



The role of political connections as a moderating determinant of tax avoidance

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ABSTRACT

Background: Taxes are a primary source of state revenue to finance development and public welfare. However, the government's interest in optimizing tax revenue often conflicts with companies, who view taxes as a significant burden, thus encouraging tax avoidance practices. Indonesia's low tax ratio and fluctuations in mining sector tax revenues indicate the potential for such practices. Thin capitalization and transfer pricing schemes are suspected to be key strategies, with political connections amplifying them. This study examines the influence of these two strategies on tax avoidance, with political connections acting as a moderating variable. **Methods:** The sampling technique used in this study was purposive sampling, resulting in a sample of 44 mining companies listed on the Indonesia Stock Exchange from 2013 to 2022. The method used in testing the hypothesis was the Generalized Method of Moment (GMM). **Findings:** The results of this study indicate that thin capitalization and transfer pricing have a significant effect on tax avoidance. In addition, this study reveals that political connections can moderate the effect of thin capitalization and transfer pricing on tax avoidance. **Conclusion** Research shows that thin capitalization increases tax avoidance, transfer pricing decreases it, and political connections moderate both, implying more effective and comprehensive tax regulations. **Novelty/Originality of this article:** This research is one of the studies that examines thin capitalization and transfer pricing in tax avoidance with political connections as a moderating variable. Political connections were chosen as a moderating variable because they are thought to have a non-technical effect on tax avoidance practices carried out by companies.

KEYWORDS: political connections; tax avoidance; thin capitalization; transfer pricing.

1. Introduction

Taxes are an important element of a country's national income. Tax revenue is needed by the government to finance the implementation of various government functions, the management of infrastructure and educational facilities, and various other matters to improve the welfare of the people (Mankiw, 2012). The government's efforts to optimize tax revenue are always at odds with companies as taxpayers (Setyaningrum & Suryarini, 2016). For companies, taxes are one of the most significant expenses incurred by companies and have a direct impact on profitability (Landry et al., 2013). Therefore, the tax burden on companies has led to the emergence of tax avoidance practices (Chen et al., 2010). The definition of tax avoidance is often associated with companies' efforts to reduce their tax liabilities by finding loopholes in existing tax regulations (Lim, 2011). Even though tax avoidance strategies are legal, the strategies implemented by companies will still be detrimental to the state (Masri & Martani, 2012). Tax avoidance practices by companies also

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have an impact on the country's tax ratio. Indonesia's lowest tax ratio was only 8.33% in 2020, while the highest was 13.60% in 2013 (Santika, 2023). According to the Organization for Economic Co-operation and Development (OECD), Indonesia's tax ratio in 2022 will be lower than the Asia-Pacific average tax ratio of 19% and also below the OECD average of 33.5% (Sukmana, 2022). This phenomenon shows that Indonesia has not been able to collect taxes optimally.

In response to the prevalence of tax avoidance practices in Indonesia, Finance Minister Sri Mulyani stated that such activities would have an impact on global tax revenues and could potentially result in a loss of around Rp3,360 trillion per year through base erosion and profit shifting practices (Makki, 2021). State institutions, in this case the Corruption Eradication Commission/*Komisi Pemberantasan Korupsi (KPK)*, consider the mining sector to be prone to corruption, one form of which is tax evasion (Wicaksono, 2019). This is supported by a report from Indonesia Audit Watch (IAW) to Minister Mahfud Md on alleged tax evasion by mining companies (Wibowo, 2023).

Indonesia is a country rich in natural resources, especially copper commodities (Annur, 2023). Indonesia's mineral reserves are very high, ranking first in the world for nickel and third for tin (Isnanto, 2023; Setiawan, 2022). For gold commodities, Indonesia ranks sixth globally and contributes 5% of the world's total reserves (Anwar, 2021). With its enormous potential, the mining sector contributes to Indonesia's tax revenue. The level of contribution of mining tax revenue to Indonesia's tax revenue in 2013-2022 is shown in Figure 1. It can be seen that the average growth in mining tax revenue was only 9.7%, indicating tax avoidance and many taxpayers defaulting on their tax obligations.

Thin capitalization and transfer pricing schemes can be considered as companies' attempts to avoid tax obligations (Lietz, 2013). Thin capitalization is chosen by companies to engage in tax avoidance activities because interest on debt can be a deductible expense (Utami & Irawan, 2022). Taylor & Richardson (2013) studied thin capitalization in international tax avoidance mechanisms. This action is a major factor driving tax avoidance practices, resulting in a macro effect of reducing the state's potential tax revenue. Companies use this strategy for tax avoidance by increasing their debt-to-equity ratio. The higher the debt, the higher the interest that must be paid by the company to creditors, resulting in lower taxable income. This implies that the company's tax liability will be lower. The emergence of thin capitalization is caused by tax regulations that treat loan interest payments as deductible expenses for calculating taxable income (Prastiwi & Ratnasari (2019). This provision creates a tax loophole, whereby the higher the loan interest expense, the lower the tax payable (Natama & Irawan, 2021).

