

Ensuring a Balanced Tax System

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ASYMMETRIC INFORMATION AND  
ITS IMPACT ON TAX COMPLIANCE  
COST IN INDONESIA:  
A CONCEPTUAL APPROACH

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# ASYMMETRIC INFORMATION AND ITS IMPACT ON TAX COMPLIANCE COST IN INDONESIA: A CONCEPTUAL APPROACH

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A complexity of a tax system has a direct relationship with the hidden cost of taxation. The hidden cost of taxation is considered as compliance cost. There is a missing link between the relationship of compliance cost and the complexity of a tax system starts from the situation called asymmetric information.

Asymmetric information clarifies the behavior patterns of actors in a transaction in the situation where there is an imbalance of information that could potentially result in a market failure. Through assuming a model where actors are interacting with each other in a tax system, thereby could be found the implication of compliance cost in Indonesia.

In the context of economics of development, the presence of compliance cost will trigger high cost economy of a country and considered as a disincentive to taxpayers in complying with the tax system. Focusing on a conceptual approach and its relationship with current tax developments in Indonesia, this study recommend several policies that are considered to anticipate its negative effects on the economy.

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## 1. Introduction

In conforming with government requirements for compliance with tax laws, businesses are at least faced with the following kinds of expenditures: (i) the sacrifice of income from the payment of the tax itself; (ii) distortion costs, which are costs that arises from changes in the supply and demand of products due to taxes, which in turn alter the pattern of economic behavior; and (iii) tax operating cost, which are the resources needed to take up in operating the tax system in order to comply with tax regulations. From business perspective, tax operating cost is considered as *compliance cost*.<sup>2</sup>

The theory regarding compliance cost and its impact on taxation was first introduced by Sandford (1973). According Sanford, compliance costs and other administrative expenditures are considered as the hidden cost of taxation. Since then, various studies have been conducted, which acknowledge compliance cost as an important variable for increasing the level of compliance of taxpayers.

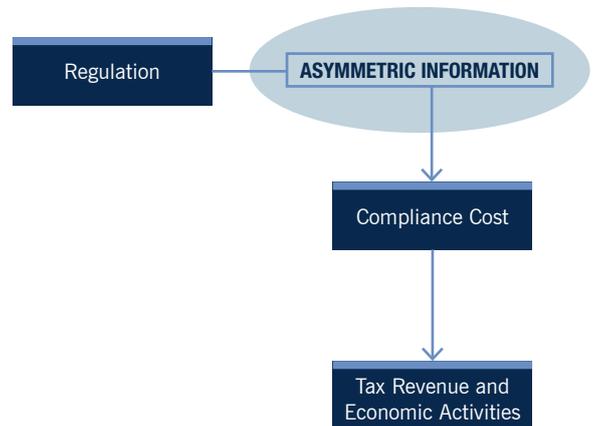
Most of these studies only clarifies that a complexity of a tax system has a direct relationship with compliance cost. Yet, there is no further study on the subject regarding the level of impact that a complexity of a tax system has on compliance cost, especially in Indonesia. For instance, whether a simple tax system would automatically result in a decrease of compliance cost or the other way around? Surely the answer to this question could be found if also the behavior pattern of stakeholders in a tax system is known. This is what has been lacking on the research on compliance cost, particularly in Indonesia.

In the author's opinion, the missing link between the relationship of compliance cost and the complexity of a tax system starts from the situation of asymmetric information (see Figure 1). Simply put, asymmetric information is a situation where one party has more or better information than the other party, while negotiating a contract to a transaction. In such a situation one of the party will lack the ability to observe the other party's actions and preference, thus creating an imbalance of power in transactions.

Up to date, there is lack of comprehensive data to study the level of compliance cost in Indonesia, especially when the subject is connected with the issue of asymmetric information. Despite of the

above, this article will attempt to study the subject on asymmetric information and its impact on compliance cost, thereby focusing on a conceptual approach and its relationship with current tax developments in Indonesia.

