

CHAPTER II

LITERATURE REVIEW

2.1. Tax

According to Rochmat Sumitro, taxation is the transfer of resources from the people to the state in order to fund regular spending, with the surplus going toward public investment (Suandy, 2016). The state's income is derived from its citizens through taxation or from the country's natural resources. These are the two most important sources of revenue for the country. Taxation diminishes individual income or wealth, but it is communal revenue that is subsequently returned to the community through routine and development investment that benefits the people whether they pay or not (Suandy, 2016).

Tax collection can be forced and does not provide direct rewards to taxpayers. This is in accordance with Article 23 A of the 1945 Constitution, namely that levies and other taxes are controlled by law and used as a kind of coercion to meet state demands. There are two functions of tax, namely the financial function and the regulatory function. The financial or budgetary function means putting as much money as possible into the state treasury. Meanwhile, the regulating function states that taxes are used as a tool to regulate society, both in the economic, social, and political fields with certain objectives.

Taxes are created by the government as a source of income to finance public services, infrastructure, and state programs. However, tax regulations are often providing loopholes or opportunities for individuals or companies to optimize their

financial situation to reduce the amount of tax. Generally, tax avoidance is accomplished by utilizing legal loopholes or various legitimate tax incentives. Based on Law No. 7 of 2021, the government has the right to stop tax avoidance techniques since they represent an attempt on the part of taxpayers to lessen, avoid, or delay paying taxes that are due, which runs counter to the goals and purposes of the laws and regulations pertaining to taxes.

2.2. Tax Avoidance

Tax avoidance is defined by Robert H. Anderson as a means of lowering taxes that is permissible under tax rules and regulations, particularly tax planning (Santoso & Rahayu, 2019). Some tax avoidance practices require in depth knowledge of the tax system which ultimately raises questions about tax fairness and its impact on state revenue for society. Tax avoidance can be done in three ways, namely the taxpayer not doing something that can be taxed, moving a business location with high taxes to a location with a low tax rate, and juridical tax avoidance or taking advantage of the void or lack of clarity in the law (Santoso & Rahayu, 2019).

The relationship between tax avoidance and corporations often gives rise to debates about companies' ethical obligations, legal compliance, and their impact on society and the economy as a whole. Companies often seek to maximize their profits by using tax avoidance strategies, but with this arise ethical questions surrounding their contribution to social development and tax revenues needed for the public good. Theoretically, companies implement tax avoidance strategies to

increase profitability and maximize value for shareholders. This is considered a rational action and a goal that must be achieved from a business perspective. Tax avoidance is one method that may generate big profits for companies and shareholders by increasing company development through investment or increasing the amount of money available to shareholders by dividend distribution. However, the market and investors may perceive this decision unfavourably since it may result in indirect expenses to the firm in the form of dividends paid to shareholders. In the event that the fiscal authorities challenged, or reverse positions established incorporate tax fillings, a company may be required to pay additional taxes, interest, and fines (Kovermann, 2018).

2.3. Management Ownership

One of the keys to a company's long-term growth, profitability, and ability to compete in the worldwide business environment is the implementation of efficient corporate governance, particularly for those that have been able to expand and go public (Daniri, 2005). Milton Friedman has traditionally said that:

"Corporate governance refers to running a company in line with the goals of the owner or shareholders, who often want to maximize profits while abiding by the fundamental social norms set out by the law and regional conventions." (Rankin, 2023).

James D. Wolfenshom stated that strong corporate governance is going to end up as important to the global economy as good national government (Daniri, 2005). Independence, fairness, responsibility, accountability, and openness are the fundamental principles of good corporate governance. Effective corporate governance is strengthened by external as well as internal factors. External

influences are those that originate from outside the organization and have a significant impact on how well excellent corporate governance is implemented. Among them, there is a good legal system and support from the government organizations that promote the execution of good corporate governance. Internal aspects that support the efficient execution of good corporate governance within the company includes business cultures, risk management, and transparency of public information (Daniri, 2005).

Managerial ownership is an example of the internal aspect that contributes to the effective execution of good corporate governance. Implementing good corporate governance and managerial ownership are interrelated in running a company because management is the most influential party in the company. Managers are expected to add value to the resources they use, through a set of identifiable activities that focus on tasks, processes, and management contexts (Boddy, 2020). The composition of capital between debt and equity, including the split between insider and outsider share ownership, is referred as an ownership structure (Haryono, 2005). However, managerial ownership refers to the proportion of shares owned by directors, managers, and the board of commissioners (Efendi, 2013).

