The Role of Corporate Political Connections in the Relation of CSR and Tax Avoidance: Evidence from Indonesia

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ABSTRACT

The study aims to examine the effect of practice of tax avoidance towards the level of CSR disclosure, along with the role of political connections in moderating the relationship. By using quantitative approach, we find evidence that firms that actively conduct tax avoidance, conduct a higher level of CSR disclosure to maintain the legitimacy of their operational activities and cover up the opportunistic acts. However, the variable of political connections is not proven to moderate the impact of tax avoidance towards CSR disclosure. To the researchers' knowledge, this study is the first one to consider the role of political connections in moderating the effect of practice of tax avoidance towards the level of CSR disclosure.

Keywords: Tax avoidance; CSR disclosure; political connections; legitimacy

1. INTRODUCTION

The practice of tax avoidance is not confined to Indonesia and developing countries, it is a every country's problem. Tax avoidance is done to find loopholes in tax regulations so that the amount of tax paid by firms get lowered making the profit higher. On one hand, the practice of tax avoidance increases shareholders' welfare, but on the other hand the practice of tax avoidance negatively impacts other stakeholders, such as the government and society, that they face a heavier burden for development of infrastructures and other public facilities (Landolf, 2006). The practice of tax avoidance can be viewed as unethical and irresponsible. In contrast, CSR is viewed, by stakeholders, as firms' moral obligation to the society and environment around them for the impacts created by their operational activities.

Lanis & Richardson (2013) find that firms that actively violate the tax regulations produce more CSR disclosure to cover up their opportunistic acts. In addition, the CSR disclosure is intended to maintain legitimacy in front of society and environment that surround them, which is needed for coftinuation firms' activities. The firms' legitimacy will be threatened when the society is aware of the act of tax avoidance, potentially disturbing the firms' operational activities. Moreover, as a background, the study also

uses the case of Starbucks, known for its high commitment to CSR, which is convicted for tax avoidance by income shifting from countries with relatively high rate to countries with low one. The case is one of the evidence to suggest CSR is a tool used by management to conduct the firms' activity (Vogel, 2005).

In relation to political connections¸ Kim & Zhang (2016) elaborates on how firms that have political connections own several criteria against which several strategies are chosen and executed. The criteria owned by corporate political connections include: lower risk of being caught during the practice of tax avoidance, access to information that is related to better tax regulation; and lenient enforcement that enables lack of transparency due to lower pressure. Firms with political connections also have different incentives for CSR disclosure; according to Lin et al. (2008) firms main drive for CSR disclosure is to lower the political cost and attract government attention to obtain special assistance and facilities. Therefore, the factor of political connections in testing the impact of tax avoidance towards the level of CSR disclosure should not be neglected.

As such, the study tries to test the impact of tax avoidance towards CSR disclosure and the role of political connections in moderating the impact. Previous study by Lanis & Richardson (2013) laid out the evidence that suggest firms that actively practive tax avoidance conduct higher level of CSR disclosure to maintain legitimacy in the firms' operational activities and to minimize the risk produced by the practice of tax avoidance. In other words, CSR disclosure done by firms is used to mask management' opportunistics acts such as tax avoidance.

By using balanced panel data from 63 manufacturing firms in Indonesia from the period of 2013-2015, we find that firms that actively commit tax avoidance are more likely to conduct disclosure related with its past CSR events. The disclosure is act to maintain legitimacy and prevent the impacts produced by the practice of tax avoidance such as being caught and stigmatized as irresponsible. Political connections is not proven to be related with the moderation of the impact; due to time limitation for the study, the measurement of political connections variable only rely on information found on firms' annual report. Moreover, the study is limited to manufacturing firms as the group being used as sample; the role of political connections in this group might not be as prevalent as in other groups of industries such as mining or oil and gas that utilize state-owned natural resource in the firms' operational activities.

The next section of the paper will discuss the theoretical foundation and previous studies that are relevant along with the development of hypothesis for the study. After that, section 3 will discuss the process of sample selection, the model of the research and the operationalization of variables used as hypothesis. Section 4 will discuss the result of

the hypothesis testing and the analysis, which will be linked to the theoretical framework and previous studies as discussed in Part 2. Lastly, the study is summed up in part 5 that consists of general summary of the test results, the literary and practical implication of the research, disclaimer of limitation and suggestions for further studies.

