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Journal of Asian Economics 16 (2005) 1029–1046

JOURNAL OF ASIAN ECONOMICS

Indonesia's new tax reform: Potential and direction

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Received 3 August 2005; received in revised form 30 September 2005; accepted 14 October 2005

Abstract

This study aims to provide direction for policy and provide input to improve the quality of taxation services, by emphasizing and analyzing the existing tax potential and recommending a taxation reformation plan in accordance with fiscal sustainability and efforts to increase the level of Indonesian competence both for the transition period and in the long term. The result of the study has indicated that there is still the opportunity to increase national revenue without increasing rates and by increasing the capacity of tax administration and expanding the tax base, tax collection/revenue will increase. There are a number of indicators that illustrate this, such as the ratio of tax revenue to the GDP which is still relatively low compared to other countries, wide scope for increasing value added tax (VAT), PIT and CIT revenue productivity, etc. Our best estimation for potential tax revenue expansion for the next 2–3 years would be 2.1% of GDP where PIT and CIT contributed more than half of that expansion.

Keywords: Tax potential; Tax base; VAT

1. Introduction

Recently, the Indonesian government has faced the real challenge to assure its fiscal sustainability in the near and longer future. The continual decline of revenue from oil and gas can no longer be prevented. At the same time, the government's commitment to gradually lessen the budget reliance on foreign debt also gives rise to the worsening government budget funding. Moreover, those funding problems are complicated by the considerable needs for fund to support, particularly, the ongoing decentralization process as well as the completion of the economic

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1049-0078/$ – see front matter
doi:10.1016/j.asieco.2005.10.004

recovery process. By considering the above factors, as a result, efforts should be made particularly to mobilize funding and increase the efficiency of expenditure.

At the revenue side, the Indonesian government has no other choice but to effectively mobilize revenue from taxes. Taxes have a great potential to be the main source of government funding. New tax increases can be achieved through improved taxation administration or by expanding the tax basis or by increasing rates. Nonetheless, tax implementation up to 2003 shows that there is still the opportunity to increase national revenue without having to increase current rates. There are a number of indicators that illustrate this, including:

1. Tax ratio in Indonesia is still relatively low compared to other countries. The Indonesia non oil and natural gas tax revenue ratio for 2003 is still as much as 11.9%, far lower than many countries with per capital incomes lower than Indonesia, like India (11.49%), Pakistan (13.76%), Srilanka (19.8%) and other developed countries like Philippines (11%), Thailand (16.5%), Korea (16.07%) and Malaysia (18.5%).
2. The filing ratio, i.e. the ratio between taxpayers that actually pay taxes and registered taxpayers who are unable to afford the three main taxes, individual income tax, commercial income tax and added value tax. For the three types mentioned especially for income tax, the amount of actual taxpayers compared to those registered shows a decrease in the last year.
3. Realization of tax revenue for all types of taxes: income tax and value added tax (VAT) is still below potential. The administration efficiency ratio (AER)—the ratio of actual tax revenue to potential is still quite low. The 1998 IMF study show that the AER for individual income tax was the lowest compared to two other types of taxes. This illustrates that not only the amount of taxpayers is low, but also that many taxpayers do not pay the required amount.
4. The elasticity of tax collection for all types of tax is till greater than one, in fact for certain taxes like added value tax, import duty, excise duty and land and construction tax, elasticity is still greater than two. This shows that the in actuality the tax potential is yet to be reached.
5. The distribution of tax revenue is still concentrated on too few tax payers. For example, in 2002, 1% of registered individual tax payers contributed to about 50% of PIT revenues while 2% of registered tax payers contributed to more than 80% of corporate income tax revenues. Those figures revealed a significant potential for tax revenue expansion through tax base expansion rather than an increase in tax rates. The high level of concentration of tax revenue also shows the high level of tax revenue vulnerability. It also calls for a broader tax revenue basis.

All five indicators mentioned above illustrate once more that without increasing rates and by increasing the capacity of tax administration and expanding the tax base, tax collection/revenue will increase.

The need to reform the tax system in Indonesia is also raised from business competitiveness perspective. With a more integrated world economy, a tax system plays one of the main indicators for investment climate. As a result, tax competition among countries—particularly developing countries—is intensified in order to attract more investors—both domestic and foreign ones—to put their portfolio in their countries.

This paper is organized as followed. Following this introductory section, Section 2 presents an overview on the current tax system including our assessment on its tax potential revenues. Section 3 specifies an analysis of Indonesia's tax competitiveness. This analysis will give guidance how far the Government of Indonesia should provide incentives to improve its competitiveness without sacrificing its potential revenues. In Section 4, we will discuss the new