

The Effect of Tax Transparency and Trust on Taxpayers' Voluntary Compliance

Fadjar O.P. Siahaan, *Airlangga University Surabaya*

Abstract— Indonesia uses a self-assessed taxing system that relies on voluntary compliance by taxpayers. Voluntary compliance is a complex behavioural issue and its investigation requires the use of a variety of methods and data sources. Increasing taxpayers' voluntary compliance are important aims of government. This article reports a study that examines the direct and indirect effect of tax transparency and trust on voluntary compliance. This study was conducted in Surabaya, East Java. The respondents of the study are individual taxpayer working in service industries. Fifty six taxpayers participated in this study. The findings of this study show that: (1) the direct effect tax transparency on taxpayer voluntary compliance is insignificant (2) the indirect effect of tax transparency on voluntary compliance through trust is positive and significant.

Keywords: tax transparency, trust, voluntary compliance

I. INTRODUCTION

Trust in government within the public has decreased sharply, especially after tax corruption scandals in recent years. How to restore trust among the public has become a crucial issue for Indonesian government because trust is claimed to be an important indicator of taxpayers' compliance behavior. Nowadays scholars and policymakers worldwide are interested in how to mitigate tax evasion and maximize compliance with the tax laws. Since individual income taxes are the major source of revenue for a government, non compliance has a significant economic impact. Tackling of the policy problem of tax evasion requires some understanding of the factors underlying the individual's decision to pay or evade his taxes.

There is a myriad of studies undertaken by researchers in order to measure levels of taxpayers' compliance behavior. Prior researchers have examined how individual compliance is affected by age (Tittle, 1980; Grasmick et al., 1984), Sex (Minor, 1978; Grasmick and Scott, 1980), income source (Madeo et al., 1985), occupation (Mason and Calvin, 1978; Westat, 1980), transparency (Yankelovich et al. 1984; Etzioni, 1986), complexity (Sanders and Wyndelts, 1989; Magro, 1999; Spilker *et al.*, 1999), tax rates (Mason and Calvin, 1984; Keller, 1998), tax compliance costs (Nam, 2002), audit adjustments (Chan and Mo, 2002) and moral obligation (Bobek and Hatfield, 2003).

Despite this research, most behavioral research have not incorporated transparency and trust in their model for predicting compliance behavior. Transparency and trust in government operations is getting increased scrutiny. Although a relatively new subfield of study in public affairs, academic books and articles are helping to build a body of knowledge that defines, prescribes, and measures governmental trust and transparency (Rawlins, 2008; Florini, 2007; Piotrowski, 2007; Roberts, 2006). It is argued that transparency provides the government a great opportunity to enhance taxpayers' compliance. When taxpayers perceive that the government is not transparent they will react by trying not to pay taxes.

Feeling of transparency could create sense of trust among taxpayers. Trust in government is increasingly investigated by scholars. In the picture of trust in government, a special place is given to trust in civil service. Several public administration reforms have been motivated by a willingness to strengthen trust in government. When taxpayers trust a tax institution, they are willing to be vulnerable to the tax institution's actions, confident that their rights and interests will not be abused (Hosmer, 1995; Mayer et al., 1995). Taxpayers can trust revenue body (tax institution) when they know and understand the goals of the institution. When there is a hidden agenda, there is no trust. Transparency was closely connected with trust and the two are positively related. According to Rawlins (2008), "As employee perceptions of organizational transparency increased so did trust". Trust promoting positive attitude toward tax institution, and ultimately increase voluntary compliance.

The current study differs from prior studies in two significant areas. First, the direct effect of tax transparency on trust has been examined by previous researchers. This study extended the research by investigating the effect of tax transparency on trust, and then the effect of trust on voluntary compliance. Second, the previous research using these two variables (transparency and trust) to investigate the relationship between organization and its employees. This study is an extension of previous studies to measure the two variables in the relationship between government and citizen in the tax area. This study contributes not only to the research literature but also to help government to develop strategies toward improving taxpayers' voluntary compliance.