2. LITERATURE REVIEW

2.1 Legitimacy: Determinant of Corporate Sustainability

To conduct their operational activities, firms need legitimacy from the society and environment around them, otherwise the firms cannot sustain their operations. Lanis & Richardson (2013) posited that legitimacy is something that society grants firms to conduct their operation. As such, in making decisions, firms should consider the interests of all stakeholders. On one hand, the practice of tax avoidance is legal and potentially profitable, but on the other hand tax avoidance is viewed as unethical and irresponsible and shift the burden of financing development of public infrastructures and facilities to other stakeholders. Should stakeholders find out about the tax avoidance, firms' legitimacy will be tarnished in the eyes of society and environment around them, which disrupt the firms operation and sustainability. This is a serious threat for the firm.

According to Gray et al. (1995), the legitimacy theory can be an indicator of gap between firms' conducts and society's expectations that the management resorts to various means, such as CSR disclosure, to help address the gap. By conducting CSR disclosure, firms can display concern and responsibility over the negative impacts from firms' operational activities to the society and environment around them, so that a good reputation in the stakeholders' eyes can be built. This method can also be used by firms to obtain legitimacy in conducting the firms' operational activities in the society. Therefore, according to the legitimacy theory, firms use CSR as a tool to deal with the risk of losing legitimacy due to tax avoidance, especially in relation with societies' perception and expectation.

2.2 CSR Disclosure as a Tool for Corporate Risk Management

According to signaling theory, CSR activities are used to signal the stakeholders, concern for the society and environment and fulfillment of responsibilities over the impacts of firms' activities. The disclosure of CSR reports is a communication way between firms and society, and will result in negotiation process to obtain legitimacy for the firms' activities (Robert, 1992). Specifically, Wibisisono (2007) posits a couple of other purposes that firms might have when disclosing CSR, such as building positive image and reducing the risk of firms' activities. Therefore, according to the signaling theory, firms can use CSR disclosure to construct a good image of being responsible in

front of stakeholders and to reduce the risk from unethical actis such as tax avoidance.

2.3 Tax Avoidance and CSR Disclosure

Prior studies have tested negative relationships between tax avoidance and CSR. Similar to Lanis & Richardson (2015) which used ethical theory as a framework to construct measurement of the effect of CSR disclosure towards tax avoidance. The ethical theory suggested that firms that are concerned with ethical values are apparent in the level of CSR disclosure. As the level of CSR disclosure goes up, the firms are considered ethical and unlikely to be involved in unethical activities such as tax avoidance. Other studies that used similar theoretical framework and relationship is Bozzolan et al. (2015) and the results are consistent, showing that CSR is negatively related with with unethical activities such as tax avoidance and earning management. Hoi et al. (2013) suggested that CSR is done by firms as a strategy to improve its public reputation. Therefore, firms will not damage their own reputations, which they have built through CSR activities by conducting unethical and irresponsible conducts such as tax avoidance.

On the other hand, this studies examine for opposite relationships and different causality, that tax avoidance is positively influence CSR disclosure. As the firms' unethical practices get more frequent, such as tax avoidance or earning management, the level of CSR disclosure that firms do will be higher as well. Aside from being a form of firms' responsibility to the society and environment around them, CSR can also be used as a signal to build good reputation in front of stakeholders (Hoi et al., 2013). The practice of tax avoidance might damage the established reputation should society find out. It therefore indicates that firms use CSR disclosure as a tool to manage risk from irresponsible activities such as tax avoidance, thus the relationship between CSR and tax avoidance from this perspective is positive. Due to lack of legal obligation for firms to disclose CSR and CSR disclosure still voluntary, we suggests that testing the impact of the practice of tax avoidance to the level of CSR disclosure as management's strategic tool might be more appropriate. Therefore, the first hypothesis to be tested in this study is as follows:

HI: The practice of tax avoidance is positively influence the level of CSR disclosure

