



Does tax aggressiveness and capital structure affect firm performance? The moderating role of political connections

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Abstract

This study examines how company performance affects tax aggressiveness, capital structure, and political connections. In addition, we also examine whether political connections moderate the effect of tax aggressiveness and firm performance, as well as capital structure and firm performance. Companies with aggressive tax strategies where they are politically connected perform better than vice versa. In addition, companies with larger external capital structures perform better when the company's boards are politically connected. In order to avoid the disadvantages of an aggressive tax strategy and a high external political model structure, the Company builds connections through the board to obtain projects from the government and avoid the risk of oversight by the authorities. Therefore, we suggest that regulators conduct inspections and supervision of companies that have political connections through the board to use unconstitutional methods to obtain projects from the Government or other benefits. In addition, we recommend that shareholders carefully carry out oversight in the context of overcoming agency problems in companies that are politically connected.

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Introduction

Tax avoidance is one of the problems faced by developing countries, including Indonesia. In addition, the high cost of debt, as well as political interference, and the ineffective implementation of corporate governance have a negative impact on economic growth and company performance. [Dyrenge et al. \(2016\)](#) revealed that aggressive tax actions by managers by ignoring transparency of financial reporting would increase agency conflicts between contracting parties, thus exacerbating information asymmetry problems. Consequently, [Cook et al. \(2017\)](#) revealed that companies face an increased risk of litigation, scrutiny by regulatory authorities, and a reputation that will suffer due to aggressive tax actions. These negative consequences increase risks for investors, creditors, and shareholders. Creditors are reluctant to invest in companies that have dubious accounting practices and are at high risk. Furthermore, if creditors are willing to fund these risky companies, they will provide more stringent provisions in the credit agreement clauses, including demands for high debt costs. In addition, the debt agreement can provide restrictions on companies not to invest in risky projects that have an unfavourable impact on company performance.

In order to overcome the consequences of aggressive tax actions, they try to establish political connections through the board and shareholders. This improves company performance ([Yan & Chang, 2018](#)). [Khwaja & Mian \(2005\)](#) and [Faccio et al. \(2010\)](#) argue that political relations established by companies are carried out to obtain projects from the government, subsidies, and to avoid or obtain protection from authorities against supervision or inspection. Thus, it can be concluded that various benefits can be obtained when the company has political connections so that it can fulfil the company's goals in order to gain profits through increasing profits from obtaining projects from the government and ease of access to funding.

Aggressiveness and tax evasion are severe problems in Indonesia. In 2020 and 2021, Indonesia had a tax-to-GDP ratio of 8.33% and 9.11%, much lower than several ASEAN countries, which show figures above 11%. [Dewanta & Machmuddah \(2019\)](#) revealed that this indicates that the opportunistic behaviour of taxpayers causes it through an aggressive tax strategy. Low tax revenues have affected public sector development spending, economic growth and contributed to high inflation in the country. Given the importance of adequate tax revenues for development, policymakers, academics, industry stakeholders and the general public must make a concerted effort for broader structural changes to Indonesia's tax system.

[Inger \(2014\)](#) reports that tax aggressiveness positively affects company performance. The research argues that when these aggressive actions are carried out transparently, they can improve the company's performance. Furthermore, [Chen et al. \(2010\)](#) also stated that the positive effect of tax aggressiveness on company performance can occur when they have an effective corporate governance mechanism. However, several studies have also found a negative relationship between tax aggressiveness and financial performance ([Hanlon & Slemrod, 2009](#); [Zhang et al., 2017](#)). This is due to the high information asymmetry and cost of agency causing the Company's weak performance.

Several previous studies have produced variations on the effect between capital structure and company performance. [Velnampy \(2014\)](#); [Fathony & Syarifudin \(2021\)](#); and [Ritonga et al. \(2021\)](#) found a negative effect between capital structure and company performance. In contrast, [Ningsih & Utami \(2020\)](#) and [Mai & Setiawan \(2020\)](#) revealed a positive influence between capital structure and company performance, respectively in the property and real estate industry and the sharia manufacturing industry.

In order to improve performance, the Company establishes political relations through the board. [Utamaningsi \(2020\)](#) revealed that companies with political connections had better performance than those without; this happened during the lifetime of the associated politician. Furthermore, political connections positively affect financial and environmental performance ([Mustika et al., 2020](#)). This condition results from a series of environmental management policies implemented by companies with political connections.

