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Leverage, Political Connections, and Tax Avoidance in the Energy Sector

Salsabila Crysanti Taswa[1]*, Azwir Nasir[1], Lila Anggraini[1]

Affiliation:
[1] Department of Accounting, Faculty of Business & Economy, Riau University, Pekanbaru, Indonesia

***Correspondence:**
salsabila.crysanti4347@student.unri.id

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Abstract:
Research aims:
This study seeks to analyze whether leverage, political connections, and firm size influence tax avoidance behavior among energy sector companies listed on the Indonesia Stock Exchange (IDX) over the 2021–2023 period.
Design/Methodology/Approach:
A quantitative research design is adopted using panel data derived from 37 energy firms, generating 111 firm-year observations. Tax avoidance is proxied by the Cash Effective Tax Rate (CETR). Panel regression analysis is applied to evaluate the association between the explanatory variables and corporate tax avoidance.
Research findings:
The empirical results show that leverage is positively associated with tax avoidance, indicating that firms with higher debt levels tend to engage more actively in tax-reducing strategies. Conversely, political connections and firm size do not exhibit statistically meaningful effects. The explanatory variables account for 15.1% of the variation in tax avoidance, implying that additional factors may also shape corporate tax behavior.
Theoretical contribution/Originality:
This study enriches the agency and political connection literature by offering empirical evidence from a capital-intensive industry context. The findings underscore that financial structure plays a more prominent role in influencing tax avoidance than political affiliation or organizational scale.
Practitioner/Policy implication:
The results suggest that tax authorities and regulators should pay closer attention to firms with high leverage, as debt financing arrangements may systematically create incentives for tax minimization.
Research limitation/Implication:
This study is constrained by a relatively limited observation period and the exclusion of firms reporting losses. Future research may broaden the time horizon and incorporate governance-related variables to provide a more comprehensive understanding of corporate tax avoidance dynamics.

Keywords: Tax Avoidance, Leverage, Political Connection, Company Size

Introduction

Tax revenue constitutes the backbone of fiscal sustainability in many emerging economies, including Indonesia. Beyond serving as a primary source of government financing, taxation plays a broader role in supporting infrastructure development, social protection, public services, and macroeconomic stability. The effectiveness of a country's tax system therefore reflects not only administrative efficiency but also the strength of its governance framework (Farounbi et al., 2020). Despite continuous reforms aimed at improving compliance and enforcement, concerns remain regarding corporate tax behavior, particularly tax avoidance practices that may reduce effective revenue collection

Tax avoidance is commonly defined as the legal reduction of tax liabilities through strategic financial planning and regulatory interpretation (Hanlon & Heitzman, 2010). Although such practices operate within the boundaries of the law, aggressive tax planning can weaken fiscal capacity and create distributive concerns. In Indonesia, the relatively low tax ratio compared to other Asia-Pacific economies suggests structural challenges in compliance and monitoring effectiveness (Rachmania, 2025). These challenges highlight the importance of understanding the firm-level factors that influence tax avoidance decisions.

Prior empirical research has examined several corporate characteristics as determinants of tax avoidance, including leverage, political connections, and firm size. From an agency theory perspective, leverage may incentivize tax minimization due to financial pressure and the availability of interest tax shields (Desai & Dharmapala, 2009;Nabilah & Kuntadi, 2023;Hikmah & Zuraidah, 2025). However, higher debt levels may also intensify external monitoring by creditors, potentially limiting opportunistic behavior. Political connections present a similarly complex relationship. While firms with political ties may benefit from regulatory advantages or enforcement leniency (Faccio, 2006;Heitz et al., 2023;Crane & Koch, 2025), such connections can also increase public scrutiny and reputational risk. Firm size likewise yields mixed evidence, as larger firms possess greater tax planning resources but face stronger oversight and visibility.

Despite extensive investigation, empirical findings remain inconsistent across institutional settings (Duhoon & Singh, 2023). These inconsistencies suggest unresolved theoretical tension between financial incentives explained by agency theory and institutional dynamics highlighted by political connection theory. Moreover, most existing studies rely on heterogeneous multi-sector samples, which may mask industry-specific governance characteristics. Limited attention has been given to how these determinants operate within capital-intensive and strategically regulated sectors in emerging markets.

