Economics and Business Quarterly Reviews

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Determinants of Tax Avoidance in Indonesia: Moderating Role Political Connections

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Abstract
This research aims to provide empirical evidence regarding thin capitalisation, transfer pricing, and tax avoidance, with political connections serving as moderating variables. The research employs a purposive sampling technique, resulting in a sample of 31 mining companies listed on the Indonesia Stock Exchange from 2013 to 2022. The technique used for hypothesis testing is panel data analysis through the Ordinary Least Squares (OLS) approach. The results of this research indicate that thin capitalisation and transfer pricing have a significant effect on tax avoidance. Additionally, this research reveals that the role of political connections can strengthen the impact of transfer pricing on tax avoidance but does not demonstrate that political connections can reinforce the effect of thin capitalisation on tax avoidance. The findings of this research are expected to serve as a basis for government considerations in establishing tax-related regulations. This study recommends that future research utilise different research subjects for comparison, add other independent variables outside the current model that may influence tax avoidance, and apply alternative tax avoidance measures, such as book-tax differences and tax shelters.

Keywords: Political Connection, Tax Avoidance, Thin Capitalisation, Transfer Pricing

1. Introduction

Taxation plays a pivotal role in generating revenue for a nation. The administration relies on tax collections to fund a wide range of essential functions, including maintaining and enhancing infrastructure, supporting educational systems, and implementing various initiatives aimed at improving the general well-being of the population (Mankiw, 2012). The administration's efforts to maximise tax revenues often conflict with the interests of businesses, which bear the burden as taxpayers. This inherent tension is intensified by the competing objectives of fiscal policy and corporate financial priorities (Setyaningrum & Suryarini, 2016). For businesses, taxes are considered one of the most important costs incurred and are directly impacted by revenue ability (Landry et al., 2013). Thus, the tax burden on businesses leads to an increase in tax avoidance practices (Chen et al., 2010).

Tax avoidance is typically characterised by a business's strategic efforts to reduce its tax liabilities by exploiting loopholes or ambiguities in existing tax legislation. This practice involves identifying and leveraging gaps in the regulatory framework to minimise the amount of tax owed (Lim, 2011). Although tax avoidance techniques are legal, the methods employed by businesses can still harm the country (Masri & Martani, 2012). Tax avoidance practices carried out by businesses also impact the country's tax ratio. Indonesia's lowest tax ratio was recorded in 2020 at 8.33%, while the highest was recorded in 2013 at 13.60% (Santika, 2023). According to the Organisation for Economic Cooperation and Development (OECD), Indonesia's tax ratio in 2022 was below the Asia-Pacific average of 19% and the OECD average of 33.5% (Sukmana, 2022). This phenomenon indicates that taxes have not been collected optimally in Indonesia.

The rise in tax avoidance practices in Indonesia has prompted a response from Finance Minister Sri Mulyani, who stated that these activities could impact global tax revenues, with a potential loss of approximately IDR 3,360 trillion annually due to revenue shifting between countries (base erosion and profit shifting) (Makki, 2021). The mining sector is regarded by state institutions, particularly the Corruption Eradication Commission, as vulnerable to corruption, with tax avoidance being one of the primary concerns (Wicaksono, 2019). This is supported by a report from Indonesia Audit Watch to Minister Mahfud Md regarding alleged tax avoidance by mining companies (Wibowo, 2023).