The interaction between managers and capital contributors such as shareholders is an important link since shareholders give managers a capacity to make important firm decisions. Based on stewardship theory, managers are trusted and have an obligation to behave honestly in the best interests of all people in the company. As a result, while managers should make decisions, they may make decisions that benefit a company as a whole rather than themselves in some instances.

2.4.Earnings Management

Earnings management is a management activity to influence and intervene in financial reporting, which uses certain deliberate steps to manage income (Sulistyanto, 2008). Ronen and Yaari in Rankin (2023) classified earnings management definitions as white, grey, or black. There are two main motivations for getting involved in earnings management. First, earnings managed for the benefit of the entity for several reasons, including satisfying the expectations and forecasts of analysts and shareholders, maximizing the company's stock price and valuation, accurately conveying private information, avoiding violation of restrictive debt covenants, and to avoid business difficulties or bankruptcies. Secondly, earnings managed to meet short term objectives, leading to the maximization of management compensation and bonuses (Rankin, 2023).

According to Healy and Wahlen in Rankin (2023), earnings management occurs when managers modify financial statements and transaction structures in order to mislead stakeholders about the company's real economic performance or to affect the outcome of contracts that rely on the disclosed accounting information. Therefore, earnings management can range from beneficial, because it signals the entity's long-term value to stakeholders, to harmful because it hides the entity's true value in both the short and long term.

2.5.Political Connection

Politics is a system used by community, society, or group creating collective decisions using influence and power (Ethridge & Handelman, 2016). Political

connections are a special relationship that a company has with the government or political parties which aims to facilitate company affairs and reduce tax detection (Wicaksono, 2017). In Firmansyah et al., (2022) political connections are crucial and have an impact on business strategy. Close interactions between the corporation and political parties or government officials are the examples of political connections in the corporate sector. Political connections are considered to be a potentially valuable resource for obtaining support and favours from the government. The advantages of having political connections might include improved access to the policy process, which allows corporations to participate in defining rules that affect their industry. Political connections can also result in special treatment, such as tax incentives or regulatory dispensations, which provide a competitive advantage for the company.

A corporation is considered attached to a political connection if at least one person of its board is a politician, minister, or member of parliament, either now or in the past (Boubakri et al., 2008; Alshirah et al., 2021). Political directors on the board of politically connected firms are likely to have personal interests in the business. Being explicitly involved in political connections may give negative impact to a company's image and give the impression that the company is using political power for personal gain, as well as creating inequity in the business environment for other companies that do not have the same access to favourable policies.

2.6. Conceptual Framework

2.6.1. Stewardship Theory

The stewardship theory was created to illustrate relationships derived from different behavioural foundations (Donaldson & Davis, 1989; Donaldson & Davis, 1991; Davis et al., 1997). This concept depicts a scenario in which managers are not driven by their personal objectives but act as overseers motivated in alignment with the objectives pursued by their organizational heads or the principles (Davis et al., 1997). The underpinning of this theory originates from the fields of psychology and sociology, investigating circumstances where executives are driven to behave in the best interests of the people they serve as stewards (Donaldson & Davis, 1989; Donaldson & Davis, 1991; Davis et al., 1997). Within the stewardship theory, the human portrayal is based on an overseer whose behaviour regulated that actions supporting the organization and being collective are deemed more valuable than self-serving behaviour. Faced with a choice between self-serving behaviour and actions supporting the organization, a steward wouldn't undermine the organization's interests. Therefore, even though the interests of the manager and the actor may not always align, the manager places more value on collaboration than personal interests because stewards perceive greater benefits in cooperation and compliance, which can be deemed rational behaviour.

Experts in stewardship theory assume a close connection between organizational success and the satisfaction of organizational leaders. A steward protects and enhances the company's value for shareholders through organizational performance, maximizing the benefits derived from the

stewardship role. Considering the diverse goals held by shareholders, a steward's behaviour may be seen as organization centric. A successful manager in enhancing company performance generally satisfies a majority of groups, as most stakeholders have their interests met through an increase in the company's value. Thus, a manager advocating for the organization will be motivated to improve company performance, thereby meeting the competing interests of shareholders.

2.6.2. The Relationship between Management Ownership with Tax Avoidance

The connection between management ownership and tax avoidance activities has a fascinating dynamic in the stewardship theory. Strong managerial ownership is often seen as reinforcing the connection between managers and the long-term success of the company. In this context, managers holding shares in their company tend to have a greater stake in ensuring the long-term welfare of the organization. Substantial managerial ownership is regarded as a key factor influencing managerial inclinations toward considering the tax implications of the company's operations. Managers adopting the role of organizational stewards tend to display behaviour more focused on achieving the collective goals of the company comprehensively, such as fostering innovation, enhancing profitability, driving sales growth, and ensuring the continuity of the company (Vallejo, 2009; Griesert et al., 2012).