The energy sector provides a particularly compelling context for examining corporate tax behavior. Energy firms are characterized by substantial capital investment, complex financing structures, and significant regulatory exposure. These features may shape managerial incentives and monitoring mechanisms differently from firms operating in less regulated industries. However, empirical evidence regarding whether traditional firm-level determinants retain explanatory relevance within such environments remains limited. Addressing this gap is important for both theoretical refinement and policy development.

This study therefore investigates the influence of leverage, political connections, and firm size on tax avoidance among Indonesian energy companies listed on the Indonesia Stock Exchange during 2021–2023. By focusing on a capital-intensive strategic industry, this research evaluates the relative strength of financial structure and political affiliation in shaping corporate tax behavior. The study integrates agency and political connection perspectives within a unified analytical framework and provides sector-specific evidence from an emerging market context. Specifically, this research aims to (1) assess the effect of leverage on tax avoidance, (2) examine whether political connections influence tax behavior, and (3) evaluate the role of firm size in determining tax avoidance practices. The findings are expected to contribute to the broader literature on corporate taxation and governance, while offering insights for policymakers seeking to strengthen fiscal oversight in strategically important industries.

Literature Review and Hypothesis Development

Theoretical Framework

This study is grounded in agency theory and the political connection perspective to explain corporate tax avoidance behavior. Agency theory argues that conflicts arise when managers (agents) exercise discretionary authority over financial decisions while shareholders (principals) face information asymmetry and limited monitoring capacity (Jensen & Meckling, 1976). In taxation decisions, managers weigh the trade-off between potential financial benefits from tax minimization and the associated regulatory or reputational risks. Tax avoidance thus reflects managerial responses to financial pressure, monitoring intensity, and institutional constraints (Desai & Dharmapala, 2009 ;Hanlon & Heitzman, 2010).

From this perspective, firm characteristics shape both managerial incentives and monitoring mechanisms. Financial structure influences internal pressure, political embeddedness affects enforcement risk, and organizational scale determines resource capacity and visibility. Therefore, leverage, political connections, and firm size are expected to influence tax avoidance through distinct but interrelated governance channels.

In addition, the political connection perspective suggests that firms embedded in political networks may experience modified regulatory exposure and enforcement intensity (Faccio, 2006). Political ties can provide informational advantages, regulatory flexibility, or informal protection, thereby altering the perceived cost of tax aggressiveness. However, in highly regulated sectors, political affiliation may also increase scrutiny and reputational risk, potentially constraining aggressive tax behavior (Baudot et al., 2020). Together, these theoretical lenses provide a structured explanation of how internal financial incentives and external institutional linkages shape corporate tax behavior.

Leverage and Tax Avoidance

Leverage directly influences managerial financial pressure. Firms with higher debt levels must meet fixed interest obligations, which increases the importance of maintaining liquidity and stable cash flows. Under agency theory, managers facing higher financial pressure may adopt tax minimization strategies to preserve internal funds and improve short-term financial performance (Yahaya, 2026;Mohamad Ariff et al., 2024).

Interest expenses create tax shields that reduce taxable income, thereby lowering effective tax payments. Empirical evidence suggests that debt financing is associated with greater use of tax-reducing mechanisms, particularly in capital-intensive industries (Richardson & Lanis, 2007;Anggraeni & Badjuri, 2025;Sulistiana et al., 2025). As leverage increases, firms face greater financial pressure arising from fixed interest commitments. This heightened pressure strengthens managerial incentives to reduce taxable income through available tax-reduction mechanisms, thereby increasing the likelihood of engaging in tax avoidance.

Although creditor monitoring may constrain managerial opportunism, in industries characterized by high capital requirements, such as the energy sector, the incentive effect of financial pressure often outweighs monitoring discipline. Therefore, leverage is expected to positively influence tax avoidance.

H_1: Leverage has a positive effect on tax avoidance in energy sector companies

Political Connections and Tax Avoidance

Political connections affect corporate behavior by altering regulatory risk perception. Firms with political ties may enjoy preferential treatment, reduced enforcement intensity, or access to strategic policy information (Faccio, 2006). These advantages can reduce the expected cost of aggressive tax planning, thereby increasing managerial willingness to engage in tax avoidance (Lee & Yoon, 2020;Saragih & Ali, 2023).

