Tax, governance and administration: Challenges and opportunities in China, Indonesia and Thailand

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1. Introduction

This paper considers issues related to tax, governance and administration through an analysis of aspects of the Chinese, Indonesian and Thai tax systems. It does this in the context of exploring some of the tax challenges and the opportunities that face such rapidly developing countries. The three countries examined in this paper are in many ways typical of others in the ASEAN region and in the broader community of developing nations, notwithstanding their socio-cultural, economic and political diversity. It is argued that key lessons can be learned from scrutiny of tax, governance and administration in these three countries.

The tax system is a critical component in the governance and legitimacy of any nation, and in turn governance and legitimacy are essential to guarantee rule compliance.[1] The purposes of the tax systems in China, Indonesia and Thailand are, rather obviously, no different from the purposes of most tax systems, whether in developed or in developing nations.[2] In the first place they are clearly there to raise sufficient revenue to permit their governments to discharge their many spending responsibilities, whether on development, social welfare, education, defence, infrastructure building or whatever else. But tax systems are much more than simply revenue raising mechanisms. They also have a role to play in tackling income inequality, fostering economic growth and well-being and in building state legitimacy.

Indeed, tax systems are a fundamental component of any attempt to build nations. As Brautigam has noted, "(t)axes underwrite the capacity of states to carry out their goals; they form one of the central arenas for the conduct of state-society relations, and they shape the balance between accumulation and redistribution that gives states their social character".[3] In short, taxes build capacity (to provide security, meet basic needs or foster economic development) and they build legitimacy and consent (helping to create consensual, accountable and representative government).[4]

The aim of this paper is therefore to consider aspects of the complex inter-relationships of tax, governance and administration in order to establish how China, Indonesia and Thailand are performing in these areas and to identify what other

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[1] Tom Tyler, *Why People Obey the Law*, (1990) New Haven, Yale.

[2] The distinction between developed and developing countries is entirely arbitrary and masks a degree of complexity in classification which is beyond the scope of this paper.

[3] Deborah Brautigam, 'Introduction: Taxation and State-Building in Developing Countries', in Deborah Brautigam, Odd-Helge Fjeldstad and Mick Moore (Eds) *Taxation and State-Building in Developing Countries: Capacity and Consent*, (2008) Cambridge University Press, Cambridge 1-33, 1.

[4] Margaret McKerchar and Chris Evans, 'Sustaining growth in developing economies through improved taxpayer compliance: Challenges for policy makers and revenue authorities', (2009) 7(2) e*Journal of Tax Research* 171-201, 171.

ASEAN and similar developing nations might learn from the experiences in the three countries under consideration.

The paper is structured as follows. Section 2 expands upon the critical role that taxation plays and shows, in the three countries, how its revenue contributes to GDP and also how it relates to the level of tax effort or capacity. This analysis forms the basis for the development of a series of key challenges relating, inter alia, to institutional quality and tax administration. Section 3 then discusses governance issues, including aspects of institutional quality, in broad terms and then more specifically in relation to the effectiveness of government and the control of corruption, again with particular reference to the three countries that are the focus of this paper. Section 4 then considers aspects of the efficiency and effectiveness of tax administration in China, Indonesia and Thailand, contrasting the experiences in those countries with performance in the broader ASEAN region and in the OECD. Concluding comments, including identification of the challenges that confront countries such as China, Indonesia and Thailand along with the opportunities that may be available, are contained in Section 5.

2. Tax revenue and tax effort

The first section of this paper has made it clear that taxes matter, both in the amounts they raise and in the manner in which they are administered. Their critical revenue raising importance, on a comparative basis, can be ascertained by reference to two concepts: tax revenue and tax effort (or capacity), each of which is considered in turn.

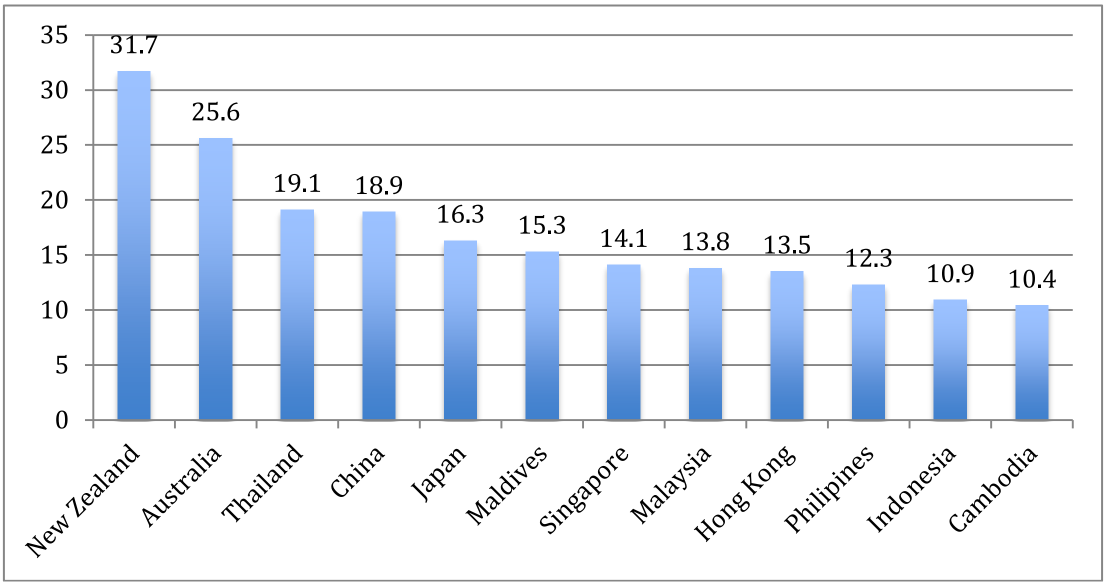
Tax revenue

The tax-to-GDP ratio is a measure of a country's tax burden. However, this 'burden' is also the source of funding for government services: the lower the ratio the more likely significant fiscal deficits will exist. The tax ratio, or tax revenue as a share or percentage of GDP, is a simple average. This assigns the same weighting to all countries, irrespective of their size or level of development. Tax ratios vary by income levels, on average rising as per capita income rises.[5]

Figure 1 compares the recent tax ratios of various ASEAN and nearby countries. By way of comparison (and not shown in Figure 1), the average ratio in OECD countries for 2012 (provisional) was 35 per cent, up from 34 per cent in 2011 but restoring the position that had typically existed prior to the global financial and economic crisis in 2007 (when the tax to GDP ratio was also 35 per cent).[6] Note, however, that the tax burdens between OECD countries vary considerably: they ranged in 2011 from 20 per cent in Mexico to 48 per cent in Denmark.

[5] Richard M Bird and Eric M Zolt, 'Tax policy in emerging countries' (2008) 26(1) *Environment and Planning C: Government and Policy* 73-86; Richard M Bird and Eric M Zolt, 'Introduction to Tax Policy Design and Development' (Practical Issues of Tax Policy in Developing Countries, World Bank, 2003).
[6] OECD, 'Revenue Statistics 1965-2012' (OECD, 2013) 11.