However in practice, the connection involving managerial ownership and tax avoidance can vary. In reality some managers with significant shares in the

company might still engage in tax avoidance practices. There are a lot of reason underlying this case, ranging from motivations to achieve greater financial gains to efforts to meet specific targets required by the external market or shareholders. According to stewardship theory, because of a sense of responsibility and loyalty, management as stewards will act in the best interests of the stakeholders. In such situations, managerial ownership or share ownership in a company may encourage them to act in accordance with their desires as shareholders, including engaging in tax avoidance. Managers who are also company shareholders are more likely to employ legal and ethical tax avoidance strategies to maximize company profits, in addition to increasing the value of their shares. Although tax avoidance can boost short-term profits, it is important to remember that this practice must be carried out carefully and in accordance with regulations to avoid ruining the business's reputation.

2.6.3. The Relationship between Earnings Management with Tax Avoidance

Stewardship theory discusses managerial responsibility for the long-term interests of the company. In this context, the relationship with earnings management highlights how managers' behaviour in managing financial reports can influence the accurate representation of company performance. Earnings management, which is the practice of altering financial reports to show better performance than actual performance, is often carried out to meet market targets or investor expectations. A manager who feels responsible for enhancing shareholder welfare may use earnings management to present a more stable and favourable financial picture. By carefully adjusting financial figures within legal

limits, managers can reduce their company's tax liabilities without breaking the law, thereby optimizing net profit. However, in line with stewardship theory, such actions must be performed with high integrity and transparency, without compromising the integrity and trust that have been previously established.

Earnings management and corporate tax avoidance are closely related in the realm of corporate finance. Earnings management involves managing financial information with the aim of influencing stakeholder perceptions of company performance. Meanwhile, tax avoidance focuses on legal strategies to reduce a company's tax burden by exploiting loopholes in tax regulations. Although the goals are different, there are times when earnings management practices, such as revenue or expense manipulation, can be part of a tax avoidance strategy. In certain cases, adjustments to financial statements to reduce income or increase expenses can be used to legally reduce the tax burden that should be paid.

2.6.4. The Relationship between Political Connection with Tax Avoidance

In the context of stewardship theory, political connections can be a factor that influences company strategies regarding tax avoidance. Strong political connections give companies greater access to government and the tax policymaking process. Companies with strong political connections can use the leverage they have to influence the determination of tax regulations or obtain special tax incentives that may not be available to other companies. Thus, political connections may provide opportunities for more aggressive tax avoidance or even the acquisition of tax policies that are highly favourable to the

company. Political connections exploited to obtain certain tax advantages can create misalignment between tax regulatory objectives and corporate interests.

Stewardship theory emphasizes that managers must use these connections transparently to ensure that their actions not only benefit the company in the short term but also maintain the company's long-term reputation and integrity. Therefore, as stewards, managers must ensure that the use of political connections for tax avoidance purposes is conducted within legal frameworks to preserve shareholder trust. Managers with political connections may use these relationships to acquire information and access that enable them to legally minimize the company's tax liabilities. At various scales, political connections have a big impact on tax behaviour. The percentage of executives, board members, or shareholders who have served or are now currently serving in the government, military forces, political parties, central or regional government, or parliament indicates the strength of political connections (Firmansyah, 2022). When individuals or companies have close relationships with political authorities, this can lead to special treatment in terms of tax policy. The impacts can vary, ranging from reducing tax rates, dispensations in providing tax obligations, to certain tax exemptions that are not available to the public.

2.6.5. Previous Research

The first previous research conducted by Alkurdi and Mardini (2020) with the title “The impact of ownership structure and the board of director's composition on tax avoidance strategies: empirical evidence from Jordan”. Over a period of six years, the research was carried out in Jordan by analysing 58

companies. The major focus of the present research is the ownership of management, foreign, and institutional in the organization. The study's outcomes indicate that management ownership and tax avoidance are negatively correlated, while institutional ownership and tax avoidance are negatively correlated as well. However, the outcomes of the study reveal that foreign ownership and tax avoidance have a positive connection.

The second previous research conducted by Cabello et al., (2019) with the title “Tax avoidance in management-owned firms: evidence from Brazil”. A total of 107 companies that were listed between 2001 and 2015 on the Brazilian Stock Exchange were analysed for this study. Tax avoidance is the dependent variable in this study and management ownership is the independent variable. The results indicate a positive relationship between management ownership and tax avoidance.