Figure 1 - Regulation, asymmetric information and compliance cost



## 2. Theory of asymmetric information and compliance cost

### 2.1. Asymmetric Information

Asymmetric information is one of the important branches in the discipline of microeconomics, which clarifies the behavior patterns of actors in a transaction in the situation where there is an imbalance of information that could potentially result in a market failure. The theory on the subject was first introduced by George Akerlof (1970), through his paper titled "The Market for Lemons: Quality, Uncertainty and the Market Mechanism". Joseph Stiglitz and Michael Spence further developed the theory.<sup>3</sup> The theory of asymmetrical information has been applied in various contexts and cases, such as: stock markets, insurance, investment decisions by companies and others.

Normally, an agreement or a written contract could reduce losses that could arise from asymmetric information. Ideally, a contract should become a solution for each party in the transaction to optimally satisfy each party in the transaction in accordance with their expectations. In order to so, a contract should at least fulfill the following requirements: (i) the contract should be feasible; (ii) the contract should produce an outcome that is deemed rational for each party; (iii) every measure agreed in the contract should give an incentive

<sup>2</sup> Cedric Sandford, "General Report: Administrative and Tax Compliance Costs of Taxation", in *Administrative and Tax Compliance Costs of Taxation* (Editor: Cedric Sandford), Kluwer Law and Taxation Publishers, 1989, p. 20.

<sup>3</sup> Both authors have contributed in the clarification of behavior patterns of economic agents in an Asymmetric Information situation. Stiglitz pioneered the theory of "screening". In this way, the under informed party can induce the other party to reveal their information. While Spence, introduced the idea of "signaling", where in a situation of Asymmetric Information it is possible for people to signal their type, thus believable transferring information to the other party and resolving the asymmetry.

at a certain level.<sup>4</sup> Further it also important to distinguish between risk-averse and risk-neutral behaviors. Such behaviors could influence a different outcome in an asymmetric information situation.

There are two classic issues which arises from asymmetric information: (i) *moral hazard*, which is a (ex-post) situation where a party lacks information about performance of the agreed upon transaction or lacks the ability to retaliate for a breach of the agreement, (ii) *adverse selection*, which is a (ex-ante) situation where a party lacks information while negotiating an agreed understanding or a contract to the transaction.

## 2.2. Compliance cost

Compliance cost are costs incurred by the taxpayers in meeting the requirements imposed on them by the law and the revenue authorities, over and above the actual payment of tax and over and above any distortion costs inherent in the nature of the tax.<sup>5</sup> On the other hand, we have an administrative costs; costs incurred by the public sector (such as the revenue department) for operating the tax system. Generally, there will be a trade-off between both compliance costs and administrative costs.

Compliance cost could be further distinguished between (i) mandatory cost, which are costs unavoidable to be incurred for complying with requirement of a tax system such as salary expenditure for employees that are responsible for preparing a tax return, and (ii) voluntary cost, which are costs that are avoidable such as payment for an external tax adviser.<sup>6</sup>

It is most often difficult, if not impossible, to measure compliance cost accurately, due to its complex nature and connection with other issues. It is also often not so clear which costs are to be accounted for as compliance cost, because this is influenced by the structure, system and tax environment of different countries. Generally compliance costs are influenced by the following factors: (i) salary expenses of staff who are responsible for tax matters in a company, (ii) expenses for external advisers, (iii) incidental costs. Besides the above there are also other types of

expenses, which may be included into compliance cost, such as physiological expenses due a tax issue that is faced by a taxpayer.<sup>7</sup>

## 3. Relationship of asymmetric information and compliance cost

To analyze the relationship between asymmetric information and compliance cost, we have to assume a model where involved parties (economic agents) are interacting with each other in a tax system. For the purpose of this analysis, it is assumed that the following parties that are relevant to the model:

- Taxpayers, in this case represented by enterprises;
- Tax authorities;
- Tax Consultants;
- Tax Court; and
- The Public; as proximity the author assumed the press and public figures to represent the public.

For the purpose of this analysis, the interactions between the above parties are further divided into the following 4 layers:

- i. Interaction between taxpayers and tax authorities;
- ii. Interaction between taxpayers, tax authorities and tax consultants;
- iii. Interaction between taxpayers, tax authorities, tax consultants and the tax court;
- iv. Interaction between taxpayers, tax authorities, tax consultants, the tax court and the public;

### 3.1. Interaction model layer 1

Analyzing asymmetric information in Indonesia could be started from the analysis on regulations. This is important, because regulations are the manifest of contracts, which is one of the means to avoid asymmetric information situations. In this context, contracts should facilitate a clear documentation of expectations of parties in transacting with each other. In other words, the author assumes regulations as the equivalent of contracts for the purpose of this analysis.