II. LITERATURE REVIEW AND HYPOTHESES DEVELOPMENT

2.1 Tax Transparency

According to Transparency International, transparency is a 'characteristic of governments, companies, organisations and individuals of being open in the clear disclosure of

information rules, plans, processes and actions' (Transparency International 2009). "Transparency is the degree to which an organization shares information its stakeholders need to make informed decisions" (Holtz, 2009). Transparency is the state in which social policies, processes, and actions are visible to external observers (Steiner and Steiner, 2009). Piotrowski (2007) states that governmental transparency allows the public to develop a more accurate picture of what is happening inside a government. According to Rawlins (2009), there are three aspects of transparency:

1. **Informational Transparency** means openness, making publicly available all legally releasable information -- whether positive or negative in nature -- in a manner which is accurate, timely, balanced, and unequivocal. Information must be substantial to meet stakeholders needs. Disclosure by itself does not equal transparency, in fact some forms of disclosure can defeat the purposes of transparency.
2. **Participatory Transparency** is what separates transparency from disclosure. Transparency cannot be successful unless you know what stakeholders want and need to know. So, to ensure that the information shared is relevant and useful, stakeholders must be allowed to identify what they need to know.
3. **Accountability Transparency.** Transparency holds people accountable for their actions, words and decisions.

2.2 Trust

Trust is an intangible aspect of human life, it is very difficult to define. In fact, in the scholarly world, a universally accepted definition does not exist (Grabner-Kraeuter, 2002). Robbins and Judge (2009) define trust as positive expectation that another will not – through words, actions, or decisions – act opportunistically. Hosmer (1995) defines trust as the expectation by one person, group, or firm of ethical behavior—that is, morally correct decisions and actions based upon ethical principles of analysis—on the part of the other person, group, or firm in a joint endeavor or economic exchange. "Trust occurs when parties holding certain favorable perceptions of each other allow this relationship to reach the expected outcomes" (Wheless and Grotz 1977). A trusting person, group or institution will be "freed from worry and the need to monitor the other party's behavior, partially or entirely" (Levi and Stoker 2000, 496). Tschannen-Moran & Hoy (2000) provide a fairly comprehensive definition with the following: "Trust is one party's willingness to be vulnerable to another party based on the confidence that the latter party is (a) benevolent, (b) reliable, (c) competent, (d) honest, and (e) open".

Robbins and Judge (2009) identify three types of trust in organizational relationships: deterrence based, knowledge based, and identification based.

1. **Deterrence-Based Trust.** This form of trust is based on fear of reprisal if the trust is violated. Individuals who are in this type of relationship do what they do because they fear the consequences from not following through on their obligations.

2. **Knowledge-Based Trust.** Most organizational relationships are rooted in knowledge-based trust—that is, trust is based on the behavioural predictability that comes from a history of interaction. It exists when you have adequate information about someone to understand them well enough to be able to accurately predict his or her behaviour.
3. **Identification-Based Trust.** The highest level of trust is achieved when there is an emotional connection between the parties. It allows one party to act as an agent for the other and substitute for that person in interpersonal transactions.

In a similar way, Thomas (1998) suggests three conceptions of trust, namely fiduciary trust, mutual trust, and social trust. Fiduciary trust, which is notable for asymmetric relationships and attendant opportunities for malfeasance; mutual trust, which develops between individuals who repeatedly interact with one another; and social trust, which is embedded within institutions we know in common and take for granted.

2.3. Linkage Between Tax Transparency and Voluntary Compliance

Nowadays, taxpayers need greater information towards tax transparency, they want the government inform more openly about the taxes they pay. Transparency is generally defined as the open flow of information (Holzner & Holzner, 2006; Piotrowski, 2007). Tax transparency is the extent to which taxpayers have ready access to any required information about tax. To increase taxpayers' voluntary compliance, governments must be more open and transparent with their tax. Information transparency can be exploited by governments as an opportunity to improve voluntary compliance of existing taxpayers and to attract new ones. Increased tax transparency can encourage greater voluntary compliance by ensuring taxpayers that their tax payments are reaching the desired objectives.

Based on the arguments developed above, tax transparency is expected to have positive and direct effect on voluntary compliance behavior. This suggests the first hypothesis

H₁: There is a direct effect of tax transparency on voluntary compliance

2.4. Linkages Among Tax Transparency, Trust and Voluntary Compliance

Transparency arises as one of the most important factors contributing to the increase of levels of trust (Golin, 2004; Savage, 2005). One important impact and consequence of perceived transparency that has been made theoretically is to trust in government, which is a necessary part of healthy democracy (Nye, 1997). Heald (2006: 62) stresses that „transparency is expected to contribute positively to trust by building credibility“. Furthermore, increasing transparency, a government can reduce its taxpayers' uncertainty and allow taxpayers to make a rational decision. In a study of employees, Rawlins (2008) found that as the perception of

organizational transparency increased, so did trust in the organization. If transparency plays a major role in an organization’s ability to obtain and maintain public trust, a profession that wants to be trusted by its publics needs to be transparent (Bunting, 2004).