The third previous research was conducted by Amidu et al., (2019) with the title “Transfer pricing, earnings management and tax avoidance of firms in Ghana”. This study was carried out in Ghana using a sample of international corporations that went public between 2008 and 2015. Tax avoidance is the dependent variable in this study, whereas transfer pricing and earnings management are the two independent variables. The studies demonstrate that the independence and dependence variables have a positive association.

The fourth previous research was conducted by Firmansyah et al., (2022) with the title “Political connections, investment opportunity sets, tax avoidance: does corporate social responsibility disclosure in Indonesia have a role?” This

research analyses companies listed in IDX with a total sample of 42 from 2014-2019. This research focuses on the impact of political connections and investment opportunities on tax avoidance and also involves corporate social responsibility as a moderating variable. This study includes corporate social responsibility as a moderating variable in addition to focusing on the impact of investment opportunities and political connections on tax avoidance. The study's findings indicate that political connections and tax avoidance reveal a strong positive relationship. This is in line with the outcome's relation between tax avoidance and investment opportunities. Assessed from the moderating variable, corporate social responsibility disclosure can weaken the positive influence of political connections and company's investment opportunity on tax avoidance.

The fifth previous research was conducted by Wahab et al., (2017) with the title "Political connections, corporate governance, and tax aggressiveness in Malaysia". This research was conducted in Malaysia by analysing companies listed on the Bursa Malaysia's Main Board from 2000 to 2009 with a total of 2,538 firms' observation. This research investigates political connection variables with corporate governance as the independent variable and tax aggressiveness as the dependent variable. This research shows that political connection is significantly have a positive association with tax aggressiveness. Meanwhile, for the corporate governance variable there is limited evidence if corporate governance strengthens or weakens tax aggressiveness.

Table 2.1. Previous Research

No	Researchers	Variable	Subject	Result
1	Alkurdi, A., Mardini, G.	Tax Avoidance (Y)	58 Jordanian listed	1. Managerial ownership is

	(2020) The impact of ownership structure and the board of director's composition on tax avoidance strategies: empirical evidence from Jordan	Managerial ownership (X1) Foreign ownership (X2) Institutional ownership (X3)	companies from financial, manufacturing, and services sectors in the period of 2012-2017	significantly negative related to tax avoidance. 2. Institutional ownership is significantly negative related to tax avoidance. 3. Foreign ownership is significantly positive related to tax avoidance.
2	Cabello, O., Gaio, L., Watrin, C. (2019) Tax avoidance in management-owned firms: evidence from Brazil	Managerial Ownership (X1) Tax Avoidance (Y)	107 firms listed in B3 (stock market from Brazil) in the period of 2001-2015	1. Managerial ownership is significantly positive related to tax avoidance.
3	Amidu, M., Coffie, W., Acquah, P. (2019) Transfer pricing, earnings management and tax avoidance of firms in Ghana	Tax Avoidance (Y) Transfer Pricing (X1) Earnings Management (X2)	Multinational company listed in 2008-2015	1. Transfer pricing is significantly positive related to tax avoidance. 2. Earnings management is significantly positive related to tax avoidance.
4	Firmansyah et al., (2022) Political connections, investment opportunity sets, tax avoidance: does corporate social responsibility disclosure in Indonesia have a role?	Political Connection (X1) Investment Opportunity (X2) Corporate Social Responsibility (Moderator)	Total sample 42 companies listed in IDX from 2014-2019	1. Political connection is significantly positive related to tax avoidance. 2. Investment opportunity is significantly positive related to tax avoidance. 3. Corporate social responsibility disclosure can weaken the positive influence of

				<p>political connections on tax avoidance.</p> <p>4. Corporate social responsibility disclosure can weaken the positive influence of the company's investment opportunity set on tax avoidance.</p>
5	<p>Wahab et al., (2017) Political connections, corporate governance, and tax aggressiveness in Malaysia</p>	<p>Tax Aggressiveness (Y) Political Connection (X1) Corporate Governance (X2)</p>	<p>Companies listed in the Bursa Malaysia's Main Board from 2000 to 2009 with total of 2.538 firms</p>	<p>1. Political connection is significantly positive related to tax aggressiveness.</p> <p>2. Corporate governance is significantly negative related to tax aggressiveness.</p>