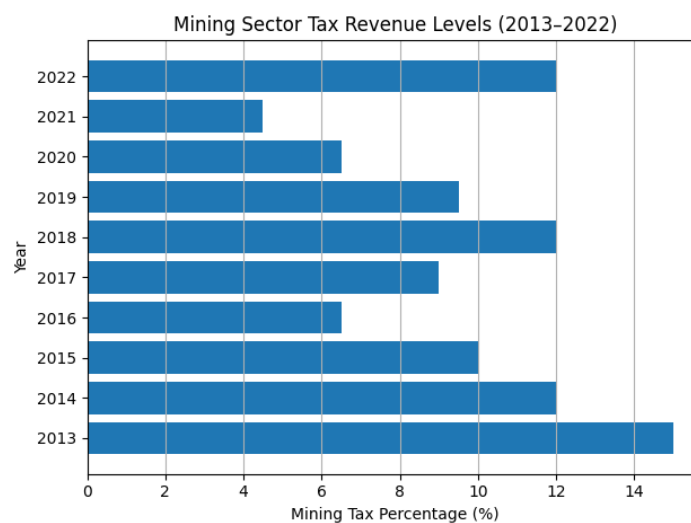


Fig. 1. Mining tax revenue data for 2013-2022

Furthermore, transfer pricing practices carried out by companies can regulate transfer prices for transactions with related parties so that companies are motivated to transfer profits between these companies with the aim of increasing revenue through tax avoidance (Kurniawan, 2015). According to Lingga (2012), transfer pricing can be defined as transactions of goods and services between several divisions within a business group at unreasonable prices, which can increase (mark up) or decrease (mark down) prices, and is mostly carried out by multinational enterprises. A multinational enterprise is a company that operates in more than one country under the control of a particular party. Transfer pricing is also often associated with systematic price engineering aimed at reducing profits, which in turn reduces the amount of tax or duty payable to a country (Mangoting, 2000).

Political connections are considered one of the factors that companies use to avoid taxes (Ajili & Khelif, 2020; Fasita et al., 2022; Firmansyah et al., 2022). Political connections often occur in developing countries, including Indonesia (Ferdiawan & Firmansyah, 2017). According to Faccio (2007), political connections are also one of the factors that cause companies to engage in tax avoidance. Political connections will influence the enforcement of corporate tax obligations with a lighter tax burden (Chen et al., 2015). A strong level of political connection to the government can be used by companies to become more involved in tax management activities. A strong position will make it easier for companies to obtain government support in the form of lower audit facilities than companies that do not have political connections with the government.

Research on the relationship between thin capitalization, transfer pricing, and political connections to tax avoidance has been conducted by Taylor & Richardson (2013), Amidu et al. (2019), Andawiyah et al. (2019), Prastiwi & Ratnasari (2019), Salwah & Herianti (2019), Ajili & Khelif (2020), Aristyatama & Bandiyono (2021), Budiman & Fitriana (2021), Widarjo, et al. (2021). Alfiyah et al., (2022), Budiman & Bandi (2022), Fasita et al., (2022), Firmansyah et al. (2022), Nurhidayah & Rahmawati (2022), Pamungkas & Setyawan (2022), and Rachmad et al. (2023).

This study was conducted because there are still many cases of tax avoidance in Indonesia, especially in mining companies. The growth rate of mining tax revenue fluctuates annually, with an average of only 9.7%. By combining the factors that influence tax avoidance, particularly political connections as a novelty in this study, this research was conducted with the aim of obtaining empirical evidence on the influence of thin capitalization and transfer pricing on tax avoidance, as well as political connections as a moderating variable. Political connections were chosen as a moderating variable because they are suspected of having a non-technical effect on the tax avoidance practices carried out by companies. In addition, research on the topic of moderation is still rare in Indonesia, as political connections have been used in many previous studies as an independent variable. The Indonesian Tax Authority can use the findings of this study to develop taxation policies in the political, social, and economic fields.

1.1 Literature review

1.1.1 Trade-off theory

The Trade Off Theory was developed by Modigliani and Miller in 1963. This theory explains the concept of a company's capital structure, which is sourced from debt financing and equity capital. The Trade Off Theory assumes that there are other benefits that companies obtain through the use of debt financing, such as tax benefits (Christiana & Martani, 2016). Debt incurs interest expenses that can reduce the tax burden paid to the government when dividends and retained earnings do not have the same ability. On the other hand, the impact of excessive debt financing is high bankruptcy costs (Afifah & Prastiwi, 2019). In trade-off theory, companies choose to have a higher level of debt than capital in order to obtain tax benefits and sacrifice interest payments, which are the consequences of using debt. The implication of trade-off theory is that when choosing debt as financing, there is a tax shield caused by interest expenses (Doyon & Gullikson, 2024).

The tax shield arises from reduced taxable income as a result of interest expenses, which leads to lower income taxes for the company concerned.

