

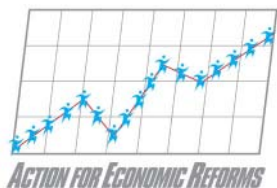
Assessing Indonesia's Tax Optimization

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Towards Tax Justice

Policy Research Paper

2010



Taxation constitutes one of the main elements of government management – which includes empirical observations and thought regarding the role of government in economic development. Taxes themselves comprise – rightly so – the main source of a country’s income. Based on this income, the government can regulate economic conditions and growth, rates of unemployment and inflation, leading not only toward economic ends (such as increasing per capita income, economic growth, reducing unemployment and stabilizing the economy) but also, social improvement ends, such as equity, education and health.

Nicholas Kaldor – a leading British economist – argued that in order to progress, a country must be able to collect taxes amounting to 25 to 35% of its gross domestic product (GDP). Although calling for a lower target, the UN Millennium Project in 2005 stressed the need for a 4% increase from the current average tax-income-to-GDP percentage, namely 18%.³

In principle, the state, as a producer involved in the creation of value together with the whole society, earns income in four forms. The first of these is Direct Taxes, that is, part of the income that is generated through the production of commodities, which constitutes part of the surplus value and wages produced in a given period. The second is Public Loans, for example, state-issued bonds that people purchase using the surplus value they have accumulated, in the expectation of gaining additional surplus value from their investments. The third form is Indirect Taxes, such as excise tax (on imported commodities as well as commodities that circulate in country, such as cigarettes), sales tax and value-added tax. These are called “indirect” because what is paid is not part of the income that has been generated, but is added on to the sales price

¹ Working Paper for the Perkumpulan Prakarsa Project entitled: “Towards Tax Justice: Raising Awareness, Building Capacity, Supporting International Coordination and Policy Dialogue to Make National and International Tax Systems More Supportive of Development”. The first draft of this paper received input in a peer-review meeting on 20 November 2009 at the Perkumpulan Prakarsa office with the following reviewers: Sugeng Bahagijo, Ah Maftuchan, and Sopril Amir (Perkumpulan Prakarsa), Yuna Farhan (Sekjen Sekretariat Nasional Forum Informasi untuk Transparansi Anggaran/Seknas FITRA – Secretary General of the National Secretariat of the Information Forum for Budget Transparency), Mickael B. Hoelman (Program Coordinator, TIFA Foundation) and Novita (Expert Staff of the Democratic Party of Struggle of the Indonesian National Parliament).

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³ Bahl and Bird (2008), p. 5.

of a commodity. So the tax is not levied against total individual income but only against the income an individual spends on these taxable goods. Indirect taxes will have a greater impact on people with limited incomes, since they spend a greater portion of their incomes on daily necessities than people with higher incomes, who use a smaller portion of their earnings for this. The last form is currency printing, through which a country generates its purchasing power with respect to commodities and expenses, including salaries. However, as the quantity of money printed is multiplied, its value decreases, so that more of it is needed for exchange, which is equivalent to an increase in prices. People with limited earnings will be more affected by the impact of this because they lack options to convert their money into goods with more stable value – such as gold, stronger foreign currencies, stocks, fixed assets and art objects.

The impact of these four forms of state revenue on people's incomes and welfare will appear based on how the state uses the funds, in the purchase of commodities, investments, the payment of wages and salaries, and various kinds of state provisions, as well as payments of interest on the public debt. It is these expenditures that will determine the allocation of demand for the various commodities, which in turn influences the progress of business in general, and may even affect the cycle of industrial development. Ironically, most taxation policy analyses today are commonly made in isolation from the expenditure budget side of things, whether in developed or developing countries.⁴ Thus, discussions about taxes become discussions free of debate, whether at the level of ideas or impacts, regarding the priorities to be given in the use of state revenues – to meet what needs, in order to impact what segments of society? Under such sterile conditions, taxes are not discussed as tools of social redistribution; rather, more attention is paid to ways of collecting tax, along with turning a blind eye to the range of dynamics around the use of taxes to create surplus value, and its aggregation at the level of the nation – which constitutes the essence of development.

A critical review of various taxation strategies reveals that taxes have been neglected as a weapon to fight poverty and build democratic accountability in poor countries.⁵ Generally, the countries of the world have pursued three main strategies: vying to lower corporate taxes in order to attract foreign investment; following trade liberalization, by cutting back taxes previously obtained from international trade – which is a betrayal for poor countries that still rely on primary commodities as a main source of income; and tolerance of possibilities for wealthy people and multinational companies to move their wealth and profits abroad where they can escape the burden of paying taxes.

This paper is organized into a number of parts. The first part addresses the development of domestic revenues, through which the increasing role of taxation can be seen. Then, the discussion moves on to tax reform in Indonesia, followed by a comparison with tax reform in a number of other countries. Based on this comparison, the next part points out things that could strengthen tax reform strategies in Indonesia. The paper concludes with an overview of tax reform and the purposes it serves. It should be acknowledged that the scope of the current writing is limited, considering the broad dimensions of issues of taxation, especially regarding its technical aspects, although an attempt has been made in this paper to accommodate this breadth.

⁴ Bahl and Bird (2008), p. 5.

⁵ *Ibid.*, p. 16.

The Development of Domestic Revenues

From the point of view of two key components of domestic revenue – namely, the tax revenues and non-tax revenues of the state – it is evident that tax revenues make a significant contribution. From 2005 to 2007, tax revenues contributed 67% of Indonesian state revenues and grants. Developments in realization for the years 2005 to 2007 and projected for 2008 are shown in tables 1 and 2.

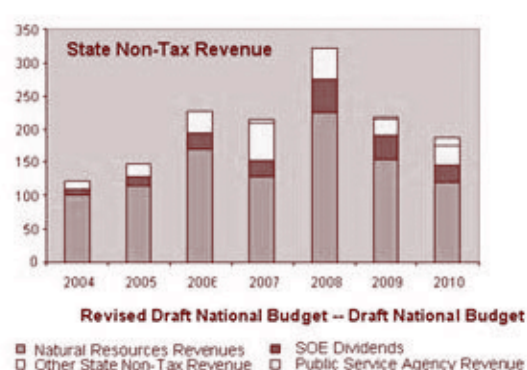
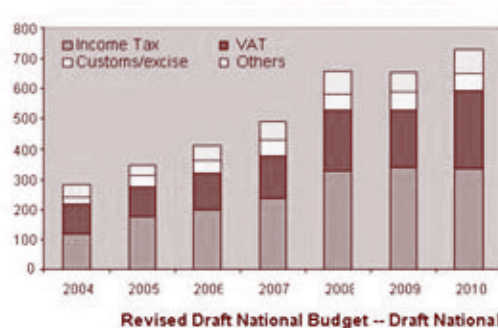
Table 1. Development of Domestic Revenues for 2005 - 2007 and Estimates for 2008 – 2010

Description	2005		2006		2007	
	Realization	% of GDP	Realization	% of GDP	Realization	% of GDP
Domestic Revenues	493.9	17.7	636.2	19	706.1	17.8
1. Tax Revenues	347	12.5	409.2	12.3	491	12.4
a. Domestic Taxes	331.8	11.9	396	11.9	470.1	11.9
i. Income taxes	175.5	6.3	208.8	6.3	238.4	6
1. Oil and gas sector	35.1	1.3	43.2	1.3	44	1.1
2. Non-oil and gas sector	140.4	5	165.6	5	194.4	4.9
ii. Value-added taxes	101.3	3.6	123	3.7	154.5	3.9
iii. Land and building taxes (PBB)	16.2	0.6	20.9	0.6	23.7	0.6
iv. Land and building title transfer taxes (BPHTB)	3.4	0.1	3.2	0.1	6	0.2
v. Excise taxes	33.3	1.2	37.8	1.1	44.7	1.1
vi. Other taxes	2.1	0.1	2.3	0.1	2.7	0.1
b. International Trade Taxes	15.2	0.5	13.2	0.4	20.9	0.5
i. Import duties	14.9	0.5	12.1	0.4	16.7	0.4
ii. Export duties	0.3	0	1.1	0	4.2	0.1
2. State Non-Tax Revenues	146.9	5.3	226.9	6.8	215.1	5.4
a. Natural Resource Revenues	110.5	4	167.5	5	132.9	3.4
i. Oil and gas	103.8	3.7	158.1	4.7	124.8	3.2
ii. Non-oil and gas	6.7	0.2	9.4	0.3	8.1	0.2
b. State-owned Enterprise (SOE) Profit Shares	12.8	0.5	21.5	0.6	23.2	0.6
c. Other State Non-tax Revenues	23.6	0.8	36.5	1.1	45.3	1.1
d. Bank Indonesia (BI) Surplus	0	0	1.5	0	13.7	0.3

Table 1. Development of Domestic Revenues for 2005 - 2007 and Estimates for 2008 – 2010 (continued)

Description	National Budget (APBN)	Revised National Budget (APBN-P)	% of GDP	Estimated Realization	% of GDP	% of APBN-P
Domestic Revenues	779.2	892	19.9	959.5	20.3	107.6
1. Tax Revenues	592	609.2	13.6	633.8	13.4	104
a. Domestic Taxes	570	580.2	12.9	599.2	12.7	103.3
i. Income taxes	306	305	6.8	318	6.7	104.3
1. Oil and gas sector	41.6	53.6	1.2	62.1	1.3	115.8
2. Non-oil and gas sector	264.3	251.4	5.6	255.9	5.4	101.8
ii. Value-added taxes	187.6	195.5	4.4	199.8	4.2	102.2
iii. Land and building taxes	24.2	25.3	0.6	25.5	0.5	101
iv. BPHTB	4.9	5.4	0.1	5.5	0.1	101.8
v. Excise taxes	44.4	45.7	1	47	1	102.7
vi. Other taxes	2.9	3.4	0.1	3.3	0.1	99.2
b. International Trade Taxes	22	29	0.6	34.7	0.7	119.6
i. Import duties	17.9	17.8	0.4	19.8	0.4	111.1
ii. Export duties	4.1	11.2	0.2	14.9	0.3	133.2
2. State Non-Tax Revenues	187.2	282.8	6.3	325.7	6.9	115.2
a. Natural Resource Revenues	126.2	192.8	4.3	229	4.8	118.8
i. Oil and gas	117.9	182.9	4.1	219.1	4.6	119.8
ii. Non-oil and gas	8.3	9.8	0.2	9.9	0.2	100.3
b. SOE Profit Shares	23.4	31.2	0.7	35	0.7	112.2
c. Other State Non-Tax Revenues	37.6	58.8	1.3	61.7	1.3	105

State Revenues 2004 -2010



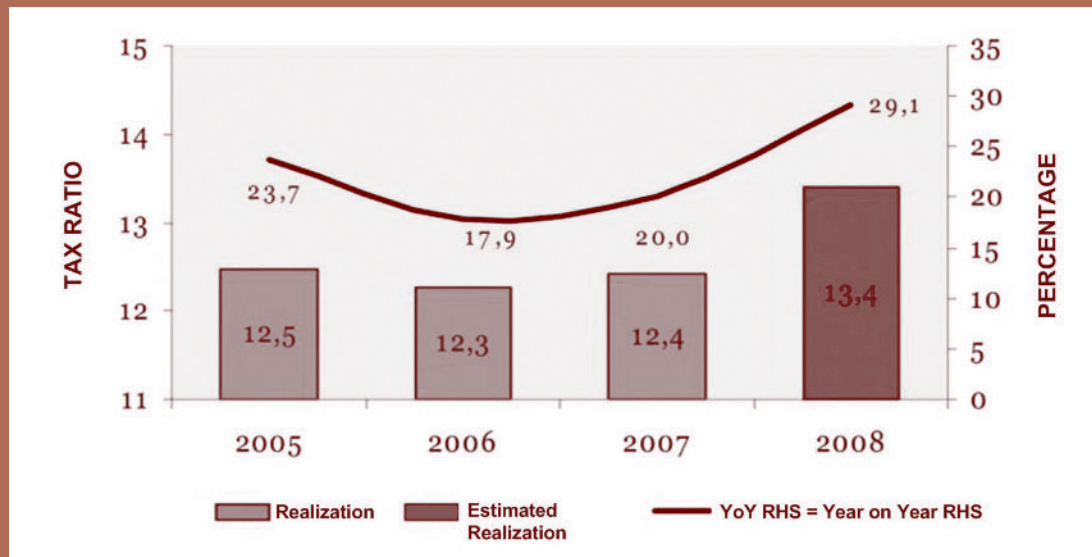
- Taxation Revenues in 2010 to rise by 11.8% from 2009 (non-oil and gas taxes to rise 14.4%).
- The 2010 tax ratio to be approximately 12.1% of the GDP (compared to approximately 12.0% in 2009). The real GDP to rise rapidly, with many areas not/not yet taxable.
- Tariff incentives for corporate income tax and VAT, as well as Import Duties to support the real sector and business world, and further tax and customs and excise duty reforms. Pressure to be placed on tax evasion.
- Optimization of Oil, Gas and Coal products, assuming the price of oil to be US\$60 per barrel. The need to synchronize state tax and non-tax revenue policy coordination in the future.