Political connections may diminish managers' perception of enforcement intensity, leading to a lower expectation of regulatory penalties. As the perceived cost of non-compliance declines, managerial incentives to adopt tax avoidance strategies are likely to increase. Empirical studies find that politically connected firms often exhibit more aggressive tax behavior in environments where institutional enforcement is weak (Baudot et al., 2020;Fan & Chen, 2023).

However, in strategic industries subject to strong public and regulatory oversight, political connections may also increase reputational exposure. Energy firms, due to their strategic importance and public accountability, operate under heightened scrutiny. Thus, political affiliation may either facilitate tax avoidance through protection mechanisms or constrain it due to visibility risks. Given this dual pathway, political connections are expected to significantly influence tax avoidance behavior.

H_2: Political connections affect tax avoidance in energy sector companies

Firm Size and Tax Avoidance

Firm size influences tax avoidance through resource capacity and monitoring exposure. Larger firms typically possess more sophisticated financial expertise, access to professional tax advisors, and the ability to design complex tax planning structures, including cross-border arrangements (Ftouhi & Ghardallou, 2020;Yanney, 2025). This resource-based mechanism suggests that firm size enhances tax planning capability.

However, larger firms are also subject to stronger regulatory oversight, higher media attention, and greater stakeholder scrutiny, which may deter aggressive tax behavior (Baudot et al., 2020; Donelson et al., 2024;He et al., 2023). Therefore, the relationship between firm size and tax avoidance reflects a tension between resource advantage and visibility constraint.

Firm size operates through a dual channel: larger firms benefit from greater financial and professional resources that facilitate complex tax planning strategies, yet they also face heightened regulatory supervision and stakeholder visibility, which may limit the extent of tax avoidance. In highly regulated sectors such as energy, where firms are strategically important and publicly visible, the net effect becomes an empirical question. Accordingly, firm size is expected to significantly influence tax avoidance behavior.

H3: Firm size affects tax avoidance in energy sector companies.

Research Method

Population, Sample and Data

This study employs a quantitative research design using secondary data obtained from the annual financial reports of energy sector companies listed on the Indonesia Stock Exchange (IDX) for the period 2021–2023. The use of archival financial statement data is common in

empirical tax avoidance research, as it ensures objectivity and comparability across firms (Hanlon & Heitzman, 2010). The unit of analysis is firm-year observations, resulting in a balanced panel dataset that captures both cross-sectional and time-series variation (Wooldridge, 2013).

The initial population consisted of 90 energy sector firms listed on the IDX during the observation period. Sample selection was conducted based on data availability and reporting consistency to ensure reliable and comparable financial information (Gujarati & Porter, 2010). Firms were excluded if they did not publish complete annual financial statements during the study period. Additionally, firms reporting negative pre-tax income were excluded because the measurement of tax avoidance using the Cash Effective Tax Rate (CETR) may generate extreme or economically meaningless values when earnings are negative (Dyreng et al., 2008;Hanlon & Heitzman, 2010).

After applying these criteria, 37 firms were retained, resulting in 111 firm-year observations (37 firms × 3 years). The final sample provides adequate cross-sectional and longitudinal variation to estimate panel regression models and examine the determinants of tax avoidance behavior (Baltagi, 2008).

Operational Definition and Measurement of Variabel

To ensure consistency in empirical analysis, each variable is operationalized using established measures from prior literature. Tax avoidance, leverage, political connections, and firm size are measured using financial data derived from audited annual reports. Table 1 presents the operational definitions and measurement formulas for each variable.

