

# The Effect of Government Effectiveness, Rule of Law and Control of Corruption Toward Tax Obedience

Marselina, Tri Joko Prasetyo  
University of Lampung , Indonesia

**Abstract:** This study examined the effect of government effectiveness, rule of law and control of corruption on tax obedience. Tax obedience will increase when society trust on government. The trust these good governance government is implemented. variables ax revenue. In recent years, good government governance is the main reason and measurement for society to pay tax. The purpose of the paper is to investigate the relationship between government effectiveness, rule of law and control of corruption as a set of good government governance and tax obedience, using data from 30 countries since 2002-2014. The empirical analysis applies panel data methodology to provide this relationship. Using fixed effect model, there was found evidence that rule of law and control of corruption significantly affect tax obedience. However, government effectiveness is not significantly effect on tax obedience

## INTRODUCTION

Tax become crucial economic tools for any country, but most of tax research focus on macro-economic perspective such as income , rate of tax, the number of tax objection, inflation, economic potential (Koch, SF, Schoeman, and Tonder (2005), Greenidge (2009), Karras, G (2009), Romer, et all (2010), Takumah (2014), Dackehag, M (2012). A few studies of tax is investigated from a government governance perspective. Good governance government is needed to get people trust. Good governance govermentis implemented by enforcing transparency, accountability in managing public funds. This commitment has a positive impact toward the level of people trust, including tax paying obedience. Good government governance is now required for many countries as the requirement in providing fund and facilities (Santiso, 2001. Good governance is a requirement for an economic development in a country (Riddell, 2009) and as a reflection of the government's performance to build democracy through transparency, accountability, openness and public participation (Kosac and Fung, 2014). It is interesting to investigate, the influence of the governance government practice to tax obedience. If people believe and satisfied with government from provision of infrastructure and other quality goods, fair law enforcement and efforts to respect the action against corruption , it will encourage people to pay the tax.

This study aims to convince and provide empirical evidence of the effect of government effectiveness, the rule of law and control of corruption on tax payments, in some countries. Tax .

obedience is reflected in increased tax revenues. In the concept of state finance, the effectiveness of tax revenue can be measured by tax ratio that is share of tax revenue to GDP.

## Good Governance Government

According to UNDP (2016), good governance has six principles, namely legitimacy, rights of opinion, transparency and accountability, performance and fairness. The framework whereby all agents, both private, NGO and all citizens can play an active role in development then encourage the growth of business and public trust. According to Kaufmann , Kraay and Matruzzi (2009) good government governance has some dimensions, government effectiveness, rule of law and control of corruption.

## Government Effectiveness

It reflects perceptions of the quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies (world bank). According Australian Taxation Office (1997), the heart of the tax reform strategies was building of tax official to be professional, responsive, fair, open, and accountable. These strategies in helping to increase public trust, respect and support all government program. Well-working government that promote and maintenance peace, provide public goods and tranquility are costly and taxes are the customary means by which public pay to obtain these services, and it comes from taxes

## The Rule of Law

It reflects perceptions of the extent to which agents have confidence in and abide by the rules of society, and in particular the quality of contract enforcement, property rights, the police, and the courts, as well as the likelihood of crime and violence (world bank) Rule of Law will provide positive energy for the climate of business, it will encourages investors to continue investing (Dickinson (2010))

### **Control of Corruption**

It reflects perceptions of the extent to which public power is exercised for private gain, including both petty and grand forms of corruption, as well as "capture" of the state by elites and private interests (world bank). Corruption becomes a threat to the state and prohibitive of the efficient operation of the market. Institutional corruption is not unique to many developing countries and this phenomenon is widespread in tax and customs administration The government's commitment to eradicate corruption is expected to affect tax payers' obedience. Various policies and efforts made by the government to overcome tax leaks. Commitment to eradicate corruption becomes a major energy for investment, especially foreign investment. The aspects of corruption influence on tax revenues are examined by Ahsan and Wu (2005), Imam and Jacobs (2007), Gupta (2007), Bird, Vaquez and Torgler (2008), Mukhlis, Sugeng and Yuli (2014) to Syadulah and Wibowo (2015) found that corruption control efforts had a positive effect on tax revenues. Corruption reduces tax revenues (Abed and Gupta: 2002).

## **METHODOLOGY**

### **Data Collection .**

Kaufmann, Kraay and Mastruzzi (2009) states that Worldwide Governance Indicators (WGI) and World Development Indicators (WDI) provide comprehensive index data on governance processes, ranging from government capacity to implement effective policies, citizenship and institutions to government rules, as well as state control over acts of corruption such as using power for private concern through elite and private roles. Arndt and Oman (2006), WDI and WGI are set comprehensive measurement to measure the implementation of good corporate governance in countries. WGI and WDI published by World Bank covers many countries. Some of the indexes presented by WGI and WDI are government effectiveness index, rule of law index, and the control of corruption index. As a sample countries, this study using 30 countries with surveyed by WDI and WGI since 2002 to 2014.