Figure 1: Tax revenue as per cent of GDP, 2011



Note: Hong Kong, Malaysia, Australia and Maldives data is for 2010; China data is for 2009.
Source: Satoru Araki and Iris Claus, 'A Comparative Analysis of Tax Administration in Asia and the Pacific (Asian Development Bank, April 2014) 4.

Over the period 2005 to 2012, China's tax ratio increased from 16 per cent to 19 per cent. In contrast, Indonesia has decreased slightly from 12 per cent to 11 per cent while Thailand has remained roughly the same.[7]

Indonesia has one of the lowest tax-to-GDP ratios in the region. This limits fiscal resources and constrains the government's ability to spend on social and economic development. The IMF puts the low collection of tax revenues down to the narrowness of the tax base, Indonesia's dependence on the commodity sector (which is not only declining but sensitive to movements in global prices and exchange rates) and weak administration.[8] Notwithstanding a nearly fourfold increase in registered taxpayers over the last decade, voluntary compliance and enforcement procedures remain low.[9] Aspects of the challenges posed by institutional quality and tax administration in Indonesia are considered further in Sections 3 and 4.

Expanding the tax base through strengthening tax administration is part of Thailand's strategy to achieve its medium-term fiscal goals, which include having a balanced budget by 2017 and to keep public debt to below 50 per cent.[10] One measure highlighted and prioritised is to improve the efficiency of tax collection. This, and related tax administrative issues, are also considered further later in the paper.

[7] ADB, 'Key Indicators for Asia and the Pacific 2013' (Asian Development Bank, 44th ed, 2013) 318.
[8] IMF, 'Indonesia: Staff Report for the 2013 Article IV Consultation' (IMF Country Report No. 13/362, International Monetary Fund, December 2013), 56.
[9] Ibid.
[10] IMF, 'Thailand: Staff Report for the 2013 Article IV Consultation' (IMF Country Report No. 13/323, International Monetary Fund, November 2013), 9.

Tax effort or capacity

Using the share of taxes in GDP as a measure of comparing the tax burdens of different countries is only meaningful when those countries have similar economic structures and levels of income. Factors such as macroeconomic, demographic and institutional constraints also affect how efficiently taxes can be collected. It is these factors that determine a country's tax capacity.[11]

Thus, another method of measuring the taxation performance of countries is via the tax effort index, which has been developed by economists at the World Bank. This index relates the actual tax revenues of a country (as measured by the share of taxes in GDP) to its tax capacity.[12] It undertakes a sophisticated empirical estimation process using a regression methodology based upon the impact of such variables as macroeconomic factors (the income level of a country, its GDP, trade openness, agricultural contribution), demographic factors (the growth rates of the population and its age dependency), and institutional governance quality (based upon bureaucracy and corruption indices). When the tax effort index exceeds one, that country is considered to have a "high tax effort". This means that the country fully utilises its tax base to increase tax revenues, indicating there is little scope or potential to raise further tax revenues.[13] In contrast, when the tax effort index is below one the country concerned has "low tax effort", suggesting that various measures – including measures related to improving the quality of institutional arrangements and to tackling weaknesses in tax administration – can be undertaken to improve revenue raising effort.

The use of tax effort and actual tax collection benchmarks allows the ranking of countries into four different groups and can provide insights as to how reform in such countries might take place by reference to tax capacity and tax revenues collected.

The four possible rankings, based upon the work of Le et al,[14] are:

Low tax collection and low tax effort

In this group of countries, the collection of taxes is currently low and lies below their taxable capacity. The group principally comprises low income (developing) countries (and particularly Asian countries, including Thailand), and also three of the six BRIICS countries (China, India and Indonesia).[15] It also includes (somewhat surprisingly) Canada, Japan, Korea and the United States (US). The direction of reform in countries in this group, it is suggested, should be in "deepening comprehensive tax policy and administration reforms focusing on revenue enhancement".[16] In particular the authors of the World Bank report suggest that any

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[11] Tuan Minh Le, Blanca Moreno-Dodson and Nihal Bayraktar, 'Tax Capacity and Tax Effort: Extended Cross-Country Analysis from 1994 to 2009' (WPS6252, Policy Research Working Paper 6252, Investment Climate Department, The World Bank, October 2012), 3; Marina Kesner-Skreb, ' Has Croatia reached the tax maximum?' (2014) 84 *Institute of Public Finance Newsletter* 1.

[12] Le et al, above n 11.

[13] Ibid, 7.

[14] Ibid.

[15] The other three BRIICS countries are Brazil, Russia and South Africa.

[16] Le et al, above n 11, 24.

improvements in the quality of governance "can help this group of countries have higher efficiency in terms of lower administrative and compliance costs, encourage investment and mitigate evasion."[17]

Low tax collection and high tax effort

Countries in this group tend to be low and middle income countries (for example Ghana, Kenya, Pakistan and Zambia), typified by low levels of taxation despite high tax rates on a few over-exploited revenue sources. Rampant evasion, skewed and narrow bases (as a result of widespread preferential treatment to various economic sectors) and inefficient tax administration prevent the revenues collected being commensurate with the tax effort involved. It is suggested that short term tax reform measures should include the streamlining of tax policy and tax administration procedures to reduce compliance costs, encourage formality and lower tax barriers to firms' entry and operations, while medium to long term reforms may expand the scope for raising revenue by broadening the effective tax base and enhancing the functioning of the tax system.[18]

High tax collection and low tax effort

Countries in this group tend to be middle (for example Bulgaria, Estonia, Latvia, Turkey, Ukraine) and high (for example, Denmark, Germany, Ireland, Spain, Sweden and Switzerland) income countries, almost exclusively European and with a predominance of transitional countries from the former soviet bloc. Whilst these countries collect high taxes relative to the world average, their macroeconomic and demographic features lead to a low tax effort. Reform focus in these countries, it is suggested, should be upon implementing changes to reduce distortions and reach a higher level of efficiency in tax collection. This may involve restructuring the tax mix and improving the quality of governance.[19]

High tax collection and high tax effort

Being in this category means that the country fully utilises its tax base to increase tax revenues, indicating there is little scope or potential to raise further tax revenues. This group comprises, primarily, middle and high income countries, including Australia, the United Kingdom (UK), New Zealand and South Africa. Le at al note that, given the already high revenue collections which are above taxable capacity (signified by the score above 1 on the index), further increases in tax revenue collection may lead to unintended economic distortions.[20] Their suggestion is therefore that tax reform should not focus on revenue, but should "rather aim at raising the efficiency of tax collection, including reducing tax-induced distortions and improving the business climate through further rationalizing the tax regimes, rebalancing the tax mix and simplifying administration procedures. Any further improvements in the quality of governance (lower corruption or higher bureaucratic quality) can increase the efficiency of the tax system of this group of countries".[21]

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[17] Ibid.
[18] Ibid, 26.
[19] Ibid, 27.
[20] Ibid, 26.
[21] Ibid, 26.

Figure 2 shows the classification of selected countries based on their tax effort and tax collection.[22] China, Indonesia and Thailand are considered to be low tax collection, low tax effort.