1.1.2 Theory of planned behavior

The Theory of Planned Behavior can explain managers' behavior in determining transfer pricing schemes (Apriyanti et al., 2023). Transfer pricing decisions can be influenced by the benefits of transfer pricing (Hang, 2019). Different perceptions of international and domestic norms, including the influence of the multinational company environment, can be categorized as normative beliefs (Zvarikova & Kovalova, 2021). These beliefs can influence and drive a company's transfer pricing behavior (Merle et al., 2019; Satyadini et al., 2019). In addition, control beliefs or control differences can facilitate transfer pricing behavior by looking at internal and external factors. Internal factors, such as company resources and subsidiaries, will facilitate transfer pricing practices (Takilal Singh, 2019), while external factors, such as weaknesses in transfer pricing regulations, will encourage companies, especially multinational companies, to develop transfer pricing policies for tax avoidance purposes (Kamilah, 2019).

1.1.3 Upper echelon theory

Upper Echelon Theory is a theory developed by Hambrick & Mason (1984) which states that organizations are a reflection of top management. Wan Yusof (2010) states that upper echelon theory explains the importance of studying the characteristics of commissioners and directors, because company performance is a reflection of top management. Upper Echelon Theory is a theory that considers top management as the main strategic decision makers within an organization. Therefore, the strategic decisions made by leaders have a direct impact on the organization's results. Company leaders, in this case commissioners and directors who have a social background, group characteristics, and political connections, will be more daring to make risky decisions because they feel close to the government, so they tend to choose to evade taxes for the benefit of the company (Asadanie & Venusita, 2020). According to Putra & Suhardianto (2020), top managers who have experience in politics can influence company strategy. Political experience may be related to tax avoidance because management can apply values and decisions relevant to their political experience, which will influence the company's loyalty to the government.

1.1.4 Tax avoidance

According to Darussalam & Septriadi (2007), tax avoidance does not imply illegal action. It refers to companies' activities to legally manipulate their tax burden in accordance with existing regulations in order to reduce the amount of tax owed. Meanwhile, according to the OECD (Organisation for Economic Co-operation and Development), tax avoidance activities are forms of efforts by taxpayers to reduce their tax liabilities that do not violate regulations but are contrary to the objectives of the applicable regulations. Therefore, these activities are classified as *fraus legis*, which is a position between tax compliance and tax evasion. Thus, tax avoidance can be defined as a phenomenon that needs to be considered by the government given its unique and complex nature, as it is deliberately carried out by companies to reduce and/or eliminate their tax liabilities.

1.1.5 Thin capitalization

Thin capitalization is a situation in which a company is financed through high debt compared to its capital, or is highly leveraged. This is reinforced by the OECD's statement that the higher the level of debt in a company, the higher the interest expenses that must be paid, thereby reducing fiscal profits. Taxable income can become smaller because, under tax regulations, debt interest is a deductible expense. Therefore, companies can take advantage

of incentives in the form of tax reductions due to interest expenses. Thin capitalization is the formation of a company's capital structure with a combination of more debt and less capital (Taylor & Richardson, 2013). According to Minister of Finance Regulation No. 169/PMK.010/2015 (BPK,2015), the maximum debt-to-equity ratio is set at four to one (4:1). When a company uses debt exceeding the specified limit, the borrowing costs that can be calculated as a deduction from taxable income are only equal to the ratio specified in the PMK.

1.1.6 Transfer pricing

Transfer pricing is the price charged by one division for goods or services provided to another division within the same organization (Hornngren et al., 2015). This is in line with Hansen & Mowen (2005), who state that transfer pricing within a company or group of companies is the price charged by the sales division to the purchasing division. In a broader sense, transfer pricing is the transfer price of goods, services, or intangible assets in transactions between a company and a related party (OECD, 2009). Eden & Smith (2011) state that transfer pricing is an effort to minimize the amount of tax payable by reducing income or increasing expenses. Transfer prices consist of international and domestic transfer pricing (Putra & Farida, 2024). According to Garrison et al. (2021), international and domestic transfer pricing have different objectives. The main objective of international transfer pricing is to minimize taxes by taking advantage of different tax rates between countries, while the objective of domestic transfer pricing is to evaluate performance.

1.1.7 Political connections

Political connections are defined as special relationships between a company and authorities within the government where the company is located (Trinugroho, 2017). Political connections may exist because the owners or managers are government officials, politicians, or have close ties to the ruling party at the time. Various researchers have documented that political connections are very valuable in developing and developed countries, as they can influence government policy towards companies, including tax-related policies. Companies establish relationships with the government to obtain benefits related to import licensing, taxes, and supply funds (Sudibyoy & Jianfu, 2017).

1.1.8 The effect of thin capitalization on tax avoidance

Thin capitalization is the formation of a company's capital structure by maximizing debt contributions and minimizing capital contributions. Thin capitalization is a tax avoidance scheme through loopholes in existing tax regulations by converting capital contributions from parties with special relationships into loans, either directly or through intermediaries (Afifah & Prastiwi, 2019). Debt ownership will incur interest expenses, which, under tax regulations, can reduce a company's taxable income. Based on trade-off theory, recognition of the dominant use of debt in the capital structure can be used as a tax saving by obtaining tax incentives in the form of interest expenses that will become deductible expenses.