2.4 Role of Political Connections

Political economy literatures suggest that the factor of political connections is tightly related to firms' operational activities and is significantly influencing firms' selection of strategies (Faccio, 2006; Leuz & Oberholzer-Gee, 2006; Guedhami, et al., 2014). However, the role of political connections in testing the relationship between tax

avoidance and CSR is still rarely analyzed. Boubakri et al. (2012) and Kim & Zhang (2016) suggest that a couple of other characteristics that firms have might influence selection of strategies, such as: low risk of being detected of tax avoidance, better access to information tax regulation changes; lenient supervision from the creditors; lack of pressure for transparency; and close relationship with regulatory bodies that the firms have better access to special governmental facilities or assistance. The researches posits that with such characteristics, firms with political connections do not need to resort to CSR disclosure as means to prevent the risk from the practice of tax avoidance. Therefore, the company's characteristic, which have political connections, might weaken the impact of tax avoidance to CSR disclosure.

H2: Political connections weaken the impact of tax avoidance to the level of CSR disclosure

3. RESEARCH METHODOLOGY

3.1 Source of Data and Sample Selection

The population is this study is firms classified as manufacturing industries, according to Zimmerman (1983), firms that are classified as manufacturing industries are appropriate for tax-related testing. The financial data is obtained from Indonesian Capital Market Electronic Library (ICAMEL), along with data obtained from datastream and firms' annual report. The level of CSR disclosure is obtained with the help of the software Envivo to determine intensity of CSR-related keywords, according to the framework from GRI (Verbeeten, 2016).

Total 189 firm-years from 427 firm-years manufacturing industries from 2012-2015, is selected with the filtering process as below:

a. Firms with negative income as the ETRs are distorted (Zimmerman, 1983), deduct 101 firm-years;
b. Annual reports are not recognized by Envivo software, deduct 24 firm-years;
c. Use non-IDR denomination in its financial reports, deduct 6 firm-years;
d. Firms with incomplete data, deduct 13 firm-years;
e. Unbalanced panel data, deduct 45 firm years.

3.2 Dependent Variable

The level of CSR disclosure as a dependent variable is measured by a content analysis that refers to a study by Verbeeten (2016) by measuring the intensity of keywords developed from CSR framework in firms' annual report as illustrated in figure 1. The calculation of intensity of keywords or coverage area is selected to increase the objectivity in measruring the level of CSR disclosure compared to other methods of

content analysis (Beattie & Thomson, 2007). The distinction between measurement method in this study and in the one by Verbeeten (2016) is the usage of Envivo software that the data generated is more reliable to measure the level of CSR disclosure by the firms. In addition, the research also inputs Indonesian translation of the GRI keywords to accommodate the language of the annual reports.

Figure 1. Keywords used to measure the level of CSR disclosure

Environment	Social
Recycled (*daur ulang*)	Employment (*pekerjaan*)
Energy Consumption (*konsumsi energy*)	Employee turnover (*pergantian karyawan*)
Emissions (*emisi*)	Collective agreements (*persetujuan bersama*)
Effluents (*limbah*)	Occupational health (*keselamatan kerja*)
Waste (*sampah*)	Occupational safety (*keamanan kerja*)
Spills (*tumpahan*)	Training (*pelatihan*)
Biodiversity (*keanekaragaman hayati*)	Equal opportunities (*kesempatan sama*)
Environmental impact (*dampak lingkungan*)	Human rights (*hak asasi manusia*)
	Discrimination (*diskriminasi*)
	Freedom of association (*kebebasan berserikat*)
	Child labor (*pekerja anak-anak/ di bawah umur*)
	Forced labor (*kerja paksa*)
	Compulsory labor (*kerja wajib*)
	Community (*komunitas*)
	Corruption (*korupsi*)
	Public policy (*kebijakan publik*)
	Compliance (*kepatuhan*)
	Fines (*denda*)
	Sanctions (*sanksi*)
	Product responsibility (*tanggung jawab produk*)
	Customer health (*kesehatan pelanggan*)
	Customer safety (*keamanan pelanggan*)

Source: Verbeeten et al. (2016)