Figure 2: Classification of selected countries based on tax efforts and tax collection, 1994-2009

Classified 1994-2009		Tax Effort	
		Low	**High**
Tax Collection	**Low**	37 countries including China, Ethiopia, India, Indonesia, Japan, Mexico, Thailand and the United States.	12 countries including Cote 'd'Ivoire, Ghana, Kenya, Mali, Pakistan, Sri Lanka, Togo and Zambia
	High	20 countries including Bulgaria, Estonia, Germany, Latvia, Russia, Spain, Switzerland, and Turkey	34 countries including Australia, Botswana, Brazil, France, Netherlands, New Zealand, South Africa and the United Kingdom

Source: Adapted from Tuan Minh Le, Blanca Moreno-Dodson and Nihal Bayraktar, 'Tax Capacity and Tax Effort: Extended Cross-Country Analysis from 1994 to 2009' (WPS6252, Policy Research Working Paper 6252, Investment Climate Department, The World Bank, October 2012) 25.

The classification of China, Indonesia and Thailand in to the "low tax collection and low tax effort" category suggests a number of challenges and reform opportunities that may enable those countries to improve their tax revenue raising capacity and to enable them to raise those taxes in a more efficient and effective fashion. More particularly such countries can seek to make improvements in the quality of governance in the broadest sense, particularly through the control of institutional corruption; and seek to improve the tax administrative functions of government, particularly through appropriate re-organisation, through tackling evasion and the shadow economy and through minimising the operating costs of the tax system.

Each of these challenges is now explored in greater detail – broad governance issues in Section 2, and tax administration issues in Section 3.

3. Governance

Governance is broadly defined as the traditions and institutions that determine how authority is exercised in a country.[23] As noted by former United Nations Secretary-General Kofi Annan: "Good governance is the single most important factor in eradicating poverty and promoting development".[24]

[22] Adapted from Le et al, above n 11, 25.
[23] Daniel Kaufmann, Aart Kraay and Pablo Zoido-Lobatón, 'Governance Matters: From Measurement to Action' (2000) 37(2) *Finance and Development*.
[24] UNDP, 'Human Development Report 2002' (United Nations Development Programme, New York, 2002) 51.

The literature posits a positive correlation between the quality of institutions and governance structures on the one hand and economic growth on the other.[25] Notwithstanding the Asian Financial Crisis of 1997, the last three decades have seen an economic transformation in most Asian countries. Yet good governance has not always kept pace with this economic growth. Given that good governance is closely associated with economic growth, continued sustained economic growth may be constrained by a lack of good governance. This point is critical to all three countries under consideration.

For example, within three decades, China has transformed itself from a centrally-organised, closed economy to a market-oriented open economy. China is now the second largest economy in the world, with GDP accounting for about 10 per cent of the world's total.[26] This rapid growth brought with it significant macroeconomic, environmental and social challenges. China's governance and institutions will be key to ensuring that it continues to reform and strengthen, and yet to date there are serious concerns about the quality of the country's institutional arrangements and their capacity to cope with such fundamental change.

In Indonesia there is widespread agreement that corruption has been inhibiting economic growth.[27] Although much has been said about eliminating corruption, there is little evidence to suggest that progress is being made.[28] Indeed the recent case of a relatively junior tax official has highlighted the ineffectiveness of the anti-corruption campaign.[29] Genuine progress in eliminating corruption requires an investment in good governance.

The institutions that provide public services, such as revenue authorities, and the way they interact with citizens, are fundamental components of governance. Indeed, the quality of governance is generally judged through the experience of public service delivery.[30] Similarly, weak governance is often to blame for public service failures, with corruption and the lack of transparency attracting the most attention.[31] A study published by the Asian Development Bank on the effect of governance on tax revenue

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[25] See for example Stephen Knack and Philip Keefer, 'Institutions and Economic Performance: Cross Country Tests Using Alternative Institutional Measures' (1995) 7 *Economics and Politics* 207-227; Paolo Mauro, 'Corruption and Growth' (1995) 110(3) *Quarterly Journal of Economics* 681-712; Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert Vishny, 'The Quality of Government' (1998) 15(1) *Journal of Law, Economics and Organisation* 222-279; Kaufmann et al, above n 23.

[26] Ligang Song, 'Asia's Economic Transformation: Implications for Australia – China' (Policy Briefs 10, Crawford School of Economics and Government, Australia National University, April 2011)

[27] Huiyan Zhang, 'Corruption, Economic Growth and Macroeconomic Volatility' (2000) 2(1) *Perspectives*.

[28] Ross H McLeod, 'Asia's Economic Transformation: Implications for Australia – Indonesia' (Policy Briefs 10, Crawford School of Economics and Government, Australia National University, April 2011).

[29] For a report on the full allegations see Olivia Rondonuwu, 'Game over for corrupt, wig-wearing Indonesian tax official' (Reuters, 19 January 2011).

[30] ASB, 'Asian Development Outlook 2013 Update: Governance and Public Service Delivery' (Asian Development Bank, 2013).

[31] Ibid, 79.

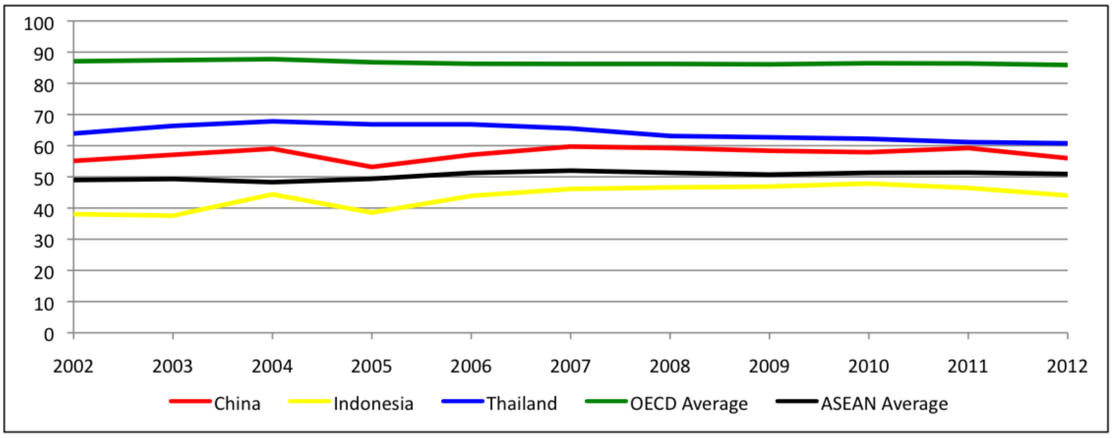
mobilisation concluded "the tax revenue mechanism is particularly strong".[32] Thus governance and the quality of institutions go hand in hand.

The Worldwide Governance Indicators[33] report on a number of categories of governance including government effectiveness and the control of corruption. Both of these are considered in turn.