Generally, the complexity of regulations is not the only factor that contributes to asymmetric information. Besides the above, regulations that are frequently changed from time to time or

4 Andreu Mas-Colell, et.al. *Microeconomic Theory*, Oxford University Press, 1995, p. 479.

5 Sandford (1994): "The costs incurred by the taxpayers in meeting the requirements imposed on them by the law and the revenue authorities, over and above the actual payment of tax and over and above any distortion costs inherent in the nature of the tax."

6 Tracy Oliver and Scott Bartley, "Tax System Complexity and Compliance Costs — Some Theoretical Considerations", as accessible from [http://www.treasury.gov.au/documents/1009/HTML/docshell.asp?URL=05\\_Tax\\_Complexity\\_and\\_Compliance.htm](http://www.treasury.gov.au/documents/1009/HTML/docshell.asp?URL=05_Tax_Complexity_and_Compliance.htm)

7 Woellner, R. Coleman, C. Mc Kerchar, M. Walpole, M. dan Zetler, J. (2001), "Taxation or Vexation – Measuring the Psychological Costs of Tax Compliance", in *Tax Compliance Costs: A Festschrift for Cedric Sandford*, (editor: Evans, C. Pope, J. dan Hasseldine, J.), Prospect, p. 35-49.

regulations that are not known by taxpayers also contributes to asymmetric information. There are at least three factors that influence the relationship between regulations and asymmetric information:

- i. Regulations that are drafted in such way that arises multi-interpretations by both taxpayers and tax authorities alike. Not clearly defined regulations will blur the rights and obligations that is agreed between the parties, which in turn may lead to: *moral hazard* and *adverse selection*.
- ii. Representation of taxpayers in drafting the regulations. Every aspect of taxation should take in considerations the people's choice. In Indonesia this is stated in the Article 28h paragraph (4) of the Constitution:

*"Each person has the right to own private property and such ownership shall not be appropriated arbitrarily by whomsoever"*

Whereas Article 23A of the Constitution states:

*"Taxes and other compulsory levies required for the needs of the state are to be regulated by law"*

From the above, it could be concluded that Indonesia recognizes the concept of "private property" and allows the levy of taxes, however only if such taxes are regulated by law, which is a product of public representation (public choice).

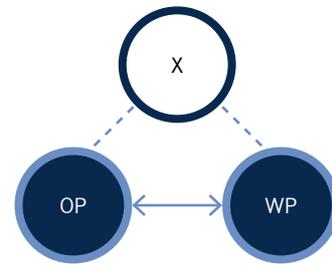
- iii. Complexity of tax system could increase the potential to arise asymmetric information situations. Generally, tax authorities are more familiar to the details of tax regulations if compared to the taxpayer. This may lead to a situation where possession of information is not balanced between tax authorities and taxpayers. Consequently this situation may drive one of the parties to conduct *signaling* to the other party. As example: tax authorities may create a situation where taxpayers feel as if they have made a mistake in reporting their tax obligations.

Interaction model layer 1 could be illustrated as Figure 2.

Besides the above, another issue is how far regulations are socialized /informed evenly and balanced to all taxpayers. As long as regulations are published through Government Gazettes, then the legal fiction<sup>8</sup> applies and the Government has in principle no further obligation to inform the public regarding the enacted regulations. However, technical details on the application of tax laws

<sup>8</sup> Legal fiction is a fact assumed or created by the Law, in which all subjects of the Law are assumed to know and understand the Law in a way binding to them.