However, [Azizah and Amin \(2020\)](#) found that there is no influence between political connections and company performance which is reflected in profitability, while [Kristanto \(2019\)](#) argues that political connections have a negative effect on firm performance, which is due to the high political costs incurred thus reducing the company's performance.

Based on the discussion above, this study analyzes the influence between tax aggressiveness, capital structure, political connections, and company performance in Manufacturing Companies in Indonesia. Furthermore, the consistency of the results of previous research needs to provide sufficient evidence about the relationship between tax aggressiveness, capital structure, political connections, and company performance in Indonesia. Therefore, this study has several research objectives. First, this study analyzes the relationship between tax aggressiveness and firm performance. Second, testing the influence of capital structure on company performance. Third, we analyze whether political connections moderate the influence between (i) tax aggressiveness and firm performance and (ii) capital structure and firm performance.

This study uses tax aggressiveness and capital structure as independent variables. The literature provides several proxies to measure tax aggressiveness ([Lanis & Richardson, 2011](#)). The measurement of tax aggressiveness uses the effective bag rate, which is the proportion of tax expense to profit before tax, consistent with previous studies ([Choi & Park, 2022](#); [Guenther et al., 2017](#)). A company is considered to carry out an aggressive tax strategy when the taxes paid are lower than the corporate tax rates determined by the government ([Chen et al., 2010](#); [Nurcahyono et al., 2022](#); [Richardson et al., 2013](#)). Furthermore, the capital structure is calculated as the proportion of total liabilities to total assets of the Company, which is consistent with ([Fathony & Syarifudin, 2021](#); [Fauzi et al., 2022](#); [Nurcahyono et al., 2021](#); [Ritonga et al., 2021](#)). In addition, this study uses political connections as an independent variable and a moderator. Measurement of political connections through a dummy variable where the value is one if the company is politically connected and 0 if not ([Faccio et al., 2010](#); [Junaidi & Siregar, 2020](#)). A company is considered politically connected if the board of directors is directly or indirectly affiliated with a political party. A company is considered to have direct political connections when a politician is present on the board. Furthermore, indirect political connections can be developed when an assembly member has close ties to a political party or politician ([Faccio et al., 2010](#)).

The purpose of this study is to fill the existing gaps so that the research results are expected to contribute to the level of accounting science by developing a theoretical understanding through the variables in the research and providing positive managerial implications concerning factors that influence company performance. The study findings provide input to regulators in order to limit politically connected companies from using unconstitutional methods in order to obtain projects from the government.

Hypothesis Development

Tax Aggressiveness and Company Performance

Tax aggressiveness can be interpreted as the Company's efforts to reduce tax obligations through various accounting strategies ([Hanlon & Heitzman, 2010](#)). Tax aggressiveness has the potential to provide benefits but also disadvantages for the Company and stakeholders. [Khuong et al. \(2020\)](#) revealed that companies taking an aggressive tax strategy could lead to higher free cash flow, so these conditions provide good creditworthiness, low risk and cost of capital. Tax aggressiveness provides benefits when managers' interests align with those of shareholders ([Desai & Dharmapala, 2006](#)). Agency theory reveals that when there is a conflict of interest between managers and shareholders as principals, agents can expropriate excess free cash flows obtained from aggressive tax strategies. Conversely, several studies argue that shareholders and creditors consider companies that choose aggressive tax strategies more risky. This is because companies face tax audits and legal efforts that can damage their reputation ([Drake et al., 2019](#); [Guenther et al., 2017](#)). In addition, [Hasan et al. \(2014\)](#) revealed that this action exposed the company to the tight regulation of credit agreements with lenders; this was done because creditors were faced with agency conflicts and low

performance. Furthermore, an aggressive tax strategy exposes companies to the high cost of equity provided by shareholders because they consider them to lack transparency and acute information asymmetry problems (Goh et al., 2016).