Government effectiveness

'Government effectiveness' is a measure of the perceptions of the quality of public services and the degree of independence from political pressures, and the quality of policy formulation and implementation as well as the credibility of government's commitment to such policies. The results (in Figure 3) from the Worldwide Governance Indicators are shown as percentile ranking. Percentile ranks indicate the percentages of countries worldwide that rank lower than the country being assessed. Higher values indicate better governance scores.

Figure 3: Government effectiveness 2002-2012



Note: The ASEAN average includes Indonesia and Thailand
Source: Worldwide Governance Indicators

Figure 3 shows that over the period from 2002 to 2012, China (marginally) and Indonesia (more so) improved with respect to government effectiveness. While Thailand went backwards on this indicator, it is nevertheless perceived as performing better than both China and Indonesia. The percentile ranking for the average of OECD and ASEAN countries has been stable over the decade.

Research has indicated that there is a negative correlation between institutional quality and tax evasion.[34] In other words, the higher the quality of institutions, the lower the levels of tax evasion. For a tax system to generate compliance, the governing institutions must be credible, equitable and fair and represent the values of society. The evidence from China, Indonesia and Thailand suggests that improving the effectiveness of government will continue to be a key challenge for these

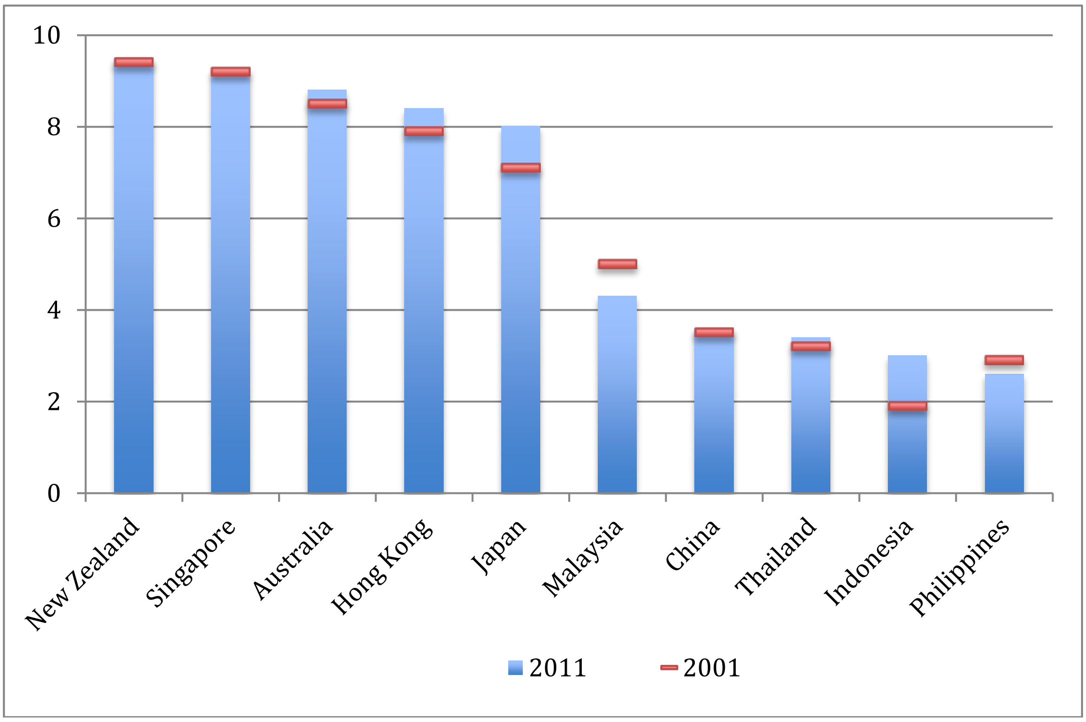
32 Kunal Sen, 'Governance and Development Outcomes in Asia' (Asian Development Bank, Economics Working Paper Series No. 384, January 2014), 13.
33 See http://info.worldbank.org/governance/wgi/index.aspx#doc.
34 Benno Torgler, 'Increasing Tax Compliance in Papua New Guinea' (National Research Institute, Tax Research and Review Symposium, Port Moresby, 29-30 May 2014), 27.

countries in coming decades, and that further improvements can have a significant and self-reinforcing impact on the legitimacy of government and on revenue raising capacity.

Corruption

"Corruption" is defined as "the abuse of entrusted power for private gain".[35] The Transparency International Corruption Perception Index is based on experts' opinion of government corruption. On a scale of 0 (highly corrupt) to 10 (very ethical), most developing Asian countries scored below 5 in 2011, roughly the same as in 2001.[36] This is shown in Figure 4. While China (2011: 3.6; 2001: 3.5) and Thailand (2011: 3.4; 2001: 3.2) have remained relatively steady over the decade, Indonesia has apparently improved substantially from a score of 1.9 in 2001 to a score of 3 in 2011. However, it has slipped in the rankings from 88 in 2001 to 100 in 2011. This shows that, relative to other countries, Indonesia has not made as much progress as its improved score might otherwise suggest.

Figure 4: Corruption perception index, 2001 and 2011: various countries



Source: Transparency International, Corruptions Perception Index 2011, 2001.

The Worldwide Government Effectiveness Indicators also provide an assessment of the levels of corruption in various countries. Figure 5 shows a similar pattern to the 'government effectiveness' indicator. China has fluctuated over the period, commencing in 2002 at 34 per cent, increasing to 43 per cent the following year before finishing 2012 at 39 per cent. Indonesia steadily improved from a position in the lower 10 per cent of all countries in 2002 to 29 per cent in 2012. Thailand

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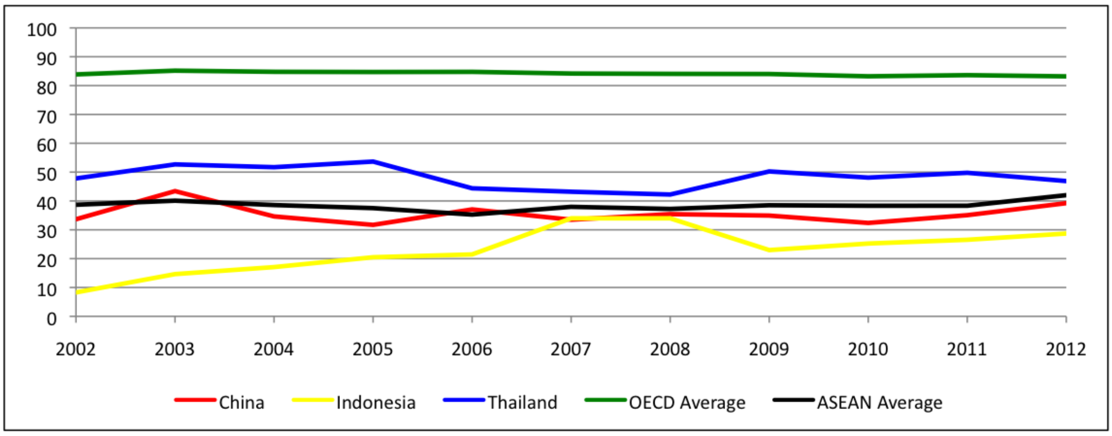
35 Transparency International, available at www.transparency.org/whatwedo accessed 3 May 2014.

