

# THE EXTERNAL TRANSACTION COST OF TAX COMPLIANCE ON INSTITUTIONAL CHANGE OF TAX REGULATION

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## Abstract

Tax regulation reformation become a part of institutional change in tax system, designed to increase tax compliance of taxpayers. The changing of tax regulation makes some new cost of the implementation of new tax system. Furthermore, it would increase transaction cost in tax compliance. This research aims to analyze the external transaction cost of the changing of tax system in Indonesia from official tax system to self assessment tax system. Qualitative approach is used to analyze the external transaction cost in the implementation of a new tax system. This study explores the external cost that is incurred by the taxpayers due to the change of the tax regulation. The result will be important to the evaluation of new regulation implementation In Indonesia.

**Keywords:** *Institutional change, Transaction Cost, External Cost, Self Assessment System*

## I. Introduction

Tax is a primary source of national income. Tax income is the biggest of all other income sources, such State Non-tax Revenue (PNBP) and Grants. The total of tax income realization is 85% of total national income, while the State Non-tax Revenue (PNBP) is only 27%, and grant funds only less than 1% in 2015 (BPS). Therefore, Indonesian Government is trying to keep the tax revenue increasing along the escalation of national expenditure. The effort given by government is by reforming the institutional level or on the other term called by tax reformation, one of the purposes is to improve the level of tax compliance. Tax reformation was initially conducted in 1983 by reforming the tax collection system from Official Assessment System (OAS) to Self-Assessment System (SAS).

The implementation of SAS improves the tax compliance, since it is technically fair and equal to all tax payers. Contrast to the former system (OAS) which the tax payer acted passively, and the tax assessor was the one who had the right to calculate the unpaid tax by tax payers. In SAS, tax payers act actively, and tax payers have an authority to manage all of their taxation matters independently. Although it is equal and fair, the implementation of SAS will increase the transaction cost of tax by tax compliance. SAS increases compliance cost since there is a transfer of responsibility of taxation from government to tax payer (Sanford, 1990 in Mansor and Hanefah, 2008). Compliance cost is all costs which caused by the miss implementation of tax regulation by tax payers to the proper regulation, including the uncomfortable system faced in the process of obeying the given regulation (Eragbhe and Modugu, 2014). Whereas the tax compliance cost is one of the main factors which involve the tax payer to obey to the taxation (UN-DESA, 2014).

Furthermore, there was an effort to modernize the taxation system in the tax reformation phase one(1) by forming a new department in tax service office called by Account Representative (AR). AR is divided into two functions, the service and consultation, as well as monitoring and potential tax exploration. The first function is to provide technical and guidance service as well as to provide consultation service to tax payer. The existence of AR could reduce the cost of tax compliance which includes external cost of tax payer.

## II. Literature Review

### Transaction Cost Theory

Transaction Cost appears on the New Institutional Economics approach is using the framework of Neoclassical Economics, excluding the neoclassical assumption that there would be an imperfect information in economic activities, perfect rationality, and no transaction cost. Coase Theorem implied that the inefficiency in neoclassical economics did not only happen because of imperfect market structure, but also was caused by transaction cost (North, 1992 in Yustika, 2013). Hence, transaction cost is frequently used as an analytical tool to measure the efficiency of institutional design. Higher transaction cost means inefficient design of one institution, and vice versa (Yustika, 2013).

Transaction cost is defined as a cost of using the price mechanism which exists in resources allocation. This cost includes the cost of determining relevant price, cost of negotiation, organizing and ensuring the contract agreement of both sides (Coase, 1937, 1961 in Wang, 2003). Williamson argued that transaction cost is a cost which has to be lowered in order to set compliance to the management of rule or contract, a cost of comparison of planning, adopting, and observing the running process which is correlated to the compliance of the management of a rule. (Rao, 2002). Furthermore, Williamson also argued that in order to reach the goal of a organization, the strategies are chosen to combine an activity and the transaction cost which elaborates the most optimal result, or in other words, to produce the high income (strategizing) with a low transaction cost (economizing) (Prasetyo, 2008).