Source: Data derived from the 2009 Draft National Budget (RAPBN) and Finance Notes and the Press Conference on the 2010 Draft National Budget (RAPBN) and Finance Notes.

During the 2005-2007 period, tax revenues grew from Rp 347.0 trillion (2005) to Rp 409.2 trillion (2006) and Rp 491.0 trillion (2007), or by an average annual rate of 18.9%. Subsequently, in 2008, the total rose 12.6% higher than the estimated National Budget realization target for that year. This increase in 2008 was supported by the successful implementation of taxation policy and reforms in the tax administration system, along with the development of macro-economic assumptions.

Efforts were also made for the tax ratio (ratio of taxation revenue to the GDP, which often serves as an indicator of the capacity of government to levy taxes), to continue to rise. In 2005 the tax ratio ranged around 12.5%, but was targeted to rise to 13.4% by 2008.

Figure 1.
Tax Ratio
Development
2005-2008



Source: GOI's
Financial Note and
National Budget
Plan, p III-5

However, it appears that the target of boosting the tax ratio up to 13.4%, as illustrated in figure 1, proved to be too high relative to its performance in previous years, when it was still struggling at the scale of 12.5% (2005). The sudden increases that took place did not constitute real surges relative to the GDP either, because further review of the available data indicates fluctuations from year to year.

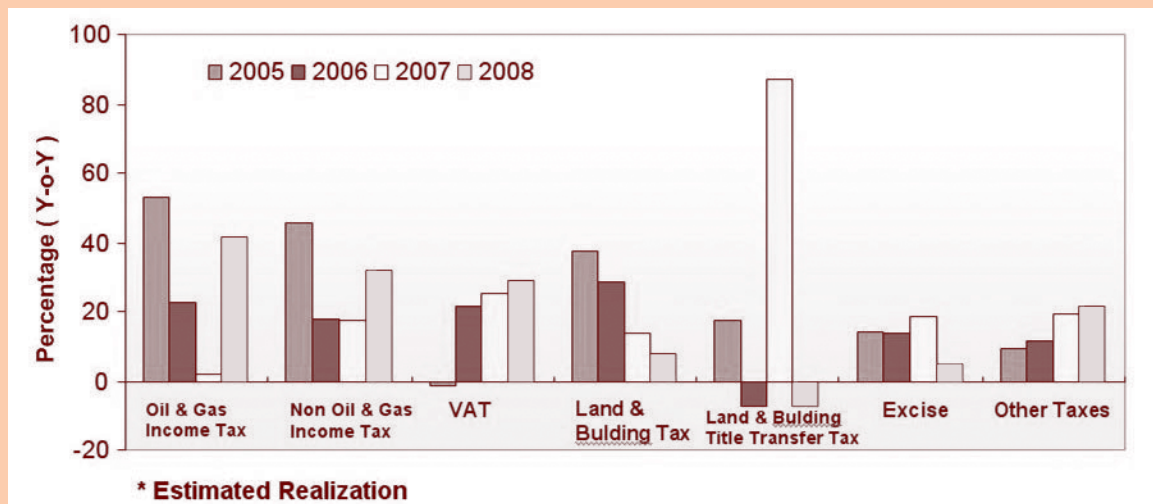
Taxation policy in the 2005-2008 period was focused on broadening the tax base, improving services and reducing the tax burden through increases in non-taxable income, along with the provision of tax facilities to the business community without disrupting the achievement of the tax revenue targets. The government kept working on tax policy and administration reforms through a program of intensification (consisting of mapping, profiling taxpayers, benchmarking, the activation of non-filers among those liable for taxation, monitoring potential individual taxpayer compliance, the utilization of third party data, and the optimization of the use of taxation data); and a program of extensification (expansion of the tax base or increase in taxpayers through an Employer-based and Government Treasurer-based approach, with targets including employees, civil servants and state officials; a property-based approach targeting individuals who do business or own businesses in centers of commerce; and a profession-based approach with targets including doctors, artists, lawyers and notaries). It included as well as a program of modernization, involving: office modernization, the applica-

tion of the latest information technology – such as: online payment, e-SPT⁶, e-filing, e-registration and a Directorate General of Taxation (DJP) information system, a tax awareness and care campaign, and the development of a data bank and *Single Identity Number*. Aside from these three programs, the government also actively undertook a law enforcement policy (to investigate tax crimes) and tax policy (to provide tax relief to taxpayers with the goodwill to fulfill their income tax payment responsibilities). Additionally, the government undertook tariff harmonization, the establishment of main service offices at main gateways (such as Batam and Tanjung Priok), and the development of a *National Single Window* to improve customs. Meanwhile, in the excise area, the government enacted policies on retail price raises and the implementation of specific tariffs.

Domestic taxes – which include Income Tax (PPH) in both the oil and non-oil sectors, Value Added Tax (PPN), Sales Tax on Luxury Goods (PPnBM), Land and Building Tax (PBB), Land and Building (Property) Title Transfer Tax (BPHTB), and excise and other taxes – rose in the 2005-2007 period by Rp 138 trillion, with an average annual rate of growth of 19.0% during this timeframe. The BPHTB in particular rose 87.0% in 2007 with the Pertamina’s (State-owned Oil Extraction Corporation) payment of over Rp 1.5 trillion in government-borne value added taxes (PPN-DTP) accompanying the change of Pertamina into a limited liability company (PT). Meanwhile, most of the other taxes came from tax stamps/stamp duties, which contributed an average of 96.6% of the total of other tax revenues. Details of these developments are shown in figure 2.

Furthermore, a comparison of the contributions of each type of tax can be seen in figure 3. Income tax contributions rose from 50.7% in 2007 to 53.7% in 2008. Meanwhile, excise tax contributions fell from 9.5% in 2007 to 7.7% in 2008.

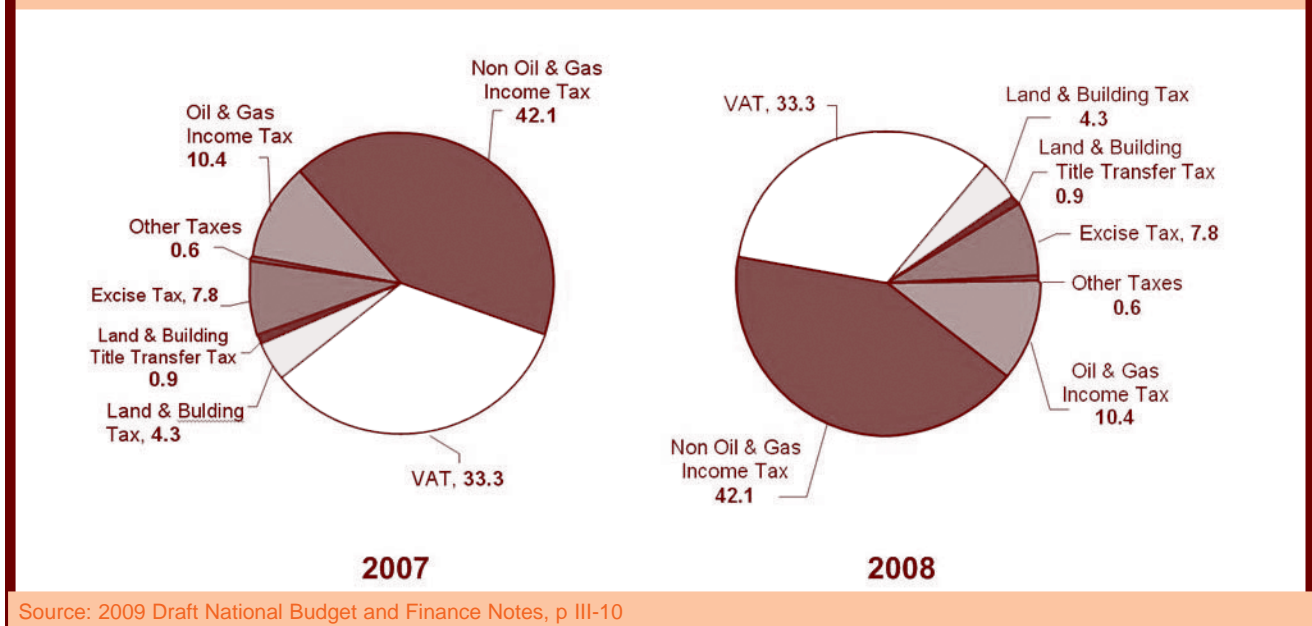
Figure 2.
Growth in Domestic Tax Revenues 2005-2008



Source: 2009 Draft National Budget and Finance Notes, p III-9

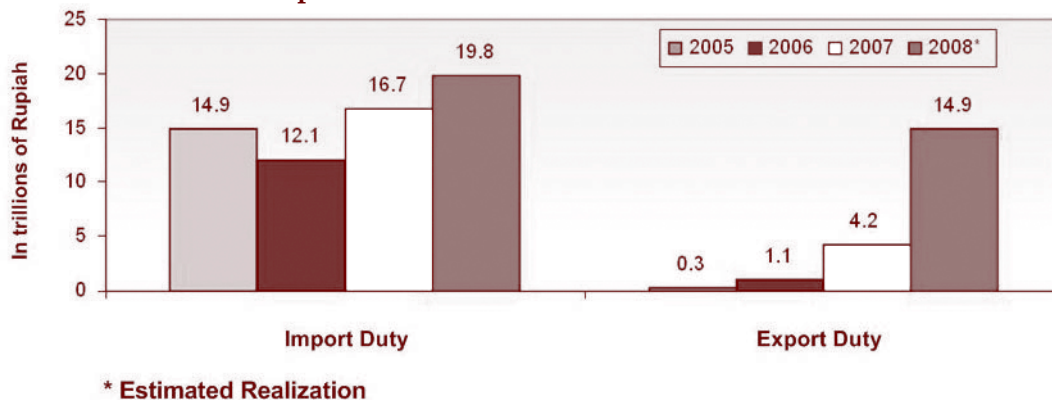
⁶ SPT is an abbreviation for “Surat Pemberitahuan” or means “Tax Report” in English. This report usually submitted by tax holder as annual report in print out version after they filled-in the form, but currently this report can be submitted paperless through the website of Indonesia’s Tax Directorate. e-SPT or electronic-SPT is a software made by the Indonesia’s Tax Directorate to simplify tax holders in submitting the SPT.