Indonesia is a country rich in natural resources, especially copper commodities (Annur, 2023). Indonesia's mineral reserve potential is very high, ranking first in the world for nickel and third for tin (Isnanto, 2023; Setiawan, 2022). For gold commodities, Indonesia ranks 6th globally and contributes 5% of the world's total rehandles (Anwar, 2021). The mining sector, with its enormous potential, contributes significantly to Indonesia's tax revenue. The level of this contribution from mining tax revenue to Indonesia's total tax revenue from 2013 to 2022 is shown in Figure 1, where it can be observed that the average contribution from mining tax revenue is only 9.7%. This suggests that tax avoidance is prevalent, with many taxpayers not fulfilling their tax.
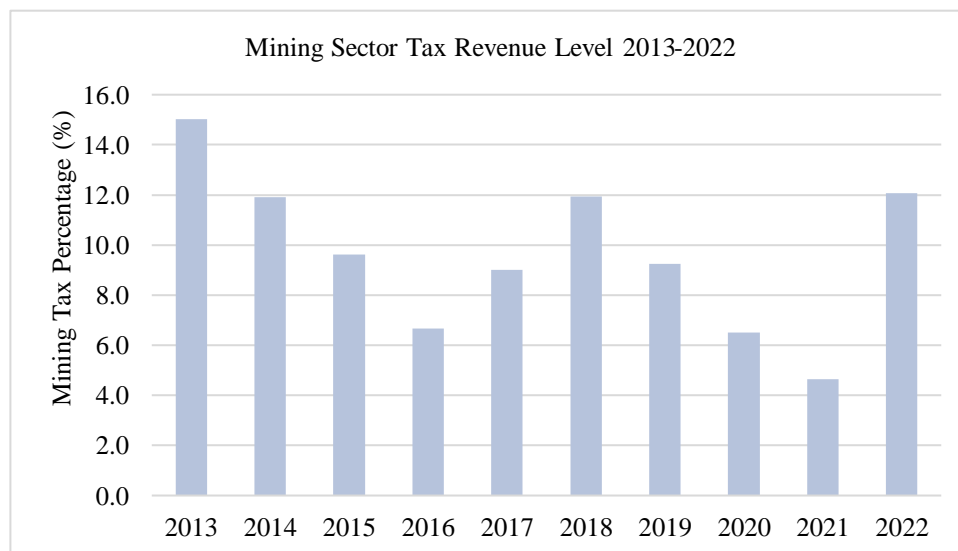

Figure 1: Mining Tax Revenue Data 2013-2022

Thin capitalisation and transfer pricing schemes can be said to be the business's exertions to avoid tax (Lietz, 2013). Businesses choose thin capitalisation for tax avoidance activities because interest expenses are allowed to be treated as deductible expenses (Utami & Irawan, 2022). Furthermore, businesses may engage in transfer pricing practices by setting transfer prices for transactions between related parties, thereby transferring revenues among these entities to increase profits through tax avoidance (Kurniawan, 2015).

Based upon Faccio (2007), political connections are also a factor that can lead businesses to avoid taxes. Such connections can influence corporate tax enforcement, resulting in a lighter tax burden (Chen et al., 2015). A strong

stage of political connection to the administration can be used by businesses to get involved in tax management activities. Strong affiliations can make it easier for businesses with political connections to receive administrative support in the form of reduced inspections, compared to businesses without such connections.

Researched on the relationship among thin capitalisation, transfer pricing, and political connections regarding tax avoidance has been conducted by Amidu et al. (2019), Prastiwi & Ratnasari (2019), Ajili & Khlif (2020), Aristyatama & Bandiyono (2021), Budiman & Fitriana (2021), Widarjo et al. (2021), Alfiyah et al. (2022)., Fasita et al. (2022), Firmansyah et al. (2022), Nurhidayah & Rahmawati (2022), Pamungkas & Setyawan (2022), and Rachmad et al. (2023).

This research incorporates factors influencing tax avoidance with a focus on political connections to introduce a novel perspective. Political connections are utilised as a moderating variable, as they are believed to exert a non-technical influence on tax avoidance practices undertaken by businesses. Furthermore, research on this moderating effect remains limited in Indonesia, where political connections have typically been studied as an independent variable. The Indonesian Tax Authority could use the findings of this research to enhance tax guidelines within the political, social, and economic sectors.

2. Literature Review and Hypothesis Development

2.1 Trade-Off Theory

Modigliani and Miller expanded the trade-off theory in 1963. This theory explains the concept of a business's capital structure, which is derived from a combination of debt financing and equity capital. The trade-off theory assumes that businesses gain certain advantages from debt financing, such as tax benefits (Christiana & Martani, 2016). Debt increases interest expenses, which can reduce the tax burden paid to the government, unlike dividends and retained earnings, which do not offer the same advantage. However, excessive debt financing can lead to high bankruptcy costs (Afifah & Prastiwi, 2019). According to the trade-off theory, businesses opt for a higher level of debt over equity to gain tax benefits, even at the expense of interest payments resulting from debt utilisation.

