CHAPTER I

INTRODUCTION

1.1 Background

Tax evasion is one of the persistent and common problems in every country (Din et al., 2018). Tanzi & Shome (1993) mention that Plato wrote about tax evasion about two thousand five hundred years ago. A hollow stone in the aging Venetian Ducal Palace is evidence that the republic was once informed of tax evaders. Now, almost all countries worldwide face tax evasion as a global phenomenon. It takes place in all societies, social classes, professions, industries, and economic systems (Tanzi & Shome, 1993).

Wysłocka & Verezubova (2016) defines tax evasion as an act of hiding taxable income, which includes evasion of taxes and duties owed to the state budget. In line with Wysłocka & Verezubova's statement, Rashid (2020) opines that an illegal act done by people paying a tax is called tax evasion. Tax evasion happens because the taxpayer does not fulfill their duty in paying tax intentionally, neither they do not fill annual tax returns, wrong report income, nor less amount of payment over the tax which they actually able to pay it. Moreover, according to Korndörfer et al. (2014), tax evasion is an act against the law which breaks the law and deviates the social norms on the duty of paying tax. Like the previous statement,

Gottschalk (2010) defines tax evasion as an intentional effort to circumvent tax law to diminish someone's tax liability illegally.

Cerqueti & Coppier (2011) argue that government may face a severe impact on the economy from the loss of tax revenue. Tax evasion puts pressure on the government to respond quickly to public services due to the significant loss of government revenue. Therefore, the government considers tax evasion challenging to overcome, and the tax authorities improve their performance by increasing tax revenue from taxpayers (Rashid, 2020). On the other side, Mason et al. (2018) argue that unfair policy-making processes or the unfavourable impact of policies felt by companies lead to the reluctance of companies to comply with tax laws. In the meantime, Androniceanu et al. (2019) argue that research on tax evasion has significant relevance in determining a nation's social, economic, and cultural development degree. The research results of Androniceanu et al. (2019) explain that the fiscal policy impacts the country's economy, and the act of reducing tax evasion results in a sizeable increase in macroeconomic indicators, which characterizes a country's economy.

Apart from that, Nurunnabi (2018) presented a socio-economic theory explaining tax evasion based on "institutional infrastructure" (Pickhardt & Prinz, 2014). In this theory, economic and non-economic factors are classified from tax evasion into three big categories: taxpayer's behaviour, state structure, and the behaviour of the tax authority. Based on the study of Islam et al. (2020), the structure of the state is described through economic freedom, which consists of rules of law (property rights), regulatory efficiency (monetary freedom and fiscal

freedom), open markets (investment freedom and financial freedom), and government size (government spending).

Based on Nurunnabi (2018), the study finds that lack of monetary freedom, such as high inflation, is negatively correlated with tax evasion or correlated with less tax evasion. The findings also show that lack of fiscal freedom, such as high corporate taxes and inadequate law enforcement, leads to tax evasion. Meanwhile, Li & Ma (2015) explain that more severe tax evasion correlates with larger governments, especially nations and collective firms. Those effects are more powerful when the local government becomes worse. So, the leading government can not carry out a strong nation capacity in order to maintain the tax law in China locally.

When viewed on a global scale, it is reported that total tax evasion is around 5.1% of world GDP or an estimated over USD3.1 trillion. Europe experienced a tax loss of USD 1.5 trillion, Asia USD 666 billion, North America USD 453 billion, South America USD 376 billion, and Africa USD 79 billion (Murphy, 2011).

In ASEAN, the economic growth was undeniably fast, doubling the world's gross domestic product (GDP) from 3.3% (1967) became 6.2% (2016), making them the global sixth-largest group of the economy. However, among the five Association of Southeast Asian Nations (ASEAN-5), Singapore became the lowest with a tax loss of USD 4.1 billion. Malaysia with USD 11.2 billion, followed by the Philippines with USD 11.7 billion, Indonesia with USD 17.8 billion, and Thailand became the highest among other countries with USD 25.8 billion (Murphy, 2011).

Martinez-Vazquez (2011) argues that when viewed globally, the tax burden in Asia on a regional scale is the lowest. Quoted from The Heritage Foundation (2021), the size of the tax burden imposed by the government is called the tax burden. Furthermore, the tax burden includes direct taxes, in terms of the top marginal tax rates on individual and corporate incomes, and overall taxes, including all forms of direct and indirect taxation at all levels of government, as a percentage of GDP. In Asia, the average tax-GDP ratio is about half that of the European Union. It is also below America, Africa, and the Middle East. However, there is a disparity between ASEAN-5 countries in the tax-GDP ratio, with Indonesia being the lowest (13.6%), the Philippines (13.8%), Singapore (14.1%), Malaysia (15.8%), and Thailand being the highest (16.3%) (Martinez-Vazquez, 2011).

