

POWER, TRUST, AND INSTITUTION: TAX AUTHORITY VS TAXPAYER IN INDONESIA

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Abstract

This study aims to estimate tax compliance in a relationship between power of authority and trust in authority in Indonesia, and how institution plays a key role to shape tax reform. Using the aggregate data of individuals and firms per region tax office in all provinces in Indonesia in 10 years of taxing period (2008-2017) in time-fixed effect model, we found that soft and medium approach in power of authority gives significant effect in increasing tax compliance. However, other findings show that the higher taxpayer income, the lower the tax compliance. In addition, Java, Bali and Nusa Tenggara still give higher compliance than the other location in Indonesia. Tax reform needs institution as a rule to adapt in taxpayer behavior and understand the compliance risk.

Keywords: *institution; power of authority; tax authority; tax compliance; trust in authority*

Abstrak

Penelitian ini bertujuan untuk memperkirakan kepatuhan pajak dalam hubungan antara kekuatan otoritas dan kepercayaan terhadap otoritas di Indonesia dan bagaimana institusi memainkan peran kunci untuk membentuk reformasi perpajakan. Menggunakan data agregat individu dan perusahaan per kantor pajak daerah di seluruh provinsi di Indonesia dalam 10 tahun periode perpajakan (2008-2017) dalam model efek tetap waktu, kami menemukan bahwa pendekatan lunak dan menengah dalam kekuasaan otoritas memberikan efek signifikan dalam meningkatkan kepatuhan pajak. Namun, temuan lain menunjukkan bahwa pendapatan wajib pajak yang lebih tinggi, semakin rendah kepatuhan pajak. Selain itu, Jawa, Bali, dan Nusa Tenggara juga masih memberikan kepatuhan yang lebih tinggi dibandingkan lokasi lainnya di Indonesia. Reformasi perpajakan membutuhkan institusi sebagai aturan untuk beradaptasi dalam perilaku wajib pajak dan memahami risiko kepatuhan.

Kata kunci: lembaga; kuasa hukum; otoritas pajak; kepatuhan pajak; kepercayaan terhadap otoritas

Introduction

Most countries still rely on tax revenue to support the running of their country, regardless tax issues are always struggling with tax compliance. To achieve high tax compliance, the cooperation between tax authority and taxpayer is needed, if it cannot say a good relationship. However, the attitude of taxpayers to comply are resulted from

different motives, mostly are the cost for non-compliance is too high or they feel responsible as a citizen and members of the community (Wahl, I., Kastlunger, B., & Kirchler, 2010). Therefore, tax regulation is required to capture the taxpayer's motives and the given authority for tax authority to ensure the tax administration run well.

Most recent studies have been conducted to study deeply how both tax authority and taxpayer having role in the tax compliance. Regulation and power are believed to be determinant factors as policy tools to enhance tax compliance, such as audit rates and fines. Moreover, hard approaches are often used to provide a deterrent effect. This angle of perspectives had brought researchers in many years ago to study more in this area includes perception of audit rates, penalty rates, fines (financial or non-financial), and investigation which affect compliance (Alm, J., Bahl, R., & Murray, 1993), (Fortin, Lacroix, & Villeval, 2007), (Wahl, I., Kastlunger, B., & Kirchler, 2010), (Allingham & Sandmo, 1972), (Yitzhaki, 1974). However, those factors often show inconsistent effects on tax compliance because many studies have shown that majority of people are willing to pay taxes (Wahl, I., Kastlunger, B., & Kirchler, 2010).

In the same way, regulation and power of authorities cannot stand alone. Tax compliance always need interaction and relationship between taxpayer and tax authority. The attitude of taxpayer is needed to be considered as unit that cannot be separated. Motivations to comply with tax law are often based on enforced and voluntary cooperation, therefore how people perceive the law and the power of authority is interested to deeply explore. Some studies found that social and institutional environment in individuals (Faizal, Palil, Maelah, & Ramli, 2017), (Hessing, Elffers, Robben, & Webley, 1992), (Wenzel, 2004), and trust in institution as well (Feld & Frey, 2003) affect the compliance. The interaction between power of tax authority and trust in authority brings idea to integrates economics and psychological factor as the social dilemma framework called slippery slope framework (Wahl, I., Kastlunger, B., & Kirchler, 2010).

