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Comprehensive Tax Reform: The Indonesian Experience, 1981-1988

I. Introduction

A. Barriers to Tax Reform

Indonesia enacted a major tax reform in 1983. The new system represents a sharp departure from tax policies followed since independence in 1945. This paper explains why tax reform was so long in coming in this country, what it sought to achieve, the extent to which objectives were fulfilled, and why. The paper also attempts to draw important lessons from this experience, lessons that may or may not prove useful in other settings.

This tax reform is best understood against the broader backdrop of overall economic policymaking following the economic and social upheavals of the mid-sixties that led to virtual national collapse in 1966. Indonesian economic history since that time is laden with notable examples of far- reaching policy reforms affecting such key "macro prices" as exchange rates, interest rates, domestic oil prices, and prices of agricultural staples, especially rice. (Gillis 1984) To illustrate, two major, and largely successful reforms in policies affecting credit and growth of liquid assets were enacted over the period 1967-1983. Furthur, there were five devaluations, of which at least four were successful by almost any measure (Gillis and Dapice, 1986). Also, agricultural price and subsidy policies were subjected to a a series of major and adjustments over the fifteen years prior to

1983, and by 1979 had yielded generally positive results both for production of staples and rural income growth. (Collier et.al., 1982)

Policy reform in these critical areas from 1966-83 played a significant role in improving living standards in this, the fifth most populous country in the world, after the United States. Over that period, real GDP more than doubled, (Gillis, 1984) so that by 1983, income per capita, at $560, was high enough to place Indonesia among those nations classified by the World Bank as lower-middle income developing countries. (IBRD, 1985, World Development Report)

The tax system, however, remained essentially untouched by any significant reform initiatives throughout the seventies and early eighties, in spite of widely acknowledged defects in tax structure and tax administration. Many of the most serious defects in tax structure stemmed from the fact that income, sales and property taxes were all based on outdated tax legislation left as one of the dubious legacies of the last few decades of the three centuries of Dutch Colonial Administration.

To be sure, changes were introduced in the system after Independence, but most of these resulted from generally unsuccessful efforts to fine-tune the tax system to achieve a such non-revenue goals as regional development, income redistribution and industrial growth. By 1981, the tax system had, as a result of decades of such manipulation, become a complex maze of virtually unenforceable, if not unintelligible, collection of amendments, decrees and regulations. Because it was both outdated and unusually complex, the generally applicable tax system was unproductive of revenue, a source of substantial economic waste and essentially inequitable in every important sense. Given the glaring weaknesses in the tax system through the early eighties, the nation was able to avoid massive budget deficits only because of rapid growth in taxes on foreign oil companies (Table 1, column 2). These taxes were collected on the basis of special, much simpler, tax provisions contained in the oil agreements themselves.

Inattention to the need for tax reform, in the face of such obvious problems, was due to at least three factors. First, low-income groups were generally unaware of the costs imposed upon them by a system of indirect taxes that was almost wholly hidden from ultimate consumers. Second, few higher income persons could have been dissatisfied with a system that extracted so little from them: personal income taxes were little more than 1 percent of GDP; virtually all corporation tax collections came from larger state-owned enterprises and foreign firms, and in any case amounted to less than 1 1/2 percent of GDP. Moreover, penalties for tax evasion, when imposed at all, were so light as to be virtually non-existent. Third, the tax administration was by and large quite comfortable with the system, particularly since it demanded little effort from them. Also, the extreme complexity of the system meant that very few outside the tax administration knew exactly which tax laws and regulations applied in any given case: the scope for corruption in tax administration was therefore very wide.

The three foregoing factors, however, were relatively unimportant impediments to tax reform compared to the fourth: the massive inflow of government receipts from oil, and later liquified natural gas (LNG) from 1973-81. The implications of these natural resource revenues in stifling tax reform are most apparent when comparing trends in non-oil taxation and government spending. Table 1 portrays the evolution of the tax ratio (ratio of taxes to GDP) in Indonesia over the twenty year period beginning in 1967. In interpreting this table, it is essential to know that the tax system had virtually vanished in the years of extreme economic instability of 1963-66 that culminated in hyperinflation in 1966-67. The revenue capacity of the system recovered slowly but steadily over the next six years even as the tax structure was steadily weakened by growing complexity and as standards of conduct in tax administration continued to erode. The tax ratio reached 10.3% in 1970 and 13% in 1972, the year before the first oil boom. For the period 1972-76, the tax ratio for Indonesia averaged 16%, just about matching the average for all LDCs over the same period (Gillis et. al., 1987). However, in Indonesia's case, more than half of government revenues then came from the enclave oil sector (including LNG). Dependency upon oil revenues became even more pronounced after the onset of the second oil boom in late 1978: for the next four years, oil and LNG revenues accounted for more than 2/3 of total domestic tax revenues. (Table 1)