According to the Williamson's concept above, the purpose of organization in taxation is for loading the treasury fund by transferring resource (tax fund) from public to the government. Cost is needed to realize mentioned purpose, the cost has to be minimized in order to gain an efficient tax revenue. The mentioned cost is the transaction cost in taxation. Tax transaction cost is a spent cost in order to set compliance within taxation rule which includes planning, adopting, monitoring the running regulation (tax regulation), which in this context is a contract between government and a tax payer as a citizen.

Shah (2014) argued that transaction cost is caused by market failure in derivative information, or imperfect information as a consequence of the opportunistic behavior and bounded rationality embedded on transacting stakeholders, or interacting with an uncertainty, and small number of bargaining correlated to environment factors. Opportunistic behavior itself is defined as an individual self-interest action which gaining benefits for itself by practicing immoral transaction. meanwhile, bounded rationality is an individual limit to acquire, accept, regain, and proceed the incomplete information, and informational complexity.

Tax regulation is a contract binding the public to set a tax as a compulsory matter, and also binding the government to set the tax as a certain income source. Then, there is a two-way interaction in tax regulation between human limitations (Tax payer), the informational complexity. Bounded rationality sets not all of complex matters correlated in the written contract, so that the resulting contract will not be as perfect as expected. Furthermore, tax payers have a rational limitation in understanding, and processing as well as interpreting information in the regulation. For example, tax payers failed to understand a point of new reformed regulation cause them miscalculating the tax payment. In the result, tax payers have to reprocess the form filling (SPT) to the tax payment.

### III. Tax Compliance Cost

Tax compliance cost is a significant factor to determine the level of compliance of tax payer in order to fulfill the tax obligation. Hence, it is an ideal aspect that the costs should not burden the tax payer as well as not to inhibit the tax payer to fulfill its tax compliance (Sanford in Prasetyo, 2008). Sanford also explained that there are three kinds of cost in taxation, those are : the individual sacrifice to utilize income or assets to pay the tax (sacrifice of income); cost which is caused by transformations in the production process, and production factor because of the existing tax which distorts an economic behavior (distortion cost); and running cost which is an unavailable cost if the system does not exist includes an administrative cost as spent costs by government in order to maintain the national taxation system and compliance cost as spent costs by tax payer in order to fulfill the tax compliance.

Blazic (2004) defined compliance cost as a cost that should be spent by tax payer for fulfilling legal requirements, and budget authority for an actual tax payment and for distortion cost that embedded to the tax characteristic. Hanefah *et al* (2002) said that compliance cost is a cost that is correlated to the requirement of tax including a cost of managing or applying tax refund on time according to the tax regulation in a country. Furthermore, compliance cost is divided into two parts: internal cost and external cost. Internal cost consists of spent time by staffs or employee of a corporation to complete and to prepare the information to the professional supervisor such a tax consultant, fulfilling SPT form, and dealing with business owner or investor about complaints or appeals. On the other hand, external cost is spent in order to obey the tax, and it is also used by professional supervisor as a tax consultant, and public accountant.

Next, Rahayu in Prasetyo (2008) defined the tax compliance cost as every costs that excluded unpaid tax spent by tax payer in the process of fulfilling its tax compliance, start from planning tax aspects until accepting appeal decisions, and paying the unpaid tax. Rahayu classified tax compliance cost as an actual cash outlay, and opportunity cost of time. Actual cash outlay is all of expenditure in the form of cash which is spent for tax compliance. Whereas, opportunity cost of time is a time value, converted to rupiah, spent by tax payer for tax compliance. Then, tax compliance cost is also classified into internal and external costs. The internal cost is a tax compliance cost which is caused by a contract agreement with an imperfect information, opportunistic behavior, and limited rationality in the hierarchical organization. External cost is a tax compliance cost caused by contract agreement with an imperfect information, opportunistic behavior, and limited rationality excluding hierarchical organization (Prasetyo, 2008).