In the following years, the concept of slippery slope framework (Wahl, I., Kastlunger, B., & Kirchler, 2010) had been translated in the theoretical and practical terms. Practically, changes in dynamics of interactions provide an opportunity for tax authorities to improve the service climate and trust to improve compliance (Gangl, Hofmann, & Kirchler, 2015). Furthermore, other experimental study found out that even though trust and power shows positively effect on tax payment, however in voluntary compliance, trust increase and power decreases compliance and vice versa on enforced compliance (Wahl, I., Kastlunger, B., & Kirchler, 2010).

In Indonesia while tax revenue is still a mainstay to support the government budget, tax compliance issue always leaves problem to be addressed. In the last few years until 2018, tax revenue has never been reached, not to mention tax compliance that it is still disappointing. The level of tax compliance with tax reporting is still low. In 2018, there is only 61% from 18 million taxpayers who submit their tax return. Moreover, Indonesia is currently carrying out tax reform to improve tax administration system. Some research studies in Indonesia found out that tax morale had a significant effect in tax compliance, while demographic variable is the strongest factor (Widodo, Djefris, & Wardhani, 2010). Another experimental study described that understanding of tax and good sentiment to institution are catalyst to enhance tax compliance (Parlaungan, 2017).

The latest research in tax compliance in Indonesia brought the idea of slippery slope of framework to apply in the sense of trust and power climate in Indonesia tax

administration system. The idea is not very common, but it brings insight how to apply the concept in Indonesia. It results that tax compliance is below the optimum level where power of authority and trust in authority are above the optimum level (Prihandini, 2018). Moreover, institution is the underlying adaptive changes in society. As a humanly devised constraint that shape human interaction through time, institution is profound concept to explain how dimension of learning process take into account (North, 1994).

Method

Based on previous research in the slippery slope framework by (Kircher, 2008), this study is using the same analytical framework to see the effect of power of authorities and trust in authority in tax compliance, and how the interaction between them shape the tax compliance over time. The latest research in Indonesia by (Prihandini, 2018) had brought the new insight on how the slippery slope framework can be applied in Indonesia tax administration. Therefore, the empirical analysis in this research is basically using (Prihandini, 2018) analytical framework, but it is modified in certain variables and data.

$$TC = \alpha + \beta_1 PoA_{it} + \beta_2 TiA_{it} + \beta_3 PoA_{it} \times TiA_{it} + \beta_4 Inc_{it} + \beta_5 Loc_{it} + \emptyset_t + Z_i + Z_{it} + \varepsilon_{it}$$

Where:

i and t = individuals or firms' data and year;

TC = tax compliance

PoA = power of authority in year t-1

TiA = trust in authority in year t-1

PoA x TiA = the interaction between power of authority and trust in authority

Inc = categorical variables of income of individuals or firms.

For individuals:

- a. Inc = 1 (Income ≤ Rp50M),
- b. Inc = 2 (Rp50M < Income ≤ Rp250M),
- c. Inc = 3 (Rp250M < Income ≤ Rp500M),
- d. Inc = 4 (Income > Rp500M).

For firms:

- a. Inc = 1 (Income ≤ Rp4,8),
- b. Inc = 2 (Rp4,8B < Income ≤ Rp50B),
- c. Inc = 3 (Income > Rp50B).

Loc = Loc is categorical variables of region where individuals or firms are located. The categorical variables for Loc are:

- a. Loc = 1 if location in Sumatera,
- b. Loc = 2 if location is in Java, Bali, and Nusa Tenggara,
- c. Loc = 3 if location is in Kalimantan,
- d. Loc = 4 if location is in Sulawesi and North Maluku, and
- e. Loc = 5 if location is in Papua and Maluku;

\emptyset = individual or firms fixed effect;

Z = time fixed effect;

Z x t = Individual/firms in specific time trends; and

ε = the error terms.

In this research, we estimate the model using fixed-effect method. However, income and location as control variables are also important things to put attention to,

therefore this research uses pooled least square to find out how categorical variables show the effects of them in tax compliance model.