Figure 3.
Comparison of Domestic Tax Revenue 2007-2008



In addition to domestic taxes, tax revenues come from international trade taxes. International trade tax revenues rose by an average of 17.2% per annum (from Rp 15.2 trillion in 2005 to Rp 20.9 trillion in 2007). This increase came from spikes in export duty tariffs and increases in the volume and export of strategic commodities – especially crude palm oil (CPO) and its derivatives – undertaken to maintain domestic price stability. It was estimated that the total would keep on rising in 2008, when the estimated international trade tax revenue realizations reached Rp 34.7 trillion, exceeding the target (Rp 29 trillion) by 19.6%. Import duty revenues were dominated by four sectors, namely, motor vehicles and parts (including aircraft), the metal and processed products sector, upstream chemical industry sector, as well as the machinery and components sector. Upon analysis, the magnitude of its export and import duties can be taken as an illustration of the economic posture of Indonesia today. Indonesian exports are dominated by palm oil, which assumed an important role following the decline of the oil and gas sector. The imports do not reflect the existence of a post-1997 crisis industrialization recovery. Imports related to the transportation sector occupy a large portion, precisely reflecting the chaos in public transportation management. Imports that seem so clearly evident, such as the many cheap consumer products from China and agricultural products encountered in the field, do not even appear as tax revenue sources. International trade tax revenue realizations can be seen in the following figure.

Figure 4
Comparison of Domestic Tax Revenue 2007-2008



Source: 2009 Draft National Budget and Finance Notes, p III-25

Aside from tax revenues, the state also derives income from state non-tax revenues (PNBP). The PNBP come from revenues sourced from the management of government funds, revenues from the exploitation of natural resources (oil and gas as well as non-oil and gas, namely, general mining, forestry and fisheries), revenues resulting from the management of the state assets which have been divided up, revenues from service activities performed by the government, revenues based on court decisions and originating from the imposition of administrative fines, grant revenues to which the government is entitled, and other revenues regulated under their own separate laws. Within the structure of the National Budget (APBN), the state non-tax revenues (PNBP) consist of natural resource revenues, revenues from the government's portion of State-Owned Enterprises (SOE) profits, and other PNBP (including income from sales, rentals, services, PNBP from abroad, prosecutors and the judiciary, education, the payment of receivables, other income from oil and gas enterprise activities, and other budget revenues). In retrospect, the PNBP have been dominated by natural resource revenues, from oil and gas in particular. Developments in PNBP realizations for the 2005-2007 period are shown in table 2.

Table 2.
PNBP Realization Development, 2005 - 2007
(in trillions of Rupiah)

	2005		2006		2007	
	Realization	% of GDP	Realization	% of GDP	Realization	% of GDP
State Non-Tax Revenues (PNBP)	146.9	5.3	227	6.8	215.1	5.4
a. Natural Resource Revenues	110.5	3.7	167.5	5	132.9	3.4
i. Oil and Gas	103.8	2.6	158.1	4.7	124.8	3.2
Oil	72.8	2.7	125.1	3.7	93.6	2.4
Gas	30.9	1.1	32.9	1	31.2	0.8
ii. Non-Oil and Gas	6.7	0.2	9.4	0.3	8.1	0.2
General Mining	3.2	0.1	6.8	0.2	5.9	0.1
Forestry	3.2	0.1	2.4	0.1	2.1	0.1
Fisheries	0.3	0	0.2	0	0.1	0
b. SOE Profit Shares	12.8	0.5	21.5	0.6	23.2	0.6
c. Other PNBP	23.6	0.8	36.5	1.1	45.3	1.1
d. Bank Indonesia Surplus	0	0	1.5	0	13.7	0.3

Source: 2009 Draft National Budget and Finance Notes, p III-32

On the average, the PNBP rose by 21.0% per annum during this time period, although in 2007 they fell due to a decrease in oil and gas natural resource revenues.

At a glance, what has been achieved is extraordinary. Based on comparative data on world averages,⁷ it appears that the burdens of the tax system in Indonesia are relatively light compared to those of other countries in the same region. This can be seen in table 3, where the Indonesian average is compared with those of all countries in the world, OECD (Organization for Economic Cooperation and Development) countries, and non-OECD countries, respectively.

⁷ These comparative data are cited from Brondolo et.al. (2008), p. 11.

Table 3.
Rates and Composition of Tax Revenue in Various Country

	Total Tax Revenue	Income Taxes			Consumption Taxes				Property Taxes	Total Revenue
		Total	Corporate	Personal	Total	General	Excise	Trade		
Indonesia	9.9	4.3	5	3.4	1.1	0.5	0.5	18.3
Average for all countries	17.6	8.6	3.8	4.9	7.4	3.7	2.6	0.8	1	24.8
OECD										
Australia	30	18.1	4.9	13.2	7.6	2.5	3.3	0.6	2.9	33.2
Japan	17.7	9.3	3.5	5.7	5.1	2.4	2	0.2	2.8	39.7
Korea	15.7	5.7	2.7	3	9.6	4.5	4	1.1	0.4	30.8
New Zealand	36.2	21.3	4.4	15.3	12.5	8.9	2.1	0.6	2.1	40.8
Average	24.9	13.6	3.9	9.3	8.7	4.6	2.9	0.6	2.1	36.1
Non-OECD										
China	15.9	4.1	2.7	1	11.3	9.5	1	0.9	0.5	17.1
Hong Kong	10	5.7	3.4	2.3	3.9	0	3.9	0	0.1	13.6
Malaysia	14.3	7.9	5.8	2.1	4.5	2.9	1.7	1.4	0.1	18.3
Philippines	13.1	5.8	2.5	2.3	7.2	2.8	1.8	1.4	0.1	14.8
Singapore	16.3	7.8	5.5	2.3	6.8	1.4	4	0.7	1	30.5
Thailand	14.1	4.8	3	1.8	8.4	2.8	3.8	1.8	0.1	16.1
Average	14	6	3.8	2	7	3.2	2.7	1	0.3	18.4

Source: Brondolo et. Al., p.11

Based on table 3, a number of conclusions may be drawn:⁸

- Income taxes (corporate as well as individual) cover 4.3% of the GDP (not including tax income from oil and gas), which is much lower than the world average and the average for non-OECD countries.
- General consumption taxes in Indonesia contribute 3.4% of GDP, where the component taxes consist of the VAT and tax on luxury goods (covering a long list of goods). However, if the tax on luxury goods were to be reclassified into the excise category, then the value of the general consumption taxes would only amount to 3% of the GDP, meaning it would not be higher than the non-OECD country and world averages.
- Excise only contributes 1.1% of the GDP, which is extremely low compared to the regional average of 2.7%, world average of 2.6%, and OECD country average of 2.9%. The low level of excise revenue in Indonesia is due to the absence of an excise or luxury goods tax on gasoline and oil products, whereas in many countries, the fuel component of excise contributes significant revenues.
- The quantity of international trade taxes in Indonesia have a lesser value than the regional average, due to weak law enforcement and supervision, rampant ignorance and exemptions, and generally low tariff rates.
- Land and building (property) taxes amount to 0.5%, which is a bit higher than the regional average (0.3%), but still very low compared with the OECD country average (2.1%). This is related to the design of policies in which the tax level is 0.5%, but since assets are generally assessed at only 40% of their market value, the effective rate of the property tax is only 0.2% – an extremely low value.

These low tax revenues are caused by several issues – namely, weaknesses in the law and governance framework, deficiencies in organizational structuring and the administrative apparatus, the ineffectiveness of tax-payment and case-handling services, and an outdated information system – which reduce the effectiveness and efficiency of the Directorate General of Taxation in collecting taxes.⁹ These deficiencies in turn result in a high level of tax evasion by taxpayers, and give rise to high costs in doing business in Indonesia. Attempts are being made to overcome these problems through tax reform, in an effort to increase tax income and improve the investment climate in a sustainable manner.

⁸ Brondolo et. al. (2008), pp. 11-12

⁹ Ibid., pp. 14-15

Tax Reform in Indonesia

Although, based on the data presented in the Draft National Budget Finance Notes (*Nota Keuangan RAPBN*), it is evident that although taxation figures have been rising, a comparison with other countries indicates that Indonesia is still lagging behind. Economic analysts in Indonesia often voice their dissatisfaction with the performance of taxation in the country. Usually, the analyses conducted take the discussion of various data and indicators related to tax performance as their point of departure. In this paper, an attempt is made to backtrack further, to look at historical aspects of the issue of taxation before discussing the approach to tax reform itself.

Since the onset of Indonesian independence, there have been analyses indicating a paradox regarding the collection of state revenues.¹⁰ Indonesia's first leaders were strongly influenced by European socialist thinking when they formulated the country's economic policies, but it may be said that within the 1950-1965 timeframe, the government gradually adopted a "hands off" approach to the economy. This was far different from conditions under the Dutch Colonial Government in the 1930s, when government management of the economy was highly conspicuous, as measured by increases in state spending and regulations. In contrast, the 1950s and early 1960s showed decreases in both revenues and expenditures relative to the GDP, such that people have often remarked that since the Government of Indonesia was influenced by the Indian (if not the Russian) style of socialism, government spending should have been substantial, all the more so given its situation as a newly independent country.¹¹ Many observers considered the reason for the decreases to be the existence of a deficit in Indonesia's expenditure budget, although it turns out that the deficit was only 7% of the GDP – not much different from its size in the 1930s, which was actually achieved under conditions of deflation.

A review of the state's revenue policy provides an answer to its failure to collect revenues, which may be seen as the real culprit responsible for the low level of government revenues. Around 60% of the government's revenues at the end of the colonial period came from taxes, the rest from monopolies and public services. Of this 60%, one third came from individual and corporate income taxes; one third from import-export taxes, and the balance from land and building taxes and excise duties – demonstrating the diversity of a tax system that succeeded in contributing state revenues amounting to 10-12% of the GDP. International trade taxes never exceeded 25% of total state revenues, and mostly ranged only around 15-20%. In the early 1950s, the revenue-to-GDP ratio was actually higher than it was in the 1930s, but direct taxes shrank while foreign trade taxes increased to more than half of the government's total

¹⁰ Booth, A. (1995), pp. 295-297

¹¹ The example cited is that the state expenditures portion of India's budget was more than twice as high its national revenues for the first 15 years after the country gained independence.

revenues. The transition to the new government of Indonesia was exacerbated by a fall in export commodity prices after the Korean War, along with the spiral of chronic inflation that followed. This inflationary spiral led Indonesia to become a large nation with the lowest ratio of investment to the GNP in Asia. The situation increasingly worsened in the 1960s, when the government could no longer maintain the existing infrastructure, yet tended to spend lavishly on defense equipment. Burma, Pakistan, and Thailand, which were equally extravagant in defense spending, remained in decent condition because they managed to spend more on economic and infrastructure services, both in terms of their percentage of the GDP and of the total budget. The subsequent fall of the Old Order Government was followed by a program of economic stabilization up to the early 1970s.

With the entry of the 1970s decade, an oil boom occurred that produced a “lazy” fiscal regime that was based on state revenues from the oil and gas sector, while neglecting non-oil and gas revenues, the reform of the topsy-turvy administration, the enforcement of taxation compliance, and the cleanup of a tax collection process that was inefficient and full of corruption.¹² Consequently, indirect taxes from international trade remained the largest contributor to the total non-oil and gas revenues of the state. It was when revenues from oil began declining that the Indonesian government began to undertake tax reform.

Tax reform is on the agenda of many different developing countries today. Usually, the scheme undertaken involves the transformation of an old tax system that is mostly reliant on indirect taxes that come mainly from taxing international trade, into a system in which direct taxes are levied on incomes, on an individual or corporate basis. Apart from that, another common aspect is a focus on broadening the tax base.

Through the course of Indonesia’s history, tax reform has been undertaken four times.¹³ The first round of tax reform was in 1983, when the most fundamental reorganization of the tax system was achieved by replacing the system of official assessment with self assessment. Along with this, some laws were launched pertaining to income tax (PPh), VAT (PPN), value-added tax on luxury goods (PPnBM), tax on land and buildings (PBB) and duty stamps. The 1983 tax reforms were praised as a planned and comprehensive approach¹⁴ because of the high level of ownership by the Indonesian people themselves, because the time required to prepare and evaluate policy options was relatively quick, that is, only a couple of years. It was praised also because it was aimed at the majority of income sources (except tariffs), focused not only on the tax structure but also on its administration, and offered as a single policy package rather than being treated in a fragmentary manner. Additionally, an investment was made in training tax officials to run the new system and in updating the information components of the new administration.

