The Effects of Management Control Systems in a Changing Public Organization: Evidence from Indonesian Tax Office Transformation

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Abstract

This study investigates about the effects of management control systems in change strategy and performance of Indonesian Tax Offices. This research is important for several reasons. First, there are no academic discussions about the effects of administration changing to the performance of Indonesian tax offices. This change has been done by improving services, information technology and human resources since 2002. Second, some facts showed that there is a declining performance in modernized offices. Third, there are no conclusive findings about the effect of management control systems in a changing public sector organization.

This research is prepared by a survey to two groups of respondents. The First group is 145 Income Tax Offices and Land and Building Tax Offices (response rate 44%). The second group is 145 taxpayers in some Indonesian regions.

This research examined the control theory and the change theory. This research uses interaction and system of fit to examine independent, moderating and dependent variables. By using regression and correlation test, the findings are as follows. First, for tax offices using a strategy of radical change, emphasizing budget evaluative style during performance evaluation is associated with high performance (service quality). Second, for tax office employing a strategy of radical change, increase in decentralization is associated with high performance (tax revenue). Third, for tax office employing a strategy of radical change, use of formal control is associated with high performance (tax revenues). Fourth, by using system of fit, an appropriate match of all three key management control systems (budget evaluative style, decentralization, and form of control) with change strategy are not associated with high tax offices performance. Subsequent analysis shows that system of fit for management control systems is stronger to adaptive change strategy.

Keyword: change strategy, budget evaluative style, decentralization, type of control

INTRODUCTION

This research is aimed to verify the role of management control systems to change strategy and performance of Indonesia's tax offices. There are three inter-related issues: (1) tax office change and its effects to performance, (2) the moderating effect of management control systems to the performance of a changing tax office, and (3) the test of system fit of management control systems with change strategy and its effect to the tax office performance.

The first issue is related to the tax office change and its effect to performance. Tax revenue has often been related to external factors, such as inflation, economic growth, interest rate, and so on. Meanwhile, internal factors are rarely discussed. In Indonesian tax research, previous research (Nurmantu, 2007; Rachmany, 2005) did not focus on change effect on tax office performance. The Directorate General of Tax of the Finance Department of the Indonesian Republic has been reforming its tax service office. This transformation changes the way of tax offices in serving taxpayers. In the future, tax offices will be divided into Large Taxpayers Office (LTO), Medium Taxpayers Office (MTO), or Small Taxpayers Office (STO).

The different organization should follow a different approach in changing its organization (Dreachslin and Saunders, 1999; Greve, 1999; Wischnevsky and Damanpour, 2006). The issue of organizational change in Indonesia context (social, culture, and economic background) is relevant to be discussed because Higgs and Rowland (2005) argued that although many organizations tried to transform their organization, most of them failed. So, it provides another opportunity to investigate further about which change strategy fits to the organizational performance.

The second issue is related to the role of contingency factor (management control systems) to the performance of a changing tax office. Public sector organizations, such as Indonesian tax office, face a specific problem for its control and it's quite different from private sector (Mia and Gayol, 1991). Chenhall and Smith (2003) and Ford and Greer (2005) argue that Management Control Systems are important in providing information to assist in formulating and implementing strategies particularly when the change is strategic in nature. Because of inconclusive findings about the relation between change strategy and performance, this research proposes the other variables which moderate the both.

The third issue concerns about system fit approach. In contingency context, the issue is whether the alignment between change strategy and controls can improve a tax office performance. This issue is investigated in low cost and differentiation strategy by using business entities (Govindarajan (1988), Govindarajan dan Fisher (1990), dan Riyanto (2001).

THEORY DEVELOPMENT AND HYPOTHESIS DEVELOPMENT

Literature Review

Tax reform is an ongoing process, with policymakers (government) and tax administrators (tax office) continually adapting their tax systems to reflect changing economic, social, and political circumstances. The tax reforms have been driven by the need to provide a more competitive fiscal environment: one which encourages investment, risk-taking, entrepreneurship, and provides more job incentives.