## **Hypotheses Development**

### **Effect Government Effectiveness on Tax Obedience**

According to Kaufmann, Krayy and Mastruzzi (2009), government effectiveness is the ability of government to provide public goods and also its ability to apply policy well. Good governance is also supported by a consistently run system. If public appreciates with the public goods which is provided by the government from the taxes its pays, it increase their trust. Public believe that taxes are needed to finance the provision of these public goods (Fjeldsad, 2001).

$H_0(1)$  = The higher the index of government effectiveness, the higher the obedience of paying taxes, where tax compliance is proxied with tax effort

### **Effect Rule of Law on Tax Obedience**

Benno (2003) found that trust and legal certainty have positive effect on tax moral. The higher of rule of law index, the higher tax revenue. The Spanish Government approved the Royal Decree-Law that introduces rules and announced the start of the parliamentary process to aim at increasing tax revenues.

$H_0(2)$  = The higher the index of rule of law, the higher the obedience of paying taxes, where tax compliance is proxied with tax effort

### **Effect of Control of Corruption on Tax Obedience**

Control of corruption is the government's reward for eradicating corruption. In tax matters, because there is a fairly intense interaction between taxpayers and tax officials, the chances for corruption will be high (Imam P and Devina: 2007). The interaction was quite intensive, starting from the calculation of the tax burden to the tax payments. Corruption will degrade the motivation to pay taxes and impede investment, business barriers, high-cost production processes. Therefore, the extent to which governments can control corruption, will be a reflection of the people paying taxes.

$H_0(3)$  = The higher the index of control of corruption, the higher the obedience of paying taxes, where tax compliance is proxied with tax ratio

### **Structural Model::**

$$TR_{it} = \alpha + \beta_1 GE_{it} + \beta_2 CC_{it} + \beta_3 RL_{it} + e_{it}$$

in which, TR = Tax Ratio, GE = government effectiveness, CC = control of corruption, RL = rule of law,  $\beta_i$  = coefficients determination,  $\alpha$  = intercept, i = period, t = country sample (i).

This study used panel data analysis, in which panel data is to combine cross sectional data and time series data (Verbeck, 2004), and able to control the heterogeneity of the individual (Firdaus, M: 2012). Nachrowi and Usman (2006) stated that in estimating panel data, some regression techniques can be used, namely Fixed Effect ModRandom EffectModel (REM).

**Fixed Effect Model (FEM).** FEM arises when there is a correlation between individual effects and explanatory variables with  $X_{it}$  or error component

( $e_{it}$ ) containing individual effects and explanatory

variables being part of the intercept. The FEM estimator can be calculated by 3 approaches: Pooled Least Square (PLS), Within Group and Least Square Duy Variable (LSDV) or using pooled so that there are N x T observations, with the following model:

$$\bar{y}_{it} = \alpha_i + X_{it}\beta + \mu_{it}$$

The weakness of this PLS model is that the parameters can be biased because this approach can not distinguish different observations over the same period, or can not distinguish the same observations at different periods. Because of the weakness of this PLS approach, this method is less appropriate if used.

**Random Effects Model (REM).** The REM model is chosen when there is no correlation between individual effects and regressors. This assumption makes the error component of the individual effects and the time effects included in the error or the expected value of  $x_{it}$  for each t = 0 or  $E(t, x_{it}) = 0$  (Firdaus, 2012) There are three approaches for calculating REM estimators: (1) Generalized Least Square (GLS), (2) Between Estimator, (3) Hausmann Test, but the most widely used is the Hausmaan Test. According to Nacrowi and Usman (2006), to obtain the best model of the two alternative models can be used the test stages, namely Chow Test and Hausmann Test.

### Chow Test

Chow test is used to identify the best model between FEM and Common Effect with compare value of F test. If cross section F- value > 0,05 we select common effect, but if cross section F- value < 0,05, Fixed Effect Model (FEM) is the best model and we used it. In this study we used FEM because cross section F-value 0000 < 0.05.