Data in this research are primarily collected from internal data tax authority in Indonesia, Directorate General of Taxes from period 2008-2017. Different from latest research by (Prihandini, 2018) which using 105 companies listed in Indonesia Stock Exchange in 2013, this research uses bigger data, if it cannot say population data in certain period in Indonesia. Data is an aggregate number of individuals and firms' taxpayer or declared letter by tax authority per region tax office in all provinces in Indonesia. Initially, we collect the data by sending the formal request to conduct research in Directorate General of Tax (DGT), Indonesia and DGT gave the permission to use the DGT's data for this research.

For purpose in this research, the assumption of each variables is very important. Based on the above framework, we collect data as follows as Figure 2:

- a. Tax Compliance is the attitude of taxpayers on filling tax return on due date.
- b. Power of authority is measured by the approach of tax authority to deal with tax compliance in tax administration system, therefore in this research, we divide the tax authority's strategies become soft approach, medium approach, and hard approach. Soft approach is measured by letter of inquiry declared by tax authority to taxpayer, medium approach is measured by report of audit result issued by tax authority on the audit carried out to taxpayer, and hard approach is measured of letter of reprimand sent to taxpayer.
- c. Trust in authority is the attitude of taxpayers in addressing fairness value, in this case fairness is redistributive fairness which is the attitude of taxpayers to address the action of tax authorities ensuring that the taxpayer comply with the tax law. Therefore, trust in authority is measured according to tax authority approach. If tax authority using soft approach, then trust in authority is measured by how many taxpayers response to letter of inquiry, and if tax authority using medium approach, then trust in authority is measured by how many taxpayer do not raise appeal of tax assessment, and lastly if tax authority using hard approach, then trust in authority is measured by how many taxpayers make appropriate payment according to tax return.

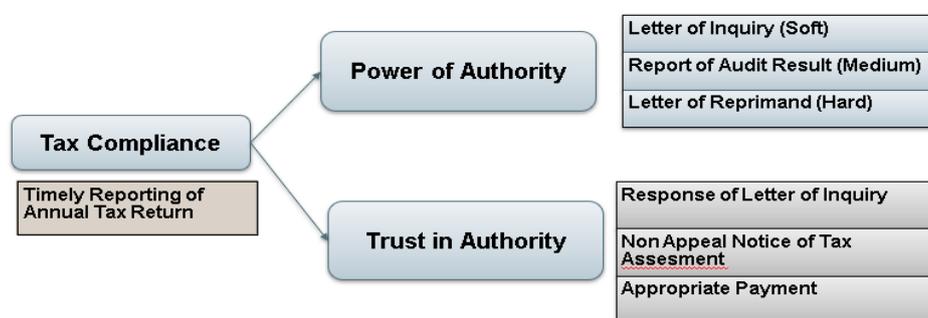


Figure 1
Data structure
 Source: Author

Result and Discussion

1. Result

In the following result, analyses of tax compliance by trust and power are presented. Table 1 estimated tax compliance over ten years taxing period. In individuals and firms, tax compliance reveals that there is interaction between trust and power. For individual, letter of inquiry declared by tax authority as a soft approach to remind taxpayer of their obligation to submit tax return gives significant effect to tax compliance, as well as the attitude of taxpayer respond the act of tax authority in the response of letter of inquiry. In every single letter of inquiry declared to taxpayer will increase approximately three taxpayers to comply on submitting their tax return in next period. As well as, if one individual response the inquiry letter will increase around two taxpayers to comply in next period. However, in firms, the trust of taxpayer seems not relevant to affect the tax compliance, even though the power of authority contributes more significant effect.

In the case of category of income, it shows that first category of incomes gives high contribution to tax compliance instead of others as well as in firms. Similarly, other than first category income in individuals and firms shows the same level of low tax compliance. The location itself describes that tax compliance in location 2 is better than the others, while in individual, location 5 is the worst.

This result depicts that soft approach using by authority to increase tax compliance is more effective in individual taxpayer rather than firms to increase tax compliance, even though both affect tax compliance itself. Furthermore, interaction between power and trust gives significant affect for tax compliance. This finding supports the previous research by (Kircher, 2008) where synergistic climate could bring the good environment for taxpayer to increase tax compliance.