2.2 Theory of Planned Behaviour

Hidayat and Nugroho (2010) noted that the theory of planned behaviour gives a framework for enhancing the behaviour of taxpayers who fail to comply by in tax avoidance. Taxpayer intentions drive this behaviour, affected by three key elements: attitudes, subjective norms, and perceived behaviour control (Putri & Fadhlia, 2017). The theory of planned behaviour explains how managers make decisions regarding transfer pricing schemes (Apriyanti et al., 2023). The potential advantages of transfer pricing can influence decisions, with the associated incentives playing a crucial role in guiding these choices (Hang, 2019). Varying interpretations of both international and domestic norms, along with the impact of the multinational corporate landscape, can be classified as normative beliefs. These beliefs are shaped by the diverse expectations and standards inherent inside these differing contexts (Zvarikova & Kovalova, 2021). These underlying beliefs belong to the capacity to shape and propel a firm's behaviour in relation to transfer pricing implementations (Merle et al., 2019; Satyadini et al., 2019). Getting over, variations in control, or control beliefs, enable transfer pricing behaviour by considering both internal dynamics and external influences. These factors collectively shape the decision-making process inside firms (Kamilah, 2019; Taklalsingh, 2019).

2.3 Upper Echelon Theory

The Upper Echelon Theory, introduced by Hambrick and Mason (1984), posits that an organisation is essentially a reflection of its top executives. This theory emphasises the pivotal role of senior management, viewing them as the primary architects of an organisation's strategic direction and decision-making processes. Consequently, the strategic choices made by top executives directly influence organisational outcomes. Business leaders, especially commissioners and directors with specific social backgrounds, group characteristics, and political connections, are

more likely to make high-risk decisions. Their close ties to government entities increase the likelihood of engaging in tax avoidance strategies to maximise corporate revenues (Asadanie & Venusita, 2020).

2.4 Tax Avoidance

Based upon Darussalam & Septriadi (2007), tax avoidance means no illegal action. Tax avoidance involves no criminal acts. It refers to a business's legal exertions to manipulate the tax burden in accordance with existing rules, aiming to minimise the quantity of tax payable. Meaning, based upon the OECD (Organisation for Economic Co-operation and Development), tax avoidance activities are a form of taxpayer exertion in decreasing taxes payable that does not violate the provisions but is contrary to the objectives of the applicable regulations. So, the activity is classified as fraus legis, that is, the drawback between tax compliance and tax evasion.

2.5 Thin Capitalisation

Thin capitalisation occurs when a business is financed by high levels of debt relative to its equity or is highly leveraged. This concept is reinforced by the OECD's assertion that the higher a business's debt level, the greater the interest expenses it must pay, thereby reducing taxable income. Taxable earnings may decrease because, under tax regulations, interest on debt is a deductible expense. Consequently, businesses can benefit from tax incentives in the form of reduced tax liabilities due to interest expenses.

2.6 Transfer Pricing

Transfer pricing refers to the price one division charges another within the same organisation for goods or services provided (Horngren et al., 2015). Hansen & Mowen (2005) state that in a business or group of businesses, transfer pricing is the price the selling division charges the purchasing division. More broadly, according to the OECD (2009), transfer pricing refers to the pricing of goods, services, and intangible assets in transactions between a business and its related parties. Eden & Smith (2011) stated that transfer pricing is an attempt to minimise the quantity of tax payable by minimising earning or enhancing costs.

2.7 Political Connections

A political connection refers to a unique association between a business and governing authorities within the jurisdiction where the business operates. This relationship involves a close affiliation between the business and government officials or entities (Trinugroho, 2017). Political connections often arise when a business's owners or executives hold positions as government officials, politicians, or maintain close ties with the prevailing political party. Numerous studies have highlighted the significance of these connections, demonstrating their value in both developed and developing nations. Such affiliations can influence government policies affecting businesses, particularly in areas like taxation. Companies cultivate relationships with government authorities to secure advantages such as favourable tax treatment, import licenses, and access to financial resources or public funds (Sudibyo & Jianfu, 2017).

2.8 The Effect of Thin Capitalisation Upon Tax Avoidance

Thin capitalisation refers to structuring a business's capital by prioritising debt financing over equity contributions. This approach often aims to exploit gaps in tax legislation to minimise tax liabilities. It involves transforming the equity stakes of affiliated entities into loans, either directly or through intermediaries, as a means of circumventing tax regulations. This technique is frequently used as a tax avoidance strategy within corporate financial arrangements (Afifah & Prastiwi, 2019). In the context of the trade-off theory, the extensive use of debt inside a firm's capital pattern can be leveraged to secure tax advantages. Companies achieve this by utilising tax incentives, where interest remittances upon debt are treated as deductible expenses, decreasing taxable earnings. Consequently, they can strategically balance the tax savings benefits with the costs of higher debt stages. Based on Amni et al. (2023), Julianti & Ruslim (2023), Mahardika & Irawan (2022), Prastiwi & Ratnasari (2019), Taylor & Richardson (2013), and Fasita *et al*. (2022), thin capitalisation has a positive effect on tax avoidance, indicating

that as the proportion of interest-bearing debt in a business's financial structure increases, the firm is more likely to engage in tax avoidance practices. Therefore, the research hypothesis proposed is as follows:

H_1 : Thin capitalisation has a positive effect on tax avoidance.