Taylor & Richardson (2013) studied thin capitalization in international tax avoidance mechanisms. This action is a major factor driving tax avoidance practices, resulting in a macro effect in the form of reduced potential state revenue from taxes. Prastiwi & Ratnasari (2019) also showed that the higher the MAD ratio, the higher the tax avoidance. The emergence of thin capitalization is caused by tax regulations that treat loan interest payments as deductible expenses for calculating taxable income. This provision creates a tax loophole, whereby the greater the loan interest expense, the lower the tax payable (Natama & Irawan, 2021). Therefore, the greater a company's interest expense, the lower its taxable income and the lower its tax burden. Based on this explanation, the research hypothesis is as follows: H1: Thin has a positive effect on tax avoidance.

1.1.9 *The effect of transfer pricing on tax avoidance*

According to the Theory of Planned Behavior, tax avoidance is a deliberate effort by companies to minimize their tax liabilities. This deliberate action is influenced by the company's intentions and motivations. In this regard, individual attitudes toward transfer pricing can be influenced by several factors, such as the existence of greater incentives, profit targets, and corporate objectives. For example, if a company wants to achieve high profit targets, it will tend to use high transfer pricing practices to maximize the parent company's profits. Another way to minimize tax liabilities is to transfer profits to countries with lower tax rates than Indonesia.

Amidu et al. (2019) explained the positive effect of transfer pricing on tax avoidance practices by conducting research in Ghanaian companies. This means that the higher the transfer pricing value, the higher the level of tax avoidance. This condition is caused by non-compliance in transfer pricing, which leads companies to engage in corporate tax avoidance. In addition, there are special relationship transactions that take advantage of loopholes in international tax laws, resulting in low corporate tax burdens. This scheme is carried out by increasing the purchase price and minimizing the selling price between companies within the group, then transferring the profits to companies operating in countries with lower tax rates (Richardson et al., 2013). Aristyatama & Bandiyono (2021) researched transfer pricing in tax avoidance in Indonesia. Transfer pricing activities are suspected to be caused not only by transactions affiliated with foreign entities but also with domestic entities, considering several reasons, namely that one of the affiliated parties receives compensation for losses and that the affiliated transaction is subject to final income tax. Thus, the hypothesis that can be proposed is as follows, H2 : Transfer pricing has a positive effect on tax avoidance

1.1.10 *The role of political connection moderating variables*

Tax avoidance activities are triggered by taxpayers' desire to engage in non-compliance behavior in paying their tax liabilities (Putri & Fadhlia, 2017). Referring to cases that have occurred both internationally and in Indonesia, as well as various previous studies, tax avoidance can occur through thin capitalization and transfer pricing schemes. Indonesia is a country with the highest political influence on the business world (Harymawan & Nowland, 2016). With politics, companies will have greater business opportunities because of the ease of obtaining projects and access to government policies (Boubakri et al., 2008). Based on the upper echelon theory, companies with political connections will use their proximity to obtain available benefits in the market. This is also reinforced by research (Muttakin et al., 2015) which states that companies with political connections will use their proximity to politicians and state officials to obtain benefits in the market and avoid the possibility of being punished for expropriation and poor management.

The amount of corporate debt and the prevalence of tax avoidance practices can be influenced by various factors, one of which is political connections. The existence of political connections helps companies obtain bank loans more easily (Butje & Tjondro, 2014), obtain favorable credit terms (Arifin et al., 2020), have higher loan levels (Chen et al., 2014), and high interest rates due to high debt (Bliss & Gul, 2012). Therefore, politically connected companies will tend to encourage debt-based financing due to the ease of access to bank loans, which increases the cost of debt (Wijantini, 2007). This shows that there is a positive influence between the interest rates charged on debt and companies that have political connections (Bliss & Gul, 2012; Liedong & Rajwani, 2018; Saeed et al., 2015).

In addition, political connections tend to influence every decision made by company management, so that decisions to implement transfer pricing schemes will also be intervened by politicians associated with the company's performance and expenses (Newton & Uysal, 2019). Companies use their political connections to reduce tax payments through lobbying activities and the exploitation of looser supervision (Doh et al., 2022; Gammeltoft & Panibratov, 2024; White et al., 2014). Companies take advantage of this to

further avoid taxes by utilizing overseas activities to reduce taxes through profit shifting schemes (Rathke et al., 2021). Strong political connections can help companies conduct related-party transactions for the purpose of tax avoidance safely (Qian et al., 2012). Based on these arguments, the following hypothesis is formulated: (1) H3a : Political connections can strengthen the positive influence of thin capitalization on tax avoidance, (2) H3b : Political connections can strengthen the positive influence of transfer pricing on tax avoidance.