36 Transparency International, 'Corruptions Perception Index' available at www.transparency.org/research/cpi/overview accessed 3 May 2014.

remained relatively consistent over the ten year period, but performed better than both Indonesia and China, starting and ending marginally below 50 per cent. Once, again, the OECD average has been stable over the decade and well above the ASEAN countries, while the overall ASEAN average improved by 3 percentage points to 42 per cent in 2012.

Figure 5: Control of corruption 2002-2012



Note: The ASEAN average includes Indonesia and Thailand.
Source: Worldwide Governance Indicators.

High levels of corruption are associated with increased activity in shadow economies[37] and higher income inequality and poverty.[38] Tanzi notes several situations in which corruption is likely to be a problem in tax administration.[39] These include difficulty in understanding and interpreting tax laws, lack of electronic tax payment systems, lack of management controls, poor accountability mechanisms and tax administrators having discretion over important decisions such as those related to the provision of tax incentives, determination of tax liabilities and selection of audits. These aspects are elaborated upon in Section 4 of the paper.

Challenges and opportunities

One of the greatest challenges for developing nations is the need to build state capacity and legitimacy so that appropriate revenues can be raised from their own resources without having to rely on foreign aid and investment. But the raising of revenue also needs to reflect the interaction of policy (such as efficiency and growth) with social interests (such as equity and fairness). Government stability and legitimacy is necessary to implement policies that aim to increase economic performance and reduce income inequality. Where political interests dominate,

[37] Benno Torgler and Friedrich Schneider, 'The Impact of Tax Morale and Institutional Quality on the Shadow Economy' (2009) 30 *Journal of Economic Psychology* 228-245; Eric Friedman, Simon Johnson, Daniel Kaufmann and Pablo Zoido-Lobaton, 'Dodging the Grabbing Hand: The Determinants of Unofficial Activities in 69 Countries' (2000) 76 *Journal of Public Economics* 459-493.
[38] Sanjeev Gupta, Hamid Davoodi and Rosa Alonso-Terme, 'Corruption and the Provision of Health Care and Education Services' in George Abed and Sanjeev Gupta (eds) *Governance, Corruption and Economic Performance* (International Monetary Fund, 2002) 458-486.
[39] Vito Tanzi, 'Corruption Around the World: Causes, Consequences, Scope and Cures' in George Abed and Sanjeev Gupta (eds) *Governance, Corruption and Economic Performance* (International Monetary Fund, 2002) 19-58, 28.

politically fragile states are constrained in their ability to act without fear or favour when attempting to be more efficient and effective.[40] Several factors can assist in limiting the abuse of political power such as education, a free press and well-functioning and accountable institutions.

China has had to deal with a rapidly expanding economy. This increased reliance on market-based policies has meant that the governance structures and institutions need to be substantially reformed for this growth to be sustainable. As a result China has implemented major tax reforms over the last two decades, including significant measures to improve governance in taxation.[41]

Indonesia began its institutional reform in 1998 and has transformed itself into a relatively open, stable and democratic nation.[42] It has also made substantial progress in upgrading its institutions, and in particular tax administration, in the last decade.[43] However, a number of tax-related cases in 2010 and 2012 involving tax administrators have undermined the level of public trust not only in the tax institution but in the tax administration reform process.[44]

Political commitment requires strong, receptive and sustained support. Public sector reform also commenced in Thailand in the late 1990s, including a new constitution in 1997. There were essentially three aspects to the reforms: improving governance, efficiency and equity; enhancing accountability and transparency of resource management and delivery; and increasing decentralisation and public participation.[45] Institutional capacity was enhanced through the establishment of new institutions such as the Large Taxpayer's Office, the National Counter Corruption Commission and the Administrative Courts.

Yet reform is an ongoing process. Governance in tax administration can be improved by strengthening transparency and accountability mechanisms. Integrity is an essential element of good institutional performance. While much has been achieved in China, Indonesia and Thailand, there is still scope for improvement in the areas of increasing transparency and accountability (or government effectiveness), establishing a level playing field, reducing corruption and improving service delivery.

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[40] Richard Bird, 'Tax Challenges Facing Developing Countries' (IIB Paper No. 9, Institute for International Business Working Paper Series, University of Toronto, 2008).
[41] OECD, *Governance in China* (OECD, 2005).
[42] Dan Harris and Marta Foresti, 'Indonesia's Story: Indonesia's progress on governance: State cohesion and strategic institutional reform' (Overseas Development Institute, 2010).
[43] OECD, *OECD Economic Surveys: Indonesia 2012* (OECD, 2012).
[44] Ibid.
[45] World Bank, 'Thailand. Country Development Partnership: Governance and Public Sector Reform' (Program Assessment and Implementation Completion Report, December 2006).

4. Tax administration

Clearly the effectiveness of the tax systems in countries like China, Indonesia and Thailand can be improved significantly with improvements to institutional quality and broader governance reforms of the nature considered in Section 3. Reducing corruption reduces leakages in tax revenues. There is also scope in Asian countries generally to increase tax revenues by increasing tax rates and/or tax bases. However, without an effective tax administration system these tax revenues may not eventuate. The quality of this particular institution is therefore paramount. Greater administrative capacity allows for more efficiency in tax collection.

Tax administrations are responsible for ensuring compliance with tax law. By enforcing these laws, tax administrations can send a clear message that bribery and corruption are not acceptable business practices.

There have been changes in relation to broader tax policy (including in relation to tax revenues and tax mix over the years) in China, Indonesia and Thailand in recent years, but more dramatic changes have taken place in these countries and in many others in the way that taxes are administered. Most notably there have been significant changes in the way that revenue authorities have been organised and the manner in which they have approached the tasks of administering the law and collecting the tax revenue that is properly due – "extracting the maximum amount of feathers [from taxpayers] with the minimum amount of hissing."

Major trends in this sphere have included:

- the modernisation and professionalisation of tax administrations, promoting increased flexibility in human resource organisation and pay scales with greater emphasis on externally validated merit based performance targets;
- the introduction of autonomous and semi-autonomous structures whereby tax administrations operate independently, or more independently, of their political masters;
- the growth of the internal organisation of revenue authorities by reference to market segments (eg, Large Taxpayer Units) rather than solely by reference to the type of tax being collected or the function being performed by revenue officers;
- an increased reliance on self-assessment as opposed to official assessment;
- far greater use of technology in all aspects of revenue administration work; and
- above all, a shift away from a command and control regulatory frameworks reliant on penalties and enforcement to ensure compliance to a risk management approach designed to foster voluntary compliance – making it easy for those who wish to comply and providing plausible and effective deterrence to those who do not.

Picking up on these broad themes, three specific aspects of tax administration, highlighting the major global trends identified above, are considered in more detail in this section. Firstly, the paper considers aspects of organisational design of the tax administrations, including the relationship of the revenue authority to the government (usually as represented by the Ministry of Finance or Treasury Department), and the manner in which the revenue authority is internally organised. Secondly, it considers the size of the shadow economy, a useful indication of the extent to which a tax administration is able to minimise the so-called tax gap (the difference between what a revenue authority theoretically should collect and what it actually does collect).[46] The third aspect discussed in this section is the tax operating costs of the tax system, from both the administrative (revenue authority) and compliance (taxpayer) perspectives.