Hypothesis:

$H_0$ : Common Effect

$H_a$ : Fixed Effect

Criteria:

Chi-square calculate < Chi-square critical = Accept  $H_0$ , If Chi-square calculate > Chi-square critical = Reject  $H_0$ , Accept  $H_a$

### Hausmann Test .

To determine whether a suitable FEM or REM model is performed Hausmann Test. This test is done to find out whether or not there is correlation between regressors with individual effects, by the formula:

$H_0 : E(\tau_i x_{it}) = 0$  or REM is the right model

$H_1 : E(\tau_i x_{it}) \neq 0$  or FEM is the right model

Basic rejection of the hypothesis by comparing Hausmann stat (H) with Chi Square ( $X^2$ ).  $H_0$  is rejected if H test >  $X^2$  table, means the exact model is FEM, and vice versa. From Chow Test and Hausman Test, on Chow Test, it was found that the FEM model is more appropriate to use than the CEM (Chow Test) model. While Hausmann Test and REM models are more appropriate to use than the FEM model. So the conclusion is that the FEM is the most appropriate model to be used in this research.

## RESULT

### Chow Test

Based on Table 1, Chow-test, it shows that  $H_0$  is rejected. It means Fixed Effect Model (FEM) is the best model that can be used in other regression on the next panel data.

Table 1. Chow Test

Effects Test	Statistic	d.f.	Prob.
Cross-section F	201.802990	(29,117)	0.0000
Cross-section Chi-square	589.831318	29	0.0000

**Hausman Test**

Based on Table, Hausman Test, it shows that p-value = 1.0000 so Cross section test variance is invalid, Hausman statistic set to zero. This indicates that the Random Effect Model (REM) is not appropriately used in this model. Thus, the appropriate model to be used in the next experiment is FEM.

Table 2. Hausman Test

Test Summary	Chi-Sq. Statistic	Chi-Sq. d.f.	Prob.
Cross-section random	0.000000	2810	1.0000

\*Cross-section test variance is invalid. Hausman statistic set to zero.

Assuming that Fixed Effect Model (FEM) model is a model that can be used to process the next regression, then based on the analysis results obtained the following results.

**FEM Model**

Table 3. FEM Model

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	18.46913	0.221977	83.20290	0.0000
LAW	2.415303	0.693429	3.483131	0.0007
GOV	0.577942	0.584640	0.988544	0.3249
CORUPT	0.295427	0.037254	7.930089	0.0000

$$TR = 18,46 + 2,41 Law + 0,57 Gov + 0,29 Corruption$$

The study show that government effectiveness, rule of law and control of corruption all together with, have an effect on tax obedience This result is also supported by Bird, Vasquez (2008). However, as we are done partial analysis, only rule of law and control of corruption have an effect on tax compliance. However, government effectiveness, partially, has no effect on tax obedience.

**DISCUSSION**

The role of government effectiveness no longer has much influence when the system in a country already exists and runs well. The function and role of government only regulate and coordinate the activities and interests that exist. Governance effectiveness is needed for developing countries, but for developed countries, where the system runs well including legal sanctions is not too important. Taxes should still be paid as a liability. The existence of sanctions and the nature of tax binding is, then the tax attenuation still increases any form of government effectiveness. Syadullah and Wibowo

(2015) support this study. that public is sure that providing public goods is the main task of government, so the observance of paying taxes is not influenced by the effectiveness of government, but it is obligatory.

The rule of law effects on the tax obedience. Taxes are the obligations of citizens who have clear legal sanctions. The better the rules of law in a country, including the practice, the sanctions, the tax payer obedience increases. This result is also supported by Benno (2005), that trust and legal certainty have positive effect on tax moral. Higher of rule of law index, the higher tax revenue. It is also practiced in Spain that implements the Royal Decree-Law to aim at increasing tax revenues.

Corruption raises people's disbelief. Public obedience paying taxes decreases when the public feels the tax is being misappropriated. Control of corruption has significantly positive effect on tax ratio. This result, is also supported by Ahsan dan Wu (2005), Faslan (2017) The opportunity of corruption is quite large in the country in which the system is not running well. Taxes payers requires frequent interaction to tax authority. Imam and Davina (2007) suggest that buiding system which is reducing face-to-face contacts between tax payers and tax officials. Reduce the interaction through online payments, strengthening the internal control system of the tax office, making the standard operational procedure (SOP) of calculation, payment and complaint which are clear and transparant.

**Cross Section Effect**

Based on Table 4, from 30 countries samples, there are 19 countries have tax ratio upper than on tax ratio on the average if government effectiveness, rule of law and control of corruption are remains constant. These are developed countries such as Denmark, Argentina, Finlandia , Australia, Sweden , Norwegia, Portugal, except Brazil is developing country. 11 countries, have tax ratio under the tax ratio on average. Surprisingly, Singapore has the highest downturn in tax ratio if good governance government is not implemented well.. Most the countries from the ASEAN.