2. Methods

2.1. Research data

This study is a quantitative study using secondary data. Mining companies listed on the Indonesia Stock Exchange (IDX) from 2013 to 2022 were used as the research population, totaling 80 companies. The sampling technique used was purposive sampling with the following criteria: (1) Mining companies listed on the IDX from 2013 to 2022, (2) Companies that were not delisted from 2013 to 2022, (2) Companies that published annual reports from 2013 to 2022, (3) No mergers or acquisitions occurred in the company, and (4) Complete and available data. Thus, the final sample used in this study was 44 companies with observations during 2013-2022, resulting in 440 observation data.

2.2. Model estimation and variable measurement

Dynamic panel data regression can be defined as a regression model that changes over time. This method is commonly used in economics, which has dynamic variables such as the dynamic nature of corporate tax avoidance practices (Salihu et al., 2015). The advantage of the dynamic panel regression model is that it can determine the long-run effect and short-run effect (Nabilah & Setiawan, 2016).

Given the dynamic nature of the panel data in this study and in line with Minnick & Noga (2010), this study applies a standard linear relationship between tax avoidance, thin capitalization, transfer pricing, and political connections with several control variables that are considered to influence corporate tax burdens. The first model can be written as follows:

$$ETR_{it} = \alpha + \beta_1 TC_{it} + \beta_2 TP_{it} + \beta_3 ROA_{it} + \beta_4 DAR_{it} + \beta_5 CR_{it} + \beta_6 SIZE_{it} + \beta_7 AGE_{it} + \varepsilon \quad (\text{Eq. 1})$$

Description: ETR = *Effective Tax Rate*; α = Konstanta; β_1 - β_7 = Regression Coefficients; TC = *Thin capitalization*; TP = *Transfer pricing*; ROA = *Return on Asset*; DAR = *Debt to Asset*; CR = *Current Ratio*; SIZE = *Company Size*; AGE = *Company Age*; ε = error

The subscripts *i* and *t* indicate the company and year of research. ETR is corporate tax avoidance as a dependent variable and is measured using the Effective Tax Rate (ETR) because it is considered to describe tax avoidance activities through the company's financial condition based on the total tax burden paid to the state (Rego & Wilson, 2012). α is the constant, β_1 to β_7 are regression coefficients, and ε is the error in the model. Family indicates family ownership and is measured as the proportion of family members on board (Wan-Hussin, 2009).

This study has two independent variables: thin capitalization and transfer pricing. Thin capitalization uses the MAD ratio proxy, which is calculated by dividing the average debt by the company's SHDA (Prastiwi & Ratnasari, 2019). According to Taylor & Richardson (2013), the MAD ratio can illustrate that the higher the debt ratio, the more thin capitalization a company experiences. Furthermore, transfer pricing is assessed by dividing accounts receivable from related parties by total accounts receivable (Tiwa et al., 2017). This proxy was chosen because transfer pricing is often associated with sales transactions, and the emergence of accounts receivable can be due to large transactions, resulting in companies making purchases in installments (Refgia, 2017). Profitability (Return on

Assets), Solvency (Debt to Assets), Liquidity (Current Ratio), Company Size, and Company Age are the control variables in this study. The second model for investigating the interactive impact of political connections can be written with the following equation:

$$ETR_{it} = \alpha_i + \beta_1 TC_{it} + \beta_2 TP_{it} + \beta_3 PC_{it} + \beta_4 TP_{it} * PC_{it} + \beta_5 TP_{it} * PC_{it} + \beta_6 ROA_{it} + \beta_7 DAR_{it} + \beta_8 CR_{it} + \beta_9 SIZE_{it} + \beta_{10} AGE_{it} + \varepsilon \quad (\text{Eq. 2})$$

Description: ETR = Effective Tax Rate; α = Constant; β_1 - β_{10} = Regression Coefficients; TC = Thin capitalization; TP = Transfer pricing; PC = Political Connection; ROA = Return on Assets; DAR = Debt to Assets; CR = Current Ratio; SIZE = Company Size; AGE = Company Age; ε = Error

This study uses political connections as a moderating variable. A company is considered to have political connections if at least one member of its board of directors or board of commissioners holds or has held a position in the government, namely in the executive, legislative, or judicial branches, or in other institutions necessary for the functioning of the state (Maulana & Wati, 2019). In this study, political connections are measured using a comparison between the number of board members in a company, both the board of directors and the board of commissioners, who have political connections and the total number of members of the board of directors and board of commissioners (Iswari et al., 2019). This measurement is considered to be more capable of showing the impact of political connections on other variables than simply measuring the existence of political connections alone.

The criteria for politically connected boards are company boards that are currently or formerly heads of state, parliament, military, ministry officials, other government agencies, local government leaders, or have close ties (family) or friendships with politicians (parties) (Supatmi & Handayani, 2022). Furthermore, the research criteria were expanded with reference to the research by Habib et al. (2017); Rahman & Nugrahanti (2021) by involving the background of the board of commissioners and directors. The background in question includes positions, job history, and kinship with government positions and the Indonesian National Armed Forces or the Indonesian National Police.