Table 1
Estimation Results Using Soft Approach
Dependent variable: timely_report

Variables	Individual		Firms	
	FE	PLS	FE	PLS
inquiry_letter	2.988862*** (0.6544692)	4.6664549*** (0.7820679)	3.6178034** * (0.5127167)	4.2204344*** (0.4975907)
inquiry_respons e	2.2736427** (0.8638438)	0.10764377 (1.065195)	-0.22195026 (0.742424)	-0.7748479 (0.7265071)
inquiry_letter x inquiry_respons e	- 0.0018745** *	-0.00139549*** (0.0003314)	- 0.0039357** *	- 0.00347962*** (0.0005547)
inc_category 1		base		base
inc_category 2		-1539.3139*** (48.66242)		-658.44372*** (16.81452)
inc_category 3		-1551.0226*** (49.3944)		-665.43995*** (16.9642)
inc_category 4		-1493.5121*** (45.13985)		
Loc 1		-265.61919*** (63.91021)		-43.75854** (16.20772)
Loc 2		base		base
Loc 3		-549.99477*** (71.81555)		-59.027975*** (16.06863)
Loc 4		-410.5766*** (77.52387)		-34.386131 (24.7702)
Loc 5		-673.88587*** (85.35835)		-38.188883 (32.98498)
Constant	879.37124** * (15.2595)	1632.8328*** (52.05414)	271.78352** * (7.688762)	647.64521*** (18.65834)
Obs (N)	2903	2903	4496	4496
R2	0.42688482	0.55683572	0.49219544	0.64773935

SOFT APPROACH

Source: Data Processed, Stata 2019

Reported figures are the estimated coefficients followed by their standard errors. *, **, *** denote statistical significance at the 10 per cent, 5 per cent, and 1 per cent level of significance respectively. Standard errors in parentheses.

Different result is shown in Table 2. Using medium approach as a power of authority, the audit gives promising result to increase tax compliance. For individual, every single audit result issued by tax authority will increase around thirty-seven taxpayer to submit tax return on time, as well as firms, every single audit result will enhance eight taxpayers to comply in next period. The interaction between power and trust shows significant effect, it means tax compliance needs trust and power to increase

tax compliance. The attitude of taxpayer to see the audit approach taken by tax authority and response it by non-appealing notice of tax assessment results the positive and significant effect to increase the tax compliance. In individual and firms, for every single individual or firms who trust in authority by responding non-appealing tax notice will increase four taxpayers to comply in next period. Nevertheless, in one percent level of significance, power shows bigger magnitude than trust in enhancing tax compliance, even though the interaction between them is needed to shape the tax compliance over time.

In the case category of income, the result shows that more taxpayer in individual or firms in first category submit their tax return on time rather than the other income categories. The level of compliance in fourth category in individual income shows the worst result. Meanwhile, in the location category, location 2 in individual provides more taxpayers to comply rather than others. However, it is different with firms' characteristic where location 5 shows higher level of compliance.

This result shows that medium approach using by authority to increase tax compliance is effective both in individual taxpayer and firms to increase tax compliance. Furthermore, interaction between power and trust gives significant affect for tax compliance. This finding supports the previous research by (Kircher, 2008) where tax audit gives significant effect to increase tax compliance.

Table 2
Estimation Results Using Medium Approach
Dependent variable: timely_report

Variables	Individual		Firms	
	FE	PLS	FE	PLS
audit_result	37.092424*** (3.488504)	50.607931*** (4.568338)	8.6677912*** (0.7245142)	4.5606188*** (0.7326501)
nonappeal_notice	3.9985074*** (0.6685164)	7.0861897*** (0.9979385)	4.2248835*** (0.2555032)	6.1964515*** (0.2561863)
audit_result* nonappeal_notice	-0.056242*** (0.0127108)	- 0.07153184** (0.0225071)	- 0.03043773*** (0.0043542)	- 0.02900315*** (0.0061839)
inc_category 1		base		base
inc_category 2		- 758.94363*** (43.97821)		-465.65638*** (10.3645)
inc_category 3		- 772.87264*** (45.05119)		-486.06314*** (12.184)
inc_category 4		- 900.22738*** (45.05119)		
Loc 1		-25.92708 (48.02424)		-16.999666 (9.977217)
Loc 2		base		base
Loc 3		- 238.49696*** (45.85839)		-43.914031*** (10.6341)
Loc 4		- 224.71364*** (58.49077)		29.720258 (16.64786)
Loc 5		- 213.47179*** (62.31318)		71.778686** (24.10101)
Constant	597.86642*** (32.25874)	725.13475*** (47.95998)	102.19916*** (11.18469)	395.14274*** (13.18402)
Obs (N)	3787	3787	7622	7622
R2	0.25494373	0.58298672	0.41156787	0.66923784