Table 3. Cross Section Effect

ARGENTINA	11.95736
AUSTRALIA	2.859097
BELANDA	-2.301787
BRAZIL	12.74347
CAMBODIA	-4.463325
CANADA	1.774508
CENTRALAFRICA	-6.961895
CHINA	0.247519
COLOMBIA	1.111281
DENMARK	22.45246
EGYP	-3.751353
FINLANDIA	5.154351
GHANA	-4.189950
INDIA	-2.171554
INDONESIA	-5.486718
KAMERUN	-3.138235
MALAYSIA	-6.058440
MEXICO	-1.830503
NIGERIA	-1.227471
NORWEGIA	6.576019
PHILIPINA	-3.915144
POLANDIA	-1.032845
PORTUGAL	1.836368
SINGAPORE	-10.95169
SLOWAKIA	-3.995694
SPAIN	-1.304415
SUDAN	-9.038916
SURINAME	-1.154777
SWEDIA	7.784390
THAILAND	-1.522116

### CONCLUSION

Rule of law and control of corruption have an effect on tax obedience which is measured by tax ratio but government effectiveness is not significantly effect . Rule of Law has biggest effect on tax obedience .There are 19 countries have tax ratio upper on the average, there are 11 countries have under the average, if all the independent variable (good governance government) are remains constant. The rule of law and control of corruption is kept and consistent to implement in order to encourage public trust especially in tax paying

### REFERENCES

1. Abed, T. Goerge and Sanjeev Gupta. 2002. Governance, Corruption and Economic Performance. IMF
2. Arndt, C. and Oman, Charles. 2006. Uses and Abuse of Governance Indicators. Development Centre Studies .OECD Publishing.
3. Benno , T. 2003. To Evade Taxes or Not To Evade: That is the Question: *Journal of Socio- Economics*.pp 283-302.
4. Bird, Richard and Jorge Martinez Vasquez and Benno Torgler .2008. Tax Effort in Developing Countries and High Income Countries: The Impact of Corruption ,Voice and Accountability. *Economic Analysis and Policy*. 38 (1): 55-71.
5. Dickinson, Ben. 2010. Tax and Good Governance. *OECD Journal: General Papers*.
6. Faslan S. 2017., Analisis Pengaruh Tata Kelola Peerintahan yang Baik Terhadap Tingkat Ketaatan Membayar Pajak. Thesis. Thesis Unila
7. Firdaus,M, 2011. Aplikasi Ekonometrika Untuk Data panel dan Time Series.IPB Press.
8. Fjeldstad,O.H.2001. Taxation, Coercion and Donors: Local Government tax Enforcement in Tanzania. *The Journal of Modern African Studies* (39). pp 289-306
9. Ghura, Dhaneshwar. 1988. Tax Revenue in Sub Sabara Africa: Effects of Economic Policies and Corruption. IMF Working Paper 135.
10. Greenidge, Kevin and Lisa Drakes. 2009. Tax Policy and Macroeconomic Activity in Barbados.
11. Gupta,S. 2007.Determinants of Tax Revenue Efforts in Developing Countries. IMF Working Paper.184
12. Imam, Patrick and Davina F, Jacobs. 2007. Effect of Corruption on Tax Revenues in the Middle East.IMF Working Paper. WP/07/ 270
13. Karras, G., & Furceri, D. 2009. Taxes and growth in Europe. South-Eastern Europe *Journal of Economics* , 2,pp 181-204.
14. Kaufman,D.A, Kraay and Mastruzzi, 2009. Governance matters VIII: Governance Indicators for 1996-2002, WB Policy Research Working Paper 4978
15. Koch, S. F., Schoeman, N. J., & Tonder, J. J. 2005. Economic growth and the structure of taxes in South Africa: 1960-2002. *South African Journal of Economics* , 73, 190-210.
16. Kosack,S., and Fung,A. 2014. Does Transparency Improve Governance

- Indicators: *The Annual Review of Political Sciences* 17. pp 65-87.
17. Nachrowi,N., and Usman H,. 2006. Pendekatan Populer dan Praktis Ekonometrika Untuk Analisis Ekonomi dan Keuangan. LPFE-UI. Jakarta.
  18. Santiso,C. 2001. Good Governance and Ad Effectiveness: The World Bank and Conditionality. *The Georgetown Public Policy review*.63 (2).134-139
  19. Syadullah, Makmun and Tri Wibowo. 2015. Governemnt and Tax reform in ASEANCountries. *Journal of Social and Development Sciences* 6 (2).pp
  20. Takumah, Wisdom . 2014. Tax Revenue and Economic Growth in Ghana: A Cointegration Approach.
  21. UNDP. 2016.
  22. Verbeek. M. 2008. A Guide to Modern Econometrics. Third Edition. Jhon Wiley and Sons.