2.3. Data analysis methods

The Generalized Method of Moments (GMM) model is a dynamic panel data regression model with lagged dependent variables and is an improvement on the instrumental variable method (Wicaksono et al., 2023). The GMM method is a model whose estimates are unbiased, consistent, and efficient. The use of the GMM model approach is based on two reasons: GMM is a common estimator and provides a more useful framework for comparison and assessment, and the GMM method provides a simple alternative to other estimators, especially maximum likelihood. Therefore, this study proposes the use of the GMM estimator for the analysis of the above model.

3. Results and Discussion

3.1 Descriptive statistics

Table 1 shows the descriptive statistics for each variable used in this study. The average ETR of 0.1612 indicates that mining companies listed on the IDX allocate an average of 16% of their pre-tax income to taxes. Thin capitalization resulted in an average of 1.35543 with a standard deviation of 6.1170. The high standard deviation indicates significant variation in thin capitalization and significant differences in the capital structure of companies in the research sample. The average transfer pricing for 440 observations was 0.273168, indicating that no more than 50% of mining companies listed on the IDX during the 2013-2022 period engaged in transfer pricing. Furthermore, political connections obtained an

average of 0.1490 and a standard deviation of 0.1516. This means that the average value is lower than the standard deviation value, proving that the data in this variable is almost well distributed because the difference between the average and the standard deviation is only 0.0025.

Table 1. Descriptive statistics results

Variable	Mean	Median	Maximum	Minimum	Std. Dev.
ETR	0.1612	0.2280	26.0698	-2.1575	1.9253
TC	1.3554	0.8955	38.0172	-1.0130	6.1170
TP	0.2731	0.1084	2.0660	0.0000	0.3315
PC	0.1490	0.1428	0.5454	0.0000	0.1516
ROA	0.0202	0.0169	1.3433	-1.1221	0.1763
DAR	0.5894	0.5300	4.9178	0.0084	0.4752
CR	3.1218	1.3005	146.1302	0.0000	11.5258
SZE	28.1689	28.4015	32.3055	21.1402	2.2014
AGE	32.3636	36.0000	122.0000	-9.8200	160.2689

3.2 Correlation matrix

The Pearson correlation matrix for the dependent, independent, and control variables is presented in Table 2. The results of this test show that thin capitalization has a positive correlation with ETR, while transfer pricing has a correlation with ETR. In addition, Table 2 shows correlation values of less than 0.8, so it can be said that this research model is free from multicollinearity. Multicollinearity testing can be seen through the VIF (Variance Inflating Factor) value shown in the last row of Table 2. The test results show VIF values for the thin capitalization and transfer pricing variables of 1.0265 and 1.0349, respectively. This confirms that there are no multicollinearity issues in the research model.

Table 2. Pairwise correlation

Variable	ETR	TC	TP	PC	ROA	DAR	CR	SZE	AGE
ETR	1.0000								
TC	0.0194	1.0000							
TP	-0.0115	0.0413	1.0000						
KP	0.0151	-0.0810	0.1247	1.0000					
ROA	0.0484	-0.0402	0.0736	0.0908	1.0000				
DAR	-0.0104	0.0573	0.0085	-0.0528	0.1439	1.0000			
CR	-0.3067	-0.0290	-0.1047	-0.1236	-0.1269	-0.1205	1.0000		
SZE	0.0473	-0.1081	0.0601	0.1977	0.0182	-0.1369	-0.2227	1.0000	
AGE	0.0251	0.0420	0.0746	0.0428	0.0196	0.0364	-0.0489	-0.0574	1.0000
VIF		1.0265	1.0349	1.0758	1.0472	1.0676	1.1100	1.1317	1.0161

3.3 Regression analysis

Table 3 shows two research models that present the regression results in this study. Model 1 in this study examines the effect of thin capitalization and transfer pricing on tax avoidance as measured by the Effective Tax Rate (ETR). The results of hypothesis 1 testing are supported by observational data that thin capitalization has a positive effect on ETR. This can be demonstrated by the fact that the TC probability value of 0.0014 is less than 5%, and the positive coefficient value is 0.0707. This means that the greater the thin capitalization value, the greater the company will engage in tax avoidance.

Thin capitalization refers to a company's capital composition through a proportion of high-interest debt and low capital (Anggraeni & Oktaviani, 2021). Thin capitalization is one of the methods chosen by companies to achieve maximum profits and good operating performance by reducing the tax burden payable by the company. Therefore, companies with a high debt-to-equity ratio will engage in tax avoidance. This is due to a loophole in tax

regulations with a debt-to-capital ratio of 4:1, which companies exploit to reduce their tax burden. This action is a debt restructuring strategy used by multinational companies to reduce their global tax debt (Prastiwi & Ratnasari, 2019).