2.9 The Effect of Transfer Pricing Upon Tax Avoidance

The theory of planned behaviour suggests that businesses deliberately engage in tax avoidance to minimise taxes payable. This intentional action is driven by the business's intentions and motivations. In this context, attitudes toward transfer pricing can be influenced by various factors, such as the presence of incentives, revenue targets, and business objectives. For example, if a business has a high revenue target, it may be inclined to employ aggressive transfer pricing strategies to maximise the parent company's revenue. Another way businesses minimise taxes payable is by transferring revenues to nations with lower tax rates than Indonesia. Amidu et al. (2019), Lo et al. (2019), Suntari & Mulyani (2020), and Aristyatama & Bandiyono (2021) explained that transfer pricing has a positive effect on tax avoidance. This means that as the transfer pricing value improves, the stage of tax avoidance also goes up. This occurs due to non-compliance with transfer pricing, leading businesses to avoid corporate taxes (Amidu et al., 2019). The persistent outcomes in the research prompt researchers to strengthen the following hypothesis:

H_2 : Transfer pricing has a positive effect on tax avoidance.

2.10 The Role of Moderating Variable Political Connection

Tax avoidance activities are triggered by the desire of taxpayers to non-compliance behaviour in paying their tax burden (Putri & Fadhlia, 2017). In relation to issues occurring both internationally and in Indonesia, as well as findings from previous studies, tax avoidance can be facilitated through thin capitalisation and transfer pricing schemes. Kurniawan (2015) stated that thin capitalisation serves as a framework for tax avoidance by making debt the dominant source of funding compared to equity. Furthermore, businesses pose a significant risk to national tax revenues through transfer pricing, as they can shift taxable earnings to jurisdictions with lower, favourable tax rates. This manoeuver erodes the tax base of higher-tax nations, ultimately undermining their fiscal capacity.

Indonesia is a country that has the highest political influence upon the business world (Harymawan & Nowland, 2016). Due to political factors, the business's opportunities will increase because of easier project fulfilment and improved access to administrative guidelines (Boubakri et al., 2008). According to upper-echelon theory, companies with political affiliations are likely to leverage their connections to capitalise on advantageous market opportunities. Research findings further support this notion, highlighting how such relationships influence business practices. Muttakin et al. (2015) state that businesses with political connections leverage their proximity to politicians and state apparatus to secure market advantages and avoid penalties for expropriation and poor management. These arguments suggest that political connections can amplify the effects of thin capitalisation and transfer pricing on tax avoidance practices. Therefore, we propose the following hypothesis:

H_{3a} : Political connections strengthen the positive influence of thin capitalisation on tax avoidance.

H_{3b} : Political connections strengthen the positive influence of transfer pricing on tax avoidance.

3. Method

This research employs quantitative analysis using secondary data from mining companies listed on the Indonesia Stock Exchange (IDX) between 2013 and 2022. The data includes financial statement information obtained from www.idx.co.id and the companies' official websites. The study focuses on all mining companies listed on the IDX during this period. Samples were selected using a purposive sampling technique based on the criteria outlined in Table 1, resulting in 31 mining companies and 310 observations.

Table 1: Research Sample

No.	Sampling Criteria	Total
1.	The number of mining businesses registered on the IDX.	80
2.	Businesses going public after 2013	(23)
3.	Delisting businesses in 2013-2022	(3)
4.	The business made acquisitions or mergers	(8)
5.	Non-multinational businesses	(13)
6.	Unavailable business data	(2)
	Number of observations during the research duration: 31x10 (2013-2022)	310