### IV. Research Method

The object of this research is tax compliance cost spent by small and micro enterprises in 2015. The informant of this research involving 32 key persons of tax payers which are owners or employees of small and micro enterprises that are registered in tax service office Pratama Candisari Semarang. The definition of small and micro enterprise used in this research is according to Undang-undang No 20 tahun 2008 about small and micro enterprise, which are; net asset ownership more than Rp.50.000.000,00 (fifty million rupiahs) to the maximum of Rp.500.000.000,00 (five hundred million rupiahs) not include land and building of business; or have an annual sales income for more than Rp.300.000.000,00 (three hundred million rupiahs) to Rp.2.500.000.000,00 (two billions and five hundred rupiah) for micro enterprise and net asset ownership more than Rp.50.000.000,00 (fifty million rupiah) to the maximum of Rp.500.000.000,00 (five hundred million rupiah) not including land and building of business; or have an annual sales income for more than Rp.300.000.000,00 (three hundred million rupiah) to the

maximum of Rp.2.500.000.000,00 (two billions and five hundred million rupiah) for small enterprise.

The determination of key persons is conducted by incidental sampling technique. Key persons are met incidentally when the tax payer were reporting annual SPT from March 1<sup>st</sup>, 2016 until April 30<sup>th</sup>, 2016. Qualitative approach is used to gain information of the actual experience of tax payers when spending the tax compliance cost in the form of external cost both opinion statement and direct information about total amount of external cost that they spent. This research uses observation and in-depth interview as a collecting data technique. The type of interview used is structured interview conducted by guidance.

### **Tax Compliance Cost**

**External cost** is calculated based on the result of adding transaction cost in the form of direct money cost and time cost.

$$\text{External Cost} : \text{direct money cost} + \text{time}$$

Direct money cost is a value of money that has to be incurred by tax payer correlated to process of compulsory implementation and taxation rights (Rosdiana and Tarigan, 2005). Direct money cost includes; (a) Cost in rupiah in one year that is incurred by enterprise to pay the service of tax consultant related to SPT management in the period of Value Added Tax (PPN). (b) Cost in rupiah in one year that is incurred by enterprise to pay the service of tax consultant related to SPT management in the period of annual Income Tax (PPH). (c) Cost in rupiah in one year that is incurred by enterprise to pay the service of tax consultant related to tax consultation. (d) Cost in rupiah in one year that is incurred by enterprise to pay the service of tax consultant related to tax planning. (e) Transportation Cost in rupiah in one year that is incurred by enterprise to visit tax consultant office.

Time cost is a cost in the form of time which is needed by tax payer to fulfill the obligations and rights of taxation (Rosdiana and Tarigan, 2005). Blazic (2004) explained that time cost is calculated from net salary per hour excluding social insurance contribution. Furthermore, Eragbhe and Modugu (2014) explained that time cost is calculated by quantifying time (in hour) into money value, by multiplying time with the average of net salary of enterprise tax officer per hour. Thus, in this research, time is calculated by the following method;

$$\text{Time Cost} = \text{Time} \times \text{The average of net salary of enterprise tax officer per hour}$$

The average of net salary of enterprise tax officer is calculated by ;

$$\text{Average Salary} = \frac{\text{Salary per month}}{24 \text{ working days} \times 7 \text{ hours per day}}$$

Time cost includes; changed time into cost in rupiah which is used to do a consultation with tax consultant.

## V. Result And Discussion

External cost in tax compliance cost occurred because enterprise or company uses tax consultant service. In this research, only 9 of 32 key persons that use the tax consultant service, while the rest 23 key persons choose to not using tax consultant service so that they do not spend external cost.

