Family Ownership, Management Compensation, And Tax Avoidance: Evidence From Indonesia

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Abstract: This study aims to investigate the effect of management compensation to tax avoidance. However, prior research has offered no consistent conclusions on the relationship between management compensation and tax avoidance. This study also tests whether family-firm ownership attempt to decrease the negative effect of management compensation and tax avoidance. Using a sample of Indonesian listed firms during period 2011-2014, the empirical evidence suggests management compensation is negatively affected to tax avoidance. This result consistent with Armstrong et al. (2012) that management was decreasing in incentives to do tax avoidance if there is high management compensation. Also, the family firm's ownership could reduce the negative effect of management compensation for tax avoidance. It shows that family firms in Indonesia tend to do tax avoidance although management has high contract compensation.

Keywords: Tax Avoidance, Management Compensation, Family Ownership


Keywords: Penghindaran Pajak, Kompensasi Manajemen, Kepemilikan Keluarga

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1. Introduction

Prior research shows that there is a positive relationship between management compensation and tax avoidance (Armstrong et al., 2015; Armstrong et al., 2012; Minnick and Noga, 2010). Based on the perspective of agency theory, tax avoidance reflects the opportunistic management to reduce the tax burden to increase corporate profits that influence their compensation (Desai and Dharmapala, 2006). However, in contrast to prior research such as Robinson et al. (2010) and Armstrong et al. (2012) found a negative relationship between compensation and tax avoidance. Armstrong et al., (2012) shows that negative effect between compensation and tax avoidance.

Besides, several studies also assert that family ownership can affect a firm's decision on tax avoidance. Chen et al. (2010) argue that there is a different level of tax avoidance, family firms will have a lower level of tax avoidance compared to non-family firms. Chen et al. (2010) showed that family-owned firms would prefer to pay higher taxes rather than receive a bad reputation if they caught in illegal tax avoidance cases. However, family firms in Indonesia tend more aggressive action to do tax avoidance because of its worse organizational structure and low market reaction (Sari, 2010). Furthermore, the majority of listed companies in Indonesia are family-owned which certainly is unique in considering tax avoidance.

Claessens et al. (2000) argue that most of the firms in the East Asia Region including Indonesia have a family-owned and concentrated ownership structure. Besides, there are still practices of crony capitalism in Indonesia, such as Salim Group, Raja Garuda (Tanoto Sukanto / Asian Agri Group), and companies owned by the Cendana family (Soeharto). This will certainly impact the differences in corporate behavior in tax avoidance (Claessens et al., 2000). Wang (2006) found that family-owned companies have more reliable financial reporting qualities than if the family did not own them. However, some cases in Indonesia shows just the opposite that family firms more tax avoidance, so that it can be said that the financial statements more untrustworthy than companies that are not family owned. This suggests that Wang's (2006) findings are inconsistent with the facts occurring today especially in the context of companies in Indonesia.
This research provides some contribution. First, prove the empirical evidence that family firms are associated with management compensation to tax avoidance in a country that has majority family-owned firms like Indonesia. Second, modifying proxy for family ownerships as measurement refers to Wang (2006) by using dummy variable. Third, using a proxy for tax avoidance measured by book-tax differences refers to Tang and Firth (2008) to test the relationship between management compensation and tax avoidance.

The remainder of the study proceeds as follows. Section 2 provides literature and the development of hypotheses. Section 3 introduces research methods and describes the samples. Section 4 describes the results of research. Section 5 is the conclusion of this study.

2. Theoretical Framework and Development Hypothesis

2.1 Compensation management and tax avoidance

Following recent academic studies on tax avoidance, there are pros and cons regarding the impact of tax avoidance activity. Prior research shows that tax avoidance can provide benefits through corporate tax savings by reducing the risk of bank defaults and lowering borrowing costs (Mills, 1998; Graham and Tucker, 2006). However, another opinion stated that there is a negative impact of tax avoidance that may expose some risk to the firm which increasing the agency risk and the risk of tax audits (Mills 1998; Desai and Dharmapala, 2006; Balakrishnan et al., 2012).

Hasan et al. (2013) indicate that there are two stakeholders perspective in responding to tax avoidance. First, lenders (debt holders) may respond to avoidance negatively by the firm because risky to the firm’s future and the possibility of default (increasing risk exposure). Second, the shareholder’s perspective actually responds positively because it can increase the firm’s profit which in turn will give benefit to shareholders (increasing benefit).