The next round of tax reforms was implemented in 1994, by making further changes to the laws produced by the 1983 tax reforms, along with adding legal instruments for dispute resolution, regional taxes and fees, tax collection with warrants, and duties on the acquisition of titles to land or buildings.¹⁵ The 1994 tax reforms were much criticized be-

¹ Hill, H (1996), pp. 47-52

² Setiyaji and Amin (2005), pp. 5

³ Bird (2003), pp. 10-12

⁴ Setiyaji and Amin (2005), pp. 6

cause they restored many tax facilities that had previously been cut with a view to promoting exports. The third round of reform was carried out in 2000, with the establishment of a Tax Service Office for Large Tax Payers, and further changes to the laws, in addition to bringing a Tax Court into existence to replace the Tax Dispute Settlement Board, so that the tax judiciary, previously controlled by the Directorate General of Taxation, was now an independent judiciary subject to the Supreme Court. The lack of focus from the Tax Reform in 2000 to contain the effort to recover Indonesian economic posture after the crisis is somewhat strange, although it may be praised by international financial institutions and mainstream economists as a necessary step to move away from the unsuitable posture in the past.

The fourth round of tax reform began to be implemented in 2005, and consists of a First Phase (*Reformasi Jilid Satu – Reform Part One*), completed in February 2009, to be continued in a second phase (*Reformasi Perpajakan Jilid Dua – Tax Reform Part Two*).¹⁶ The first phase covers three main activities, namely, the modernization of the tax administration system; policy reforms; and intensification and extensification. The results so far are better, more integrated and professional information and complaint-handling services based on a “One Stop Service” concept, with services performed by Account Representatives, utilizing information technology for e-filing, e-SPT, e-registration services, and the establishment of a call center. Law enforcement aspects have also been strengthened, with more transparent and professional tax inspection, collection and investigation through the enforcement of good governance at all levels. The first phase of reform concluded with *the Sunset Policy* enabling taxpayers to get some abolitions of administrative sanctions that emerged from previous obligations.

Reformasi Jilid Dua is intended to improve upon *Reformasi Jilid Satu* by focusing mainly on the System and Management of Human Resources and Communication and Information Technology. Phase two is planned to consist of employee capacity and competence building; the implementation of automated mapping, profiling and benchmarking; the improvement of payment services; and the implementation of the *Project for Indonesia Tax Administration Reform (PINTAR)* – a tax administration improvement program that adopts best practices of tax administration systems worldwide. The PINTAR program has four components, that is, core business process and system improvement, human resource management, tax compliance, and change management. It is expected that with the support of communication and information technology, the quality of services will improve so that they are easier, quicker and more accurate. Unfortunately, although *Reformasi Perpajakan Jilid Dua* is attractive and comprehensive, the funds for its implementation have been obtained through loans.¹⁷

A summary of the evolution of tax reform in Indonesia is shown in table 4.

Table 4. Summary of Tax Reform in Indonesia

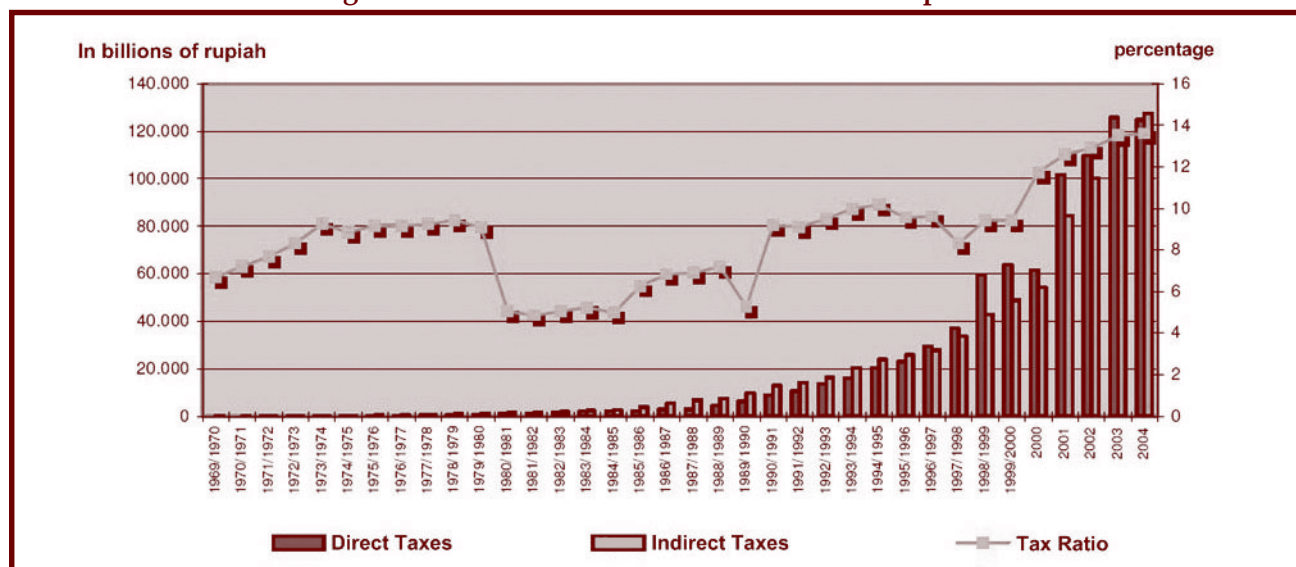
Tax Reform	Key Changes	Remarks
1983	<ul style="list-style-type: none"> ➔ Change of the official assessment into a self assessment system. ➔ Launching of a number of laws related to income tax (PPh), VAT (PPN), luxury goods tax (PPnBM), land and building tax (PBB) and duty stamps. 	<ul style="list-style-type: none"> ➔ Implementation was lauded for its effectiveness and efficiency ranging from its planning, to its process and evaluation. ➔ Implemented as a single policy package, and sufficient investment made to prepare the system and its human resources. ➔ Policy targeted the tax structure and its administration.
1994	Further changes to the laws produced by the 1983 tax reforms, along with the development of additional legal instruments.	Much criticized for restoring tax facilities previously cut with a view to promoting exports.
2000	Further changes to the laws, establishment of the Large Tax Payer Tax Office, establishment of a Tax Court (to replace the Tax Dispute Resolution Board) subject to the Supreme Court (no longer under the Directorate General of Taxation).	Improvements more focused on administration and services, accompanied by the dizziness of changes based on the economy, which has not fully returned to its pre-crisis stance.
2005	<p><i>Reformasi Jilid Satu</i> focuses on modernizing the tax system, policy reform with improvements in information and complaints handling services through a One Stop Service, with services performed by Account Representatives, utilizing information technology for e-filing, e-SPT, and e-registration services, and the establishment of a call center, along with the strengthening of more transparent and professional inspection, collection and investigation services.</p> <p><i>Reformasi Jilid Dua</i> focuses on the System and Management of Human Resources and Communication and Information Technology.</p>	The return of the program to being more administration and technology centered, with still minimal attention given to post-crisis economic restructuring. Tendency of the project to be motivated by debt-financing is exposed.

¹⁶ Ditjen Pajak (2009)

¹⁷ As cited by various media, such as Kompas (23 June 2009), Hukum Online (29 June 2009) and Rakyat Merdeka (22 June 2009). This is rather ironic if, to quote James Tobin, the spirit of fiscal policy governing the obligations of citizens in the field of taxation should be directed at seeking to extract their own potential and reduce dependence.

The impacts of the consecutively implemented tax reforms are shown in figure 5 .

Figure 5. Tax Revenue and the Tax Ratio Development



Source: Setiyaji and Amin, p. 6

Through the implementation of the tax reforms, since 1996/1997, direct taxes have begun to dominate tax revenues. Additionally, there have been fairly consistent increases in the tax ratio.

These increases in the tax ratio are inseparable from the tax reform efforts made by the government, that is: reducing individual and corporate tax tariffs by 5% at the highest tariff level, providing incentives to taxpayers who make capital investments in certain fields of business and certain regions, accelerating the provision of tax rebates to compliant taxpayers and taxpayers from specific sectors and certain other taxpayers from one year to one week, making some goods VAT-exempt, expanding the range of deductible expenses – such as donations, and modernizing the tax office and simplifying tax procedures to improve services to taxpayers.¹⁸

Increasing the tax ratio in years to come poses a number of challenges, namely:

1. Optimizing the collection of individual taxes, since in reality, the number of private taxpayers who are registered is still low.¹⁹ A recent study to calculate potential tax revenues²⁰ notes that currently, individual income tax revenues only amount to 43% of the total potential.

2. Collecting taxes on e-commerce, which is becoming increasingly widespread as a mode of sales in our society, ranging from TV shopping to catalogue sales, internet shopping and commodity exchanges. The fundamental issues in connection with e-commerce taxation efforts are whether the levy should be based on the location of the seller or the location of the buyer, how tax compliance can be enforced and administrated, the need for improvement of equipment and human resources, and the maintenance and updating of data to prevent the occurrence of errors and fraud.²¹

3. Another potential challenge is posed by foreign exchange transactions, which amount to at least Rp 250 trillion in funds monthly (2004 data).²² Foreign exchange transactions are difficult for the tax authorities to pursue because of Bank Indonesia regulations that make foreign exchange transactions confidential, so that tax officials do not have access to the existing data.

4. The government still seems not aggressive enough to pursue the tax evasion perpetrated transnationally, through the use of various financial instruments and facilities. This, notwithstanding the fact that concerns are frequently raised internationally that such tax evasion has made it possible for many

¹⁸ Djuhartika (2008)

¹⁹ The Directorate General of Taxation has disclosed that there are only six million people who have individual taxpayer numbers (NPWP) although the number of potential taxpayers amounts to 25-30 million people.

²⁰ Ikhsan et. al. (2005), pp. 13-14

²¹ Djuhartika (2008)

²² Tempo Interaktif, 11 October 2004: *Potensi Transaksi Devisa Kena Pajak Rp. 250 Triliun*

different multinational companies, rich people, corrupt leaders, criminals and terrorists to remove their assets from the clutches of the authorities of any given country. Thus, tax evasion is considered to contribute a flow of “dirty money” into the global banking system, half of which originates from developing countries and the former Eastern Bloc.²³

5. Developing taxation on capital gains, though often opposed on the ground of technical and administrative difficulty, also has the potential to precipitate negative sentiments on the flow of fast-moving financial capital associated with the floating capital market. Yet, it should be remembered that these negative sentiments will not have a lasting impact in an economy founded on strong principles. In the long term, they may even enhance the quality of portfolios of incoming floating capital, such that more attention will be given to fundamental factors and the influence of capital on the national economy (not just as something that is “passing through”). Up to now, taxes have only been levied on final transactions in stock trading. Meantime, non-final transactions in bonds trading, where a lot of the transactions are conducted outside the stock market (such as over-the-counter transactions) and retirement funds and mutual funds that are excluded in the transactional records, are usually unreported, so they are hard to detect and are likely to escape being taxed.

Reliance on the tax ratio as the mainstay in assessing taxation performance has actually reaped criticism.²⁴ Calculations based on the nominal GDP do not take into account inflation, which increases each year. Meanwhile, tax ratio increases are not necessarily associated with economic growth increases, since the increasing rates are recorded together with inflation.²⁵

To overcome the weaknesses of using the tax ratio, some people suggest the use of the *tax coverage ratio* and *tax buoyancy ratio*.²⁶ The tax coverage ratio is calculated as the ratio of tax revenue to tax potential; its year-to-year development is shown in table 5.

Table 5. Development of the Tax Coverage Ratio

Year	Revenue	Potential	Coverage Ratio
1993/1994	30,470.30	58,426.40	52.2
1994/1995	37,258.10	69,272.70	53.8
1995/1996	41,878.10	83,357.50	50.2
1996/1997	49,826.10	98,757.50	50.5
1997/1998	62,705.80	117,684.20	53.3
1998/1999	87,712.30	173,595.20	50.5
1999/2000	97,408.80	234,155.80	41.6
2000	97,484.80	145,935.30	66.8
2001	157,195.90	206,564.90	76.1
2002	180,099.00	235,731.90	76.4

Source: Setiyaji and Amin, p. 7

²³ Anonymous (2005), pp. 10-12, with sources based on Raymond Baker's book, *Capitalism's Achilles' Heel*.