Organisational aspects of revenue authorities

Autonomous revenue authorities

McKerchar and Evans have noted that in recent years many countries have established their tax departments into autonomous or semi-autonomous revenue authorities ("ARAs" or "SARAs").[47] It has been a noticeable world-wide trend, with some suggestions that the World Bank has, upon occasions, "been a persuasive salesman".[48]

The defining feature of an ARA is some degree of autonomy whereby the revenue collection function is removed, either partly or wholly, from the Ministry of Finance or Treasury Department. The management of the ARA therefore has significant independence in financial, personnel and operational matters, but is accountable for delivering agreed results, with continuation of appointment and renewal of contract for top management dependent upon revenue administration performance.[49] These independent revenue agencies, it is argued, are thus more able to provide better pay and other incentives to their staff while also imposing greater accountability for performance.[50] Taliercio argues that if one compares the pre- and post- reform state of affairs in countries where ARAs have been introduced, there is improvement in most cases along most dimensions of performance.[51]

Others are more circumspect. Gallagher notes that the jury is still out,[52] while Fjeldstad and Moore suggest that many of the perceived advantages may have been short term and identify a number of conceptual and practical problems with ARAs that suggest they are not always the panacea that the World Bank may have suggested.[53]

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[46] McKerchar and Evans, above n 4, 173.
[47] McKerchar and Evans, above n 4, 183.
[48] Odd-Helge Fjeldstad and Mick Moore, 2008, 'Tax Reform and State-Building in a Globalised World', in Deborah Brautigam, Odd-Helge Fjeldstad and Mick Moore (Eds) *Taxation and State-Building in Developing Countries: Capacity and Consent*, Cambridge University Press, Cambridge, p. 249.
[49] Jit Gill, 2003, "The Nuts and Bolts of Revenue Administration Reform", World Bank, available at <http://siteresources.worldbank.org/INTTPA/Resources/NutsBolts.pdf> accessed 21 July 2008.
[50] Mark Gallagher, 'Benchmarking Tax Systems', (2005) 25 *Public Administration and Development*, 130.
[51] Robert Taliercio, 2004, "Designing Performance: The Semi-Autonomous Revenue Authority Model in Africa and Latin America", Policy Research Working Paper 3423, World Bank, October.
[52] Gallagher, above n 50, 133.
[53] Fjeldstad and Moore, above n 48, 249-255.

It can be seen from Table 1 that the Chinese tax administration is fully autonomous in its external institutional arrangements, whilst the Indonesian and Thai revenue authorities are more closely controlled by their respective Ministries of Finance. Araki and Claus note that this is evident in the range of delegated authorities available to the respective revenue authorities.[54] In China, for example, the State Administration of Taxation (SAT) has delegated authority to: design all aspects of its internal structure; allocate budget as appropriate; determine the mix and levels of its staff; hire and dismiss staff; and negotiate staff pay levels. In contrast, in Thailand the revenue authority can only undertake the first three of these functions, and in Indonesia the Directorate General of Taxation (DGT) only has delegated authority to undertake one of those five functions: to determine the mix and levels of DGT staff.

Table 1: Classification of selected revenue bodies according to their relationship with the Ministry of Finance

Directorate in Ministry of Finance	**Affiliated with Ministry of Finance**	**Independent from Ministry of Finance**
Indonesia	Australia	New Zealand
Thailand	Hong Kong	China
Taipei	Japan	Maldives
Cambodia	Malaysia	Papua New Guinea
	Philippines	
	Singapore	

Source: Satoru Araki and Iris Claus, 'A Comparative Analysis of Tax Administration in Asia and the Pacific (Asian Development Bank, April 2014) 7.

Organisational options

Regardless of whether the revenue authority is constituted as an autonomous or semi-autonomous body, the way in which it is internally organised can have a significant impact upon the effectiveness of the tax administration. "A well-designed organizational structure can provide a foundation for effective tax administration, which minimizes tax evasion opportunities and fosters voluntary compliance".[55]

Traditionally three separate models for the organisation of revenue authorities have been suggested both in the broader organisational theory literature[56] and in more specific literature relating to tax administration:[57]

- product-based, relating to the type of tax (income tax, VAT etc) administered by the revenue authority;

[54] Satoru Araki and Iris Claus, 'A Comparative Analysis of Tax Administration in Asia and the Pacific (Asian Development Bank, April 2014) 7.
[55] Charles Vehorn and John Brondolo, 1999, 'Organizational Options for Tax Administration', paper presented at 1999 Institute of Public Finance Conference, Zagreb, June.
[56] For example, B J Hodge, William Anthony and Lawrence Gales, 1996, *Organization Theory: A Strategic Approach*, Prentice Hall, New Jersey, 5th edition.
[57] Vehorn and Brondolo, above n 55.

- functional, relating to the different administrative functions performed by revenue authorities such as processing tax returns, or auditing, or collecting taxes; and
- client-based, relating to the different types of taxpayer according to criteria such as scale of operation (large, small etc), form of ownership or industrial/economic sector.

Sometimes, revenue agencies adopt a fourth approach, involving some combination of these three models, often referred to as a matrix approach.

Developing countries have tended to move away from product-based structures built upon different types of tax to those which are based upon function, although often with elements of a client-based market segmentation approach also in evidence (for example, the introduction of large taxpayers units focusing upon the large companies which are often responsible for a disproportionate amount of revenue collections; or the introduction of industry-based organisational structures).[58] In this way they have been able to secure the advantages of improved accountability and control, enhanced compliance, better administrative efficiency, reduced corruption and more customised taxpayer service.

As can be seen in Table 2, the Chinese SAT has adopted the matrix approach, with elements of all three organisational designs in the way it operates. In contrast, in Thailand there is a mixture of the function-based and taxpayer-segment bases, and the Indonesian DGT adopts only a functional approach to its internal design.

Table 2: Models of internal organisational design

Jurisdiction	Tax Item-Based	Function-Based	Taxpayer Segment-Based
Australia	Yes	Yes	Yes
Cambodia	No	Yes	No
China	Yes	Yes	Yes
Hong Kong	Yes	Yes	Yes
Indonesia	No	Yes	No
Japan	Yes	Yes	Yes
Korea	Yes	Yes	Yes
Malaysia	No	Yes	No
New Zealand	Yes	Yes	Yes
Philippines	No	Yes	No
Singapore	Yes	Yes	No
Taipei	No	Yes	No
Thailand	No	Yes	Yes

Source: Satoru Araki and Iris Claus, 'A Comparative Analysis of Tax Administration in Asia and the Pacific (Asian Development Bank, April 2014) 15.

However institutional reform of a tax administration body (whether in terms of its external governmental relationships or its internal organisation) will not, in itself, be sufficient for improved performance of the tax administration.[59] It also needs to be

[58] Vehorn and Brondolo, above n 55, 21; Gallagher, above n 50, 133; and Fjeldstad and Moore, above n 48, 248.