Thin capitalization activities prioritize debt financing in their capital structure, thereby obtaining tax incentives in the form of debt interest, which is considered a deduction from taxable income. Thus, it can be indicated that the more debt a company has to pay, the higher the interest it has to pay, the lower its taxable income, and the lower its tax liability. These results also confirm the trade-off theory, which explains that debt financing is very profitable because companies can obtain additional tax savings through debt interest. Therefore, the reason companies use debt is to reduce the taxes they have to pay, especially multinational companies that are able to engage in tax avoidance. The results of this study support Taylor & Richardson (2013), Prastiwi & Ratnasari (2019), and Fasita et al. (2022), but contradict the research of Nurhidayah & Rahmawati (2022).

The results of the second hypothesis testing, namely the effect of transfer pricing on tax avoidance, can be seen in Table 3. The results show that the second hypothesis is supported by the observation data. This can be seen from the TP probability value of 0.0000, which is less than 5%, and a positive coefficient value of 1.340. The higher the transfer price, the more likely the company is to engage in tax avoidance.

Transfer pricing practices are often used by multinational companies to minimize their tax liabilities. This practice is usually carried out by selling goods and services at below market prices within a group and transferring their profits to groups located in countries with lower tax rates. Based on data collected by researchers, the majority of companies are suspected of engaging in transfer pricing practices with their affiliates located in countries with low tax rates. Therefore, companies take advantage of this opportunity to engage in tax avoidance. This is in line with planned behavior theory because the trigger for companies to take such actions is influenced by their intention and motivation as well as their drive to engage in tax avoidance through transfer pricing schemes.

The results of this study are consistent with Amidu et al. (2019) and Aristyatama & Bandiyono (2021). Amidu et al. (2019) explained the positive effect of transfer pricing on tax avoidance practices by conducting research in Ghanaian companies. This means that the higher the transfer pricing value, the higher the level of tax avoidance. This condition is caused by non-compliance in transfer pricing, which leads companies to engage in corporate tax avoidance. In addition, there are special relationship transactions that take advantage of loopholes in international tax laws, resulting in low corporate tax burdens. This scheme is carried out by increasing the purchase price and minimizing the selling price between companies within the group, then transferring the profits to companies operating in countries with lower tax rates (Richardson et al., 2013).

Similarly, Aristyatama & Bandiyono (2021) conducted research on transfer pricing in tax avoidance in Indonesia. Transfer pricing activities are suspected to be caused not only by transactions affiliated with foreign entities but also with domestic entities, considering several reasons, namely that one of the affiliated parties receives compensation for losses and that the affiliated transaction is subject to final income tax.

Model 2 in Table 3 presents the results of testing the hypothesis regarding the role of political connections in moderating the positive influence of thin capitalization and transfer pricing on tax avoidance. This test shows that hypothesis 3a and hypothesis 3b are supported by the observational data, namely that political connections can strengthen the positive influence between thin capitalization and transfer pricing on tax avoidance. This result is reinforced by the probability values of thin capitalization and transfer pricing of 0.0186 and 0.0004, respectively, which are greater than 5%. Thin capitalization moderated by political connections has a positive coefficient value of 0.4966. This result shows that tax avoidance will be greater when thin capitalization is moderated by political connections. This means that political connections strengthen the positive influence of thin capitalization on tax avoidance. Similarly, the results of testing transfer pricing moderated by political connections show a positive coefficient value of 9.487. This means that tax avoidance will

increase when transfer pricing is moderated by political connections. Therefore, the role of political connections strengthens the positive influence of transfer pricing on tax avoidance.

The amount of corporate debt and the prevalence of tax avoidance practices can be influenced by various factors, one of which is political connections. The existence of political connections helps companies in obtaining easy bank loans (Butje & Tjondro, 2014), obtaining favorable credit terms (Arifin et al., 2020), having higher loan levels (Chen et al., 2014) and high interest rates due to high debt (Bliss & Gul, 2012). Therefore, politically connected companies will tend to encourage debt-based financing due to the ease of access to bank loans, which increases the cost of debt (Wijantini, 2007). This shows that there is a positive influence between the interest rates charged on debt and companies that have political connections (Bliss & Gul, 2012; Liedong & Rajwani, 2018; Saeed et al., 2015).

In addition, the upper echelon perspective explains that top management (commissioners and directors) who have a social background and group characteristics that include political connections will dare to make riskier decisions, thus tending to choose tax avoidance. Political connections tend to influence every decision made by company management, so that decisions to implement transfer pricing schemes will also be intervened by politicians related to the company's performance and expenses (Newton & Uysal, 2019). Companies use their political connections to reduce tax payments either through lobbying activities or by taking advantage of looser supervision (Bianchi & Viana, 2014). Companies take advantage of this to further avoid taxes by utilizing overseas activities to reduce taxes through profit shifting schemes. Companies with high political connections tend to engage in transfer pricing by relying on their relationships with the government, which can facilitate tax avoidance (Sitompul, 2022). These results are in line with Qian et al. (2012) and Habib et al. (2017), which show that increased tax avoidance activities are caused by high levels of transfer pricing with the role of political connections.