²⁴ *Ibid*, p. 7

²⁵ The two authors referenced here cite the findings of the economic analyst, Iman Sugema, who drew comparisons between the time of the Abdurrahman Wahid administration, when the tax ratio reached 10.7% of the GDP but growth was only 4.8%, and the New Order period, when the tax ratio was 7.4% of the GDP but growth managed to reach 6.1%. Comparing quantitative indicators like these, without much regard for historical (including socio-political) context, is, to this writer, unwise, as it assumes that the economy can run automatically without being disrupted by the socio-political phenomena that must be traversed from time to time in the history of a nation.

²⁶ Setiyaji and Amin (2005), p. 8

An observation on tax coverage ratio figures, is that despite ongoing increases, it is not yet deemed optimal, because tax collection practices are still inadequate, in terms of administrative preparedness, aspects of technology, data production, and inter-sector coordination, as well as the fact that so many economic activities, such as those in the “underground economy” are not yet properly recorded. The other indicator that is also suggested to replace tax ratio is tax buoyancy, which represents the ratio of percentage change in tax revenue to the percentage change in GDP.

Table 6. Comparison of Tax Buoyancy in Different Countries

Country	Tax Buoyancy
India	2.4
Korea	2.2
Morocco	2.2
Honduras	2.2
Pakistan	2.1
Malaysia	1.9
Indonesia	
All types of taxes	1.8
Non-oil and gas taxes	1.0

Source: Setiyaji and Amin, p. 8

It is evident that the tax buoyancy ratio in Indonesia is still low in comparison with other countries.

The as-yet- ineffective handling of taxation in Indonesia – despite the tax reforms carried out – is clear from a number of other indicators. The first is the growth in the number of taxpayers, as shown in table 7.

Table 7. Growth in Number of Tax Payers

Year	Government's Treasurer	Legality (Company, Foundation))	Private Person	Employee according to Income Tax Law No. 21 (income tax deducted/r emitted by employer)	VAT	Total
1995	84,113	458,732	1,086,488	571,071	325,354	2,525,758
1996	91,475	499,361	1,163,974	622,409	351,801	2,729,020
1997	97,939	543,433	1,232,457	675,622	374,793	2,924,244
1998	105,689	582,018	1,274,719	724,184	391,963	3,078,573
1999	117,194	650,691	1,316,259	806,480	416,867	3,307,491
2000	129,756	726,655	1,381,194	899,299	451,797	3,588,701
2001	147,131	804,959	1,697,180	1,001,298	489,232	4,139,800
2002	170,519	888,949	2,028,026	1,111,467	526,854	4,728,815
2003	195,556	974,004	2,330,802	1,232,626	559,247	5,292,235
2004	198,430	991,641	2,380,771	1,251,079	563,570	5,385,491

Source: Directorate of Tax Information, Directorate General of Taxation, as cited in Setiyaji and Amin, p.8

Viewed in terms of growth in the number of taxpayers, it seems that there has been fairly significant development, as the number has more than doubled in a ten-year timeframe. However, viewed in terms of the potential number of taxpayers with regard to the total population of Indonesia, the number achieved turns out to be fairly low. Meanwhile, the level of compliance in the submission of annual tax returns has made good progress, as shown in table 8.

Once again, if this development is compared with the existing potential it is again apparent that the government is mainly passive, placing too much hope in the fulfillment of voluntary compliance. The expectation of voluntary compliance is adopted while neglecting the critical function of education in the self-assessment system, and in the absence of adequate sanctions for violators, in the midst of flourishing practices of collusion in the field of taxation.²⁷

Table 8. Level of Compliance in Submitting Annual Tax Returns

Taxation Year	Annual Tax Announcement Letter Sent			Annual Tax Announcement Letter Returned			% of Annual Tax Returned
	Corporate	Individual	Total	Corporate	Individual	Total	
1996	492,442	1,158,280	1,650,722	215,014	522,883	737,897	44.70
1997	536,013	1,226,509	1,762,522	221,528	510,322	731,850	41.52
1998	573,456	1,267,841	1,841,297	219,543	475,473	695,016	37.75
1999	640,910	1,308,412	1,949,322	235,752	454,260	690,012	35.40
2000	665,304	1,332,365	1,997,669	263,508	437,888	701,396	35.11
2001	731,113	1,539,757	2,270,870	277,053	538,932	518,985	35.93
2002*	796,099	1,787,861	2,583,960	329,186	739,280	1,068,466	41.35

Source: Directorate of Tax Information, Directorate General of Taxation, as cited in Setiyaji and Amin, p. 9

Another equally interesting thing emerges when we compare government revenues with government expenditures, which are shown in the next two tables. The first table presents the development in central government expenditures (abbreviated as BPP – *belanja pemerintah pusat*).

Table 9. Development in Central Government Expenditures (in Trillions of Rupiah)

Description of Expenditure	2005			2006			2007			2008					
	Realization	% of GDP	% of BPP	Realization	% of GDP	% of BPP	Realization	% of GDP	% of BPP	Revised National Budget (APBN-P)	% of GDP	% of BPP	Estimated Realization	% of GDP	% of BPP
1. Employees	54.3	1.9	15	73.3	2.2	16.6	90.4	2.3	17.9	123.5	2.8	17.7	122.9	2.6	16.9
2. Goods	29.2	1	8.1	47.2	1.4	10.7	54.5	1.4	10.8	67.5	1.5	9.7	57.4	1.2	7.9
3. Capital	32.9	1.2	9.1	55	1.6	12.5	64.3	1.6	12.7	79.1	1.8	11.4	71.2	1.5	9.8
4. Loan interest payments	65.2	2.3	18.1	79.1	2.4	18	79.8	2	15.8	94.8	2.1	13.6	95.5	2	13.1
5. Subsidies	120.8	4.3	33.4	107.4	3.2	24.4	150.2	3.8	29.8	234.4	5.2	33.6	281.8	6	38.6
6. Grants	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
7. Social aid	24.9	0.9	6.9	40.7	1.2	9.3	49.8	1.3	9.9	59.7	1.3	8.6	54	1.1	7.4
8. Other	34	1.2	9.4	37.4	1.1	8.5	15.6	0.4	3.1	38	0.8	5.5	46.3	1	6.4
Total BPP	361.2	13	100	440	13.2	100	504.6	12.8	100	497.1	15.5	100	729.1	15.4	100

Source: 2009 Draft National Budget Finance Notes, p. IV-8

²⁷ Ibid, p. 5

Meanwhile, developments in terms of per sector expenditures are shown in table 10.

**Table 10. Development in Central Government Expenditures by Function
(in Trillions of Rupiah)**

CODE	FUNCTION	2005	2006	2007	2008		2009	
		Government Goods/Services Procurement Policy Inclusion (LKE1)	LKE1	LKE1	Revised National Budget (ALB-B1)	Estimated Realisation	Deficit National Budget (RALB-B)	Supplementary Document
1	PUBLIC SERVICES	255,603.20	283,343.00	316,078.70	518,241.50	625,214.80	660,122.40	565,042.80
2	DEFENSE	21,562.20	24,426.10	30,685.90	10,489.70	10,489.70	13,769.00	13,769.00
3	PUBLIC ORDER AND SECURITY	15,617.30	23,743.10	28,315.90	12,306.80	12,306.80	15,662.00	15,662.00
4	ECONOMY	23,504.00	38,295.60	42,221.90	57,239.00	57,239.00	58,908.40	58,908.40
5	ENVIRONMENT	1,333.90	2,664.50	4,952.60	6,353.10	6,353.1	7,786.90	7,786.90
6	PUBLIC FACILITIES AND HOUSING	4,216.50	5,457.20	9,134.60	12,993.40	12,993.40	18,439.90	18,439.90
7	HEALTH	5,836.90	12,189.70	16,004.50	15,985.60	15,985.60	17,469.10	17,469.10
8	CULTURE AND TOURISM	588.6	905.4	1,851.2	1,393.2	1,393.2	1,612.6	1,612.6
9	RELIGION	1,312.30	1,411.20	1,884.20	791.1	791.1	1,015.2	1,015.20
10	EDUCATION	29,307.90	45,303.9	50,843.4	57,960.2	57,960.2	69,016.0	115,166.0
11	SOCIAL PROTECTION	2,272.50	2,292.20	2,650.40	3,317.30	3,317.30	3,369.00	3,369.00
TOTAL		361,155.20	440,032.10	504,623.30	697,071.00	804,044.30	867,170.50	818,240.90

Source: Basic 2008-2009 National Budget Data, p. 9

It can be seen from these two tables that there is a tendency for the development budget to be dominated by ever-increasing government consumption. There is the correlation that such government spending may be associated with the development of public welfare, although more complete data would be required to sort out which of the expenditures are expenditures enjoyed by the public, whether directly or indirectly. There are complications here, because the finances spent can be justified as expenditures for the benefit of the public at large, but turn out, upon empirical observation in the field, not to be so. If further arguments for their effectiveness and efficiency are not strongly advanced, this will give rise to assumptions that taxes, as part of the income spent, are being drawn from the people to support expenditures at the government level.

In the light of the foregoing explanation of various aspects of tax reform, it would appear that there has been some ineptitude in the determination of the focus of tax reform. The need to make taxation more stringent in the capital trading sector, which provides a rather significant contribution, coinciding with the de-industrialization and rampant flight of direct investment capital abroad characterizing the posture of Indonesia's post-crisis economy, has never been of particular concern. The focus on administration, which unfortunately, has been closely associated with the spirit of volunteerism but not accompanied by a tightening of law enforcement, shows clear evidence of the need for significant improvement of public services as well as education for taxpayers. Consequently, the focus on administration seemed to be aimed more at image creation than at developing substantive changes in tax management.

The situation that discourses on tax and taxation ignore the linkage between taxation and the resultant postures makes it difficult to raise it as a political agenda. Truly, improvements do appear to have taken place to a sufficiently significant and measurable degree, and are in fact tangible and directly observable. However, the various changes have been only on the surface, with a reluctance to dive into the more fundamental issues. In such a situation of superficiality, what happens instead is that the agenda is usually gradual and unmindful, without much attention given to the impact of policies and their fairness among citizens.

Taxation and its Reform in Different Countries

The regions of South and East Asia are unique because they have high growth rates yet are also highly integrated. Nevertheless, the overall fiscal pressure on these countries is considered low compared to other countries with per capita incomes that are not far different. There are two main factors that explain the absent or very minimal social contribution of personal income taxes, which are still underdeveloped.²⁸ This is a pattern that is consistent with the great dominance of indirect taxes that is also commonly found in the countries of South and East Asia, with the exception of Japan and Malaysia. Likewise, corporate income taxes are usually higher than personal income taxes, which remains a less-than-ideal pattern, although these firms receive various incentives that ease their tax burdens. In the Southeast and East Asia regions, personal income taxes are generally still left behind, except in Japan. Meanwhile, the VAT is more established in India, China and Thailand, although the VAT was only introduced in India in April 2005. Import duties are still found in India, China and Thailand. Only in Japan and South Korea are employee incomes subject to much higher taxes compared to the other countries.

A reliance on taxes on international trade is indeed often found in developing countries, mainly due to the fact that the reduction of import taxes often faces political opposition from various parties on the grounds of favoring domestic producers.²⁹ Additionally, shifting international trade taxes requires a good strategy for maintaining macroeconomic stability. In the short term, efforts need to be made to cover losses of revenue resulting from tariff reduction and the inability to secure income by having increasing volumes of imports to compensate the losses from the lower tax regimes.

But in the long term, what is required is an improvement in revenue acquisition that can compensate for the decline in income.

Another phenomenon faced by countries in South and East Asia is tax competition due to economic integration and the continually increasing circulation of capital.³⁰ Together with the dropping of non-tax trade barriers, investment decisions and locations become more sensitive to taxes. In connection with this, countries usually seek justification for the provision of tax incentives in order to attract foreign direct investment (FDI). Although almost everyone agrees that FDI can enhance domestic economic productivity, the effectiveness of tax incentives is still frequently questioned.