3.3 Independent Variable

The independent variable, tax avoidance, is measured by the proxy of effective tax rate (ETR) which is the ratio of current tax expense with earnings before tax. The selection of ETR as proxy also indicates the management's intention to minimize and delay the payment of tax payable, a main indicator of the practice of tax avoidance (Amidu et al., 2016). In addition, the advantage of using ETR as a proxy for tax avoidance is the ease of data collection needed, the only source of which is financial report that direct access to firms or relevant tax authorities is no longer needed. Higher ETR indicates the likelihood of practice of tax avoidance lower that the relationship between ETR and tax avoidance become negative. Therefore, the impact of ETR to the level of CSR disclosure is negative in this study, indicating a positive effect from tax avoidance to the level of CSR disclosure. As firms' ETR increase, the indication of tax avoidance become smaller that the incentive for CSR disclosure also decrease.

3.4 Moderating Variable

For the moderating variable, political connections, we use the profile of board of commissioners and board of directors on the firms' annual report. Refering to prior studies, such as Faccio et al. (2006); Bertrand et al., (2007) dan Habib et al., (2017), the measurement of variable uses dummy, 1 for firms with political connections and 0 for others. Firms are classified as having political connections upon fulfillment of one of the criteria given by Kim & Zhang (2016), one of the majority shareholders, board of directors or board of commissioners was or is currently: belongs to a political group or title such as president, ministers, or legislatives; chairman of a party caucus; chairman of a presidential or governor election campaign; holding an influential position in governance; and title as an employee in agencies of government or military.

3.5 Control Variables

To avoid influence from other non-contextual factors, we use the following control variables:

a. Firms' size (SIZE) is a natural logarithm from total assets because as the firms' size increase the incentive for CSR disclosure increase as well (Lanis & Richardson, 2013; Gantyowati & Agustine, 2017);

b. *Financial leverage* (LEV) which is the ratio of firms' long-term obligations with total assets, in which the variables display the role of creditors' oversight in maintaining the firms' behavior, therefore as the firms' obligation ratio get bigger the CSR disclosure get bigger as well (Brammer & Millington, 2005);

c. The firms' profitability, which is indicated by adjusted return on asset (ADJ$_{ROA}$) indicate that as firms' relative profit increase, the incentive to conduct CSR disclosure get bigger as well (Gantyowati & Agustine, 2017); and

d. Capital Intensity (CI) indicate the amount of firms' fixed assets, as the CI gets bigger the level of public exposure also increases that the incentive to conduct CSR disclosure get bigger as well (Lanis & Richardson 2013).

3.6 Regression Model

To examine two hypothesis in this study, we develop a model as follows:

a. To examine the effect of tax avoidance act to the level of CSR disclosure (H1)

$$CSRD = \alpha_0 + \alpha_1 ETR + \alpha_2 SIZE + \alpha_3 LEV + \alpha_4 ADJ_{ROA} + \alpha_5 CI + \varepsilon \qquad (1)$$

b. To examine the role of political connections in moderating the relationship between tax avoidance and level of CSR disclosure (H2)

$$CSRD = \alpha_0 + \alpha_1 ETR + \alpha_2 SIZE + \alpha_3 LEV + \alpha_4 ADJ_{ROA} + \alpha_5 CI + \alpha_6 CPC + \alpha_7 CPC * ETR + \varepsilon \qquad (2)$$

4. RESULTS & DISCUSSION

4.1 Descriptive Statistics

The result of descriptive statistic is as displayed in the table 1.

Table 1. Descriptive Statistics

Variable	Mean	Std. dev.	Minimum	Maximum
CSRD	0.00355	0.00189	0	0.011591
ETR	0.27280	0.15314	0	1.073363
CPC	0.15344	0.36137	0	1
CSRD*CPC	0.00073	0.00189	0	0.01002
SIZE	28.26899	1.70229	25.27668	33.09497
LEV	0.124227	0.15260	0	0.58413
Adj$_{ROA}$	10.47546	10.29702	-2.96381	66.90909
CI	0.38996	0.21310	0.00029	1.01634

Note: CSRD: level of CSR disclosure; ETR: negative proxy of tax avoidance*;* CPC: political connections*;* CSRD*CPC: moderation by political connections*;* SIZE: size of company; LEV: firms' debt ratio; Adj$_{ROA}$*:* firms' profitability; CI: capital intensity