Martinez-Vasquez (2000) discusses the choice of tax reform approach, “big-bang” and gradual approach. The change of tax systems in other countries such as Singapore, Japan, Latin America, and Europe is in line with Owens (2006) suggestion about principles of good tax design: simplification, fairness, removal of tax obstacles to growth, and move to more efficient tax bases.

The tax revenue is one of the important sources of Indonesia income. Tax ratio i.e. tax revenue compared to Gross Domestic Product (GDP) is between 11%-13.6%. This significant contribution to the state income and economic growth are affected by macro economy (economic growth, inflation, interest rate, and oil price), the number of taxpayers, delinquent taxpayers, and tax organization.

The Directorate General of Tax of the Finance Department of The Indonesian Republic has been transforming its tax office as one of the efforts to improve its performance. Traditional tax office functions are based on its tax type (income tax office, land and building tax office). The transformation include the integration of tax offices and serve all kinds of tax, specialization, service by account representatives, complaint center, help desk by using technology knowledge-base, using communication systems and up-to-date information technology, better infrastructure, fit and proper test for human resources recruitment, code of ethics, better remuneration system. In the future, tax offices will be divided into Large Taxpayers Office (LTO), Medium Taxpayers Office (MTO), Small Taxpayers Office (STO).

In 2006, the numbers of transforming offices are 20 region offices, 46 tax offices. At the end of 2008, all tax offices have been transformed. The released report by Directorate of General Tax (2007) showed the improving performance for large tax offices, the average growth since 2003 to 2006 is 31.42% which is beyond the national average (16.74%). Although there is a declining trend, these large tax offices still contribute to national revenue by 23.21%. This declining trend is assumed by declining revenue growth as a consequence of diminishing return phenomena.

1. **Change Theory.** In terms of radical or adaptive change and performance relation, there are three theories that can explain that relationship (Wischnevsky dan Damanpour, 2006). Rational model view organizations as tools designed to achieve pre-established ends (namely, organizational performance or effectiveness). Organizational change must contribute to achieving those goals. Thus, rational models of organization lead to the expectation that organizational transformation should benefit organizational performance. Population ecology provides an entirely different perspective on the relationship Relationship between organizational transformation and performance. Because of structural inertia—which prevents organizations from changing at a pace commensurate with the rate of environmental variation—changes in core features negatively impact the ability of an organization to maintain high levels of reliable and accountable performance. The institutional perspective emphasizes the homogeneity of organizational forms and practices. A central concept in this perspective is isomorphism, "a constraining process that forces one unit in a population to resemble other units that face the same set of environmental conditions" (1983: 149).

   DiMaggio and Powell (1983) propose that institutional isomorphism proceeds through three different mechanisms: coercive isomorphism (resulting from organizational and social pressures over dependent organizations that need resources and legitimacy), mimetic isomorphism (arising from the adoption of responses utilized by successful organizations, by organizations that face conditions of high uncertainty and lack of clarity regarding goals, technologies, and so on), and normative isomorphism (resulting from pressures related to professional standards).

2. **Contingency Theory.** Contingency theory asserts that organizational structure relates with situation, and that organizational effectiveness resulting from this relationship (Kaplan and Mackey, 1992). Thus, there is no single correct managerial action or organizational. Any one way of organizing is not equally effective under all conditions.

   Contingency theory argues that the design and use of control systems is contingent upon the context of the organizational setting in which these controls operate. A better match between the control system and the contextual contingency variable is hypothesized to result in increased organizational performance.

3. **Management Control Systems.** According to Ford and Greer (2005), the relevance of management control systems to successful change achievement has been conceptually acknowledged. However, the contribution of control systems to the choices of effective change strategy lacks practical investigation.

   Although control systems are often prescribed as necessary elements of effective change process, many managers appear to ignore or avoid formal control systems to manage change. The outcomes of many changes, particularly those strategic in nature, are often difficult to measure, which may reduce the effectiveness of control systems. This research considers three elements of management control systems (type of control, budget evaluative style, decentralization) that hypothesized to influence the effectiveness of change strategy.