Table 1. Operational Definition and Measurement of Variable

No	Variables	Operational Definition	Measurementof Variables
1	Tax Avoidance	Tax avoidance is a legal effort by companies to minimize their tax burden (Hanlon & Heitzman, 2010)	CETR = $\frac{\text{Tax Payment}}{\text{Profit before Tax}}$
	Leverage	Leverage reflects the proportion of a company's funding that comes from debt compared to total assets or equity (Brigham & Houston, 2014)	DER = $\frac{\text{Total Liabilities}}{\text{Total Equity}}$
3	Political Connection	Political connection refers to the relationship between a company and individuals who hold political office (Faccio, 2006).	Political connections are measured using a dummy variable: 1 if the company has commissioners/directors with a political background; 0 if not.
4	Firm Size	Company size indicates the scale of the company's operations. Based on Political Cost Theory, large companies have high public exposure (Shavell, 2005).	$Firm\ Size = Log\ n\ (Total\ Assets)$

Model and data Analysis Technique

This study uses multiple linear regression testing with the aim of testing the hypothesis of the effect of independent variables on dependent variables. (Sugiyono, 2018) state that multiple linear regression means that in a regression equation there is one dependent variable and more than one independent variable. This analysis was conducted using the Statistical Package for Social Sciences (SPSS) computer program.

$$Y=\alpha+\beta_1X_1+\beta_2X_2+\beta_3X_3+\varepsilon \qquad (1)$$

Y = Dependent Variable / Tax Avoidance
α = Constant Value
β_1,β_2,β_3 = Regression Coefficients of Each Independent Variable
X_1 = Leverage
X_2 = Political Connection
X_3 = Firm Size
ε = Standard Error

Result and Discussion

Results of Descriptive Statistics

In quantitative research, statistical analysis tests are an important stage used to process data so that it can provide an overview of the relationship between the variables being studied. Statistical analysis not only functions as a calculation tool, but also as a scientific basis for drawing conclusions. Through this test, researchers can assess whether the proposed hypothesis is proven or not, as well as determine how strong the influence of the independent variable is on the dependent variable. Thus, the main objective of statistical analysis is to provide research results that are objective, valid, and scientifically accountable. Through descriptive analysis, basic information about the data used can be obtained, such as the amount of data, maximum value, minimum value, mean value, and data distribution as shown by the standard deviation value. Table 2 below shows the results of descriptive statistical analysis of the variables of leverage, political connections, company size, and tax avoidance.

Table 2. Descriptive Statistics Test Result

	N	Minimum	Maximum	Mean	Std. Deviation
Leverage	111	.06	10.70	1.2896	1.55909
Firm Size	111	8.00	14.00	12.0631	1.42879
Tax Avoidance	111	.01	8.09	.4110	.95957
Valid N (listwise)	111				

Source: SPSS 25 Output (Processed Data, 2025)

Table 2 presents the descriptive statistics of leverage, firm size, and tax avoidance based on 111 firm-year observations. Leverage shows a mean value of 1.2896, with a minimum of 0.06 and a maximum of 10.70, indicating substantial variation in capital structure across energy firms. The relatively high standard deviation (1.55909) suggests considerable heterogeneity in debt

utilization. The maximum value implies that certain firms rely heavily on debt financing, potentially intensifying financial pressure and influencing managerial decisions related to tax planning.

Firm size has a mean of 12.0631, ranging from 8.00 to 14.00, with a standard deviation of 1.42879. The moderate dispersion indicates variability in organizational scale within the energy sector while maintaining comparability across firms. This variation supports the examination of whether firm scale affects tax planning capacity and monitoring intensity.

Tax avoidance, measured using CETR, exhibits a mean of 0.4110, with values ranging from 0.01 to 8.09 and a standard deviation of 0.95957. The wide range reflects significant differences in effective tax payments among firms and across years. The presence of relatively low values suggests instances of more aggressive tax minimization, whereas higher values may indicate more conservative tax compliance or structural differences in taxable income. Overall, the dispersion across variables demonstrates sufficient variability to support subsequent panel regression analysis.

Following the descriptive statistics of the continuous variables, Table 3 presents the frequency distribution of the political connection variable, which is measured as a binary indicator.

Table 3. Distribution of Political Connections

		Frequency	Percent	Valid Percent	Cumulative Percent
Valid	.00	61	55.0	55.0	55.0
	1.00	50	45.0	45.0	100.0
	Total	111	100.0	100.0	

Source: SPSS 25 Output (Processed Data, 2025)

Following the descriptive statistics of continuous variables, Table 3 presents the frequency distribution of the political connection variable. Of the 111 firm-year observations, 61 observations (55%) represent firms without political connections, while 50 observations (45%) represent politically connected firms.