[59] ADB, Institutional Arrangements for Tax Administration in Asia and the Pacific' (2012) 19 *The Governance Brief* 1-8.

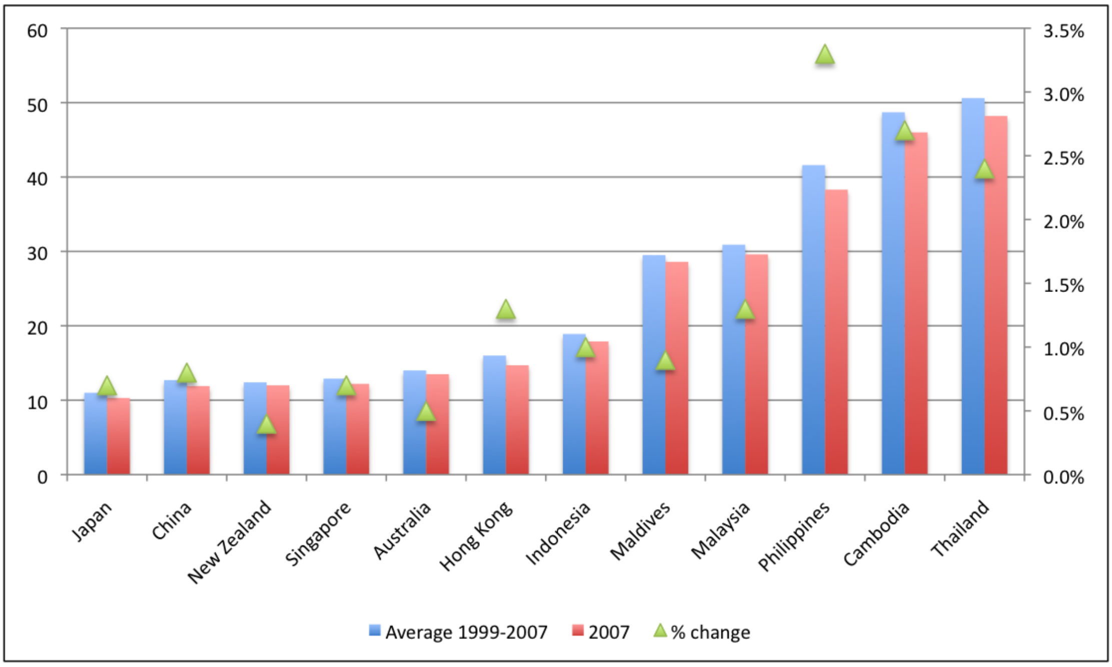
accompanied by improvements in other areas for which the tax administration is responsible in order to lead to improvements in taxpayer compliance and administrative efficiency.[60] The paper now looks at aspects of these two critical areas in some more detail.

The shadow economy

There is compelling evidence that the level of tax is a main driver of shadow economic activity.[61] This is followed, in order, by tax morale, the quality of state institutions and labour market regulation.[62]

Figure 6 shows that the size of the shadow economies (expressed as a percentage of GDP) in various Asian countries appears to be falling in 2007 (the latest year for which comparative figures are available) compared to the average of the period from 1999 to 2007. But there are mixed results for China, Indonesia and Thailand. While China's shadow economy is slightly smaller than both Australia and New Zealand, and Indonesia's shadow economy is less than 20 per cent of GDP, the shadow economy in Thailand is very nearly one half of the total economy. Given its higher base, Thailand is able to show – on a relative basis – a greater fall in the size of the shadow economy (2.4 per cent) than both Indonesia (1 per cent) and China (0.8 per cent).

Figure 6: The shadow economy for selected Asian countries as a percentage of GDP (2007)



Source: Friedrich Schneider, Andreas Buehn and Claudio E. Montenegro, 'New Estimates for the Shadow Economies of the World' (2010) 24(4) International Economic Journal 443-461, Table 2.

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60 William Crandall, *Revenue Administration: Autonomy in Tax Administration and the Revenue Authority Model* (International Monetary Fund, 2010).

61 Friedrich Schneider and Colin C. Williams, 'The Shadow Economy' (The Institute of Economic Affairs, 2013) 12; Friedrich Schneider, Andreas Buehn and Claudio E. Montenegro, 'New Estimates for the Shadow Economies of the World' (2010) 24(4) *International Economic Journal* 443-461, 445.

62 Schneider and Williams, above n 61.

The figures may not be entirely reliable for a number of reasons (not explored here) but they do at least indicate that the size of the shadow economy in certain Asian countries may represent a real challenge for policy makers in those countries.

Operating costs of the tax system

Another means by which the efficiency of the tax administration and/or the broader tax system can be assessed is by looking at the burden, or operating costs, that the tax system imposes upon the community. There are two components to tax operating costs: the administrative costs incurred by revenue authorities in collecting tax revenue and administering the tax system; and the compliance costs incurred by taxpayers in order to meet their tax obligations. Various measures have been used to identify such costs, although it is slightly surprising how few truly international comparative studies have taken place in recent years. The dangers of international comparisons are well known to most researchers. Sandford identified a number of reasons why such comparisons are more likely to mislead than enlighten, and offered the advice that "comparisons of … operating costs should be used sparingly, with the greatest care and with a comprehensive statement of their limitations".[63] Such caution is duly noted in the following analysis.

Administrative costs

The cost of collection ratio is a commonly used standard measure of administrative costs, or more particularly of the efficiency with which revenue authorities collect tax. It compares the annual costs of administration with the total revenue collected for a particular fiscal year. A downward trend is associated with reduced administrative costs (or improved efficiencies) or improved tax compliance (or improved effectiveness).[64]

However, it is important to note that many factors can influence this ratio, including differences in tax rates and structures, and prevailing economic conditions. For example, an increase in the ratio may be due to a reduction in tax revenue as a result of a financial and economic crisis rather than to any improvement in tax administrative efficiency. Conversely, a downward improvement in the ratio may be the simple result of increased taxes collected as the result of a rate rise or base broadening rather than any improvement in administrative practice.

Figure 7 compares the cost of collection ratio for selected Asian countries for 2011 with the 2010 year. While the cost of collection in Indonesia has increased slightly (from 0.48 per cent to 0.55 per cent) it is still low when compared with other Asian countries. Most countries, including Thailand, were able to reduce the ratio of tax administration expenditures to revenue collected over this one year period.