Inger (2014) found a positive relationship between tax aggressiveness and company performance. This study argues that tax aggressiveness will benefit companies if the tax strategy is transparent and avoids complex business transactions. Furthermore, implementing corporate governance can trigger increased performance in companies with an aggressive tax strategy (Desai & Dharmapala, 2006). Conversely, other studies reveal a negative effect between tax aggressiveness and firm performance (Chung et al., 2019; Hanlon & Slemrod, 2009; Khuong et al., 2020). Companies with poor performance are due to high agency costs and information asymmetry. Cook et al. (2017) argue that tax aggressiveness also triggers complicated business transactions, giving managers opportunities to expropriate cash flows and reduce the company's performance. Therefore, the hypothesis is formulated as follows:

H1: *Tax aggressiveness has a negative effect on company performance.*

Capital Structure and Company Performance

Empirical evidence explaining the relationship between capital structure and firm performance provides contradictory results. Most theories are related to capital structure, and empirical evidence proves a positive relationship between capital structure and firm performance. At the same time, other studies have found results where there is a negative influence between capital structure and firm performance. Specifically, the study of Ngatno et al. (2021); Berger & Bonaccorsi (2006); and Gill (2011) revealed that a high debt ratio is directly proportional to company performance. This condition is caused by high debt being able to suppress agency costs so that managers as agents have no room to take opportunistic actions, which causes them to act in the interests of shareholders.

Velnampy (2014); Fauzi et al. (2022); Fathony & Syarifudin (2021); Ritonga et al. (2021) found that capital structure is negatively correlated with profitability. They argue that the risk of bankruptcy or liquidity can cause companies to make efforts to get fresh money through funding from external parties so that the debt ratio increases, where this condition exposes the company to higher interest expenses which will impact decreasing the company's performance. Therefore, the high cash flow from funding makes managers act or behave discretionary or negatively impacts company performance. Thus, the hypothesis we propose is as follows:

H2: *Capital structure has a positive effect on company performance.*

Political Connections and Corporate Performance

Political connections occur when a company's board consists of directors and commissioners who have political connections (Faccio et al., 2010). Agency theory is used in analysing political connections' role in company performance. Agency theory suggests that politicians can expropriate the wealth of minority shareholders and pursue goals that may not maximize firm value. The literature shows that politically connected companies expropriate the wealth of minority shareholders in several ways. First, board members who have political connections directly get minority shareholders. Second, they motivate majority shareholders to retain minority shareholders. Third, they influence management to recruit politically connected managers to pursue their own social and political goals.

Utamaningsi (2020) revealed that companies with political connections perform better than vice versa during the term of the politician concerned. Furthermore, Sulistyowati & Prabowo (2020) found that political connections have a positive influence on financial performance as well as environmental performance. This condition results from a series of environmental management policies implemented by companies with political connections. However, Azizah & Amin (2020) found political connections and financial performance to have no relationship, while Kristanto (2019) argued that there was a negative relationship between

political connections and company performance due to the high political costs incurred, which reduced company performance. Based on this discussion, the formulation of the hypothesis is as follows:

H3: *Political connections have a positive effect on company performance.*

Tax Aggressiveness, Political Connections and Corporate Performance

Dyreng et al. (2008) revealed that tax aggressiveness could cause damage to the quality of financial reporting and trigger an increase in agency problems in companies. Previous research also argues that tax aggressiveness gives the Company the consequences of a negative reputation. This is due to the authorities' supervision and stakeholders' legal efforts (Cook et al., 2017). The results of studies on the influence between tax aggressiveness and company performance vary. Inger (2014); Sunengsih et al. (2021); Sukesti et al. (2021) argue that tax aggressiveness can improve company performance. This condition occurs because the company aims to choose an aggressive tax strategy to minimize the taxes paid. After all, taxes are a burden to the Company. Conversely, other studies reveal that aggressive tax strategies have a negative effect on company performance (Chung et al., 2019; Hanlon & Slemrod, 2009; Khuong et al., 2020).

Aggressive tax actions taken by the company can expose the company to problems when increasing external capital, and creditors will ask for conditions in strict debt agreements to restrict investment in risky projects. In addition, creditors also ask for higher interest charges on loans to protect against risks. Several studies reveal that a high debt ratio is directly proportional to company performance (Berger & Bonaccorsi, 2006; Gill, 2011; Ngatno et al., 2021). This condition is caused by high debt being able to suppress agency costs so that managers as agents have no room to take opportunistic actions, which causes them to act in the interests of shareholders. However, study Velnampy (2014); Fauzi et al. (2022); Fathony & Syarifudin (2021), and Ritonga et al. (2021) found that capital structure is negatively correlated with profitability. They argue that the risks to bankruptcy or liquidity.