The relatively balanced distribution indicates that political connections are common within the energy sector, providing sufficient variation to examine their influence on tax avoidance. This proportion supports the relevance of political embeddedness as a meaningful institutional factor in the empirical analysis.

Diagnostic Tests of the Regression Model

Prior to estimating the regression model, a series of diagnostic tests were conducted to ensure compliance with classical linear regression assumptions. The initial Kolmogorov–Smirnov test indicated non-normal residuals ($p < 0.05$); however, after transformation, the residuals satisfied the normality assumption ($p > 0.05$). Although normality is not strictly required in large samples due to asymptotic properties, ensuring approximately normal residuals improves inference reliability (Gujarati & Porter, 2010).

Multicollinearity was assessed using tolerance and Variance Inflation Factor (VIF) statistics. All VIF values were close to 1 and well below the conventional cut-off threshold, indicating that collinearity among explanatory variables is not a concern (Hair et al., 2019).

Autocorrelation was examined using the Durbin–Watson statistic, which yielded a value close to 2, suggesting the absence of serial correlation in the residuals (Wooldridge, 2010). Heteroscedasticity was evaluated through graphical inspection and the Glejser test. The absence of systematic residual patterns and statistically insignificant coefficients in the Glejser regression indicate homoscedastic error variance. Collectively, these diagnostic results confirm that the model satisfies key regression assumptions, supporting the robustness and reliability of subsequent hypothesis testing.

Model Goodness of Fit

The model explains approximately 15.1% of the variation in tax avoidance, as indicated by the Adjusted R^2 value of 0.151. This suggests that leverage, political connections, and firm size provide limited but meaningful explanatory power. In firm-level tax research, modest R^2 values are common due to the influence of multiple economic and institutional factors beyond those included in the model (Hanlon & Heitzman, 2010;Wooldridge, 2010). The remaining variation may be driven by other determinants not examined in this study.

Regression Results and Hypothesis Testing

The empirical model was estimated using multiple linear regression to assess the influence of leverage, political connections, and firm size on tax avoidance. Table 4 reports the regression coefficients and statistical significance of each explanatory variable.

The regression results indicate that leverage has a positive and statistically significant effect on tax avoidance ($\beta = 0.261$; $t = 4.529$; $p < 0.01$). The positive coefficient suggests that higher levels of debt are associated with increased tax avoidance behavior. This finding supports **H1**, indicating that financial leverage strengthens managerial incentives to reduce taxable income, consistent with agency-based arguments that financial pressure encourages tax minimization strategies.

Table 4. Multiple Linear Regression Test Result

Coefficients[a]

Model		Unstandardized Coefficients		Standardized Coefficients		
		B	Std. Error	Beta	t	Sig.
1	(Constant)	-1.479	.779		-1.899	.060
	Leverage	.261	.058	.404	4.529	.000
	Political Connection	-.046	.181	-.023	-.254	.800
	Firm Size	-.031	.064	-.045	-.490	.625

a. Dependent Variable: Ln_CETR

Source: SPSS 25 Output (Processed Data, 2025)

In contrast, political connection does not exhibit a statistically significant effect on tax avoidance ($\beta = -0.046$; $t = -0.254$; $p = 0.800$). The insignificant coefficient suggests that

politically connected firms in the energy sector do not systematically differ in their tax avoidance behavior compared to non-connected firms. Therefore, **H2 is not supported**. This result may imply that regulatory scrutiny or reputational exposure offsets any potential advantages derived from political ties.

Similarly, firm size does not show a significant relationship with tax avoidance ($\beta = -0.031$; $t = -0.490$; $p = 0.625$). Although the coefficient is negative, indicating that larger firms tend to exhibit slightly lower tax avoidance, the effect is statistically insignificant. Thus, **H3 is not supported**. This finding suggests that in the energy sector, firm scale alone does not determine tax planning aggressiveness, possibly due to countervailing forces between greater tax planning capacity and stronger external oversight.

Discussion

This study examines whether leverage, political connections, and firm size determine tax avoidance behavior in energy sector firms. The findings provide differentiated insights: leverage significantly influences tax avoidance, whereas political connections and firm size do not. These results refine the understanding of how internal financial incentives and institutional factors interact in shaping corporate tax strategies.