MEDIUM APPROACH

Source: Data Processed, Stata 2019

Reported figures are the estimated coefficients followed by their standard errors. *, **, *** denote statistical significance at the 10 per cent, 5 per cent, and 1 per cent level of significance respectively Standard errors in parentheses.

In terms of hard approach as power of authority, Table 3 presents interesting result in level of tax compliance. Compared to soft approach and medium approach as the power of authority, hard approach gives lower expectation to enhance tax

compliance. In individual, power gives insignificant and small effect to tax compliance, even though trust shows significant effect. The interaction between trust and power seems irrelevant even though it is significant. It means reprimand letters issued by tax authority do not give deterrent effect for taxpayer, and it is only because of trust and the willingness of taxpayer to contribute in tax payment makes tax compliance increase over time. However, it seems different in firms' case, power and trust are significant in increasing tax compliance. In every single letter of reprimand issued by tax authority will increase one taxpayer to comply in next period, as well as in every single firm are willing to pay appropriate tax according to tax return, it will increase one taxpayer to comply in next period. However, the interaction between power and trust seems insignificant and only gives small effect.

Based on income category, in individual and firms, first category of income still shows similar result as soft and medium approach. Taxpayers in the first category shows higher level of tax compliance compared to other categories. However, in the category of location gives vary results. In individual, location 4 looks promising in higher tax compliance compared to other locations, but in firms, location 3 shows highest tax compliance.

This result depicts that hard approach using by authority to increase tax compliance is more effective in firms rather than individual to increase tax compliance. In individual, power gives insignificant and small effect to tax compliance and the interaction between trust and power seems irrelevant, even though it is significant. This finding supports the previous research by (Kircher, 2008) where antagonistic climate could bring the bad environment for taxpayer to increase tax compliance. Other than that, fine is more effective than audit, however, it only affects slightly tax compliance.

Table 3
Estimation Results Using Hard Approach
Dependent variable: timely_report

Variables	Individual		Firms	
	FE	PLS	FE	PLS
reprimand_letter	1.7118044 (1.006381)	1.7194985** (0.6672883)	0.7859334*** (0.2060979)	0.545007*** (0.1335022)
appr_payment	0.8197314*** (0.0490088)	0.99736011*** (0.0234414)	0.81706914*** (0.0252266)	0.981404*** (0.0108989)
reprimand_letter x appr_payment	-0.00044036* (0.0001845)	-0.00039681** (0.0001503)	-0.00008744 (0.0001213)	-0.00011545 (0.0000716)
inc_category 1		base		base
inc_category 2		-139.8603*** (26.88124)		-44.87145*** (6.061467)
inc_category 3		-140.14829*** (27.30365)		-46.52465*** (6.355565)
inc_category 4		-143.40599*** (25.99174)		
Loc 1		-25.67881 (23.25149)		-17.1297*** (4.867738)
Loc 2		base		base
Loc 3		-13.970905 (33.10312)		20.36476*** (5.196588)
Loc 4		20.017938 (32.78685)		-6.3734585 (8.450918)
Loc 5		-83.720394** (30.34148)		-1.405744 (15.93407)
Constant	217.68939*** (37.91522)	140.73787*** (29.18704)	78.775169*** (10.95906)	50.96279*** (6.863292)
Obs (N)	5782	5782	8515	8515
R2	0.49481737	0.89235212	0.68612115	0.94519923

HARD APPROACH

Source: Data Processed, Stata 2019

Reported figures are the estimated coefficients followed by their standard errors. *, **, *** denote statistical significance at the 10 per cent, 5 per cent, and 1 per cent level of significance respectively. Standard errors in parentheses.