According to group of enterprise, micro scale enterprise use more tax consultant those are 5 out of 9 key persons, it showed a small gap to small scale enterprise which is 4 key persons. The interview with several key persons which are the owner or director of micro scale enterprise revealed their reasons to not using the tax consultant service. The reason is about consultant's fee which is considered expensive in the middle of business uncertainty and weak financial state. Therefore, owners of enterprise prefer to choose to manage the taxation matters by themselves. The other reason of key persons is that they felt the role of Account Representative (AR) has fulfilled the needs of tax consultation so they do not need the service of tax consultant anymore. As what already been mentioned in the introductory in tax reformation phase 1 that government is trying to improve tax compliance by modernizing tax system by forming a new department in tax service office which is Account Representative.

According to the regulation of the minister of finance number 98/KMK.01/2006, Account Representative take a duty to provide guidance and consultation about technical matters of taxation to tax payers. In fact, from the questions which are delivered to the key persons that do not use tax consultant service, majority of them stated that since the establishment of AR, they would rather choose to manage their tax matters independently by consultation and guidance from AR than using service from tax consultant. This condition indicates that before the existence of AR, the tax payers prefer to use the service of tax consultant, on the other hand that the existence of AR could remove the external cost.

Besides, key persons which come from small scale enterprise said the reason not to use the service of tax consultant is because they have a specialized employee or officer in taxation or in administrative department or general staff which at least has a basic skill of accounting and taxation.

This occurred because the small scale enterprises are able financially to employ specialized employee in taxation.

**Table 1. The Status of Key Persons Working on Taxation**

	Micro Scale enterprise		Small Scale Enterprise	
	N	Percentage	N	Percentage
Admin	5	15.6	5	15.6
Accountant	2	6.3	3	9.4
Director	7	21.9	4	12.5
Commissioner	0	0	1	3.1
Manager	0	0	1	3.1
General Staff	2	6.3	2	6.3
Total	16	100	16	100

Source : proceeded data, 2016

Table 1 indicates that according to the status of key persons working on taxation, the majority of micro scale enterprises manage the taxation independently by director, and administrative staff. It also can be seen that the small scale enterprises have more employee that be able to manage the taxation even though they are not specialized in

taxation, but have a basic knowledge of accounting and taxation. Therefore, the decision to use the service of tax consultant frequently occurred on mostly micro scale enterprise rather than small scale enterprise.

**Table 2. The Component Of External Cost By Tax Year 2015  
(In Rupiah And Percentage To Total External Cost)**

Component of external cost	Total Average	Percentage to total average of external cost
Fee of tax consultant	1.233.333,3333	97%
Transportation cost	6.653,0612	1%
Time cost	37.235,4497	3%
Average of Total Eksternal Cost	Rp 1.277.221,8448	

Source : Proceeded data, 2016

**Table 3. Reasons Of Key Persons To Use The Service Of Tax Consultant**

Reason	Important	Moderately Important	Neutral	Slightly Important	Less Important	Average Value	N
Frequently changing tax regulation that makes it difficult to be followed up without the help of professional	3	2	2	1	1	2.333333	9
Tax management is too complicated without professional guidance	5	3	1	-	-	3.222222	9
Limited skill of employee to handle tax management	3	3	3	-	-	2.333333	9
Uncertain whether tax officers are able to guide or help clearly and fast	1	1	7	-	-	0.777778	9
Enterprise wants to reduce the tax burden , so it needs consultation with professional	3	3	3	-	-	2.333333	9
Enterprise want to ensure the document and the calculation are made properly	5	3	1	-	-	3.222222	9

Source : Proceeded Data, 2016

External tax compliance cost consists of total direct cost which includes fee of tax consultant service and transportation cost, as well as time cost which is the spent times for consultation. The table below will show how the component of average external cost that is spent by 9 enterprises of key persons by tax year 2015.

The highest component of external cost is a fee of tax consultant which has Rp. 1.233.333 of total average or 97% of total average of external cost. Meanwhile, time cost and transportation cost spent by key persons for consultation are low, only 3% and 1% of total average of external cost respectively. This is because most of the key persons declared that meeting arrangement with tax consultant happened only once or twice, then next consultation could be continued by telephone also if tax payer face the difficulties or problems, some tax consultants will come into the office of key persons.