For more details, examples drawn from the cases of tax reform in six countries of South Asia and East Asia, namely China, India, Japan, Malaysia, South Korea and Thailand, can be seen in the appendix. It is instructive to view this selection of countries as clusters – Japan-South Korea, Malaysia-Thailand, and India-China – in keeping with their level of economic growth and dynamics, as briefly discussed in the next three paragraphs.³¹

²⁸ Bernardi et. al. (2006), p. 3. The discussion of the literature here focuses on six countries in the South and East Asia regions, namely, China, India, Japan, Malaysia, South Korea and Thailand.

²⁹ Ibid., pp. 4-5

³⁰ Ibid, p. 5

³¹ Ibid, pp. 5-8

Japan relies on direct taxes as its main source of revenue, while in South Korea, indirect taxes such as excise, sales and general consumption taxes, still play a very big role. Meanwhile Japan is endeavoring to redesign the various allowances given to the elderly so as not to trigger a decline in the productivity of the productive-age group, South Korea is precisely endeavoring to manage its pension system so it can serve as a source of investment capital for financing projects oriented toward national development.³² Trade import duties are almost nonexistent in either country as both have participated for a fairly long time in international free trade.³³ The structure of individual taxes in both countries is also notable. In Japan, the structure of individual taxes was initially based on comprehensive taxation, but has recently changed into an income tax-based structure. In contrast, South Korea still maintains an across-the-board taxation system where individuals are subject to progressive tax levels. As a result, the tax base in Japan has been directed to become increasingly small over time, while South Korea, since the 1990s, has been broadening its tax base. One thing that is recommended for both countries is the addition of VAT because the VAT is not equally affected in a situation where the elderly are exempt from income tax. The intriguing question is why the Japanese government has not pulled together a more comprehensive tax regime.³⁴ The primary reason is that the workforce in Japan is inelastic, so that although the number of taxpayers is shrinking demographically and taxes remain high, the impact on workers is also small because of the small number of workers employed, especially those who are newly entering labor market. The second reason stems from the way the Japanese determine salaries, whereby the labor market continues to be maintained as an organization-oriented system and is not entirely directed by the rules of the market, such that decisions about compensation are made at the corporate level and significant differences are found to exist between firms.

Taxes in Malaysia, at first glance, almost seem to follow the standards set by developed countries, and rely more on direct taxation. However, the total of recorded taxes in Malaysia is influenced by corporate income taxes that include a special tax for oil companies, with a tax bracket far higher than the tax generally levied on companies. VAT is unknown in Malaysia, where indirect taxes are most extensive in the form of an *ad valorem* single stage tax levied in the import and manufacturing sectors. As an alternative to the VAT this system does not have an equal impact on prices, so that it cannot address the limitations of individual taxation in a country where the traditional and informal sectors are still quite large, or the limitations in administrative capacity that prohibit direct taxation from functioning effectively.³⁵ Malaysia, along with Thailand, places little weight on personal income tax, relying more on the number of tax brackets and the collection of taxes spread across many items. Additionally, special attention is paid to low-income residents in both countries. After the Asian financial crisis, both Malaysia and Thailand increased state revenue collection through the rationalization of administrative procedures and increased efficiency in tax administration.

³² Ibid, p. 23

³³ Ibid, p. 21

³⁴ Ibid, p. 22

³⁵ Ibid, p. 26

As for India, the personal income tax system appears to be quite affable, with only a few brackets, where rates of increase from one bracket to another are not too steep. However, much leeway is given, so that the amount of income aggregation that occurs is quite limited. Meanwhile, in the personal income tax system in China, many types of income tax are recognized, with various levels, without aggregation or deductions at the individual level. Tax plans in China are mainly focused on developing the environment created by the range of incentives given to foreign companies, especially enlivened by tax holidays to stimulate investment. Meanwhile, in terms of indirect taxes, in China in particular, there is only the VAT, while in India the VAT has only been in effect since 1 April 2005, to replace a complex and confusing system of sales and excise taxes.

In addition to the study of the above three country clusters, there is also a study that was conducted to compare the tax structures in effect in ASEAN-member countries.³⁶ Among ASEAN countries, Brunei is the only one that does not impose income taxes. All countries in the region distinguish business income from income earned through working. Workers also get various tax exemptions and deductions in the form of basic benefits, spouse benefits, child support, health insurance premiums, retirement savings, life insurance premiums and education benefits for children schooled at government-recognized institutions. The highest corporate income taxes are imposed in the Philippines and Laos (35%), and in Myanmar (40%), although this only applies to companies not owned by citizens. In Singapore, corporate income tax is only 18%, the lowest rate in the region. Comparatively, the highest corporate income tax revenues are found in Thailand, followed by Vietnam and Singapore.

As for trade-related taxes, all ASEAN countries impose a VAT.³⁷ The highest VAT is found in Vietnam (20%). In Indonesia, while the regular VAT is 10%, it may fall to 5% or rise to 15% in line with specific government regulations. Vietnam has a fairly complex VAT structure, in order to cover more goods and services and make it possible to reduce tax exemptions. Brunei has no taxes on exports, trade, salaries or the manufacturing sector.

Another thing that is interesting to discuss when comparing taxation policies and structures in several countries has to do with tax incentives. As mentioned above, foreign companies that invest in China enjoy a very luxurious tax exemption system. Companies that fulfill the requirements, such as operating in certain industries specified by the government, may enjoy preferential tax treatment for a long period of time.³⁸ Many people think that the provision of such incentives, while it may be useful to attract foreign investors in the short term, may trigger a continuous decrease in tax revenues in the longer term.

Incentives have always been part of the main menu in taxation policies in Southeast Asian countries.³⁹ The East Asian crisis of 1997 resulted

³⁶ Domo and Raposas (2007)

³⁷ Jurado (2007)

³⁸ Bernardi et. al. (2007), p. 29

³⁹ Nicolas (2007)

in the elimination of many such incentives, although in fact, the Southeast Asian countries have recovered a variety of incentives such as tax holidays, tariffs, VAT exemptions, along with an array of non-tax incentives such as guarantees and the provision of certain services. Without these incentives, these countries would find it difficult to attract investors. With the exception of Malaysia and Laos, the ASEAN countries provide tax exemptions and tax holidays on corporate income for periods of two to ten years. Additionally, these countries also provide duty and tax exemptions to companies when importing capital goods. The Philippines is the only country in Southeast Asia that provides job-based incentives, whereby reductions in labor costs are provided for the first five years of salaries of the trained and untrained workers absorbed, if the company concerned meets the requisite capital-to-labor ratio and does not receive tax holidays for income at the same time.

The steps taken by the Philippines are very interesting for a country with a large labor force like the Philippines. Singapore offers income tax exemptions for up to ten years for pioneering companies in high-tech industries. Malaysia provides incentives aimed at research and development (R&D) and activities that improve R&D-related human resources, along with income tax exemptions for certain lengths of time and exemptions of taxes and import duties for machinery, equipment and raw materials for R&D. The strategies of Singapore and Malaysia place these two countries in the front line of technology development in the region. Meanwhile, in Thailand, tax incentives are offered to encourage investments in areas that are far from urban centers. The Philippines, Cambodia, Brunei, Malaysia, Indonesia and Vietnam also promote investments focused on certain locations as special economic development zones. Usually, a variety of incentives are given to the companies that operate in these areas, such as full or partial waivers or reductions of import duties and taxes on capital goods, machinery, components and raw materials.

Tax incentives constitute a controversial topic, in terms of whether a given incentive will be more of a cost or a benefit to the country providing it. Tactically, a country must be sharp in providing tax incentives to ensure that they do not damage the economy, the deep structure of industry, or the development of human resources and technological expertise in the long run. Incentives are not the main factor in determining investment decisions, since investors are also concerned about linking and matching other industry success factors, the business climate, and supportive policies. Tax incentives will also only succeed for tax-sensitive projects, so a country need not subject itself to investors too easily, but make reference to a national development policy with a vision strongly oriented to the creation of value.

Conclusion: Where is Tax Reform Going?

Most people know tax reform as a prescription of the Washington Consensus. The purpose of tax reform, in its original version, is to aim toward a tax system that combines a broad tax base with moderate marginal tax rates.⁴⁰ Tax structures in developing countries were considered to be unsupportive of efforts to escape the crisis of foreign debt as a legacy of the economic policies of those countries, which failed to integrate them into the development of the global economy. Added to this was the fact that taxes from international trade dropped from 32% to 25% of the total taxes in the 1990s along with the increasingly extensive practice of trade liberalization.⁴¹ To deal with this, tax reform was then focused on the application of VAT and the improvement of tax administration.

The World Bank itself saw the need to encourage the acceleration of tax reform as a measure to patch up deficits in the public service sector and to raise capital in order to carry out infrastructure investments, which would in turn boost growth rates.⁴² Yet it turned out that the implementation of tax reform did not necessarily boost state revenues. This was because these developing countries were already having problems with sluggish economic growth, difficult-to-reach tax bases, and weak tax administration. Not to mention the political opposition from the constellation of relationships among different groups in society and the fact that the transition from agrarian to industrial society left informal sectors that were fairly large, but not enough to attract the attention of policy makers to deal with them.

Additionally, there were strong tendencies among developing countries, because they experienced a scarcity of capital for development from inside the country, to then mobilize efforts to maximize the mobilization of foreign investment by providing facilities and inducements to invest. One stance that has commonly been taken is to hold down corporate tax rates and offer various incentives. The uncertainties involved in many countries in leading their informal sectors (including micro, small and medium enterprises), coupled with the domestic complexity of managing the political constellations of potential targets for tax increases, constitute one of the common problems inhibiting developing countries from increasing the growth of state revenues from taxes. Such low tax regimes appear at a glance to be a panacea, but as discussed above, many countries have not derived much benefit under these conditions.

Stepping away from the standard framework of economic analysis, a heterodox economic analysis appreciates that standard tax reform does not provide any answers to raise revenues.⁴³ Trade liberalization has significantly decreased the trade taxes that formed the main sources of revenue for most developing countries. The substitute for trade taxes is

⁴⁰ Williamson (2003), p. 10

⁴¹ Bahl and Bird (2008), pp. 6-7. The decline was quite drastic compared with the 1950s and 1960s, when tax revenues from import duties increased rapidly beyond the GDP increases in these countries.

⁴² *Ibid.*, p. 10 (quoting from the World Development Report 1988).

⁴³ McKinley (2004), pp. 5-7

the often regressive VAT, which includes items consumed daily by the poor. Meanwhile, income and wealth are usually only taxable to a modest extent, on top of the existence of leakages during tax collection and weaknesses in tax law enforcement itself. Whereas in developed countries the consumption tax ratio is more than twice the value of that in developing countries. Similarly, property taxes are often overlooked as tax revenues, especially when it comes to assessing the value of real estate and various other types of wealth.

Opposition to the agenda of raising taxes also comes from the notion that low taxes will keep money in the hands of its owners. Thus, it is reasoned that the owners can make investments in line with a spirit of entrepreneurship and innovation involving all components of society. Nevertheless, it should be remembered that to support this line of thinking, strong state leadership is required. The state must be more forward-looking to coordinate technology learning, human development and an effective policy framework, as well as to ensure the growth of small businesses by facilitating access to markets and to finance institutions. Entrusting all of this to market mechanisms can lead to conditions where surplus money in hand may trigger investments based on the highest profit, ignoring the principles of prudence and risk management. Especially if this surplus money is generated in a country that is undergoing de-industrialization and weakening global competitiveness, such that not many opportunities can be created at the level of the local economy.

On the other hand, the belief in the stimulation of state revenues through the optimization of taxation will in turn raise questions if the promise of infrastructure improvement leading toward the recovery of growth and better development is not successfully realized. When state revenues prove to be spent more for financing the government, without improvements in public services or development at the level of public infrastructure, this may cause a decline of public trust in the implementation of the tax increase agenda. Another thing that may happen is that the spending of state revenues has in fact been focused on items closely tied to the public welfare improvement agenda, but the implementation has not managed to adequately address conditions in the country concerned.