Source: Processed Data, 2024

In this study, tax avoidance is treated as the dependent variable, while thin capitalisation and transfer pricing are the independent variables. Researchers use political connection as a moderating variable, with return on assets, debt-to-asset ratio, current ratio, firm size, and firm age serving as control variables. The functional definitions and proxies for certain variables are detailed below. Tax avoidance refers to a set of practices aimed at minimising tax liabilities (Hanlon & Heitzman, 2010; Huang et al., 2018). It measures tax avoidance utilising the Effective Tax Rate (ETR) due to it effectively describes tax avoidance activities based on the business's financial condition and the total tax burden remunerated to the state (Amidu et al., 2019; Husni & Wahyudi, 2022; Rego & Wilson, 2012). A low Effective Tax Rate (ETR) indicates an increase in tax avoidance. Additionally, the Cash Effective Tax Rate (CETR) is used as a robustness test to assess tax avoidance practices. CETR is calculated by dividing the cash paid for taxes by pre-tax income, providing a reliable indicator of the actual tax rate applied to corporate earnings (Dyreng et al., 2008). Furthermore, the robustness test includes the Long-Run Cash ETR, a metric assessing long-term tax avoidance. This is determined by comparing the total cash taxes paid over a specific period with the total pre-tax earnings generated during the same timeframe.

Thin capitalisation is represented using the MAD proportion proxy, measured by the ratio between the average debt and the business SHDA (Prastiwi & Ratnasari, 2019; Taylor & Richardson, 2013). Means, transfer pricing analyses the data in the annual report utilising five indicators as conducted by Amidu et al. (2019). In addition, this research uses a moderating variable, namely political connections. Political connection is calculated as the proportion of politically connected directors and commissioners relative to the total number of board members in the business (Iswari et al., 2019). Return on assets is calculated based on the proportion of revenue after tax to total assets (Firmansyah et al., 2022). The debt-to-asset ratio is calculated by dividing total debt by total assets (Dewinta & Setiawan, 2016). Current ratio can be shaped by current assets on current debt (Budianti & Curry, 2018). Firm size is calculated utilising the natural logarithm of total assets (Ajili & Khlif, 2020). The age of the firm is determined by calculating the difference between the year of its establishment and the year of observation. (Amidu et al., 2019).

The initial model (1) serves as the framework for examining the impact of thin capitalisation and transfer pricing on tax avoidance, in accordance with the first and second hypotheses.

$$ETR = \beta_0 + \beta_1 TC + \beta_2 TP + \beta_3 ROA + \beta_4 DAR + \beta_5 CR + \beta_6 SZE + \beta_7 AGE + \varepsilon$$

The second model is used to test the role of political connections in strengthening the influence of thin capitalisation and transfer pricing on tax avoidance, as proposed in the third hypothesis.

$$ETR = \beta_0 + \beta_1 TC + \beta_2 TP + \beta_3 KP + \beta_4 KPTC + \beta_5 KPTP + \beta_6 ROA + \beta_7 DAR + \beta_8 CR + \beta_9 SZE + \beta_{10} AGE + \varepsilon$$

4. Result

Table 2 provides a summary of the descriptive statistics for some of the variables employed. The mean Effective Tax Rate (ETR) of 0.202 suggests that, on mean, mining companies in Indonesia registered on the IDX devote 20.2% of their pre-tax earnings. Regarding thin capitalisation, the mean value is 1.353 with a standard deviation of 1.689. The high standard deviation indicates significant variation in thin capitalisation and notable differences in the capital structures of businesses in the research sample. The mean transfer pricing across 310 observations is 0.395, suggesting that less than 50% of mining businesses listed on the IDX during 2013–2022 engage in transfer pricing. Furthermore, political connections have a mean of 0.169, which is greater than the standard deviation of

0.149. This indicates that the data distribution is relatively normal and does not introduce bias, suggesting reliable outcomes.

Table 2: Descriptive Statistics outcome

	ETR	TC	TP	KP	ROA	DAR	CR	SZE	AGE
Mean	0,202	1,353	0,395	0,169	0,034	0,571	1,672	28,543	51,887
Median	0,249	0,915	0,400	0,143	0,025	0,569	1,308	28,701	34,000
Max	1,654	7,925	1,000	0,545	0,729	1,898	8,352	32,306	122,000
Min	-1,343	-5,652	0,000	0,000	-0,534	0,049	0,011	21,140	6,000
Std. Dev.	0,336	1,689	0,262	0,149	0,139	0,295	1,386	2,255	43,612

Source: Processed Data, 2024

Based on Gujarati & Porter (2009), the determination of the most suitable regression model for panel data analysis requires conducting the Chow Test, Hausman Test, and Breusch-Pagan Lagrange Multiplier Test. The analysis results indicate that the Common Effect Model (CEM) is the most appropriate choice, leading to the use of panel data analysis with the Ordinary Least Squares (OLS) technique for hypothesis testing. After selecting the optimal regression model, the next step is to perform classical assumption tests to ensure that the chosen model meets the Best Linear Unbiased Estimate (BLUE) criteria. Classical assumption testing includes the normality test, multicollinearity test, heteroscedasticity test, and autocorrelation test.