The study results show that companies with political connections perform better than vice versa (Mustika et al., 2020; Utamaningsi, 2020). This is due to their convenience in obtaining projects from the government. Given the detrimental consequences for firms of aggressive tax actions, we argue that these firms develop political connections to exploit the political connections and influential status of politicians to overcome reputational issues and gain convenient and cost-effective access to finance (Faccio et al., 2010; Khwaja & Mian, 2005).

Therefore, political connections owned by the Company's board can benefit Companies with an aggressive tax strategy and high debt costs caused by the dominance of external funding, which ultimately shows better company performance. Thus, we develop the following hypothesis:

H4: *Political connections moderate the influence between tax aggressiveness and firm performance.*

H5: *Political connections moderate the influence between capital structure and firm performance.*

Method

Purposive sampling is the sampling method in this study with the criteria of companies in profit conditions during the observation period both before and after tax. 108 data from 2016-2021 manufacturing industry companies listed on the Indonesia Stock Exchange were used to analyse the relationship between variables. Data collection is carried out from the Company's annual report, which is available on the Company's website. This study investigates the relationship between political connections, tax aggressiveness, capital structure, and firm performance. This section provides measurements of the variables used in this study.

Table 1. Variable Measurement

Variable	Measurement	Previous Research
Firm Performance	Return on assets is the proportion of net profit to the company's total assets	(Sulistiyowati & Prabowo, 2020); (Pattiruhu & Paais, 2020); (Tangngisalu et al., 2020)
Tax Aggressiveness	The measurement of tax aggressiveness uses the effective tax rate which is the proportion of tax expense to profit before tax	(Choi & Park, 2022; Guenther et al., 2017)
Capital Structure	The capital structure is calculated as the proportion of total liabilities to total assets	(Fauzi et al., 2022); (Fathony & Syarifudin, 2021); (Ritonga et al., 2021)
Political Connections	Measurement of political connections through a dummy variable where the value is 1, if the company is politically connected and 0 if not	(Faccio et al., 2010); (Junaidi & Siregar, 2020)

Specifically, the model analyses the relationship between variables with multiple regression analysis. Model 1 is the basic model for testing H1, H2, and H3. H1, H2, and H3 will be supported if the coefficients of tax aggressiveness (TA), capital structure (DTA), and political connections (PC) are each statistically significant. Model 1 is presented below:

$$ROA = \beta_0 + \beta_1TA + \beta_2DTA + \beta_3PC + \varepsilon \dots\dots\dots (Model 1)$$

Furthermore, models 2 and 3 test whether political connections moderate the effect of tax aggressiveness on company performance and capital structure on company performance, using Moderated Regression Analysis. Hypotheses 4 and 5 are proven if the coefficients of TA*PC and DTA*PC are statistically significant. Models 2 and 3 are presented as follows:

$$ROA = \beta_0 + \beta_1PC + \beta_2TA + \beta_3TA*PC + \varepsilon \dots\dots\dots (Model 2)$$

$$ROA = \beta_0 + \beta_1PC + \beta_2DTA + \beta_3DTA*PC + \varepsilon \dots\dots\dots (Model 3)$$

Description: ROA: Return on Assets; β_0 : Constant; $\beta_1 - \beta_3$: Regression Coefficient; PC: Political Connections; TA: Tax Aggressiveness; DTA: Capital Structure; ε : Error

Result and Discussion

Descriptive statistics

Table 2 shows the descriptive statistical analysis of the 108 samples of the research variables. The company's Return on Assets (ROA), which measures company performance and is the dependent variable, shows a mean value of 0.12. The manufacturing company, which is the object of research, earns a profit after tax of around 12% of the total assets owned. The capital structure by the proxy of total debt divided by total assets (DTA) shows a mean of 0.41, so it can be interpreted that 41% of the company's assets are financed through debt. Tax aggressiveness (TA), as measured by the influential tax rate variable, shows a mean of 0.23, which means that, on average, Manufacturing Companies carry out an aggressive tax strategy of around 2%, from the standard tax rate of 25%. Descriptive analysis of the moderating variable, namely political connections, shows a mean value of 0.65, which means that 65% of the manufacturing companies in the research sample have political connections.