As for Indonesia, it is known for its clientelism, to the point that the majority of the rents generated by the government get caught in cronyism and corruption, which poses a *problematique* all its own.⁴⁴ Even when the authorities do succeed in disclosing something, neither parliament nor the press, international and local financial analysts or NGO (nongovernment organization) circles are really able to keep track of it, because there is always a blanket of secrecy along with sometimes mysterious multi-party relationships. Institutional tax handling problems may also be a deciding factor. The existence of an independent taxation agency or tax department may well be the ideal solution. However, based on a comparison of tax ratios, Russia, which has an independent ministry of taxation, is no better than Indonesia, while Guatemala has an independent taxation agency but is in still worse condition.⁴⁵ Institutional solutions might work in the context of proper organizational handling of the country, but when rents are left in an untouched and secretive sphere as they are in Indonesia, opportunities to manage the rents so as to turn them into added value, are minimal as well.

⁴⁴ MacIntyre (2000), p. 261

⁴⁵ Setiyaji and Amin (2005), p. 12

A final note is the fact that economic policy, including taxes, is also determined by a domestic agenda, which encourages the formation of the economy's direction and is then justified by the economists. For example, the mercantile policies that were dominant in England in the 15th to 18th centuries, and may be said to have laid the foundation for the success of the British in building their empire, provided tax exemptions only for certain activities and often imposed export taxes or even banned exports in order to make raw materials more expensive for rival countries.⁴⁶ Another example are the four maxims of Pietro Verri (the 18th century Italian economist who greatly influenced the smaller countries that later became united within Italy) regarding the tariffs that came out of the Italian political economy school of thought: (1) tariffs on exported factory goods were bad for trade, (2) tariffs on imported raw materials needed for domestic industry were bad for trade, (3) tariffs on exported raw materials were good for trade, and (4) tariffs on imported manufactured goods were good for trade.⁴⁷

Such positions need to be grounded in a country's economic development needs. Unfortunately, many countries put their faith in the prescriptions of international financial institutions to transfer management of the manufacturing sector to other countries merely due to cheap production factor considerations, while the environment, given the policies abandoned, has not yet been transformed to suit the new conditions. Finally what arises is the mushrooming of an informal sector to accommodate the workers bumped out of the manufacturing sector. Whereas the existing capital is pulled into the vortex of global capital, which spins and moves in an extraordinarily rapid dynamic. Both phenomena pose a dilemma in setting tax policy, given that, as mentioned above, fixing informal sector taxation management is not easy in human, technical and administrative terms. On the other hand, efforts to manage the taxation of capital itself also runs into challenges, as in the cases of failure of many countries – not only developing but also in developed countries – to develop better taxes on capital gains due to administrative difficulties and overrated fears of generating negative sentiments.

For Indonesia, there is need for a more integrated framework aimed at optimizing state revenues through taxation, so that it can better achieve effectiveness. Corrections of a more administrative and procedural nature should be allowed to continue, but what must not be forgotten is the need to adjust the tax policy framework to meet the need to fix the country's economy. The hope is for a time when a more progressive taxation agenda is undertaken, for example, by linking it with the reality that Indonesia has become the target of a portfolio of global capital turnover that is quite sizeable, although efforts to develop tax instruments are still lacking.

Nevertheless, all hopes of taxation reform will go stagnant conceptually (although they seem smooth at a glance) given the reality that the concept and implementation of tax reform itself are more preoccupied with administrative adjustments dominated by normative steps. Opportunities to utilize tax reform to restructure the economic posture seem to go unrealized. The lack of preparedness to seize the opportunity to restructure the economic posture, it should first be noted, is not due to a

⁴⁶ Jomo and Reinert (2005), pp. 18-19

⁴⁷ *Ibid.*, p. 38

lack of human resource capacity. A more driving factor is the limitation of vision to open more room to build an economic posture for a nation that is sometimes burdened by adherence to the prevalent international-level policy style and a lack of self-confidence to embark on schemes and policies that may be called uncharacteristic or unusual but are necessary.

Schemes and policies that may be perceived as out of the ordinary may include, for example, developing capital market taxation. Although at a glance this might seem to go against the current and could pose a risk of capital flight, it should be clearly recognized that the capital that flees is fast-moving capital. This is precisely the reason why developing taxation in the capital market will greatly help to develop the capital market itself, so it does not become a target of international speculation.

Similar challenges apply to a variety of new economic modes such as the electronic transactions discussed above. The ability to deal with them requires not just equipment but also the reform and improvement of human resources, along with developing a conducive policy framework. Collaborations between related sectors in Indonesia are often still weak in supporting approaches like these that require the integration of multiple sectors.

Besides, it is quite interesting to learn that the determination of tax policy can be directed to develop the traditional and informal sectors to gain a better competitive advantage. Given a better competitive advantage, the traditional and informal sectors just become a refuge for workers who have lost access to incomes from the formal sector. Taking steps to develop tax incentives for creative industries can be a good first step in this connection, only once again there is need for adequate facilitation, supervision and monitoring. Facilitation, supervision and monitoring are necessary to develop the in-depth structure of industry for opportunity, such as creative industries where people do not simply sew or work, but can identify competitive opportunities that combine the wealth of history, culture, patterns of interaction and linkages with various support industries. In other words, business development is not to be left entirely to the workings of the market, but involves careful investigation of the market in order to build a deep industrial structure that in turn will strengthen the fundamentals of the national economy.

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Tax Reform in Various Countries

China

China is a country with a relatively low rate of per capita income and an amazing rate of growth. It has seen rapid increases in investment despite occasional threats of decline at such times as the SARS crisis or today's global economic crisis. However, it has also had increases in the prices of raw materials, electricity and oil shortages, increases in bank loans, especially in the real estate sector, a growth in imports that exceeded growth in exports, and a decline in its trade surplus.

The Chinese fiscal system itself has a number of weaknesses, including, for example, a ratio of tax revenues to the GDP that is still very low, even in comparison to other developing countries. Another weakness is an indirect tax burden that is disproportionate and has damaging effects on both businesses and households.

Generally, the Chinese taxation system relies on the goods and services sector, which contributes 67% of total tax revenues (11.3% of the GDP). Apart from a value-added tax that contributes about 7.3% of the GDP (and over 43% of total tax revenues), there are also business taxes that are not included in the VAT, as well as consumption taxes that are levied on some types of goods classified as "luxury goods." Beyond these, several other taxes amount to 7.9% of total tax revenues, or 1.3% of the GDP. These include municipal maintenance and development taxes, a stamp tax, and a home ownership tax and residential tax in urban areas.

China initiated the most important tax reforms in 1994, when the government announced efforts to increase the ratio of tax revenue to GDP and to centralize the distribution of total revenues. Other important factors were the simplification of the taxation system and the harmonization of the tax regime, along with the development of new, rule-based criteria for balancing central and regional revenues.

Big changes were made in the value-added tax sector. The scope of the VAT was broadened to cover all industrial products, commercial sales, goods imports and several specific services known in Chinese legislative terms as "processing, improvement, and maintenance services." Tax tariffs were reduced to three: in addition to the standard 17% interest rate and 0% interest rate on exports (the latter is in keeping with general international practice), a 13% tax was applied on a limited basis to a group of goods considered essential. Additionally, since every enterprise related to taxable goods or services would be subject to the reforms of the VAT, a consolidation tax for industrial and commercial entities that had been imposed on foreign-related companies was abolished.

Other crucial changes included the imposition of corporate taxes on domestic companies, and personal income taxes. A unified "corporate income tax" was introduced with a standard rate of 33% applied to all domestic companies regardless of ownership, although special treatment for foreign investment companies would still be retained. The "individual income tax adjustment" applied to individuals, (urban and township individual industry and commercial income tax) levied on household/cottage enterprises, and "individual income tax" were all changed and simplified into a "personal income tax" which was applied more or less uniformly to Chinese citizens and foreigners.

The newer tax rules were also designed to overcome the so-called "farmers' burden." A reform of the "tax-for-fees" was launched in 2000. This was aimed at the elimination of the various unofficial fees levied by local governments and the replacement of the remaining ones subject to the tax rules mandated by the central government. In the past four years, as many as 20 provinces have adopted this policy, which it is estimated has already managed to reduce the financial burdens of some 620 million farmers by at least 30%. Because the majority of the poor live in rural areas, it is expected that these measures will manage to produce a parallel reduction in the poverty rate; further, as stated by the IMF (International Monetary Fund), they should improve budget management through the reduction of extra-budgetary funds. Starting in 2004, agriculture tax rates would have been reduced an average of more than 1% per year and agriculture taxes would be eliminated within five years.

India, despite being the country with the largest population in the world, must struggle to overcome poverty. Ironically in India the budget for social security and welfare programs is nil at the national level, while at the local level it is only 0.6% of the GDP. Meanwhile, the overall budget for public administration, law and government, and defense amounts to over 7% of GDP, equivalent to nearly one third of total state expenditures.

In 1991, in response to the high fiscal deficits caused by fiscal expansion that was overdependent on debt, India began to implement economic reforms, including tax reforms. The tax reforms were based on the “King Chelliah Committee Report” whose main proposals were to: reduce the rates of the primary taxes (individual and corporate income taxes, excise, customs); maintain the progressiveness of the system but discourage evasion; expand the tax base for all types of taxes by reducing exemptions and concessions; transform tax on domestic production into a value-added tax; and simplify laws and procedures to make the administration and implementation of the tax system more effective. All the recommendations were implemented, at least at the central government level.

Regarding personal income taxes, reductions were made in the tax rates, both in terms of tax types (reduced to three types) and their values (10, 20 and 30%), and the tax threshold was raised from Rs 40,000 to 50,000 while the number of brackets was reduced from seven to three. For corporations, corporate income tax was reduced from 40% to 35% for domestic companies and from 50% to 48% for foreign companies, although there was no expansion of the corporate tax base, particularly with respect to tax holidays and progressive depreciation in numerous business activities.

Personal and corporate income tax revenues increased after the reforms, so that the portion of revenues from direct taxes as a proportion of GDP showed a significant increase (from 14% in 1990-1 to 24% in 1997-8). A voluntary disclosure scheme (VDIS) was put into effect in 1997-8 to provide opportunities to individuals, companies, and non-permanent residents to declare hidden assets and income and then pay a tax of 30%.

Regarding tariffs, both average and peak tariffs were drastically reduced, whereas in terms of their level of differentiation, the number of tax tariffs remained high, and in recent years has even increased. For various types of excise taxes, simplification and rationalization were carried out by reducing the magnitudes of the tax levels. Meanwhile, taxation progressively shifted from specific to ad valorem levies in connection with most commodities. Exemptions along with the lowest rate (8%) were eliminated in order to broaden the tax base. Taxes on specific services (telephone, non-life insurance, and stock broker services) were introduced in 1994-5, and later on, taxes like these were extended to cover other types of services.

Tax reform in India succeeded in increasing direct tax revenues. However, there were also compensations for the decrease in indirect tax revenues, which were mainly caused by a decline in import tariffs and customs tariffs on mass consumption goods. In September 2002, the government established a new task force for tax reform and a task force for the implementation of the Law on Fiscal Responsibility and Budget Management – known as the Kelkar Committee, since both were led by Vijay Kelkar. The Kelkar Committee recommended further clean-ups, including: an increase in the income tax exemption limit to Rs 100,000; a two-level income tax rate structure (20% for income from Rs 100,001 to 400,000 and 30% for income above Rs 400,000); corporate tax cuts from about 36% to 30% in order to remove the gap between the top personal income tax and corporate tax rates, and cuts in plant and machinery depreciation to 15% from 25%, and the introduction of a basic, three-level excise tax structure (5% on raw materials, 8% on intermediate goods and 10% on finished goods); comprehensive imposition of taxes on services, only excluding public and social services as services not subject to tax; the elimination of property taxes; the merging of taxes on expenses in hotels with the service taxes; the elimination of concessional services for long-term capital gains through periodic reductions in tax rates; the elimination of tax exemptions and rationalization of incentives for savings using a simplified procedure; and a gradual movement toward the imposition of taxes on a value-added tax basis at the level of the country’s states.