4. **Organizational Performance.** Mucciarone and Neilson (2007) emphasize the performance indicators to measure economy, efficiency, and effectiveness in public sector. This research considers tax revenue and service quality of tax offices as one of economy and effectiveness performance indicators.

Hypotheses Development

This research predicts the causal effect of change strategy and performance relationship. This research considers two forms of change strategy, i.e. adaptive and radical change. The basic perspective is organizational rational model that view organization transformation is a deliberative process by decision maker to find an effective way to increase performance (Wischnevsky dan Damanpour, 2006). Thus,

H1: Change strategy has positive effect on the performance of tax offices

Different from previous research (Ford dan Greer, 2005; Paul dkk, 2000; Jaworski dan McInness, 1989), this research hypotesizes the effectiveness of change strategy depends on the control type. When an organization uses radical change (characterized by high resistant to change, high complexity task, and high task uncertainty), the more appropriate form of control is formal control. Meanwhile, for tax offices using adaptive change, the more appropriate form of control is informal one. Formal control is more appropriate because the strategic issues about national revenue. Formal control makes sure that target or output attained and the process of tax collection is effective.

This situation is quite different from adaptive change for organizational structure reasons. The employees do not experience complicated situation and all work is routine in nature. Thus,

H2.1: The use of formal control to radical change strategy has a positive higher effect to tax offices performance compared to adaptive change.

H2.2: The use of informal control to adaptive change strategy has a positive higher effect to tax offices performance compared to radical change.

Previous research on high budget stress has a negative effect on job-related tension and managerial performance as found by Hopwood had no empirical support (Brownell and Hirst 1986). Govindarajan (1988) found interactive effect between low cost and differentiation strategy and budget evaluative style to performance.

In Indonesian changing tax office, this research hypothesizes that when budget evaluation is high, radical change strategy results in higher performance compared to adaptive change strategy. This research considers that the massive tax office change still considers the goal of the change, that is the tax revenue. Thus,

H3.1 When emphasizing budgetary goals during performance is high, radical change strategy results in high tax offices performance if compared to adaptive change strategy.

H3.2 When emphasizing budgetary goals during performance is low, adaptive change strategy results in high tax offices performance if compared to radical change.

Sine et al. (2006) confirm bureaucratic organization is more possible to uncertain environment. Chia (1995) and Gul et al. (1995) finds interaction effect between participative budgeting and decentralization in affecting performance, but Govindarajan (1988) did not find interaction effect between implementation strategy and decentralization in affecting performance.

This research proposes that in tax offices using radical change's strategy, there is a need to authority delegation from organization to sub units. This is true when we see the region scope of Indonesian tax offices. Thus,

H4.1 When employing decentralization is high, radical change strategy results in high tax offices performance if compared to adaptive change strategy.

H4.2 When employing centralization is high, adaptive change strategy results in high tax offices performance if compared to radical change.

The four previous hypotheses use bivariate interaction approach. This approach test relationship between change strategy and one moderating variable and their interacting effects to performance. This research use similar work of Govindarajan (1988), Drazin and Van de Ven (1985), and Riyanto (2001).

This research hypothesizes that tax office performance depends on fit between contingency factors (budget evaluative style, decentralization and type of control) and change strategy. If tax offices adopt adaptive change strategy, organization performance will improve if it deemphasizes budget evaluation style, centralization, and informal control. If it uses radical change strategy, organization performance will improve if it emphasizes budget evaluation style, decentralization and formal control. Thus,

H5: An appropriate fit of all three management control systems (budget evaluative style, decentralization, and type of control) with change strategy will be associated with high tax office performance. A mismatch will be associated with low tax office performance.

RESEARCH METHOD

Samples

The first questionnaire is for the tax service office and Building and Land Tax Offices. The Total samples response questions are 143 (response rate 44%). The second questionnaire is sent to taxpayers. These taxpayers are from Jakarta, Semarang, Yogyakarta and Gorontalo regions. Jakarta and Semarang represent radical change, and Yogykarta and Gorontalo represent adaptive change. The numbers of taxpayers who responded this questionnaire is 143. Bias response test showed that most of variables are not significant different between early and late response.