Tax avoidance can create a conflict of interest between two parties better known as agency issues (Masri and Martani, 2012). Management as an agent wants a bonus for income performance so that management tends to be opportunistic for tax
avoidance, while the owners want the sustainability of the firm's future. So that owners give some contract compensation to management to reduce the opportunistic management through tax avoidance activities.

Ozkan (2011) and Croci et al. (2012) argue that providing optimal compensation to the management can reduce agency problems within the firm, so it can be used as a mechanism to reduce the opportunistic management in tax avoidance. Also, Morck and Yeung (2003) state that from the perspective of agency theory, management tends to make decisions that could harm a firm’s future sustainability. Therefore, optimal management compensation is needed to improve the management’s performance (Chalmer et al., 2006)

Robinson et al. (2010) and Armstrong et al. (2012) also argued that there is a negative effect between management compensation and tax avoidance. When a firm conducts aggressive tax avoidance, it will increase the uncertainty and risky for the firms against the law (Murphy, 2004). Therefore, it can be presumed that the owner considers tax avoidance is risky for the firm’s future so that the owner will provide some compensation to management in the hope that they are not opportunistic in tax avoidance.

**H1. Compensation management has negative effect to corporate tax avoidance**

**2.2 Family ownership on management compensation to tax avoidance**

Also, especially in Indonesia with majority family-owned firms, the impact of compensation will certainly be different because there is uniqueness on family firms. Arifin (2003) argue that the firm’s family ownership in Indonesia is less of an agency problem compared to the dispersed ownership firms. Chen et al. (2010) provide that usually the board of family firms is actually controlled by family members of the firms. The interests of the firms are more centered on the interests of the owner because the owner will mostly feel basically the profits and risks of the company. According to Anderson and Reeb (2003) provide that owners of family firms have a strong influence on long-term firms future because the owner is more focused to pass on to his offspring.
Wang (2006) indicated that the family firms would put family members in a strategic position of the firms to control the discretion and strategic decision of the firm. This research provides a new understanding through the definition of family ownership represented by the founding family representative on the board of directors or puts these representatives as chief executive (CEO’s) of the company.

Family firms have better control and adverse tax avoidance when compared to firms whose nonfamily ownerships. Because family firms tend to choose to maintain reputations and avoid legal risks for tax breaches (Baderther et al., 2013). So that the relationship with the provision of compensation to management in the family company is also expected to reduce the opportunistic behavior of tax avoidance that can threaten the company's reputation (Robinson et al., 2010; Armstrong et al., 2012).

Based on the literature review above can be said that if the company is family ownership indicated by a representative of the founding family as the company's chief executive (CEO), it can strengthen the negative influence of management compensation to tax avoidance.

H2. If there is a representative of the founding family as the CEO of the firm, it strengthens the negative effect of management compensation to tax avoidance compared to firms that do not have a representative of the founding family as the CEO

3. Research Method
3.1 Sample Selection

The research sample consisted of manufacturing firms listed in Indonesian Stock Exchange (IDX) from 2011 to 2014 period with a total of 268 firm-year observations. The reason for using the sample at that time, because of SFAS 7 about the disclosure of the compensation commissioner and directors was implemented in 2011 in Indonesia. Also, the reason for using sample manufacturing companies because it is the most dominant industry type listed in Indonesia Stock Exchange (IDX), so it is expected will also vary the behavior of tax avoidance.
Table 1

Sample Selection

<table>
<thead>
<tr>
<th>Manufacturing firms listed on the Stock Exchange by August 2015</th>
<th>Firm – Year</th>
<th>Firm</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>-Not using IDR (Indonesian Rupiah Currency)</td>
<td>(32)</td>
<td>(8)</td>
</tr>
<tr>
<td>-Not using the fiscal year ended on December 31</td>
<td>(56)</td>
<td>(14)</td>
</tr>
<tr>
<td>-Incomplete data from the years 2011-2014</td>
<td>(204)</td>
<td>(51)</td>
</tr>
<tr>
<td><strong>Total Sample Observation</strong></td>
<td><strong>268</strong></td>
<td><strong>67</strong></td>
</tr>
</tbody>
</table>

Variable Measurement and Regression Model

The main model of data analysis used in this study is Estimated Generalized Least Square (EGLS) with Fixed Effect Model method that uses panel data which combines cross-section data and time series. To test hypothesis H1 and H2, the regression model is as follows:

\[
TA_{it} = \beta_0 + \beta_1 KMGT_{it} + \beta_2 KMGT_{it} \times DFAMILY_{it} + \beta_3 SIZE_{it} + \beta_4 ROA_{it} + \beta_5 LEV_{it} + \beta_6 GROWTH_{it} + \beta_7 CINT_{it} + \beta_8 INVINT_{it} + \epsilon_{it}
\]

Management compensation variable (\(KMGT_{it}\)) in this research is calculated with natural logaritm of amount compensation received by the board of directors and board of commissioners of the year refers to Armstrong et al. (2012). Data used to the measurement of management compensation can be found in the company’s annual reports and processed by hand collected.