Figure 2 - Interaction model layer 1



Notes: X = Regulation; OP = Tax Authorities; WP = Taxpayers

are often publicized through Directorate General of Taxes Regulations, which are not necessarily publicized through Government Gazettes. As such, the need for socialization campaigns becomes relevant in this context.<sup>9</sup>

Currently however taxpayers are fortunate enough because, external parties are able to provide online services<sup>10</sup> (often also for free) in monitoring tax information and its developments. Moreover the information technology available today, enables taxpayers to navigate through the complexity of various regulations in more organized way, making it easy for taxpayers to find relevant regulations more efficiently. This development is further strengthening by the initiative from the Directorate General of Taxes by forming a Tax Socialization Team in each district office.<sup>11</sup>

Compliance cost in the context of interaction model layer 1 is more influenced by the quality of regulations and how information regarding these regulations is available to the parties. In order to have an equal distribution of information, corporate taxpayers will often incur *mandatory costs*, i.e. salary expenses for staff. When the tax system is complex and/or information difficult to obtain, then corporate taxpayers will often face with *voluntary cost*, i.e. cost for external advisers.

### 3.2. Interaction model layer 2

In interaction model layer 2, besides taxpayer and tax authority, an additional party, the tax consultant is also involved. The tax consultant is an external party who has a power of attorney to represent the taxpayer and is assumed to have sufficient information and expertise regarding taxes.

The need for external advisers is recognized under Ministry of Finance Regulation No. 22/PMK.03/2008. According to this regulation, only

<sup>9</sup> Since Indonesia adopt self-assessment system, advance ruling is necessary. Further, in several countries, the move to a self-assessment system was the direct and primary reason to adopt a system of formal advance rulings.

<sup>10</sup> For example: Ortax, PajakOnline, and others

<sup>11</sup> As announced in letter No. SE-99/PJ/2011

personnel of a company that are qualified formally according to a recognized educational institution are allowed to represent certain taxpayers. The regulation further states the following types of taxpayers that are allowed to be represented by the personnel concerned: (i) private individuals not conducting business or practicing a independent profession; (ii) private individuals who are conducting business but with a limited annual turnover of not more than Rp. 1.8 billion; and (iii) corporate taxpayers with a limited annual turnover of not more than Rp. 2.4 billion. As could be seen there is a significant gap of types of taxpayers who are not allowed to be represented by a personnel. This gap is fulfilled by the role of tax consultants.

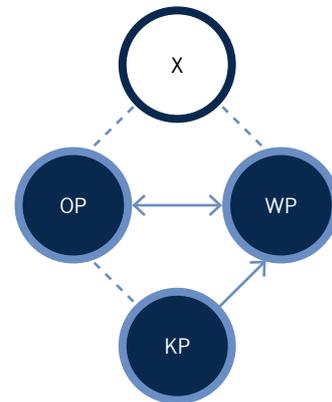
On the other hand, the same regulation stipulates that qualified tax consultants are persons who are certified in accordance with the Indonesian Tax Consultant Association (Ikatan Konsultan Pajak Indonesia, abbreviated IKPI). Considering the above, there are at least 3 options for corporate taxpayers to deal with Ministry of Finance Regulation No. 22/PMK.03/2008: (i) to hire professional services from an certified external adviser, (ii) to develop and train current employees so that they could obtain the certification, or (iii) hire new staff who are already certified. All the three options seem to impose additional *voluntary cost* for the corporate taxpayer in order to comply with the tax system.

As tax consultant services are considered to contribute in compliance cost, the remaining question is how asymmetric information contributes to costs in relation to the selection of tax consultant to be hired.

Asymmetric information in the tax consultancy market could affects the way in which taxpayers selects their tax consultants, which often is based on a biased selection. Up to date there is no objective measurement for tax consultant that is accessible to the public. The lack of such information, results that taxpayers based their selection on an alternative criteria, such brand names of globally recognized firms or tax consultants who network connections with important persons in the tax office. The preference of taxpayers to base their selection on the above criteria could be explained by the *risk-averse* nature of taxpayers, i.e. for avoiding risks.

The preference of taxpayers to select a tax consultant who has network connections with persons of the tax office does not necessarily assert that this preference is based on the urge of taxpayers to conclude informal agreements with the tax officials, but more because of rationality. In this context, the rational is to obtain more

Figure 3 - Interaction model layer 2



Notes: X = Regulation; OP = Tax Authorities; WP = Taxpayers; KP = Tax Consultants

information. A tax consultant that has network with the tax office will certainly be able to obtain information more easily.