Table 3 in model 2 also presents the effect of political connections on tax avoidance. This test produced a probability value of 0.0000 with a positive coefficient of 4.453, indicating that the higher the value of political connections, the higher the number of companies suspected of engaging in tax avoidance practices. This means that companies with political connections tend to engage in tax avoidance. This result also reinforces that political connections can strengthen the positive influence of thin capitalization and transfer pricing on tax avoidance, as explained above. This is in line with the upper echelon theory, which explains that top management (commissioners and directors) with social backgrounds and group characteristics that have political connections will dare to make riskier decisions because they are supported by their political connections, thus tending to choose to engage in tax avoidance for the benefit of the company (Asadanie & Venusita, 2020). The results of this study contradict Chaney et al. (2011), who explain that political connections can make companies more likely to avoid risky activities such as tax avoidance practices.

Companies use political connections to reduce tax payments through lobbying activities. Lobbying efforts can serve to reduce the risk of punishment when tax avoidance is discovered because they receive protection from the government. In addition, politically connected companies have easier access to legislators so they can obtain confidential information in advance to strategically plan their taxation and mitigate or effectively handle detected risks (Kim & Lee, 2021). The benefits of political connections have been proven to minimize tax burdens, as reinforced by Iswari et al. (2019), who explain that companies will seek to utilize political connections for their own interests by appointing politicians or individuals with connections to political actors to their boards of directors or commissioners.

For control variables, it appears that ROA and AGE have a positive effect on ETR. The higher the ROA and AGE values, the higher the ETR value. A high ETR value indicates that the level of tax avoidance by companies is decreasing. In addition, DAR and CR have a negative effect on ETR. The higher the DAR and CR values, the lower the ETR value. This indicates that companies tend to engage in tax avoidance. Meanwhile, company size (SZE) has no effect on tax avoidance.

Table 3. Hypothesis test results

Variable	Model 1			Model 2		
	Coefficient	t-Statistic	Prob.	Coefficient	t-Statistic	Prob.
ETR(-1)	-0.0798	-1.9327	0.0000	-0.0586	-4.5517	0.0000
TC	0.0707	1.0658	0.0000	0.1232	3.4198	0.0014
TP	1.3402	1.0898	0.0000	2.8293	5.7109	0.0000
ROA	1.3827	7.8322	0.0000	1.3351	4.3598	0.0001
DAR	-0.7150	-7.7972	0.0000	-0.6519	-2.1873	0.0342
CR	-0.0310	-5.1012	0.0000	-0.0328	-1.4665	0.0000
SZE	0.0064	0.3520	0.7265	0.0409	0.5088	0.6135
AGE	0.0965	8.9770	0.0000	0.0293	0.6293	0.5325
KP				4.4531	6.1184	0.0000
TC_KP				0.4966	2.4454	0.0186
TP_KP				9.4873	3.8137	0.0004

4. Conclusions

The purpose of this study is to determine the effect of thin capitalization and transfer pricing on tax avoidance, as well as to examine how political connections moderate the effect of thin capitalization and transfer pricing on tax avoidance. This analysis uses the Generalized Method of Moment (GMM) approach in testing the research hypothesis with a sample of 44 mining companies listed on the Indonesia Stock Exchange (IDX) from 2013 to 2022. The findings show that thin capitalization has a negative effect on ETR. This means that the higher the thin capitalization, the lower the company's ETR value. A low ETR value indicates that the company's tax avoidance is high. Transfer pricing has a positive effect on tax avoidance, so the higher the transfer pricing value, the higher the ETR value. A high ETR value indicates that the level of tax avoidance is lower. This study uses political connections as a moderating variable. The results of hypothesis testing conclude that political connections can moderate the effect of thin capitalization and transfer pricing on tax avoidance.

This study is expected to provide both theoretical and practical benefits. From a theoretical perspective, this study is expected to contribute to the development of taxation science in Indonesia, while from a practical perspective, this study is expected to provide benefits or contributions to regulators. This research can serve as evaluation material for regulators regarding the high rate of tax avoidance in Indonesia, thereby providing input for establishing appropriate taxation regulations to overcome this problem and minimize loopholes in tax avoidance activities so that the state's potential revenue from the taxation sector can be optimized.

The limitations of this study are that the research sample only focuses on mining companies, so caution is needed in making generalizations, and the approach to measuring tax avoidance only uses one approach, namely ETR. Therefore, for future research, it is hoped that different research objects will be used so that they can be used for comparison, adding other independent variables outside this research model that are suspected of influencing tax avoidance actions in order to add references to the factors that cause companies to engage in tax avoidance, and the use of tax avoidance measurements other than ETR, such as the Long-run Effective Ratio.

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Author Contribution

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Data Availability Statement

Based on the characteristics of this study, the author does not agree to share the research data with the public, so supporting data is not available.

Conflicts of Interest

The author has no conflict of interest.

Declaration of Generative AI Use

During the preparation of this work, the author used Grammarly to assist in improving grammar, clarity, and academic tone of the manuscript. After using this tool, the author reviewed and edited the content as needed and took full responsibility for the content of the publication

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