Wang (2006) stated that generally, the family company put family members or representatives in strategic positions, it is generally following the characteristics of the family company in Indonesia. Therefore, the proxy for family ownership (\(DFAMILY_{it}\)) used in this study refers to Wang (2006) is 1 if the chief executive (CEO) of the company is Owner or relative of the founding family of the company (affiliated) whose shareholding is less than 5%, and 0 otherwise. Data used to the measurement of family ownership can be found in the company’s annual reports and processed by hand collected.
Tax Avoidance \((TA_{it})\) variable is measured with improvements to previous research by measuring tax avoidance using book-tax differences (BTDs) following Tang and Firth models (2008), the most popular tax planning measurement regarding reducing taxes and maximizing time value of money. Data used to the measurement of tax avoidance can be found in the company's financial reports and processed by hand collected.

The control variables used in this research are firm characteristics that viewed based on firm size \((SIZE_{it})\), leverage \((LEV_{it})\), return on asset \((ROA_{it})\), company growth \((GROWTH_{it})\), capital intensity \((CINT_{it})\) and inventory intensity \((INVINT_{it})\). Stickney and McGee (1982) in Phillips (2003) found that capital intensity and inventory intensity had a positive effect on tax avoidance through the acceleration of asset costs based on the economic age of fixed assets. The data used to calculate the various control variables above is contained in the Financial Statement.

4. Results

4.1 Descriptive Statistics

Based on Table 2 illustrates the descriptive statistics showed that book tax differences \((TA_{it})\) of 0.05 with a standard deviation of 0.06. This means that the average manufacturing firms in Indonesia tend to avoid income raising taxes. The amount of compensation management \((KMGT_{it})\) adopted a minimum of 0.17 billion, with a maximum value of 3.31 billion. This indicates that the amount of compensation packages provided by the company is relatively large and varied.

The average family ownership \((DFAMILY_{it})\) of 64% of the total observational sample with a standard deviation of 0.48. This shows that most of the manufacturing companies in Indonesia are the majority of family ownership. The average size of the company \((SIZE_{it})\) of 21.74 trillion with a minimum value of 17.49 trillion and a maximum value of 25.16 trillion with a standard deviation of 1.46 indicates that the size of the company amount is quite varied.

Return on asset \((ROA_{it})\) of the average sample company is 0.08, and it means that the company's profitability level is positive, it shows that the sample company's
performance is quite good. Then the average corporate leverage ratio \((LEV_{it})\) of 0.56 indicates that the proportion of debt is quite balanced with its capital structure, and the company's growth \((GROWTH_{it})\) averages by 0.00 indicating the average of sample firms are barely experiencing growth. Finally, the percentage of inventories intensity \((INVINT_{it})\) and capital intensity \((CINT_{it})\) respectively by 47% and 16% of the assets owned by the company.

Table 2
Descriptive Statistics

<table>
<thead>
<tr>
<th>Dependent and Independent Variable</th>
<th>N</th>
<th>Mean</th>
<th>Median</th>
<th>Maximum</th>
<th>Minimum</th>
<th>Std.Dev</th>
</tr>
</thead>
<tbody>
<tr>
<td>(TA)</td>
<td>268</td>
<td>0.05</td>
<td>0.03</td>
<td>0.49</td>
<td>0.00</td>
<td>0.06</td>
</tr>
<tr>
<td>(KMGT)</td>
<td>268</td>
<td>0.17</td>
<td>0.06</td>
<td>3.31</td>
<td>0.01</td>
<td>0.42</td>
</tr>
<tr>
<td>(DFAMILY)</td>
<td>268</td>
<td>0.64</td>
<td>1.00</td>
<td>1.00</td>
<td>0.00</td>
<td>0.48</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Control Variable</th>
</tr>
</thead>
<tbody>
<tr>
<td>(SIZE)</td>
</tr>
<tr>
<td>(ROA)</td>
</tr>
<tr>
<td>(LEV)</td>
</tr>
<tr>
<td>(GROWTH)</td>
</tr>
<tr>
<td>(CINT)</td>
</tr>
<tr>
<td>(INVINT)</td>
</tr>
</tbody>
</table>