2. Discussion

The findings show vary level of tax compliance depends on how power of authority used and trust in authority comprehend with the perceived of fairness in every act of authority. For individual, soft and medium approach give high impact for taxpayers to comply. However, hard approach is insignificant and give small effect. Furthermore, for firms, power of authority gives high effect for taxpayers to comply. It means, tax regulation and how tax authority using their power to enforce compliance gives high effect in firms instead of individuals.

Meanwhile, trust in authority matter for tax compliance. The attitude of taxpayers in perceiving fairness highly contributes to tax compliance. However, the interaction

between power and trust do not always occur, in firms while tax authority gives hard approach, then the interaction only gives small effect and insignificant. Income and location as control variables gives us interesting part in this study. We find that the higher the taxpayer income, the lower the tax compliance. It means, that individuals or firms who have lower income tend to more comply than wealthy individuals or firms over time. Similarly, Java, Bali and Nusa Tenggara in location 2 still give higher tax compliance than other islands in Indonesia. It shows that concentration of taxpayer still located in this area.

Indonesia tax reform should put attention in how authority using their power and comprehend with public trust to enhance tax compliance. In figure 3, the interaction between tax authority and taxpayer needs institution as a rule of game which give incentives in shaping the tax reform. In the institution framework, tax authority should design simple procedures and regulation and ready to change at any time to adapt with taxpayer behavior. From the results above, we can see that hard approach is not very significant in enhance compliance, but soft and medium approach are more promising to induce high compliance. Tax authority needs to identify the compliance risk and develop strategies to deal with this problem. The hard approach should be the last way to improve compliance, and building trust is the main thing. Practically, simplify of tax reporting and tax payment, create easiness in accessing information, and mapping the audit risk are most sensible way in tax reform.

Trust in authority in other way is formed by norms of behavior among society. The more opportunity of taxpayers to contribute in society will enhance the public trust. Trust will breed trust, and voluntary compliance is the result of trust. Perceived of fairness and fair procedures are determinant to lead the positive attitude towards tax compliance (Verboon & Goslinga, 2009).

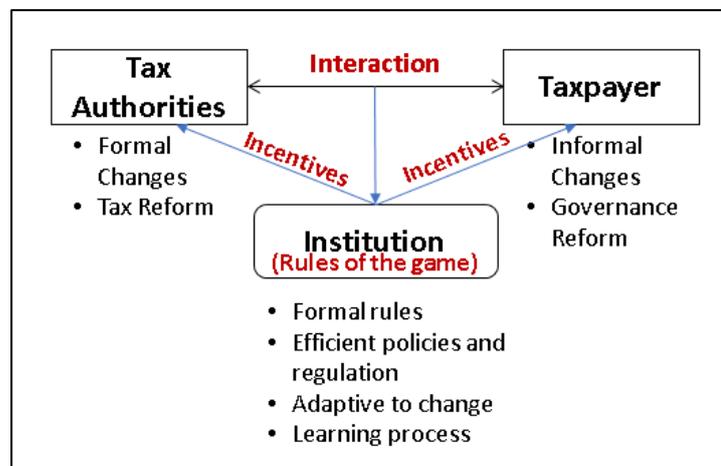


Figure 2
Tax authority and Taxpayer on Institutional Framework
 Source: Author

Conclusion

Tax compliance should be seen in broad perspective how the relationship between power of authority and trust in authority shaping the institution overtime. Based on the results above, for individual taxpayer, soft and medium approach give significant affect in tax compliance, while hard approach shows insignificant effect. However, for firms, power of authority is significant in increasing tax compliance. Taxpayer's attitude towards authority approach that represents tax authority gives significant effect as well to increase tax compliance. Furthermore, the significant effect of interaction between power of authority and trust in authority reflects that to increase tax compliance is by developing the strong relationship between power and trust in institution In the end, how tax authority using their power to enforce compliance gives high effect in firms instead of individuals. Using soft and medium approach are the most effective way for individuals.

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