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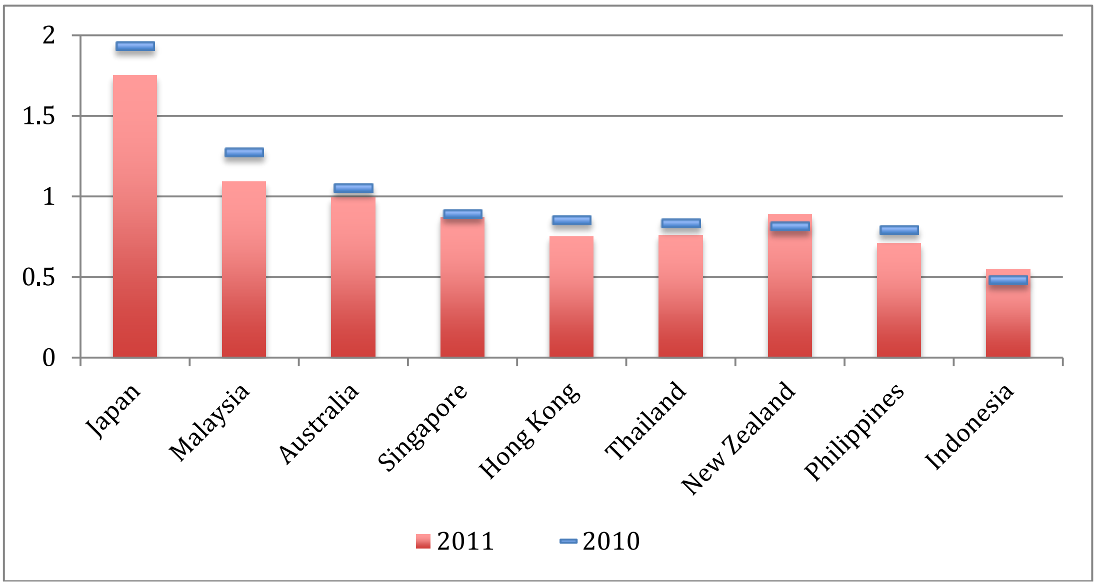
[63] Cedric Sandford, 'International comparisons of administrative and compliance costs of taxation, *Australian Tax Forum* (1994) Vol. 11, pp. 291–309.
[64] OECD, 'Government at a Glance 2013' (OECD, 2013).

Figure 7: Tax administration expenditures as per cent of net revenue collected for selected countries



Note: No data available for China.
Source: Satoru Araki and Iris Claus, 'A Comparative Analysis of Tax Administration in Asia and the Pacific (Asian Development Bank, April 2014) 43, 45, 48

Tax compliance burden

There are a number of ways that the tax compliance burden, or costs, can be assessed. For example, the compliance burden can be measured by the time taken to comply with the tax law and the number of tax payments required. The PwC "Paying Taxes" annual publication (part of the World Bank/IFC's "Doing Business Project") does this, assessing both the tax cost and tax compliance burden of business taxes.[65] The PwC Paying Taxes ranking is based on three indicators: total tax rate, time taken to comply with tax laws (hours per year) and number of payments per year. The PwC database currently covers values of the above three indicators for a large number of countries over a number of years.

There are a number of limitations of the measures used in this index, not the least of which is the very restrictive "snapshot" that is used – effectively it is based upon data in relation to one medium sized company in each country. So, for example, the "time to comply" ranking only takes into account the time taken to comply with corporate income, labour and consumption taxes.[66] Nonetheless the results can be taken as indicative even if not entirely reliable.

The results for the latest year available (2012) are provided in Table 4. The regional benchmarks are set by Hong Kong and Singapore, typified by few tax payment obligations, low hourly compliance times and low total tax rates. As a result they rank fourth and fifth (respectively) out of 189 countries.

[65] PwC, 'Paying Taxes 2014' (PricewaterhouseCoopers, 2014). These are incorporated into The World Bank's annual publication, *Doing Business*.
[66] Binh Tran-Nam and Chris Evans, 'Towards the development of a tax system complexity index', (2014) 35(3) *Fiscal Studies* forthcoming.

In contrast, Thailand performs only moderately well, and China and Indonesia perform relatively poorly. Although Thailand improved its rankings by 26 places in the period from 2011 to 2012, it still only ranks 70th. Thailand's improvement is attributable to two main factors, designed to stimulate economic growth and increase regional and global competitiveness: firstly the corporate income tax rate was reduced from 30 per cent to 23 per cent; and secondly there were reductions in employers' social security contributions.[67] Table 4 also shows that China improved its ranking marginally in 2012 compared to 2011, whilst Indonesia slipped by six places over the year, but that both are ranked among the poorer regional and global performers in terms of the ease of paying taxes/complying with tax obligations.

Table 4: Ease of paying taxes ranking of selected countries (2012)

	Overall ranking (2011)	**Total tax payments**	**Time to comply (hours)**	**Total tax rate**
Hong Kong	4 (4)	3	78	22.9
Singapore	5 (5)	5	82	27.1
New Zealand	23 (21)	8	152	34.6
Malaysia	36 (15)	13	133	36.3
Australia	44 (48)	11	105	47.0
Thailand	70 (96)	22	264	29.8
China	120 (122)	7	318	63.7
Philippines	131 (143)	36	193	44.5
Indonesia	137 (131)	52	259	32.2
Japan	140 (127)	14	330	49.7

Source: PwC, Paying Taxes 2014, Appendix 3; PwC, Paying Taxes 2013, Appendix 2.

5 Conclusions

Tax, governance and administration are closely related and all play a significant role in terms of ensuring public acceptance of the legitimacy of governments. This is particularly so in the cases of rapidly developing countries such as China, Indonesia and Thailand and similar economies in the ASEAN region. Taxes build capacity and state legitimacy. But capacity and legitimacy are both adversely affected where the quality of governance is impaired, and more so where the revenue authority is not up to the task of effectively and efficiently administering the tax system.

This paper has identified a series of tax challenges that confront countries like China, Indonesia and Thailand. Their ratio of tax revenue to GDP is constrained, and – more importantly – they have low tax collection and low tax effort or capacity. This combination prevents them from being able to fully support or sustain the levels of economic growth and social development that their growing and increasingly affluent populations crave. In order to move away from this "low tax revenue, low tax effort" paradigm and on to a more sustainable and effective level of tax capacity, such countries need to improve the quality of governance, particularly as it relates to the control of corruption and the administration of the tax system. In turn this requires some structural change (in, for example, the ways in which the revenue authority itself operates both externally and internally) as well as more effective tax management and compliance strategies designed to limit the opportunities for tax

[67] PwC, 'Paying Taxes 2014' (PricewaterhouseCoopers, 2014) 54 and 62.

evasion through the shadow economy and lower the operating costs of the tax system for all concerned.

But whilst the broad tax challenges are relatively easy to diagnose, the specific treatment is not so straightforward. One thing that can be said with some certainty, however, is that there is no “one size fits all” solution. The intensity and nature of the tax and related challenges vary from country to country, and so will the solutions. For China a key consideration has to be whether the quality of its institutional arrangements is sufficient for the task ahead. In Indonesia issues related to corruption, and how to control it, clearly represent a more significant challenge than in the other two countries. And in Thailand the size of the shadow economy – so much more significant, apparently, than in China or Indonesia – has to be of critical concern.

The essential point is that in all three countries – and in other ASEAN countries – opportunities do exist to make a significant difference to the economic and social development with carefully thought through policies. These policies need to be designed to improve institutional quality, tackle corruption and improve the effectiveness and efficiency of government and tax revenue collection. Tax, governance and administration all matter; they self-reinforce and ultimately hold the key to stable and legitimate government.