CHAPTER I

INTRODUCTION

1.1. Background

Law number 7 of 2021 states that all taxpayers who have complied with the objective and subjective standards as stipulated by tax laws and regulations must register at the Directorate General of Taxes office. This regulation focuses on increasing sustainable economic growth to optimize state revenues, realizing a fair tax system, tax reform, expanding the tax base, and the need to increase voluntary taxpayer compliance. In Indonesia, tax compliance is the main focus of the government's efforts to increase tax revenues and ensure compliance by citizens and companies with tax obligations. Tax compliance for companies in Indonesia is a fundamental pillar in maintaining the country's economic balance. Companies are required to comply with applicable tax regulations. Enforcement of tax compliance is an important effort in ensuring that companies make a fair contribution to the country's economy and support sustainable development.

Through compliance with tax obligations, companies can create trust, build a good reputation, and have a positive influence on the business environment, and society. However in fact, taxes are considered a cost and burden for the company. Hence, companies are actively devising strategies and initiatives to reduce their tax obligations (Mangoting, 1999; Marzuki & Syukur, 2021). Lajiman Djaiz said that tax management means planning, organizing, directing, coordinating, and supervising taxation, the aim of which is to increase efficiency which increases profits or income (Santoso & Rahayu, 2019). Tax planning is a legal step that can be taken by individuals or entities to avoid tax obligations. Many companies use various methods to avoid taxes.

Based on definition by N.A. Barr Tax avoidance is the practice of legally manipulating income while adhering to tax laws in order to lower the amount of tax that must be paid (Santoso & Rahayu, 2019). This tax avoidance tactic is implemented by taking advantage of gaps in tax laws or company structures that make it possible to minimize tax liabilities without breaking the law. Companies use various methods, such as transfer pricing, the use of low tax jurisdictions, or financial restructuring, to optimize their tax liabilities. Although this practice is legally legal, tax avoidance is often a topic of controversy because it can reduce tax revenues that should be allocated to social development, infrastructure, and public services. Tax avoidance that is too extreme can lead to tax evasion. Tax evasion defined by N.A. Barr as an illegal action for income to reduce the amount of tax owed (Santoso & Rahayu, 2019). The impact can affect tax equity, economic welfare, and income distribution, encouraging the government to continue revising tax policies to close loopholes that are exploited in tax avoidance practices. Therefore, tax evasion has been a fascinating topic for scholars to look into and is linked to several aspects of business strategy (Faridza, 2019), transfer pricing (Amidu et al., 2019), state ownership (Hilling et al., 2021), and many other related topics.

There are a lot of news discussing tax avoidance cases in Indonesia. Based on IMF data 2017, Indonesia itself is ranked number 11 in countries with the highest corporate tax avoidance (Simanjuntak, 2017). Companies also take advantage of the double tax agreement between Indonesia and the Netherlands to avoid taxes

(Hietland, 2019). According to a report news by Kompas, Indonesia is estimated to face losses of IDR 67.6 trillion or US$ 4.78 billion per year due to tax avoidance practices of corporations in Indonesia (Sukmana, 2020). Apart from that, there have been several cases where tax avoidance was carried out by making falsified tax invoices by companies.

The large number of cases of tax avoidance illustrates that good corporate governance practices are still not implemented comprehensively by companies in Indonesia. The definition of corporate governance used by the Organization for Economic Cooperation and Development explain as:

> "A corporate enterprise is managed and directed by a system known as corporate governance. In addition to providing the means for other parties, both inside and outside the company, to control and monitor the company's activities, a good corporate governance system guarantees that the company sets appropriate goals and then implements systems and structures to ensure those goals are achieved." (Rankin, 2023).

The use of effective corporate governance has a wide range of applications, both from the nature of its activity and from the environment in which the company operates. Thus, in this research will focus on the management.

Many studies link the implementation of good corporate governance with company ownership. Hilling et al., (2021) conduct research about tax avoidance and state ownership in Sweden shows that state ownership gives negative relation with tax avoidance. Also, research that focuses on board ownership in Thailand gives a result that Board ownership increases a company's tax aggressiveness (Marzuki & Syukur, 2020). In reality, the most influential party in corporate governance is management because they are the ones who work directly in the company. Management has an important meaning and role for the company and what management does will reflect the condition of corporate governance in the company. Stewardship theory suggests that managers acting as overseers driven by the goals set by the organizational leaders or guiding principles rather than the personal objectives. Significant managerial ownership can influence company decisions regarding taxes. Managers who have share ownership tend to have an incentive to maximize company profits by reducing the taxes they have to pay, but in some cases, this can be detrimental to the company in the long run.

Managerial ownership is closely linked to earnings management practices used in the context of tax avoidance. According to Schipper, the purpose of earnings manipulation is to intentionally interfere with the external financial reporting process in order to benefit personally (Rankin, 2023). Typically, managers are highly motivated to optimize profits and handle revenues in a way that minimizes their tax liability. Every business wants to maximize the market value of its shares, therefore managers are employed to oversee operations on behalf of shareholders, who bear responsibility for the company's success (Amidu et al., 2019). Hence the decisions and actions managers take must produce more value for the company. Managers can regulate the company's financial profits by increasing the value of book profits and decreasing taxable profits in the same accounting period (Frank et al., 2009; Hendi, 2021). Tax avoidance is one of the motivations for earnings management practices. Companies can utilize many earnings management methods such as accrual accounting, income smoothing, big bath, and others.