The average of CSR-related keywords is only 0,35% of all the words on the firms' annual report. Some firms, such as Ekadharma International, Eratex Djaja and

Indosrping almost didn't use any keyword on their annual reports, the company with the highest usage of CSR-related keywords is Merck, 1.159%. The result indicates low level of CSR disclosure among manufacturing firms in Indonesia. The average effective tax rate is 27.28%, which is 2.28% higher than the national average. There are three firms that did not disclose accumulated tax expense, making the ETR 0, the highest disclosed tax expense is Goodyear Indonesia, 107.36%. For the political connections variable, 15.34% of manufacturing firms in Indonesia have political connections.

4.2 Result of Hypothesis Testing

The result of hypothesis testing is shown in table 2 and 3 and has passed the classical assumption test that the result has fulfilled BLUE criteria (Best Linear Unbiased Estimator). In general, the model that is developed in this study is classified as good, proven by the prob F-statistic value that is significant in 1% significance rate. The R^2 for each model is 11.79% and 13.38%.

Table 2. The effect of tax avoidance towards CSR disclosure

Model 1: $CSRD = \alpha_0 + \alpha_1 ETR + \alpha_2 SIZE + \alpha_3 LEV + \alpha_4 ADJ_{ROA} + \alpha_5 CI + \varepsilon$

Variable	Predicted sign	Coefficient	Probability
ETR	-(H1)	-0.0028473	0.002**
SIZE	+	0.0022763	0.000***
LEV	+	-0.001011	0.499
ADJ$_{ROA}$	+	0.0000194	0.522
CI	+	0.0004805	0.646
N	189		
Adj. R^2	11.79%		
Prob. F-Statistic	0.000***		

***, **, * indicates significance at the 1, 5 and 10% levels, respectively

Note: CSRD: level of CSR disclosure; ETR: negative proxy of tax avoidance*;* CPC: political connections*;* CSRD*CPC: political connections as moderating variable*;* SIZE: firm size; LEV: debt to total asset ratio; Adj$_{ROA}$*:* firms' profitability; CI: capital intensity

Based on the result of hypothesis testing 1 (H1), ETR has a significant negative effect towards the level of CSR disclosure, it can be concluded that hypothesis 1 is proven. Since the value of ETR is negative, it indicates that the practice of tax avoidance has a positive value that the practice of tax avoidance has a positive influence towards CSR disclosure. This finding is consistent with legitimacy and signaling theory and

previous studies such as Landolf (2006); Williams (2007); Lanis & Richardson (2013) and Hoi et al. (2013). Firms that actively conduct the practice of tax avoidance will produce more CSR-related disclosure to maintain legitimacy of their firms' operational activities. In addition, the higher amount of disclosure can minimize the risk of the practice of tax avoidance and firms' reputation is protected. This is consistent with previous studies that indicate CSR can be used by opportunistic firms as a method to manage the risk caused by tax avoidance (Kim et al., 2012; Heming & Maclagan, 2004).

When the practice of tax avoidance is perceived as irresponsible, of such practice being detected might lead to society perceiving the company as irresponsible. Such perception will threaten firms' sustainability, because it potentially damages established legitimacy, therefore firms will conduct the strategy of more CSR disclosure as a signal that firms have concern and high responsibility over the society and environment around them. In addition to preservation of firms' legitimacy, the company's reputation will also be recovered.

Among all the control variables, SIZE is the only factor that is proven to influence firms' CSR disclosure, as expected, as firms' size increases, the resource available for CSR disclosure also increases (Lanis & Richardson, 2013; Gantyowati & Agustine, 2017). The other control variables are not proven to influence firms' level of firms' CSR disclosure.