Measurements

1. **Change Strategy**. This research uses adaptive and radical change strategy approach. To investigate whether change strategy in one tax office is adaptive or radical, this research uses instruments developed by Lines (2004), Maynard and Hakel (1997), and Whitey, dkk. (1983). The instrument consists of 17 items. High scores show radical change strategy and low scores show adaptive change strategy. Among the 17 items, 16 items are valid (factor loading is above average 0,50). Reliability test using Cronbach Alpha is 0.77.

2. **Type of Control.** Type of control is a way manager uses to supervise his/ her employee aims at achieving organizational performance. Two types of control are used in

this research i.e. formal control and informal control. This research uses instrument developed by Jaworski dan McInness (1989). The items are 9 and high score shows formal control and low score shows informal control. 6 items are valid, and reliability coefficient is 0.83.

3. **Budget Evaluative Style.** Budget evaluative style is a style that manager uses when evaluating performance. To measure this variable, this research used instruments developed by Pope and Otley (Otley dan Fakiolas 2000). High scores show performance evaluation emphasizing budget, and low scores show performance evaluation deemphasizing budget. Analysis factors showed that 4 items are valid and cronbach alpha coefficient is 0.62.

4. **Desentralization.** Decentralization is the extent of authority given to a unit in making decision. This research uses instruments developed by Vancil (Govindarajan 1988).). High scores show high decentralization, and low scores show centralization. All items are valid and reliability test is also reliable with the coefficient is 0.62.

5. **Performance**. Performance can be measured through objective data or subjective means. This research uses a different approach to evaluate the performance. Objective data is tax revenue growth for year 2005 and 2006. Subjective data use 22 items measuring service quality variable. This variable is measured by Parasuraman et al. (1988). The validity test showed that 14 of 22 items are valid and reliability coefficient is 0.86.

Table 1. Descriptive Statistic

Variable	*Mean*	Minimum	Maximum
Change Strategy	4.6215	2.94	6.63
Type of Control	5.9615	2.00	7.00
Budget Evaluative Style	5.2255	2.75	7.00
Decentralization	5.2360	2	7.00
Performance 1 (Tax Revenue)	0.1539	-0.30	0.68
Performance 2 (Service Quality)	4.6178	1.35	6.88

The test uses regression and correlation analysis. The equation is:

$$Y = \alpha + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_1 X_2 + \varepsilon$$

Y is tax office performance, X_1 is change strategy, X_2 is management control systems (type of control, budget evaluative style, or decentralization). X_1X_2 is interaction between change strategy and each management control systems.

RESULTS

Hypothesis 1: Change Strategy and Performance

For tax revenue dependent variable, R Square for this test is 0,000. This data show that variation of performance is not explained by strategy change. F test is 0,001 with 0,970 significant level. Thus, regression model can not be used to predict tax revenue performance.

For service quality dependent variable, R square for this test is 0,007. The data show that performance variance is not explained bye change strategy. F test is 0,930 with 0,930 significant level. This model also can not be used to predict service quality performance.

Table 2. Regression Test for First Hypothesis

Variable	Performance	
	Tax Revenue	Service Quality
Change Strategy	0.001 (Sig. 0.970)	-0.128 (Sig. 0.337)
F	0.001 (Sig. 0.970)	0.930 (Sig. 0.337)
R^2	0.000	0.007

Hypothesis 2: Type of Control

For tax revenue dependent variable, the regression model is positive and significant. F Test is 3.932 (Sig. 0.010) and R^2 is 0.078. Introducing interaction element increase R^2 value. For service quality dependent variable, the regression without interaction is not significant (0.797 sig. 0.453). After introducing interaction effect, the result is still insignificant. The second hypothesis is supported for tax revenue variable but not supported for service quality. Partial derivatives suggest that positive relation between radical change strategy and tax revenue exists when type of control is formal. For informal control, negative strategy and performance relation exists.