Based on the comprehensive classical assumption tests, it can be concluded that the data follow a normal distribution, show no signs of multicollinearity, and do not exhibit heteroscedasticity or autocorrelation. This is indicated by the normality test, where the One-Sample Kolmogorov-Smirnov test yielded a significance value of 0.136, exceeding the 0.05 threshold. Additionally, the multicollinearity test results show that all Variance Inflation Factor (VIF) values are below 10, confirming the absence of multicollinearity issues. Heteroscedasticity was tested using the White test, which resulted in an Obs R-squared probability value of 0.182, above the 0.05 threshold. Autocorrelation was tested using the Lagrange Multiplier Test (LM-test), where the probability value for Obs R-squared was found to be 0.732, also above the 0.05 significance level.

Hypothesis testing is a procedure used to determine whether to accept or reject specific statements (known as statistical hypotheses) about variables representing the research population based on data obtained from a predetermined sample (Ibe, 2014). The hypothesis testing outcomes for this research are given in the table below:

Table 3: Hypothesis Test Outcome

	Model 1 (Unmoderated)		Model 2 (Moderated)	
Variables	Coeff	Prob.	Coeff	Prob.
C	0,409	0,240	0,449	0,202
TC	0,023	0,001	0,033	0,001
TP	0,078	0,012	0,033	0,026
ROA	-0,373	0,010	-0,349	0,017
DAR	0,241	0,069	0,229	0,215
CR	-0,007	0,007	-0,005	0,003
SZE	0,003	0,002	0,008	0,017
AGE	0,000	0,017	0,001	0,004
KP			0,446	0,041
TCKP			0,051	0,631
TPKP			0,181	0,002
Prob. F	0,012		0,002	
Adj-R^2	0,452		0,427	
Obs	310		310	

Source: Processed Data, 2024

The coefficient of determination (R^2) is evaluated using the Adjusted R-Squared in the regression model. As shown in Table 3, the Adjusted R-Squared value is 0.452, or 45.2%. This indicates that the independent variables account

for 45.2% of the variation in the dependent variable, while the remaining 54.8% is due to factors outside the scope of this research model. The F-test results show probability values of 0.012 for Model 1 and 0.002 for Model 2. These values indicate that, in both models, the independent variables collectively have a significant influence on the dependent variable. The statistical analysis through hypothesis testing demonstrates that hypothesis 1, hypothesis 2, and hypothesis 3b are supported by the observational data. The coefficient for thin capitalisation (TC) is 0.023, with a probability value of 0.001, which is below the 0.05 threshold. This suggests that as the level of thin capitalisation increases, businesses show a greater propensity to engage in tax avoidance practices. The probability value for transfer pricing is 0.012, also below 0.05, and the positive coefficient of 0.078 suggests that as transfer pricing increases, the likelihood of a business engaging in tax avoidance likewise rises. In the moderated model (Model 2), political connections have a probability value of 0.041, which is below the 0.05 threshold, with a coefficient of 0.446. This suggests that businesses with stronger political ties are more likely to engage in tax avoidance activities. Additionally, the political connection variable strengthens the positive impact of transfer pricing on tax avoidance, as shown by its probability value of 0.002 (also below the 0.05 threshold) and a positive coefficient of 0.181. However, the hypothesis testing results indicate that political connections do not strengthen the relationship between thin capitalisation and tax avoidance.

5. Discussion

5.1 Thin Capitalisation and Tax Avoidance

The results of the partial hypothesis testing confirm that hypothesis 1 is supported by the observational data, indicating that thin capitalisation has a positive effect on tax avoidance. Thin capitalisation techniques prioritise debt financing within the capital structure, enabling businesses to benefit from tax incentives, particularly by treating interest payments on debt as deductible expenses, thereby reducing their taxable income (Fasita et al., 2022; Taylor & Richardson, 2013). Based on this, it can be concluded that the higher the business's debt, the greater the interest payments, resulting in lower taxable income and reduced corporate tax liability. This finding also supports the trade-off theory, which suggests that debt financing is favourable because it provides additional tax savings through interest deductions. For this reason, businesses—particularly multinational companies—utilise debt to lower their tax liabilities, thus facilitating tax avoidance. The outcomes of this research support Taylor & Richardson (2013), Prastiwi & Ratnasari (2019), and Fasita et al. (2022). However, it contradicts the research of Salwah & Herianti (2019) and Nurhidayah & Rahmawati (2022).