Furthermore, in this research, the author also deliver some questions about the reasons that make the key persons decide to use the service of tax consultant, by giving some optional reasons and rankings that are considered by key persons as important to less important. Key persons choices can be seen on the table 3. From all six optional reasons that are delivered by author in the interview, the reason about Tax management is too complicated to be done independently and Enterprises want to ensure the document and the tax calculation are made properly have the highest score by 3.222. the reason about Frequently changing tax regulation that makes it difficult to be followed up without the help of professional, Limited skill of employee to handle tax management are on the second rank chosen by key persons by 2.333, whereas the reason that enterprises are Uncertain whether tax officers are able to guide or help clearly and fast is on the lowest score by 0.77778.

As what mentioned before that the majority of key persons in the interview declare that tax officer especially the Account Representative is really helpful when the tax payers face the difficulties. Table 4 shows the types of tax consultant services that are used by key persons.

The majority of key persons only used tax consultation service by 5 frequencies. The next is tax calculation service for 4 frequencies, and then accountancy service and financial statement as well as annual SPT PPh management were equally 3 frequencies.

**Table 4**  
**Types Of Tax Consultation Service Used By Key Persons**

Type of Need	Frequence
Accountancy and Financial Statement	3
Tax Calculation	4
Tax Consultation	5
SPT in PPN Period Management	0
SPT in Pph Period Management	0
annual SPT for PPh Management	3
Tax Planning	0

Source: Proceeded Data, 2016

The key persons chose the accountancy service and financial statement that needed for SPT annual PPh report. Tax calculation service is for calculating annual PPh tax every

months. Both types are chosen because majority of key persons felt the difficulties to arrange financial statement and to calculate unpaid tax itself, particularly on micro scale enterprise or the recent established enterprises that have a less structured accountancy and administration. For small scale enterprise, the activity of arranging financial statement will spend much time if it is done independently, because small scale enterprise has more working transaction than micro scale enterprise. The financial statement will be more complex and complicated. Thus, the enterprises choose to use the tax consultant service and then collect and report it by themselves. Whereas, the annual SPT PPh management service is chosen by key persons because they want to be really freed from every single annual PPh management starting from arranging financial statement, calculation, collection, and reporting annual SPT PPh conducted by tax consultant.

Then, author conducted a calculation of external tax compliance cost in the tax year 2015. The result of calculation is showed in table 5 below;

**Table 5. The Result Of Calculation Of External Tax Compliance Cost In The Tax Year 2015( Rupiah)**

Group of enterprise	Average Value
Micro	263.452,38
Small	390.481,93
Total	326.967,16

Source: Proceeded Data, 2016

Total average of external tax compliance cost on micro scale enterprise is less than on small scale enterprise. The micro scale enterprises in this case use the type of tax consultant service with the lower fee from the type of service that is used by small scale enterprises. Fee on tax consultant service will meet the complexity of their tax management.

## VI. Conclusion

Institutional transformation by regulation and technical reformation on the tax collecting system from official to self-assessment system improve the tax compliance cost especially external tax compliance cost. Before Self Assessment System was implemented. External compliance cost is considered not existed, because technically tax payers are not directly involved in the taxation process. Another institutional transformation on the following tax reformation is by forming a new tax officer called Account Representative (AR), it is proven able to reduce the tax compliance cost by eliminating external compliance cost. This is proven by the statements of key persons that after the exintence of AR, they prefer to choose to arrange their tax management independently with the guidance and technical consultation from AR instead of spending external cost to use tax consultant service. As a result, in this research, only 9 out of 32 key persons of sample that spend the external compliance cost.



The complicated tax management conducted independently also the desire of enterprises that want to ensure the calculation and proper tax documents are the main reasons that make key persons use the service of tax consultant. The calculation result of external compliance cost in tax year 2015 shows Rp. 326.967,16 in average. The micro scale enterprises spent less external cost than the small scale enterprise because of different tax consultant fees which are adjusted to the complexity tax management of one enterprise, small scale enterprise pay more because its tax management is more complex than micro scale enterprise

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