Table 3. Regression Test for Second Hypothesis

Variable	Performance (Tax Revenue)		Performance (Service Quality)	
	Interaction	Without Interaction	Interaction	Without Interaction
Change Strategy	-0.520 (Sig. 0.001)	0.002 (Sig. 0.919)	-0.920 (Sig. 0.310)	-0.110 (Sig. 0.413)
Type of Control	-0.416 (Sig. 0.001)	-0.008 (Sig. 0.686)	-0.729 (Sig. 0.308)	-0.089 (Sig. 0.416)
Interaction	0.087 (Sig. 0.001)	-	0.136 (Sig. 0.365)	-
F	3.932 (Sig. 0.010)	0.083 (Sig. 0.920)	0.806 (Sig. 0.493)	0.797 (Sig. 0.453)
R^2	0.078	0.001	0.017	0.011

Hypothesis 3: Budget Evaluative Style

As data indicate, the result do not support hypothesis. For tax revenue variable, the result shows that without interaction, F test is not significant. After introducing interaction, the result is still insignificant. For service quality performance, F test is not significant. Without interaction, F test is 1.515 (sig. 0.223). After introducing interaction effect, the score is not significant either. This result can be summarized that change strategy does not interact with budget evaluative style in affecting tax offices performance.

Table 4. Regression Test for Third Hypothesis

Variable	Performance (Tax Revenue)		Performance (Service Quality)	
	Interaction	Without Interaction	Interaction	Without Interaction
Change Strategy	-0.232 (Sig. 0.057)	0.001 (0.955)	-0.111 (Sig. 0.872)	-0.064 (Sig. 0.647)
Budget Evaluative Style	-0.201 (Sig. 0.052)	-0.001 (0.946)	-0.187 (Sig. 0.750)	-0.147 (Sig. 0.150)
Interaction	0.044 (0.050)	-	0.009 (Sig. 0.945)	-
F	1.302 (0.276)	0.003 (Sig. 0.997	1.004 (Sig. 0.393)	1.515 (Sig. 0.223)
R^2	0.0270	0.000	0.021	0.021

Hypothesis 4: Decentralization

The result shows that fourth hypothesis is not supported. Both tax revenue and service quality variable, regression model without interaction is not significant. F Test is not significant. After introducing interaction term, the result is not significant either..

Table 5. Regression Test for Fourth Hypothesis

Variable	Performance (Tax Revenue)		Performance (Service Quality)	
	Interaction	Without Interaction	Interaction	Without Interaction
Change Strategy	-0.214 (0.078)	0.005 (0.819)	0.378 (Sig. 0.578)	-0.065 (Sig. 0.627)
Decentralization	-0.203 (0.048)	-0.016 (0.306)	0.159 (Sig. 0.782)	-0.219 (Sig. 0.011)
Interaction	0.041 (0.065)	-	-0.082 (Sig. 0.506)	-
F	1.509 (0.215)	0.528 (0.591)	2.648 (Sig. 0.051)	3.765 (Sig. 0.026)
R^2	0.032	0.007	0.054	0.051

Hypothesis 5: Systems Approach to Fit

The bivariate interaction approach analyzes the fit between change strategy and the administrative mechanisms, taking one mechanism at a time. The systems analysis, on the other hand, examined the impact of the fit between the management control systems, taken as a set, and tax offices strategy on tax offices performance. I used the methodology first advocated by Van de Ven and Drazin (1985) to test Hypothesis 5.

Table 6. Ideal Profile Score of Management Control Systems

Contingency Factors	**Change Strategy**	
	Adaptive	**Radical**
Type of Control	6	42
Budget Evaluative Style	4	28
Desentralization	4	28
Total	**14**	**98**

For testing fifth hypothesis, this research calculated a fit score by measuring the match between the ideal pattern and the patterns of the tax offices in the sample. Specifically, the degree of fit (or perhaps, more accurately, misfit) for any given tax office was measured as the euclidean distance between that tax office's scores and the scores of its ideal type, identified on the basis of the focal tax office's strategy. The resulting distance variable, therefore, represents a measure of the multivariate fit of each tax office with the relevant ideal profile and takes into account the overall effect of deviation on all the administrative mechanisms simultaneously. Finally, the relationship between the deviation score and tax office performance was assessed. A negative correlation between a distance score and tax office performance indicates a good fit. The greater the distance from the respective ideal type, the lower the hypothesized performance. As predicted, tax office performance is negatively correlated with a tax office misfit using tax revenue.