\(TA_{it} = \) Differences in fiscal and commercial income with book-tax differences models, firm \(i\) in year \(t\), \(KMGT_{it} = \) natural logarithm of amount compensation received by the board of directors and board of commissioners firm \(i\) in year \(t\), \(DFAMILY_{it} = 1\) if chief executive (CEO) of the company is Owner or relative of the founding family of the company (affiliated) whose shareholding is less than 5%, and 0 otherwise, \(SIZE_{it} = \) natural logarithm total assets of firm \(i\) in year \(t\), \(ROA_{it} = \) ratio of net income and total assets of firm \(i\) in year \(t\), \(GROWTH_{it} = \) Growth Companies as measured from the market to book ratio of firm \(i\) in year \(t\), \(LEV_{it} = \) ratio of total liabilities and total assets of firm \(i\) in year \(t\), \(CINT_{it} = \) ratio of total fixed assets and total assets of company \(i\) in year \(t\), \(INVINT_{it} = \) ratio of total inventory intensity and total assets of firm \(i\) in year \(t\).

Signs ***, ** and * indicate significance level 0.01, 0.05, and 0.10 (one-tailed)

4.2 Empirical Research Findings

Table 3 shows that hypothesis 1 is accepted, the management compensation variable \((KMGT)\) is significant at the 1% significance level with a negative coefficient of -0.03. These results are consistent with Armstrong \(et\) \(al\). (2012), and Robinson \(et\) \(al\).
(2010) found that management compensation had a negative effect on tax evasion. The evidence shows that higher compensation given to management will further lower tax avoidance. It means that companies in Indonesia tend to be concerned about the legal risks that arise when doing aggressive tax avoidance that companies use the compensation mechanism to close the opportunist decisions in the management of tax evasion so expect the company to avoid risks that may arise in the future.

However, basically, the company is not only responsible for the owner, but also should be responsible to the stakeholders who have an interest in the activities of the company. Therefore, all companies in Indonesia must fulfill their obligations to the government by obediently paying taxes and complying with all applicable rules. In the article 17A and 17B, KUP states that the Directorate General of Taxation (DJP) is obliged to conduct an examination of taxes Nil and tax overpaid companies (tax compensation). Inspections conducted by tax officials are often considered to pose a risk to the company because the examination process will certainly take up a lot of time, cost, energy and not to mention the possibility of the company will be exposed to legal problems if tax fiscal found new evidence that would harm the company. So many companies will still pay taxes even though they are losing money to avoid the inspection process.

Also, hypothesis 2 testing suggests that if there is a representative of the founding family as the company's chief executive, it can strengthen the negative influence of management compensation on tax avoidance. The result in table 3 shows that family ownership variable (DFAMILY) is significant at 1% level, but the positive coefficient is 0.02 with meaning that if family ownerships can weaken the negative effect of management compensation to tax avoidance, so it can be said that hypothesis 2 is rejected.

This result is inconsistent with the findings several prior research such as Baderther et al., (2013) and Chen et al. (2010) state that family firms are less likely to adverse tax avoidance. However, this evidence suggests that family firms are more opportunistic in avoiding taxes (Mills and Newberry, 2001; Hanlon et al., 2005). Fan and Wong (2002) stated that under the weak legal regime conditions that occur in East
Asian countries, family firms are more likely to have poor earnings quality and are not transparent in disclosure of their financial statements. So it can be said that family companies in the region of East Asian countries tend to be more opportunistic to avoid taxes.

In the case of Indonesia, it’s evident that tax avoidance scandals are committed by family firms such as Asian Agri Group and Bumi Resources. Asian Agri Group is a company owned by Tanoto Sukanto family, while Bumi Resources is owned company of Bakrie’s family. Both companies are proven to avoid taxes that could potentially cause state losses of 1.295 trillion and 376 billion rupiahs (Dharmasaputra, 2013).

Finally, Can be said that the weak tax rules in Indonesia open the opportunity for family companies to take advantage of the gap of the tax rules, in addition to the cost of tax avoidance can be quite low compared to the benefits that may result from tax avoidance activities due to lack of oversight of the company, not strictly legal sanctions for Companies that avoid taxes and low awareness of taxpayers to pay taxes. Therefore, it is important for regulators to improve the tax regulation so that the rules are not many loopholes, enforcing strict sanctions on companies that are proven to avoid taxes, and providing education and socialization in generating taxpayer compliance to pay taxes and save the State from the potential loss of tax avoidance.