5.2 Transfer Pricing and Tax Avoidance

The results of testing the second hypothesis, which examines the effect of transfer pricing on tax avoidance, are presented in Table 3. The findings indicate that the second hypothesis is supported by observational data: the higher the transfer pricing value, the higher the level of tax avoidance by the business. This outcome is due to non-compliance in transfer pricing, leading businesses to avoid corporate tax. Additionally, businesses exploit loopholes in tax laws across countries by conducting related-party transactions. They increase purchase prices and reduce selling prices within the group, transferring revenues to entities operating in countries with lower tax rates to reduce the overall tax burden (Richardson et al., 2013). This finding is similar to the research by Aristyatama & Bandiyono (2021), who examined the impact of transfer pricing on tax avoidance in Indonesia. Transfer pricing activities are believed to be driven not only by affiliated transactions with foreign entities but also by domestic entities, due to factors such as one of the affiliated parties receiving compensation for losses and the affiliated transaction being subject to final income tax. This outcome is inconsistent by Rachmad et al. (2023), but persistent by Amidu et al. (2019), Aristyatama & Bandiyono (2021), Fasita et al. (2022), and Pamungkas & Setyawan (2022).

5.3 The Role of Political Connection on Tax Avoidance

Model 2 in Table 3 presents the results of hypothesis testing related to the role of political connections in moderating the effect of thin capitalisation and transfer pricing on tax avoidance. This test shows that hypothesis 3a is not supported by observational data, indicating that political connections do not strengthen the relationship

between thin capitalisation and tax avoidance. The results suggest that businesses employing thin capitalisation schemes to minimise their tax burden do not rely on the political connections they may have. This outcome is not in line with Muttakin et al. (2015) and Asadanie & Venusita (2020). However, this finding aligns with the research of Chaney et al. (2011).

In contrast to hypothesis 3b, which is supported by observational data, political connections can moderate the positive influence of transfer pricing on tax avoidance. This finding indicates that tax avoidance increases when transfer pricing is influenced by political connections. Political connections can serve as a powerful tool for businesses to minimise corporate tax. This result aligns with the Upper Echelon theory, which explains that top management, such as the board of commissioners or the board of directors, is the primary strategic decision-makers in an organisation (Hambrick & Mason, 1984). The upper echelon perspective suggests that top management (commissioners and directors) with social backgrounds and group characteristics associated with political connections are more likely to make risky decisions, leading them to engage in tax avoidance to maximise tax benefits. This outcome is in line with Muttakin et al. (2015) and Asadanie & Venusita (2020). However, it is not in line with the research by Chaney et al. (2011). Table 3 in Model 2 also presents the effect of political connections on tax avoidance. The results indicate that the greater the extent of political connections, the higher the level of tax avoidance by the business.

5.4 Robustness Test

The robustness test is designed to evaluate the consistency of the research findings across various proxies. This test is conducted in two ways: first, by replacing the proxy for the dependent variable, in this case, ETR, with CETR; and second, by replacing ETR with LRCETR as the proxy for the dependent variable.

Table 4: Robustness test

Variable	Model 1-Unmoderated						Model 2- Moderated					
	ETR		CETR		LRCETR		ETR		CETR		LRCETR	
	Coeff	Prob.	Coeff	Prob.	Coeff	Prob.	Coeff	Prob.	Coeff	Prob.	Coeff	Prob.
C	0,409	0,240	0,203	0,672	0,328	0,538	0,449	0,202	0,741	0,418	0,286	0,601
TC	0,023	0,001	0,005	0,020	0,025	0,004	0,033	0,001	0,001	0,001	0,007	0,037
TP	0,078	0,012	0,197	0,005	0,005	0,019	0,033	0,026	0,324	0,021	0,008	0,012
ROA	-0,373	0,010	0,430	0,132	0,083	0,028	-0,349	0,017	0,364	0,109	0,086	0,008
DAR	0,241	0,069	-0,208	0,002	-0,166	0,009	0,229	0,215	-0,147	0,007	-0,173	0,049
CR	-0,007	0,007	-0,026	0,007	-0,048	0,031	-0,005	0,003	-0,028	0,038	-0,047	0,033
SZE	0,003	0,002	0,007	0,040	0,003	0,871	0,008	0,017	0,002	0,049	0,004	0,824
AGE	0,000	0,017	0,000	0,066	0,001	0,324	0,001	0,004	0,007	0,464	0,001	0,396
KP							0,446	0,041	0,276	0,006	0,092	0,026
TCKP							0,051	0,631	0,033	0,840	0,140	0,259
TPKP							0,181	0,002	0,304	0,036	0,013	0,007
Prob. F	0,012		0,000		0,002		0,002		0,000		0,000	
Adj-R^2	0,452		0,492		0,469		0,427		0,471		0,451	
Obs	310		310		310		310		310		310	