The tax reform initiative in Japan emerged in response to drastic changes in the structure of Japan's population, where the work force was declining due to decreases in the birth rate, increases in the average age of the population, and decreases in the average level of savings. The increasing average age of the population triggered an increase in public spending, whereby financial conditions at central as well as local levels underwent difficulties, subjecting the people to uncertainty regarding their future social security.

The tax burden was not evenly distributed among the generations, such that the tax-exempt treatment of retired civil servant began to be perceived as a burden. There were concerns that this would trigger a decline in motivation among the younger generations to carry out their social responsibilities, including taxation.

In responding to this, it was considered important to formulate a tax system that would encourage the participation of older people and women in the community economy. Additionally, increasing productivity was seen as the key to producing economic wealth in communities with smaller populations. Corporations, which played a central role in productivity, had to develop environments in which they could cope in a flexible manner with the structural changes occurring, such as globalization. The tax system had to be reviewed in a simple, neutral and clear manner to ensure it would not impede individual empowerment or corporate options. A Tax Commission was formed that produced a comprehensive report aimed at recovering the primary role of instruments to raise tax revenues and restore their redistributive functions. An urgent need was felt to expand the tax base by simplifying, consolidating, and only in certain special cases, applying some exemptions and reductions.

One interesting thing was the integration of the regulation of taxes on capital, taxes on interest, and taxes on capital gains on listed stocks. Efforts were made to reform taxation on capital income in the 2002 and 2004 fiscal years, especially in connection with capital gains, aimed at ensuring tax equity and neutrality. The rationale was that innovation in financial markets opens up possibilities of increases in speculation in both the bond market and the stock market.

However, several weaknesses could still be found in the determination of the tax base, along with significant distinctions among the various types of customers and assets. First, several types of interest were tax-exempt, such as interest from bank deposits, and interest received by certain categories of individuals such as the elderly. Second, some dividends were subject to double taxation. Third, capital gains on bonds, other than convertible bonds, were not taxed, reflecting the idea that taxes on capital gains can only be imposed if the latter are derived from speculative activities. The exemption of capital gains on bonds could trigger tax evasion behavior, including the transformation of interest (which is taxable) into capital gains on bonds. For this reason, the orientation of the Tax Commission was to move toward the generalization of taxation on all types of capital gains at a flat rate of 20%. Another challenge in enforcing the tax on capital gains was that it was not easy to find out the acquisition price, so the basis for tax imposition was hard to ascertain. To surmount this problem, Japan has implemented a flat tax rate based on the selling price, although there remains a risk of distortion in the functioning of the financial market, with the imposition of strict penalties pertaining to market trading.

Malaysia

The Malaysian economy recovered from the 1997 Asian financial crisis with a strong growth rate of 8.3% by the year 2000. In subsequent years, though, growth was again affected by a global economic slowdown, partly due to the 11 September 2001 incident in the United States. To reduce the negative impact of the external slowdown, the government designed and implemented several policies and strategies, through the Pre-emptive Stimulus Package in 2002 and the Package of New Strategies in March 2004, which contained several fiscal measures relevant to increasing investment. Some of these fiscal measures are described, as follows.

Existing incentives for small businesses were to be increased. Pre-reform packages for small businesses provided incentives in the form of pioneer status (status pelopor) income tax exemptions of as much as 70% for five years, or investment tax allowances of 60% of capital expenditure issued for five years, to be calculated based on 70% of statutory income. With the 2002 package, existing incentives were raised through an increase in the income tax exemption through the pioneer status from 70% up to 100%, and an increase in the statutory income that could balance the investment tax allowance from 70% up to 100%. With the reform package, pioneer status with a 100% tax exemption for ten years or the 100% investment tax allowance for five years were accorded on a case-by-case basis. Additionally, the pioneer status was extended from a maximum of ten years to fifteen years, and there was an extension of the investment tax allowance period from five to ten years.

Before the 2002 reforms, native Malaysian trading companies were given income tax exemptions on statutory income equivalent to 10% of the increased value of exports. To promote the exportation of locally produced goods, the rate of income tax exemption for these companies was increased from 10 to 20% of the increase in export value.

The 2002 package also carried several actions to improve skilled human resources and labor productivity; in particular, a series of fiscal measures were implemented to facilitate Malaysian education programs, the training of human resources at home and abroad, and the construction of new schools, universities and libraries. Additionally, the 2002 reforms also provided incentives relevant to a number of sectors considered strategic for the Malaysian economy, such as tourism, construction, manufacturing (for example, electronics) and agriculture, particularly involving the implementation of a series of expense allowance, deductions and relief measures.

South Korea

South Korea successfully recovered from the Asian economic crisis in just one and a half years, at which point the outputs produced reached pre-crisis levels. Within four years, the South Korean economy realized a level that was a quarter higher than before. In the framework of strengthening its economic base, tax reforms were also undertaken. The tax reforms were directed at providing loan support to middle and low income communities in 1999, energizing the tax regime in accordance with international standards in 2000, and reducing tax incentives and lowering tax rates in 2001. The direction of tax reforms in 2002 was to support middle and low income communities, provide stimuli for the local economy, improve the competitiveness of Korean companies, and turn Korea into a center of business in the East Asia region.

The main pillar of international tax reform during this period was governed by the Law on Foreign Currency Transactions (1999) and its subsequent revisions (2000), following three main directions: the first was to enable financial transaction exchanges with other countries; the second, to subject all international transactions to transfer pricing rules; and the third, to revise the rules on thin capitalization and Controlled Foreign Corporations (CFC).

In connection with the exchange of information about financial transactions with other countries, the Ministry of Finance and the Economy planned to provide information on the basis of reciprocity and

foreign revenue authority demands, on condition that the issuance of information in South Korea and in foreign companies and branches operating in South Korea would come under the scope of the new standards. Regarding international transactions subject to transfer pricing rules, some international transactions between related companies that were covered under tax and corporate income tax law and not covered by international tax laws used to be subject to a rule rejecting incorrect transactions in the past. This rule has since been changed and all international transactions have now become subject to transfer pricing rules, effective as of 2003.

South Korea expanded primary coverage of foreign shareholders by placing subsidiaries of domestic companies within the rules on thin capitalization. Since April 2003, foreign ownership, defined as more than 50% of the total shares of the South Korean companies operating domestically, determines whether a company is classified as foreign company, and thus subject to thin capitalization. South Korea also broadened the scope for foreign shareholders' presence in domestic businesses. Foreign shareholders owning over 50% of the subsidiaries of the companies concerned are now subject to the rules of thin capitalization.

The CFC rules have also undergone some changes. The aim of the CFC rules is to impose taxes on the abnormal regular flows of profit of subsidiaries in "tax-free" locations by treating them as Korean national dividends that must be paid to the parent company. The "tax-free" concept under the tax laws of South Korea refers to jurisdictions without taxes, or those that waive 50% or more of tax revenues, or have a tax rate lower than 15%. Companies that fall within the scope of the CFC rules are subsidiaries located in low tax jurisdictions where at least 20% of their capital stocks are directly or indirectly owned by a Korean parent company.

South Korean tax law allows for a number of exceptions to the CFC rules, where subsidiary companies run bona fide operations in a low tax jurisdiction through permanent business places such as offices, sales outlets or factories. Nevertheless, even if these conditions are fulfilled, CFC rules still apply to wholesale, retail, consumer goods repair, transportation, warehousing, communications, banking, insurance, and real estate or rental service companies.

There have also been several revisions of the foreign investment regime in South Korea. The South Korean government accepts the reality that foreign direct investment plays an important role in the economy. Because of this, the government planned to determine special economic zones to facilitate the entry of foreign investment. In the special economic zones, large-scale foreign investments that meet the requirements are given the same benefits as in foreign investment zones. In the foreign investment zones, companies are tax exempt for seven years and enjoy 50% reductions for three years. In the designated special economic zones, medium-scale foreign investments that meet the requirements are given the same benefits, as in the Jeju Free International City. In Jeju, companies are tax-exempt for three years and enjoy 50% reductions for two years.

Thailand

Thailand had a lot of work to do to restore its economy, which was fairly hard hit by the 1997 Asian economic crisis. Because of the crisis, many enterprises operating in the formal and informal sectors claimed their inability to pay taxes. Additionally, the existing policy framework made it possible for taxpayers to claim a variety of incentives to minimize their taxable income by increasing their expense claims. Meanwhile, in the informal sector, weak business licensing led many small business owners to avoid taxation. When various state agencies in Thailand endeavored to overcome these problems, they quickly met with a range of difficulties due to a lack of information, data on revenues and other statistics, so that tax forecasting was hard to do.

The Thai government immediately took major action to increase tax payment compliance by tightening the rules on VAT refunds, developing automated systems for VAT refunds and for audit case selection, reducing tax payment compliance costs, simplifying taxes and excise and transforming them to VAT, providing support to the large business tax administration office in managing the largest taxpayers, strengthening control over markets and street vendors, firming up requirements for business registration, and increasing VAT for registered taxpayers. In the period of 1997 to 1998, the Thai government also made efforts

to reduce the deficit, make budget cuts, increase the VAT (from 7 to 10%), increase excise taxes and import duties, and impose taxes on luxury consumer goods. Subsequently, fiscal measures were taken to reduce the social impacts of the crisis and stimulate the economy. The 1.5% VAT was eliminated for small businesses with gross incomes between 200,000 and 600,000 baht. Tax relief on personal income was provided to all taxpayers, especially in low-income communities, by exempting the first 50,000 baht of net profit (80,000 baht since 2003) from taxes. Further measures to reduce the tax burden were introduced in August 1999 through increases in the selection of excise taxes, import tariff reductions, and the acceleration of fixed asset depreciation, which was targeted to provide investment incentives. Aside from that, delays were effected in the payment of corporate income taxes and transfers of money from state-owned enterprises in order to diminish liquidity constraints in the public and private sectors.

In May 1999, in the spirit of exercising the mandate of the 1997 Constitution that was born as a response to the crisis, the government launched a three-year program of public sector management reforms aimed at increasing income and distributing the tax burden more evenly, along with fiscal decentralization.² The government effected measures to strengthen law enforcement, increase taxpayer compliance, and make information technology improvements, including the establishment of a Debt Collection Management Division.³ The responsibility for determining tax policy had already been transferred from the department of revenue, customs and excise to the fiscal policy office. The main tasks to be carried out included the creation of a functional and integrated computer system for the department of revenue, the implementation of online taxpayer registration and automated audit case selection systems, the development of modules for debt management and the creation of data entry, processing and reporting schedules for all taxes.

Increasing fiscal decentralization was another major area covered by tax reform in 1999, in line with the implementation of the 1999 National Decentralization Act, which encompassed changes in the roles of the central and local governments in fiscal and administrative relations. Two of the foci here were to avoid overlaps in functions and to increase local government revenues up to 20% of total government revenues by 2001, and to 35% by 2006.

(Endnotes)

¹ This discussion of comparative tax reform information is based on case studies on tax systems and tax reform in South and East Asia

by Bernardi et. al. (2006). The Chinese case is based on a study by Domenico D'Amico, while the Indian case study was conducted by Luigi Bernardi and Angela Frascione; the Japanese case study, by Luigi Pascali; the Malaysian case study, by Gianpaolo Fanara; the South Korean case study, by Lida Ceriani; and the Thai case study, by Marco Bartolich.

² During the crisis, tax debt increased sharply (from 0.7% of GDP in 1996 to 2% in 1999); as a result, by 1999 the collectible debt was 9.3% of the total, but thanks to the public sector loan reform program (with a US\$ 400 million loan from IMF) this percentage was reduced to 6% by 2001.

³ The Debt Collection Management Division was established with the function of preparing a three-year plan for debt reproduction, setting collection targets for each office of the department of revenue, developing enforcement procedures and monitoring debt collection performance.



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