Thus, it is argued that trustworthiness of tax authorities will enhance voluntary compliance. Although a certain amount of scepticism is also necessary, trust in government authorities has been shown to have a strong influence on citizens’ reactions to authorities and their willingness to voluntarily comply with the authorities’ directives (Tyler, 1998). Murphy (2004) shows in a study of accused tax avoiders that there is a correlation between fair and correct treatment of the taxpayer and trust in the revenue body. Trust is in turn correlated to the willingness to comply. If regulators are seen to be acting transparently, people will trust the motives of that authority, and will defer to their decisions voluntarily. Transparency and trust are thus interlinked and the one cannot exist without the other. These propositions lead to hypothesis 2.

H₂: There is an indirect effect of tax transparency on voluntary compliance through trust

Based on the arguments above, the proposed conceptual model of the present study is as follows:

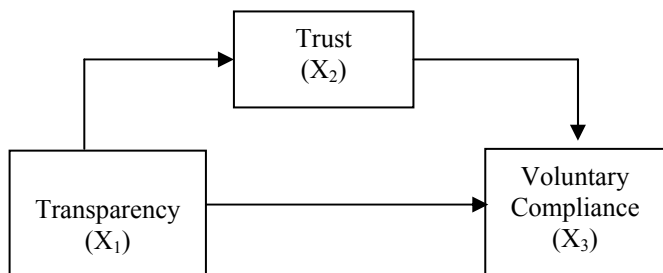


Figure 1
Basic Theoretical Model of the Present Study

III. RESEARCH METHOD

3.1 Sample

A total 100 questionnaires was distributed to individual taxpayers working in service industries in Surabaya – East Java. These taxpayers must have worked in the company at least one year, the criteria is important in order to make sure that they understand the tax law which prevails in Indonesia. A total of 67 taxpayers responded to the survey, of which 56 provided complete responses. There were 36 male taxpayers and 20 female taxpayers. The average participant was between 41 and 50 years old and had been employed by their current companies between five and ten years. Thirty two (32) of the participants were postgraduate level, 21 participants were undergraduate level, 3 participants were senior high school level.

3.2 Variable Measurement

1. **Tax Transparency.** Tax transparency is a characteristic of governments of being open in the clear disclosure of information rules, plans, processes and actions’. Tax transparency is measured by 4 items and 5 point likert type. A high score on this scale indicates that the tax system is transparent while a low score would indicate non transparent tax system. Cronbach alpha obtained in the present study was good (0,627).
2. **Trust.** Trust is one party’s willingness to be vulnerable to another party based on the confidence that the latter party is (a) benevolent, (b) reliable, (c) competent, (d) honest, and (e) open”. Trust was measure using a 5 item Likert-type scale. Taxpayer responded on a 5 point scale ranging from 1 (very low) to 5 (very high). A high numerical response indicates high degree of trust while a low numerical response indicates a low degree of trust. The cronbach alpha coefficient was 0,971 which indicated high internal reliability for the scale.
3. **Voluntary Compliance.** Voluntary compliance is accurate, timely and fully paid return without government enforcement efforts. Five items were developed to measure taxpayer compliance. Taxpayer responded on a 5 point scale ranging from 1 (strongly disagree) to 5 (strongly agree). A high numerical response indicates a perception of high degree of taxpayer compliance. The cronbach alpha coefficient was 0,940 which indicated high internal reliability for the scale.

3.3 Analysis Models

A path analytic method was used to test the model of the study as shown in figure 1. Path analysis is a statistical technique used primarily to examine the comparative strength of direct and indirect relationships among variables (Lleras, 2005). In the model, the relationships between variables were specified by a series of path coefficients (P_{ij}) which are equivalent to standardized beta (β). The equations in the path model are shown as follows:

$$X_2 = P_{21}X_1 + P_{2a} \dots \dots \dots (1)$$

$$X_3 = P_{31}X_1 + P_{32}X_2 + P_{3b}R_b \dots \dots \dots (2)$$

Where : X₁= transparency; X₂= trust; X₃ = voluntary compliance

The first equation shows the tax transparency (X₁) as the independent variable and trust (X₂) as dependent variable. The second equation treated transparency (X₁) and the trust (X₂) as the independent variable and voluntary compliance (X₃) as the dependent variable. Test on the adequacy of the regression models indicate that the assumptions of the models were satisfied by the data. Tests normality indicates that the results of each model are fairly normally distributed. To diagnose multicollinearity, the variance inflation factors (VIFs) are examined for the predictors. VIFs ranged from a low value of 1,000 to a high value of 1.161.