Where the issue of asymmetric information is present in the tax consultancy market, the tax consultants will attempt to conduct *signaling*<sup>12</sup>, to form a certain perception of themselves to the taxpayers. This could be performed by for example: branding or association with a globally recognized firm, speaking in seminars, publication of materials, or even through access with the tax authorities.

On the other hand, the asymmetric information situation in tax consultancy market will potentially cause taxpayers to incur additional expenses such as, expenses for *screening* an appropriate tax consultant, a higher fee for consultancy services, or losses due to a selection of a tax consultant that is not sufficiently capable.

In the end, tax consultants are often assumed to have the required expertise regarding tax regulations<sup>13</sup> or in other words the party that possesses complete information. As such the selection of tax consultant has to be conducted carefully in an asymmetric information situation.

### 3.3. Interaction model layer 3

When regulations are multi-interpretational, it is most often the case that taxpayers and tax authorities will have different positions on its application. Undoubtedly, both parties will defend their position rigorously and when no common understanding is reached, then the case will end-up in tax court dispute. A tax court procedure will process both evidence on the applicable facts as well as analyze the legal arguments of both parties.

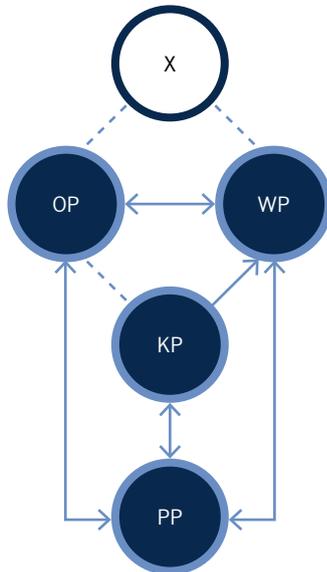
<sup>12</sup> Michael Spence, "Job Market Signaling", Quarterly Journal of Economics, The MIT Press, 1973, p. 355-374

<sup>13</sup> This is also stated in Article 49 paragraph (3) Government Regulation No. 74, Year 2011

It should be noted that in Indonesia the tax court procedure is limited to only one level<sup>14</sup>, which may cause a negative incentive for taxpayers to process their case in the tax court. At the same time, there will be a high probability of an increasing compliance cost, because taxpayers will be forced to finalize their case in its favor at this stage.<sup>15</sup>

The following illustrated Interaction model layer 3:

Figure 4 - Interaction model layer 3



Notes: X = Regulation; OP = Tax Authorities; WP = Taxpayers;  
KP = Tax Consultants; PP = Tax Court

The following are the issues in interaction model layer 3:

- i. In an asymmetric information situation, the tax consultant may potential attempt to monopolize information from the taxpayer. In other words, tax consultant may attempt to avoid information from directly reaching the taxpayer by for example avoiding taxpayers to interact directly with tax authorities and/or tax court. In this way, the information provided by the tax consultant will be the only source of information for the taxpayer.
- ii. The absence of transparency in the tax court could encourage abuse of authority and lack of quality in reasoning and arguments. This takes place even more, if the issue at hand relates to complex cases of interpretation where there

is lack of legal resources (absence of clear regulation, literature, case law and others). In such case, the tax court will favor a decision to the party, who has *signaled* most accordingly.

As could be observed previously in interaction model layer 1, an asymmetric information situation could already arise between the direct interactions of taxpayers with the tax authorities. The intention to involve tax consultants and the court in this context should have been to resolve or decrease this asymmetric information situation. Instead, the involvement of parties has in practice contributed to the opposite. An explanation to this could be due to the fact that each party involved is triggered to use asymmetric information situation for self-interests.

### 3.4. Interaction model layer 4

The involvement of the public in social issues in general, including taxation issues specifically, has in principle the purpose as a social check. In relation to this are three fundamental questions:

1. What kind of public could contribute positively to asymmetric information situations?;
2. Could the public resolve asymmetric information situations?; and
3. What could encourage the public to successfully resolve asymmetric information situations?

The public in this context is assumed to be the press and public figures because their influence in forming public opinions. In order to perform a social check accordingly, the public should be critical in nature and supported by sufficient accurate information. It is therefore of importance that the public possess a sufficient level of knowledge on current taxation issues.