Source: Processed Data, 2024

Replacing ETR with CETR as a measure of tax avoidance yields results where thin capitalisation and transfer pricing align with the main regression test outcomes, demonstrating robustness and persistence. However, using CETR as a proxy for tax avoidance reveals that the control variables, namely current ratio and firm size, remain robust, while return on assets is not robust due to its lack of effect on tax avoidance. The debt-to-assets ratio also shows non-robust results due to its negative influence on tax avoidance. Additionally, firm age is not robust, as it shows no effect on tax avoidance.

Replacing ETR with LRCETR produces outcomes where thin capitalisation and transfer pricing align with the main regression test results, indicating persistence and robustness. However, substituting ETR with LRCETR as a proxy for tax avoidance reveals that the control variable, in this case, the current ratio, remains robust, while

Return on Assets is not robust due to its negative coefficient. The debt-to-assets ratio also shows non-robust outcomes due to its negative influence on tax avoidance. Additionally, firm size and firm age appear to be non-robust, as they show no effect on tax avoidance.

Further robustness testing of the research model equation using political connections as a moderating variable, and substituting ETR with CETR or LRCETR as alternative measures of tax avoidance, yielded results consistent with those of the main model. Replacing ETR with CETR or LRCETR as alternative measures of tax avoidance demonstrates that political connections have an adverse influence on tax avoidance, thereby affirming the robustness of the main regression results as reliable and consistent. Using CETR or LRCETR also shows that political connections enhance the effect of transfer pricing on tax avoidance, aligning with the main regression model and confirming its robustness. Additionally, substituting ETR with CETR or LRCETR as a tax avoidance measure reinforces the finding that political connections do not strengthen the effect of thin capitalisation on tax avoidance, consistent with the main regression model and demonstrating robustness.

6. Conclusions

The objective of this research is to determine the effect of thin capitalisation and transfer pricing on tax avoidance and to examine how political connections may amplify the adverse effects of thin capitalisation and transfer pricing on tax avoidance. The hypothesis testing method used is panel data analysis through the Ordinary Least Squares (OLS) approach, based on a sample of 31 mining companies listed on the Indonesia Stock Exchange (IDX) from 2013 to 2022. The results indicate that thin capitalisation has a positive effect on ETR, suggesting that higher thin capitalisation levels correlate with an increased tendency toward tax avoidance. Similarly, transfer pricing positively affects ETR, meaning that higher transfer pricing values correspond to more significant tax avoidance activities. This study employs political connections as a moderating variable. The hypothesis testing results conclude that political connections can amplify the adverse effect of transfer pricing on tax avoidance but do not support that political connections strengthen the adverse effect of thin capitalisation on tax avoidance.

This research is anticipated to offer value in both theoretical and practical terms. Theoretically, it aims to contribute to the advancement of tax scholarship in Indonesia. Practically, the research is expected to provide insights and recommendations that may be of significant benefit to policymakers and regulatory authorities. It serves as a valuable tool for regulators in assessing the prevalence of tax avoidance practices in Indonesia, offering insights that can assist in shaping robust tax policies to address these challenges and close existing loopholes. By doing so, it paves the way to enhance the country's revenue potential from the taxation sector, promoting effective fiscal development.

The limitations of this research include the focus on a sample limited to mining companies, which necessitates caution when generalising the findings. Additionally, the tax avoidance measurement approach relies solely on ETR, CETR, and LRCETR. Future research is encouraged to consider different research samples to enable comparative analysis, to add other independent variables outside this model that may influence tax avoidance behaviours, and to explore tax avoidance measurement methods beyond ETR, CETR, and LRCETR, such as Book-Tax Differences (Kolias & Koumanakos, 2022; Xu et al., 2022) and Tax Shelter (Badertscher et al., 2013; Hoi et al., 2013).

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