IV. RESEARCH FINDINGS

4.1 Regression Results

As mentioned above, to test the three hypotheses developed in the present study, two regression equations were employed. The results of the equations are presented in table 1 and 2

Table 1 Results of Regression of Equation 1
The Effect of Tax Transparency (X₁), on Trust (X₂)
 $X_2 = P_{21}X_1 + P_{2a}$

Variables	Coefficient	t-statistic	P-value
X ₁ Tax Transparency	0.373	2.952	0.005

Table 2 Results of Regression of Equation 2
The Effect of Tax Transparency (X₁) and Trust (X₂) on Voluntary Compliance (X₃)
 $X_3 = P_{31}X_1 + P_{32}X_2 + P_{3b}R_b$

Variables	Coefficient	t-statistic	P-value
X ₁ Tax Transparency	0.173	1.424	0.160
X ₂ Trust	0.487	4.019	0,000

4.2. Test of Hypothesis

4.2.1 Test of Hypothesis 1

To test H1, the effect of tax transparency on voluntary compliance, a linear regression model is employed, in which the independent variable is tax transparency and trust and the dependent variable is voluntary compliance. As summarized in Table 2, tax transparency shows a insignificant effect on a taxpayers' voluntary compliance [p (0.160) < 0.05]. Hence, the results of the path model do not support for hypothesis 1.

4.2.2 Test of Hypothesis 2

It is expected in hypothesis 2 that there is indirect effect of tax transparency on voluntary compliance behavior through trust. Table 1 and 2 provide the results to assess the indirect effect. Table 1 reveals that the effect of tax transparency on trust is positive and significant [p (0.005) < 0.05]. Table 2 also provides evidence to support hypotheses 2. Table 2 shows that the effect of trust on voluntary compliance is positive and significant [p (0.000) < 0.05]. The results satisfy both conditions necessary for demonstrating mediation in support of H2. Thus it appears that the primary effect of tax transparency on voluntary compliance behavior is via trust, this means that the results of the path model provide strong support for hypothesis 2.

V. DISCUSSION, LIMITATION AND CONCLUSIONS

Public trust in tax institutions has been decreasing in Indonesia. In the absence of citizens' trust in the institutions, the legitimacy of those institutions is endangered and the probability that citizens commence to undermine the authority of those institutions becomes more likely. In this study, the author investigated empirically the intervening role of trust in the relationship between tax transparency and voluntary compliance. The results indicate that feeling of transparency

increase the propensity to trust. This finding is consistent with the findings previous researchers (Rawlin,2008.). This means that government characterized by a relatively high degree of tax transparency have exhibited greater of trust, and will be able to achieve a more taxpayers' voluntary compliance.

Contrary to expectations, the author did not find significant result on the direct effect of transparency on taxpayers' voluntary compliance behavior. There are two explanations regarding with the result. First, too much information will lead to confused taxpayers. Confusion occurs when a taxpayers fails to correctly understand or interpret information provided by the government. This, in turn, leads to them making imperfect decisions. Second, information provided by the government may not be consistent with the facts. Hibbing and Theiss-Morse (2002) state that increased citizens knowledge can have the effect of increased expectations and consequently result in greater disappointment with government performance.

This study contributes to the research in compliance behaviour in general by integrating trust in the relationship between transparency and voluntary compliance behaviour. The findings of the present study contribute to tax compliance research by providing an explanation of the underlying causes of compliance. This study also provides results to help government to develop strategies toward improving compliance. Thus this study has the potential not only to contribute to the research literature but also assist regulators (government) to make the effective tax law that could increase compliance behavior.

This study has some limitations that should be noted. First, The data collection was confined to only one relatively large city of Indonesia, the replication of the study at different regions of Indonesia enable better generalizability of the findings of the study. Second, this study covers only privately owned organizations within service industries. Generalizing the results to other industries could be done by further study. Finally, the sample for the present study comprised of 56 taxpayers, this sample is only a very small proportion of the entire population of taxpayers in Surabaya. Therefore, research studies with much larger sample size would be required to ensure appropriate generalization of the findings of the study

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Author:

Fadjar O.P. Siahaan is an Expert Staff in Indonesian Supreme Audit Institution at Airlangga University Surabaya. Email: fadjarsiahaan@yahoo.co.id