Table 3. Role of political connections in moderating the effect of tax avoidance towards CSR disclosure

Model   2:

$$CSRD = \alpha_0 + \alpha_1 ETR + \alpha_2 SIZE + \alpha_3 LEV + \alpha_4 ADJ_{ROA} + \alpha_5 CI + \alpha_6 CPC + \alpha_7 CPC * ETR + \varepsilon$$

Variable	Predicted sign	Coefficient	Probability
ETR	-	-0.003029	0.001***
CPC	?	0.0003029	0.802
CPC*ETR	-(H2)	0.0010813	0.834
SIZE	+	0.0024226	0.000***
LEV	+	0.0014649	0.330
ADJ_{ROA}	+	9.93e-06	0.607
CI	+	0.0003964	0.702
N	189		
Adj. R^2	13.38%		
Prob. F-Statistik	0.000***		

***, **, * indicates significance at the 1, 5 and 10% levels, respectively

Note: CSRD: level of CSR disclosure; ETR: negative proxy of tax avoidance*;* CPC: political connections*;* CSRD*CPC: moderation by political connections*;* SIZE: size of company; LEV: firms' debt ratio; Adj$_{ROA}$*:* firms' profitability; CI: capital intensity

Table 3 show the result of testing for hypothesis 2, indicate that political connections variable do not play a role in moderating the effect of tax avoidance towards CSR disclosure. This is probably a result of several factors, firstly the sample firms used is only in one industry, manufacturing, secondly the measurement of political connections only rely on information found in firms' annual report. Regarding the first probability, the role of political connections might be insignificant for manufacturing industries, due to lack of attention from the government. This is different from mining or oil and gas industries, which the government is particularly concerned in because the operational activities utilize country's natural resource. The second probability, the information on annual report have various limitations, the background of board of commissioners and board of directors might not be fully and accurately disclosed. Therefore, a more massive measurement that utilizes other data such as political parties' data, legislatives or other government officials is needed.

As is the case for the testing of hypothesis 1, the only control variable proven to significantly influence the level of CSR disclosure is SIZE, proven to positively influence in 1% significance, as expected, as firms' size increases, the resource available for CSR disclosure also increases. This finding is consistent with previous studies such as Lanis & Richardson (2013) and Gantyowati & Agustine (2017) that found bigger firm disclose more CSR activities in their annual reports. The other control variables are not proven to influence the level of CSR disclosure.

This study consider that political connections factor influence the strategy selection of the management, it can add to the tax avoidance and CSR-related literatures. Moreover, the study also suggests that users of financial statements or annual reports need to be more careful when analyzing and making investment decisions, holistically considering all aspects. The level of CSR disclosude does not guarantee firms' ethical behavior because manufacturing firms in Indonesia use CSR as means to cover up their opportunistic conducts that the risk produced by the practice of tax avoidance can be minimized and firms can maintain their legitimacy in front of society and environment around them.

5. CONCLUSION

The study successfully documents the evidence of strategies used by firms to

manage risks produced by unethical acts such as tax avoidance. To maintain the legitimacy of their operations, firms use CSR disclosure as a tool to create a good image that can eclipse the opportunistic acts and minimize the existing potential risks. However, the political connections factor is not proven to weaken the influence of tax avoidance towards CSR disclosure, there are two probable explanations: the role of political connections is not significant for manufacturing industries and the measurement only relies on firms' annual reports.

To the writers' knowledge, from preliminary literature studies, the study is the first one to consider the political connections factor in moderating the influence of tax avoidance towards the level of firms' CSR disclosure. With this study, we contribute to empower future studies to examine the impact of tax avoidance towards the level of CSR disclosure and the role of political connections as a moderating variable. The future studies would make an important contribution by conducting better measurement of political connections with other supporting sources. For practitioners, this study offers an urgency for more holistic assessment for firms' performance. For instance, firms with good reputation of active CSR disclosure do not guarantee their responsibilities and concerns for society and environment around them, the reputation might be used to cover up firms' opportunistic conducts.

The study is not free from limitations, such as: measurement of CSR disclosure that use CSR keywords are potentially biased because the keywords might not indicate CSR-related information; only use information on annual report to determine existence of political connections; and the usage of only one proxy to measure tax avoidance. Therefore, future studies should add the other content analysis methods to ensure that the data processing by the Envivo software do indicate CSR disclosure. Moreover, future studies should include the other sources such as the list of political party officials, state officials both in central and provincial government and list of other positions that wield political influence. Lastly, future studies can use other proxies for tax avoidance to ensure the validity and generalizability aspect of the study.

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