2.7. Hypothesis Development

2.7.1. The Relationship between Management Ownership and Tax Avoidance

The process of meeting a company's tax obligations is influenced by its ownership structure. Additionally, this enables to establish an atmosphere that supports effective and long-term growth for the company (Siswanti et al., 2017). The manager's viewpoint based on Mangoting et al. (2019), it influences all of its choices, including tax avoidance strategy. In the business realm, stewardship theory describes the close relationship between management and stakeholders. An often-used analogy is that all these parties are in the same boat, sharing the

same goals and direction for the long-term success of the company. In this framework, management ownership where managers have shares or direct ownership in the company can influence company decisions regarding tax strategy and policy. The long-term interests put forward in stewardship theory emphasize that managers, who act as administrators or stewards, must prioritize the long-term welfare of the company and its shareholders over their personal interests. Managerial ownership increases the alignment of interests between managers and shareholders, as an increase in the company's value will directly benefit the managers personally. Therefore, managers who own shares tend to be more proactive in seeking legal and efficient tax avoidance strategies to maximize the company's profits and indirectly increase the value of their shares. Additionally, with a greater financial stake in the company, managers may be more motivated to implement careful and prudent tax management practices to ensure the company's long-term financial stability.

Research conducted by Alkurdi and Mardini (2020) shows a negative association between managerial ownership and tax avoidance. These results imply that a manager is less likely to use complex tax avoidance techniques if they hold a significant amount of shares in a Jordanian company. Meanwhile, according to Cabello et al., (2019) the findings demonstrate a positive relation between managerial ownership and tax avoidance, with higher managerial ownership will result in a higher level of tax avoidance. This finding is line with Qawqzeh (2023) that indicate managerial ownership have a notably positive effect on tax avoidance actions, indicating that it intensifies the extent of tax avoidance. Zeng (2011) proposes that while companies having insider

stockholders experience increased tax payments, those with insider shareholders situated in regions with more established institutions tend to face reduced tax burdens, possibly owing to enhanced managerial expertise. Corporate governance might influence tax strategy, yet the practices related to taxes could also influence governance processes, such as the creation of hierarchical ownership structures to complement tax planning efforts (Wahab et al., 2017). Based on the theoretical basis that has been studied, explanations contained in the literature, as well as previous research that has been carried out, the hypothesis formulated is:

Ha1: Management Ownership has a Positive Effect on Tax Avoidance

2.7.2. The Relationship between Earnings Management and Tax Avoidance

Earnings management, which involves manipulating financial information to obtain a favourable result of company's performance, it is often associated with tax avoidance strategies. This relationship can be created by strategies such as time adjustments that affect reported earnings and taxable income. In the context of stewardship theory, managers responsible for enhancing shareholder welfare may use earnings management as one strategy to achieve this goal. Earnings management can be utilized to create a better financial image, which in turn can affect the company's ability to effectively avoid taxes. Managers involved in earnings management may also possess deeper knowledge of tax complexities and opportunities to avoid them. Therefore, managers who tend to

engage in earnings management may also be more capable of planning and implementing efficient tax avoidance strategies.

Amidu et al., (2019) show that earnings management is positively correlated with tax avoidance. The outcomes of this research are in accordance with Thalita et al., (2022). The findings indicate that managers seeking bonuses will make an effort to reduce the amount of taxes in order to enhance net profits. Meanwhile, findings from (Hendi, 2021) show that earnings management is not proven to have a positive effect on tax avoidance. Fiscal correction policy is one of the tools to neutralize the degree of profit manipulation by companies so that the practice of tax avoidance through earnings management is difficult to carry out. Based on the theoretical basis that has been studied, explanations contained in the literature, as well as previous research that has been carried out, the hypothesis formulated is:

Ha2: Earnings Management has a Positive Effect on Tax Avoidance

2.7.3. The Relationship between Political Connection and Tax Avoidance

Political connections may provide easier access to policymakers. This can be used to influence the development of tax laws or rules that favour those with these relationships. In the framework of stewardship theory, political connections provide managers with additional access to information and resources that can be used to legally reduce the tax liabilities of the company. Managers with political connections may be better able to understand the dynamics of tax regulations and gain better insights into policy opportunities that

can be leveraged for tax avoidance. Thus, managers with political connections may have an advantage in planning and implementing effective tax avoidance strategies.

Wahab et al., (2017) found a substantial and beneficial relationship between corporate tax aggressiveness and political connections; policies that overlap between the public and private realms of influence suggest that corporations with political connections are benefited by receiving assistance in the form of corporate tax breaks. This finding is supported by literature review conducted by Kovernmann and Velte (2019) stated political lobbying can have a considerable influence on business tax burdens. Meanwhile according to Putra and Suhardianto (2020) political connections are negatively related with tax avoidance. This finding suggests that companies with political connections had higher ETR values, a sign that they tend to be compliance with tax laws. Based on the theoretical basis that has been studied, explanations contained in the literature, as well as previous research that has been carried out, the hypothesis formulated is:

Ha3: Political Connection has a Positive Effect on Tax Avoidance