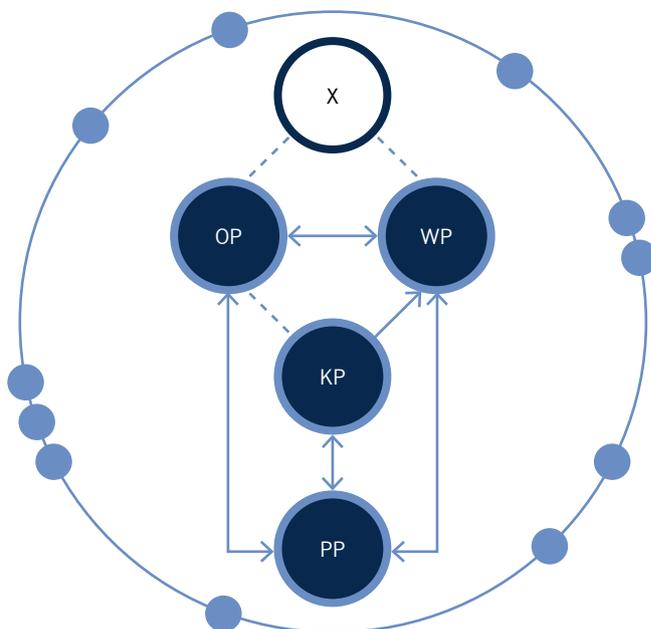
In this context, the press should have specialized journalists that have a well understanding on taxation issues in order to perform their social responsibility to inform the public on accurate information. Besides the above, the press should maintain a track record on public figures, which includes academicians, observers as well as practitioners who are also involved in the previous interaction layers. This is required because the press also acts as a filter of inaccurate and/or deviated information, which could prevent the forming of asymmetric information situations.

The success of the public in resolving asymmetric information situation also depends on information transparency in previous interaction models. Therefore, it is important that the public is granted the right to access information and the right to demand of transparency in the tax system. The following illustrates model interaction layer 4:

<sup>14</sup> According to article 33 paragraph (1) Law No. 14, Year 2002, the tax court is the competent court for making decisions regarding with tax issues at the first and last instance. Article 77 paragraph (1) Law No.14, Year 2002 further states that decisions made by the tax court are final decisions with legally binding powers, such that no further legal remedies (cassation) is available. However according to Article 77 paragraph (3) Law No. 14 Year 2002, in certain circumstances (such as "novum"), a judicial review may be proposed to the Supreme Court. This is in accordance with Article 24 paragraph (2) of the Constitution which states that tax court capacity falls under the scope of the Supreme Court

<sup>15</sup> Please note that there is also a 100% penalty if taxpayers lose at the tax court.

Figure 5 - Interaction model layer 4



Notes: X = Regulation; OP = Tax Authority; WP = Taxpayer; KP = Tax Consultant; PP = Tax Court; Points encircle interaction model shows external parties who also contributes in creation of asymmetric information

In interaction model layer 4, it could be observed that the public is flooded with information from both the press and opinions of public figures (represented with the points that encircle interaction model iii). Notwithstanding the above, publication of information and opinions are most often contribution to asymmetric information situations because both the press and public figures are also entrapped in a asymmetric information situation created in the previous interaction model and/ or due to lack of knowledge in taxation issues.

The relevance of compliance cost in the context of interaction model layer 4 lies in the fact that public opinion that is formed by inaccurate information could potentially distort or intervene indirectly to parties in a transaction. This most often result to losses for the taxpayers, due to psychological expenses, vindication, or penalties expenses due to decisions that are not balanced due to the influence of the public opinion above the facts.<sup>16</sup>

#### 4. The implication of compliance cost in Indonesia and proposed policy for its solution

All parties in the interaction models have the potential to possess incomplete information,