Tabel 2. Statistik Deskriptif

Variabel	Minimum	Maximum	Mean
Firm Performance	0.00	0.53	0.1241
Tax Aggressiveness	0.08	0.77	0.4193
Capital Structure	0.04	0.41	0.2320
Political Connections	0.00	1.00	0.6574

Sumber: Data diolah 2022

Discussion and Discussion

The Effect of Tax Aggressiveness on Company Performance

Table 3 shows the results of the panel regression. The results show that tax aggressiveness positively affects firm performance ($\beta=0.53$, $p<0.05$). This signals that companies with aggressive tax strategies generate higher profits than conservative tax strategies. This condition occurs because the company aims to choose an aggressive tax strategy to minimize the taxes paid. After all, taxes are a burden to the Company. Efficient tax payments provide benefits for the Company in the form of increased performance. This study's results align with agency theory, where companies carry out aggressive tax strategies to achieve better corporate performance in order to obtain incentives. In addition, this study strengthens the perspective on agency theory which states that there are differences in interests between companies and tax authorities, whereby to improve shareholder welfare through profits, the efficiency of tax payments is carried out through aggressive tax strategies. Zhang et al. (2017) revealed that to reduce agency costs resulting from choosing an aggressive tax strategy, corporate governance mechanisms must be strengthened to suppress or prevent managerial rent extraction. This study supports the study Inger (2014); Sunengsih et al. (2021); Caroline et al. (2023), which found that tax aggressiveness can improve company performance.

Table 3. Results of Data Analysis

Variable	Model 1 ROA		Model 2 ROA		Model 3 ROA	
	Coef.	Sig.	Coef.	Sig.	Coef.	Sig.
TA	0.537	0.038*	-0.991	0.025*		
DTA	-0.423	0.027*			-0.894	0.001*
PC	0.376	0.049*	3.71	0.000*	1.183	0.006*
TA*PC			2.27	0.000*		
DTA*PC					0.816	0.032*
R-Squared		0.111		0.213		0.114

*Signifikasi level 5%

Information: ROA: Return on Assets; β_0 : Constant; β_1 - β_1 : Regression Coefficient; PC: Political Connections; TA: Tax Aggressiveness; DTA: Capital Structure

Effect of Capital Structure on Company Performance

The analysis results show that capital structure, as measured by debt to total assets, significantly negatively affects firm performance ($\beta=-0.423$, $p<0.05$). Interest expenses increased in line with the high portion of funding through debt, which impacted the Company's profitability. This consequence is the result of management's inability to manage the significant source of funding from loans, and this may be due to low margins from the company's operations or the excess working capital that cannot be absorbed to support or develop the company's operations. This study is in line with the view of agency theory, which reveals that high debt has an impact on increasing agency costs, which in the end, the company's profits will be eroded by interest expenses so that the profits generated are low. Agency costs directly result from conflicts of interest between shareholders and creditors. Shareholders must bear high-interest expenses as a consequence given by creditors when loans dominate the company's capital structure. Creditors do this as risk mitigation when the company's financial distress, bankruptcy or liquidation occurs. This study shows that

the greater the funding through debt, the lower the company's performance. The results of this study are in line with those (Fathony & Syarifudin, 2021; Fauzi et al., 2022; Ritonga et al., 2021; Velnampy, 2014).

The Effect of Political Connection on Company Performance

The results of the study show that political connections have a positive influence on firm performance ($\beta=0.376$, $p<0.05$). This implies that the Company's political connections can increase profitability better than the absence of political connections. The Company's political connections provide benefits in several ways, including the ease of obtaining contracts from the government, obtaining preferential treatment in terms of taxation, ease of access to funding, and inadequate supervision. This special treatment gives advantages to politically connected companies so that it will encourage better performance than companies that do not have political connections (Faccio et al., 2010; Khwaja & Mian, 2005). The ease of obtaining funding provides an advantage for companies to develop their business and increase their performance or profit. Furthermore, political connections owned by the company make it easy for the company to obtain information about government projects, which will impact increasing revenue and improve the company's performance compared to its competitors. The results of this study support the view of agency theory, whereby when someone occupies the board of directors or commissioners with political connections, the company must be willing to provide more compensation in return for the convenience or special treatment they receive. This study is in line with Utamaningsi (2020) and Sulistyowati & Prabowo (2020), which reveal a positive influence on company relationships and performance.