Based on dependence resource theory, explains that there is a mutual need between companies with the government and politicians. Director General of Taxation stated that tax avoidance arises due to transactions between parties who have special relationships (Wildan, 2020). In addition, a company's political connections can also influence tax avoidance, where close relationships with authorities or politicians can provide access to information or policies that benefit the company in terms of taxation. However, too much political involvement can also increase reputational risks and conflicts of interest. Therefore, researchers want to investigate the relationship between boards member who are part of government and politics with the results of corporate tax avoidance.

Previous research that examined the factors that influence taxpayers' decisions to avoid taxes, the first of which was research conducted by Alkurdi and Mardini (2020) in Jordan. The variables of this research not only discuss managerial ownership but also the relationship between tax aggressiveness and institutional and foreign ownership and talked about board of directors' composition. This study's sample comprised all Jordanian firms that were listed between 2012 and 2017 on the Amman Stock Exchange, totalling 348 observations. This study demonstrates that management ownership and tax avoidance are negatively correlated. The second research regarding managerial ownership was carried out by Cabello et al., (2019) in Brazil by carrying out analytical calculations on 107 companies that listed on the Brazilian Stock Exchange from 2001-2015. Tax avoidance is the dependent variable in this study, while management ownership is the independent variable. The outcome demonstrates that there is a positive correlation between tax avoidance and management ownership.

Amidu et al. (2019) earlier study on earnings management focused on the connection between tax avoidance, earnings management, and transfer pricing. Multinational corporations participated in this study, which was carried out in

Ghana between 2008 and 2015. This study demonstrates a strong positive correlation between tax avoidance and earnings management. Meanwhile, Hendi (2021) used transfer pricing, earnings management, and corporate social responsibility as independent variables and tax avoidance as the dependent variable. This research was conducted in Indonesia involving 182 Indonesian listed in the 2015-2019 period.

Political connection factors have also been included in earlier studies. Wahab et al. (2017) performed research on the impact of corporate governance and political connections on tax aggressiveness in Malaysia. Using a sample of 2,538 corporations registered between 2000-2009 on the Malaysian Security Market, this study discovered a substantial positive correlation between corporate tax aggression and political connections. Contrary to this, a study on the impact of political connections on tax avoidance carried out by Putra and Suhardianto (2020) reveals that political connections have a negative correlation with tax avoidance. This research focuses only on political connection variables and uses 1.079 samples from public companies that had positive connection from 2014 to 2018.

This study builds on prior research that looked at the influence of effective corporate governance procedures and political relationships on tax avoidance. Because there are still numerous cases of tax avoidance particularly in Indonesia and the inconsistency of result based on the previous research, researchers aim to know what motivates these fraudulent tax actions. Researchers integrate factors from within the organization, which is management ownership, earnings management, and from the external environment will be analysed using the political connection variable. The fact that taxes are the state's primary source of revenue, this encourages researchers to find factors that enhance the likelihood of tax avoidance.

1.2. Formulation of the Problem

In Indonesia, the influence of management ownership, earnings management, and political connections on tax avoidance practices has become an important research focus. Research in Indonesia shows that management ownership, especially when managers own significant shares, can encourage them to engage in tax avoidance practices to maximize personal profits. However, this does not always lead to an aggressive tax strategy. Companies can also use earnings management techniques to reduce revenue or increase expenses in an attempt to legally but artificially reduce their tax liability. By doing this, companies can take advantage of gaps in tax laws to reduce the tax burden without breaking the law. Meanwhile, political connections also have an impact on corporate tax policies. Companies with strong political connection may gain incentives or influence in tax policy, although this also carries risks regarding corporate governance and transparency. Furthermore, because there are inconsistencies or gaps in previous research and there are still many cases of tax avoidance in Indonesia, this research is expected to explore in depth the dynamics of corporate governance, tax compliance, and the impact of management ownership, earnings management, and political connections for developing tax regulations in Indonesia. Through this study, researchers want to answer a question:

1. Does management ownership affect the number of tax avoidance in manufacturing company?
2. Does earnings management affect the number of tax avoidance in manufacturing company?
3. Does political connection affect the number of tax avoidance in manufacturing company?

1.3. Research Purposes

The purpose of this study is to investigate and demonstrate the effect caused by managerial ownership, earnings management, and political connection on tax avoidance. This study is based on previous research that discussed the factors that influence tax avoidance using analysis data of manufacturing company listed in Indonesia Stock Exchange because there are inconsistencies result in the previous study and there are still many problems with tax avoidance in Indonesia.

1.4. Benefits of Research

1.4.1. Theoretical Benefit

The findings of this study are expected to help academics in understanding corporate behaviour regarding tax avoidance. The results also can be utilized as a source of reference for the next research of the effect of managerial ownership, earnings management, and political connection on manufacturing company's tax avoidance in Indonesia.

1.4.2. Practical Benefits

By understanding how certain factors influence tax avoidance practices, this research can help companies to improve their corporate governance. The results of this study are likely to be taken into account by tax authorities in developing efforts to reduce the number of tax avoidance in Indonesia. The findings of this study can also be used by the government in the future to set suitable and strategic plan to decrease tax avoidance level in manufacturing company in Indonesia.