The significant effect of leverage reinforces agency-based explanations that financial structure alters managerial incentives (Jensen & Meckling, 1976). Debt financing increases fixed obligations and heightens liquidity pressure, thereby encouraging managers to optimize after-tax cash flows. Interest deductibility mechanisms embedded in tax systems create structural incentives for debt-based financing, which may systematically reduce effective tax payments (Desai & Dharmapala, 2009). In capital-intensive industries such as energy, where external financing is common, tax planning becomes closely intertwined with capital structure decisions. This finding aligns with international evidence suggesting that highly leveraged firms tend to engage more actively in tax minimization strategies (Richardson & Lanis, 2007; Taylor & Richardson, 2014).

More importantly, the result highlights that tax avoidance in this sector may be driven less by opportunistic governance behavior and more by structural financial incentives. In other words, leverage appears to operate as an embedded institutional mechanism within the tax system itself, rather than solely as a discretionary managerial choice.

In contrast, political connections do not significantly influence tax avoidance behavior.This finding nuances prior studies that suggest politically connected firms may benefit from regulatory advantages or enforcement leniency (Faccio, 2006; Kim & Zhang, 2016). The absence of a significant effect in this context suggests that political embeddedness does not automatically translate into tax aggressiveness. One plausible explanation is the institutional environment of the energy sector in Indonesia, which is characterized by strong regulatory oversight and public sensitivity due to its strategic economic role. Political visibility may increase reputational and monitoring pressure rather than reduce enforcement risk. This implies that institutional scrutiny can mitigate the potential advantages of political ties in taxation matters.

Similarly, firm size does not significantly affect tax avoidance. Theoretically, firm size operates through competing mechanisms. Larger firms possess greater financial and professional

resources that may facilitate sophisticated tax planning (Hanlon & Heitzman, 2010). However, they also face stronger monitoring from regulators, auditors, investors, and the public, which increases reputational risk and limits aggressive behavior (Watts & Zimmerman, 1986) (Zimmerman, 1983). The insignificance of firm size suggests that these opposing effects offset one another within the energy sector context. This finding contributes to the ongoing debate by indicating that organizational scale alone does not determine tax aggressiveness when institutional monitoring is substantial.

Collectively, the results demonstrate that internal financial incentives particularly those arising from leverage are more decisive in explaining tax avoidance than political affiliation or firm magnitude. In the Indonesian energy sector, regulatory enforcement and institutional scrutiny appear sufficiently robust to neutralize political influence and size-related resource advantages. Consequently, tax avoidance behavior seems primarily embedded in capital structure dynamics rather than governance privilege.

From a broader governance perspective, these findings imply that effective tax regulation in capital-intensive industries requires closer attention to financial structure incentives embedded in fiscal policy design. Limiting excessive interest deductibility and strengthening thin capitalization rules may be more effective than focusing solely on political affiliation or firm classification. The study thus bridges agency theory and institutional considerations by demonstrating that structural financial pressures can outweigh political embeddedness in shaping corporate tax outcomes.

Conclusion

This study investigates the influence of leverage, political connections, and firm size on tax avoidance in energy sector companies. The results reveal that leverage is the only significant determinant of tax avoidance, while political connections and firm size do not exhibit measurable effects.

These findings suggest that tax avoidance in the energy sector is primarily associated with financial structure rather than political embeddedness or organizational scale. The study contributes to the literature by highlighting the dominant role of debt-related incentives in shaping corporate tax behavior within capital-intensive industries.

From a policy standpoint, the results emphasize the importance of evaluating interest deductibility provisions and leverage-related tax incentives to prevent excessive erosion of the corporate tax base. Regulatory focus may be more effective when directed toward financial risk indicators rather than firm size or political affiliation.

This study is limited by its focus on a single sector and a relatively short observation period. Future research may incorporate additional governance variables, extend the time horizon, and examine cross-sectoral comparisons to provide a more comprehensive understanding of corporate tax behavior.

Conflicts Of Interest

The authors declare no conflict of interest. The funders had no role in the design of the study; in the collection, analyses, or interpretation of data; in the writing of the manuscript, or in the decision to publish the results.

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