Moderation of Political Connections on the Effect of Tax Aggressiveness on Company Performance

Analysis of the moderating variable statistically showed that the TA*PC coefficient was positive and significant ($\beta=2.27$ $p<0.05$). These results illustrate that political connections moderate the effect of tax aggressiveness and firm performance. In other words, this study finds that companies that have an aggressive tax strategy, where they are companies that establish political connections, show better company performance than those without political connections. This condition is caused by the risks faced by companies with aggressive tax strategies in the form of inspections and supervision by authorities, including low shareholder trust, which will have a negative impact on performance (Drake et al., 2019; Guenther et al., 2017; Khuong et al., 2020). However, companies with aggressive tax strategies can solve these problems through their advantage, namely by establishing political connections. This is done to avoid supervision or inspection from the authorities without compromising investors to improve their performance. Therefore, it can be concluded that although an aggressive tax strategy is risky, it can provide benefits for the Company, which is reflected in better performance. Thus, in order to minimize this risk, the Company places a board of directors and commissioners who are individuals who have political connections, which are expected to be able to protect the company so that it gets special treatment in terms of taxation in the form of avoiding the risk of inspection and supervision by the tax office.

Moderation of Political Connections on the Effect of Capital Structure on Company Performance

Furthermore, the results of moderating political connections on the relationship between capital structure and firm performance show a positive and significant direction ($\beta=0.816$, $p<0.05$). These results illustrate that political connections moderate the influence of capital structure and firm performance. These conditions indicate that companies with a capital structure through larger loans, where they are politically connected, perform better than vice versa. The capital structure, dominated by loans, has consequences in the form of high-interest expenses. However, this can be overcome by having a politically connected board, as they can open up opportunities to obtain projects from the larger government. So that even though there is a high cost of capital, with additional sources of income in the form of projects from the government plus existing non-government projects, this can increase the company's profitability. In the end, the results of this study can be concluded that although the capital structure, which is dominated by funding from third parties, has the consequence of interest expenses, as well as exposes the company to the risk of financial distress, which can affect the company's performance when the management of these loans is carried out properly,

it can improve performance for the Company. This is in line with the agency cost view whereby the capital structure through loans can suppress opportunistic actions by managers so that these conditions benefit the Company by showing better performance. In addition, political connections owned by politically connected companies provide benefits for them in the ease of obtaining projects from the government. This benefits the company by increasing revenue, which can pay high-interest expenses and increase company income.

Conclusion and Recommendation

This study analyzes the effect of tax aggressiveness and capital structure on company performance. The results of the analysis found that the variables of tax aggressiveness and political connections have a positive influence on company performance. Furthermore, capital structure has a negative influence on company performance. These results support the view of agency theory, in which they take an aggressive tax strategy to provide good performance and place politically connected boards.

The results of this study have several implications. First, regulators must limit politically connected companies through boards to use them in unconstitutional ways to obtain projects from the government. The second implication is providing input to regulators regarding the importance of policies related to transparency of financial reporting and the protection of shareholders, especially if the company has political connections. Investors should be more careful in placing their funds in companies with the main capital structure from loans. Third, this study advises shareholders to reduce agency costs, and shareholders must use their voting rights to supervise aggressive tax behaviour and improve the quality of financial reporting.

However, some limitations in this study need to be corrected. First, this research was only conducted in the manufacturing sector. Therefore, it is hoped that further studies will be carried out across industries to enrich and test the consistency of the research results on these variables. Second, the study stops at the factors that influence company performance. Furthermore, we recommend further research examining the consequences of company performance, namely on company value as reflected in stock prices and investor decisions. The third limitation is that this study only uses one measurement variable for each tax aggressiveness and capital structure variable, so it is hoped that further studies can use more than one variable, such as book-tax gap, effective cash rate and long-term debt, short-term term debt to test the consistency of the results.

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