Table 7. Performance and Misfit Correlation

		Performance (Tax Revenue)	Performance (Service Quality)
Misfit	*Pearson Correlation*	-0.012	0.106
	Sig. (2-tailed)	.091	0.104
	N	143	143

DISCUSSION

Importance of Management Control in Changing Organization

This research emphasizes the importance of management control. Match between management control systems and change strategy can help tax office manager to increase performance especially tax revenue. Bivariate interaction shows that type of control is more superior than the other control mechanisms. The tax office keeps its concern with stability of the state revenue. Thus, tax office managers prioritize formal mechanism to keep the stability of state revenue.

The result of first hypothesis states that there is no significant effect change strategy and the tax office performance. The possible explanation is the change does not answer the real needs of taxpayer that impacted to tax revenue. Although changes still continue, service aspect is not maximal yet. Reform euphoria could be one reason of this community demand. Good quality service can not be reached in a short term.

Based on third and fourth hypothesis, the results shows that the use budgetary evaluation, decentralization themselves are not the only effective means to help change of Directorate General of Tax. This in turn opens another mechanism to help change optimization.

By using system of fit, an appropriate match of all three key management control systems with change strategy are not associated with high tax offices performance. Subsequent analysis shows that system of fit for management control systems is stronger to adaptive change strategy.

Performance of Tax Office: The Factors That Should Be Considered

Some scholars has proposed the importance of organizational factors in managerial reform in the publlic sector (Parker & Bradley,2005; Higgins & McAllaster,2004). Higgs & Rowland (2005) argue that there are assertions that the root cause of many change problems is leadership behavior. If it is not supported by a good leadership, the change can not improve the performance. Bird and Vasquez (2004) argue that many developing countries face the political interest.

The dominant policy ideas in different countries about equity and fairness, efficiency, and growth, like the dominant economic and social interests (capital, labor, regional, ethnic, rich, poor) and the key institutions, both political (democracy, decentralization, budgetary) and economic (free trade, protectionism, macroeconomic policy, market structure), all interact in the formulation and implementation of tax policy. Last but not the least, Alm and Vasquez (2005) found that the intrinsic motivation to pay tax at aggregate level and individual level.

IMPLICATION, LIMITATION, AND FUTURE RESEARCH

Implications for Practice

The results of this study have both practical and theoretical relevance. At the level of practice, this research suggests to the Directorate General of Tax needs to adopt a flexible approach. In particular, this study has practical applications in two critical areas: change strategy and management control system. This study has implications not only for those responsible for managing tax offices change but also for the tax offices managers themselves to improve the overall level of Tax Office effectiveness.

In policy level, this research proposes transformation of tax offices should be done carefully. This study can also help practitioners develop new approaches to the design of control systems. Budget evaluative style, decentralization, and type of control can be used simultaneously to manage change in tax offices.

Implications for Theory

From the perspective of theory development, this study adds to the stream of research in strategic management for public sectors. This study also enriches management control systems literatures to strategy and performance relationship. This is including the first empirical study that has examined the linkage between tax office strategies and the three management control systems, especially as it relates to the effectiveness of tax offices.

Limitation and Future Research

Future research in this area could benefit by considering some of the limitations of the present study. Complex theories are needed to explain the position that, for a tax office to be successful, design choices should be internally consistent and also consistent with the tax office's strategic context. Although type of control variable might indicate a desired match with strategy, the result is not consistent with the other control systems. This research just relies on self reported measures (minus tax revenue). The future studies also need to take into account the notion of objective data. The data of this research is cross sectional and will offer an interesting benefit if the future research consider longitudinal approach. The future prospective research can use bivariate and system. The next research need consider internal consistency test among management control systems, and also their consistency to strategy and ability to detect equifinality.

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