5. Conclusion, Implication, and Limitation

This study aims to provide empirical evidence related to the effect of management compensation on corporate tax avoidance, then also illustrates how the role of moderation variable of family ownership to the relationship between management compensation and tax avoidance at manufacturing companies listed in Indonesia Stock Exchange (IDX). Based on the test results can be concluded that management compensation can be used by the owners to reduce tax avoidance. If the higher the compensation was given to the management, it could further lower the corporate tax avoidance.

Also, this study proves that if the company is family ownership illustrated by a founding family representative in a key management company will further weaken the
negative influence between management compensation and corporate tax avoidance. This can happen because family firms in Indonesia tend to have a poor quality of profit and not transparent, so it can be a concern for the tax authorities to supervise better the company, especially family companies because it is more likely to do tax evasion.

In this study, there are several limitations of the study to note that further research can fix these limitations. First, this study only measures compensated by the natural logarithm of the total amount of compensation provided to management without considering how the size of the board in a company that can also affect the amount of compensation issued by the company. Second, the measurement of family ownership using dummy variables, the company is assumed as family ownership if the chief executive (CEO) is the owner or relative of the owner, some companies have not so clear the ownership information, consequently the company may not be identified because of the limited information.
Table 3
Results of Hypothesis Testing

<table>
<thead>
<tr>
<th>Independent Variable</th>
<th>Sign</th>
<th>Dependent Variable (TA)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Intercept</td>
<td>0.17***</td>
<td>0.17***</td>
</tr>
<tr>
<td>KMGT</td>
<td>-</td>
<td>(8.20) -0.03***</td>
</tr>
<tr>
<td>KMGT*DFAMILY</td>
<td>-</td>
<td>0.02***</td>
</tr>
<tr>
<td>Variabel Kontrol</td>
<td></td>
<td></td>
</tr>
<tr>
<td>SIZE</td>
<td>-</td>
<td>-0.01***</td>
</tr>
<tr>
<td>ROA</td>
<td>+</td>
<td>0.04*</td>
</tr>
<tr>
<td>LEV</td>
<td>+</td>
<td>0.05***</td>
</tr>
<tr>
<td>GROWTH</td>
<td>-</td>
<td>-0.01</td>
</tr>
<tr>
<td>CINT</td>
<td>+</td>
<td>-0.01</td>
</tr>
<tr>
<td>INVINT</td>
<td>-</td>
<td>-0.05***</td>
</tr>
<tr>
<td>R-squared</td>
<td>0.39</td>
<td></td>
</tr>
<tr>
<td>Adjusted R-squared</td>
<td>0.37</td>
<td></td>
</tr>
<tr>
<td>F-Statistic</td>
<td>20.43</td>
<td></td>
</tr>
<tr>
<td>Prob (F-Stat)</td>
<td>0.00</td>
<td></td>
</tr>
<tr>
<td>Durbin-Watson Stat</td>
<td>1.21</td>
<td></td>
</tr>
<tr>
<td># Observasi</td>
<td>268</td>
<td></td>
</tr>
<tr>
<td># Emiten Manufaktur</td>
<td>67</td>
<td></td>
</tr>
</tbody>
</table>

$TA_{it} =$ Tax avoidance firm $i$ in year $t$ as measured by abnormal BTD, $KMGT_{it} =$ Compensation management firm $i$ in year $t$, $DFAMILY_{it} =$ dummy family ownership firm $i$ in year $t$: 1 if the chief executive (CEO) is the owner or a relative of the family of the founder of the company (affiliated); 0 otherwise, $SIZE_{it} =$ natural logarithm total assets of firm $i$ in year $t$, $ROA_{it} =$ ratio of net income and total assets of firm $i$ in year $t$, $GROWTH_{it} =$ Growth Companies as measured from the market to book ratio of firm $i$ in year $t$, $LEV_{it} =$ ratio of total liabilities and total assets of firm $i$ in year $t$, $CINT_{it} =$ ratio of total fixed assets and total assets of company $i$ in year $t$, dan $INVINT_{it} =$ ratio of of total inventory intensity and total assets of firm $i$ in year $t$. Signs ***, ** and * indicate significance level 0.01, 0.05, and 0.10 (one-tailed).
References


