical test or t-test show that the political connection value has a significance of 0.478 > α = 0.05, so it can be concluded that H3 is not supported. The results are not in line with agency theory. This indicates that political connections do not affect tax avoidance in cyclical consumer sector companies. Political connections do not guarantee that the company will avoid taxes. Companies prefer to comply with tax provisions and maintain a corporate image and government reputation. The practice of tax avoidance will bring bad risks to the company and tarnish the good name of management who has political connections. According to the Regulation Number 71/PMK.03/2010, companies wtih majority shares are owned by government are classified as low-risk taxpayers. With the privileges obtained by companies with political connections, the company will make good use of it and try not to do tax avoidance which will later impact tax sanctions. Deng et al. (2020) argue that supervision will become more stringent for companies with political connections due to government involvement so that companies will be more controlled. This research is in line with Sari and Somoprawiro (2020). It contradicts the findings of Kim & Zhang (2015) and Alfiyah, Subroto, & Ghofar (2022), which state that political connections positively affect tax avoidance.

## Conclusion

This study analyzes the influence of tax avoidance, which is motivated by profitability, leverage, and political connections. The results of this study prove that profitability positively affects tax avoidance. The higher the profitability value in the company, the more likely the company is to do tax avoidance. The results of this first test support agency theory. Meanwhile, two other variables, namely leverage and political connections, do not affect tax avoidance. This result is not in line with agency theory. The company prefers to maintain the reputation and connections built so far. The company avoids the bad risks faced if it does tax avoidance.

Some of the limitations are as follows. First, this study uses a mixture of various types of company sectors, so the results of this study do not apply to other sectors. Second, company data is relatively small, with only 55 companies that meet the sampling criteria. Third, many other factors still need to be identified to explain tax avoidance practices. Therefore, further research can add control variables or use indicators from internal or external companies, that companies should consider avoiding taxes. In addition, future research can develop this research on more specific sectors such as the health, finance, energy, transportation, and logistics or other sectors. This research has implications for the government to be more careful and thorough in supervising and examining companies that lead to tax avoidance actions. Companies are required to be more transparent in disclosing their performance in generating profits. In addition, the auditor must also be more careful in examining the financial statements in order to avoid reporting engineering in order to avoid taxes.

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