According to research conducted by Din et al. (2018), the main objective is to relate tax evasion with the stages of financial development in the five founding member countries of ASEAN – Indonesia, Malaysia, the Philippines, Singapore, and Thailand for the period 1980-2013. They conclude a long-run relationship between tax evasion and tax burden, income, and financial development. Furthermore, the empirical evidence also points to a non-linear long-run relationship (an inverted U-shaped curve) between tax evasion and financial development in the ASEAN-5 economies. The critical policy implication is that policies aiming at improving financial inclusion by the financial sectors will positively reduce the shadow economy and tax evasion in these ASEAN-5 economies. Nevertheless, this research has not answered the effect between monetary freedom and government spending on tax evasion in ASEAN.

Furthermore, from the research done by Islam et al. (2020) in South Asia, lower tax evasion is defined by a higher degree of economic freedom. Specifically, taxpayers who choose to tax evasion are influenced negatively by the government policies regarding monetary freedom and fiscal freedom. Greater government spending causes an increase in administrative spending, directly making the fiscal budget increase. It requires the government to increase tax rates, which can ultimately cause taxpayers to evade taxes (Li & Ma, 2015). However, the study of Islam et al. (2020) did not confirm government spending because it has an insignificant effect on tax evasion.

To answer the problem regarding tax evasion in ASEAN, the author will analyze the effect of monetary freedom, fiscal freedom, and government spending on tax evasion in ASEAN over some time. This study is replicated based on the research that has been done by Islam et al. (2020) in South Asia. With the topic of Tax Evasion, the author will make a final assignment paper titled "The Effect of Monetary Freedom, Fiscal Freedom, and Government Spending on Tax Evasion in ASEAN 2000-2015".

1.2 Problem

The formulation of the problem obtained from the background by the author is as follows:

1) How does monetary freedom affect tax evasion in ASEAN?

2) How does fiscal freedom affect tax evasion in ASEAN?

3) How does government spending affect tax evasion in ASEAN?

1.3 Purpose

The objectives to be achieved by the author in writing the thesis paper are as follows:

1) To find out the effect of monetary freedom on tax evasion in ASEAN?

2) To find out the effect of fiscal freedom on tax evasion in ASEAN?

3) To find out the effect of government spending on tax evasion in ASEAN?

1.4 Scope

In the final assignment paper that the author will make, its discussion is limited to the following matters.

1) Based on the data collected, the author will limit the scope of the discussion to economic factors that affect tax evasion, especially monetary freedom, fiscal freedom, and government spending.

2) The study will be conducted on countries in ASEAN from 2000 to 2015.

3) If information is impossible to obtain (e.g., unavailability of data in some countries), the authors will use countries with sufficient relevant data.

1.5 Benefits

The discussion presented in this final assignment paper is expected to benefit theoretically and practically.

1) Theoretical Benefits

This research will contribute to the tax literature. The discussion is expected to increase knowledge and insight regarding economic freedom in a country

against tax evasion. In addition, it is hoped that it can foster curiosity regarding the issue of tax evasion in ASEAN countries.

2) Practical Benefits

   a) For Writers

   The preparation of this final assignment paper is expected to be a way for writers to pour knowledge into accounting and taxation. Final assignment paper writing is also expected to be one of the learning media to produce better writing in the future.

   b) For The Next Researcher

   This study provides an essential summary of various data sources for future international tax writers or researchers, and practitioners on related issues.

   c) For Policy Makers or Government.

   This final assignment paper discussion is expected to contribute to and consider setting standards, regulations, and provisions, especially in taxations. Thus, the resulting policy benefits one party and benefits the whole community.

1.6 Final Assignment Paper Systematics

The writing system is divided into four chapters in the final assignment paper.

1) Chapter I Introduction

Chapter I contains an overview of the discussion that became the object of preparing the final assignment paper. The background describes, in general, the problem, data and methods used, and the scope of the discussion. The

formulation of the problem is the primary key to narrowing the problem. At the same time, the goal is to provide a solution approach to the problem.

2) Chapter II Literature Review

Chapter II contains the concepts that underlie the thinking in the discussion of the final assignment paper. This chapter will discuss tax evasion theory, tax evasion model, and economic freedom, including monetary freedom, fiscal freedom, and government spending. In addition, this chapter will also describe various previous research literature that became the basis of the research.

3) Chapter III Method and Discussion

Chapter III contains a collection of data obtained from the subject for later review and discussion following the topic of the final assignment paper. The author conducted various tests to produce acceptable data. The tests include descriptive statistics, unit roots, classic assumptions, static models (chow and hausman tests), and research hypothesis tests. Next, the author will discuss the problem of how the economic factors of a country's public policy affect tax evasion. The economic factors discussed are limited to monetary freedom, fiscal freedom, and government spending.

4) Chapter IV Closing

Chapter IV outlines the conclusions that answer the formulation of the problem and the purpose of writing the final assignment paper. The conclusion serves as the result of the discussion in the research. The suggestions section can be used to further researchers anticipate obstacles encountered.