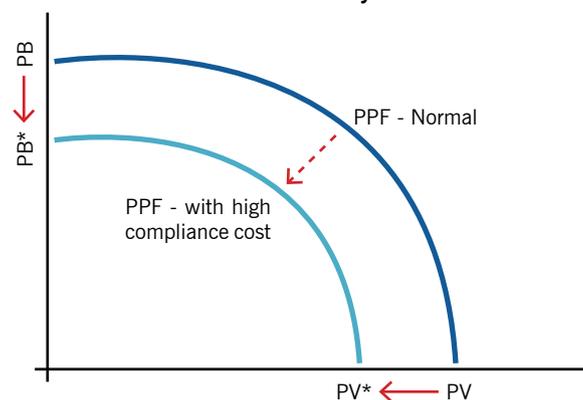
<sup>16</sup> Court decisions should always be neutral and free of public opinion as stipulated in accordance with article 3 paragraph (1) of Law No. 48, Year 2009 regarding the powers of courts which states that judges should maintain his/her independence in courts

which may cause further increasing effect in the asymmetric information situation. In such situation corporate taxpayers will attempt to minimize risks by for example hiring an external adviser, incur additional expenses for interaction with the tax authorities (information costs), or incur other expenses in connection with uncertainties (i.e. delayed decision by the tax court). In the end, this results to an accumulation of expenses that the corporate taxpayer must incur, thus increasing the compliance cost. In Indonesia specifically, corporate taxpayers will most likely incur high mandatory cost as well as voluntary cost.

Theoretically, high compliance cost will affect the economic output in a non-optimal result. This is because compliance cost will reduce the potential of companies to expand and increase its output (both private as well public goods) into the economy. As a result, the economic potential will aggregately not reach its maximum capacity. Figure 6 below, illustrates the production possibility curve of the economy formed by both private and public goods. The presence of high compliance costs will affect to the production possibility of private and public goods i.e. will fall down from PV to PV\* and from PB to PB\*. As such, the PPF will shift into a new lower combination of production, PPF with (high) compliance cost. Further, the decreasing availability supply of both public and private goods will result into a relative low position of social utility (below the optimal level).

It should be noted however, that a decrease of compliance cost does not automatically result to an increase of both private and public goods, but at least will result to an increase of production of one of the two types of products.

Figure 6 - Effect of compliance cost to the output of the economy



In the context of economics of development, compliance cost is one of the factors, which triggers high cost economy of a country and considered as a disincentive to taxpayers in complying with the tax system. Besides the above, high compliance cost is also closely connected to the phenomena of tax

avoidance, informal economy and corruption in a country.<sup>17</sup> Additionally high compliance costs also influences the investment climate of a country.

Considering the interaction models as described above and its impact on compliance costs, the following policy options are relevant to be considered in order to anticipate its negative effects on the economy:

- i. Regulations should be simple and clear for each party involved in a tax system. Regulations as a manifestation of contract between the Government (in this case the tax authorities) and the people (in this case the taxpayer) should be drafted where parties well represented, the contents are feasible, and rights and obligations are divided equally and rationally between the parties concerned.
- ii. Information on decisions made by tax court should be publicly accessible, so that the public could control its consistency with the Law.
- iii. The role of tax consultants should be regulated clearly. This role should not be discriminative in nature, but rather based on good corporate governance principles. Besides the above, tax consultant should have wider role in resolving asymmetric information by for example: an obligation to provide services for free for certain small and medium enterprises.
- iv. Development of an information system for the public to access information. Tax authorities should have an active role in providing services to the taxpayers without any preference above another. This could potentially increase administrative cost but on the same time also decrease compliance cost in a certain degree.
- v. Development of an internal information system for the tax authorities. This could ensure consistency in the perception of certain cases and/or interpretation of regulations among tax authorities.
- vi. Conduct tax training for the press to develop capacity in tax matters. This is important because the press is at the frontline for informing the public in tax matters. Besides the above, the press is also a filter for misleading information from public figures that do not have a track record in taxation.
- vii. Create certainty in the Law (add punishment) regarding uncertainties that is created by agents in the interaction models.
- viii. Evaluation of certification requirements for tax consultants to ensure clarity and balance in the certification system for tax consultants. This also includes evaluation of the education curriculum and the authorized institution which conducts such certifications.
- ix. Development of a good system of advance tax rulings to break complexity and uncertainty to lead more compliant taxpayer behavior.

<sup>17</sup> The World Bank/IFC dan PWC. 2011. Paying Taxes 2012: The Global Picture, p. 14.



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