The successive explosions in oil revenues in 1973-75

Table 1
Indonesia: Domestic Tax Revenues as
Percent of GDP, 1967-1986

Year	(1) Non-oil Domestic Tax Receipts as Percent GDP[a]	(2) Total tax Receipts on Oil and LNG Exports as Percent GDP	(3) Total Domestic Tax Receipts as Percent of GDP (1) + (2)
1967	6.2	0.9	7.1
1968	6.0	1.2	7.2
1969	7.3	1.7	9.0
1970	8.3	2.0	10.3
1971	8.7	3.0	11.6
1972	8.7	4.3	13.0
1973	9.2	5.1	14.3
1974	7.4	9.0	16.4
1975	7.9	9.8	17.7
1976	8.4	10.4	18.8
1977	8.4	10.2	18.6
1978	8.8	10.2	19.0
1979	7.9	13.7	21.6
1980	7.2	15.8	23.0
1981	6.1	15.0	21.1
1982	6.8	12.2	19.0
1983	6.7	14.1	20.8
1984	6.1	14.6	20.7
1985	8.0	11.8	19.8
1986	9.1[b]	5.2[b]	14.3[b]
1987 (est)	8.4[b]	7.1[b]	15.1[b]

Source: 1967-79: Gillis (1984) Table 3
1980-87: Dep. Keuangan

(a) Non-oil tax revenue includes surpluses from domestic oil operations in 1986 and 87: 1986 = 977 Billion Rupiah, 1987 = 114 Billion Rupiah

(b) Estimated

Table 2
Indonesia: Pre and Post Tax Reform
Government Spending, Revenue and Deficits

Year	(1) Government Spending as Percent GDP (a)	(2) Total Domestic Tax Receipts as % GDP (b) (From Table 1)	(3) Total Foreign Grants as % GDP (c)	(4) Budget Deficit as Percent GDP (1) - (2+3)	(5) Project Aid as Percent GDP (e)
1971	14.8	11.6	0.3	-3.4	-3.0
1981	23.8	21.1	0.2	-2.5	2.9
1982	22.9	19.0	0.1	-3.8	3.1
1983	24.8	20.8	0.1	-3.9	5.3
1984	22.1	20.7	0.1	-1.3	3.9
1985	23.7	19.8	0.1	-3.8	3.6
1986	20.9	14.3	0.2	-6.4	3.3
1987(d)	17.1	15.1	0.2	-1.8	n.a.

Sources:

(a) IBRD and IBRD, GDP figures.
(b) Ministry of Finance
(c) IMF
(d) Projection, based on assumption of real growth in GDP of 3.2 % and domestic inflation of 8.0%, so that 1987 GDP is RP. 119,618 million.
(e) IBRD (1987) Table 5.2.

and 1979-81 not only precluded any serious tax reform initiatives, but allowed a palpable slackening in the efforts of the tax administration to collect domestic non-oil taxes. By that year, the ratio of non-oil taxes to GDP had slipped to 6.1%, the lowest since the early years of economic rehabilitation in 1967-68, and easily among the lowest in the world.

B. Planning of Tax Reform

The Minister of Finance, supported by influential colleagues in the Planning Agency, decided early in January 1981 to initiate preparations for fundamental tax reform, for implementation sometime before the middle of the decade. This decision was made at a time when most institutions, particularly the World Bank, were projecting continued strength in world oil markets through the decade. (World Bank, 1981)

Over the next six months, decisions were reached on virtually all questions of strategy and tactics to be employed in securing reform. Most of these decisions were taken after a brief review of the tax reform experiences of such diverse nations as Japan, Indonesia, Bolivia, Colombia and Ghana, (Gillis, 1985) to determine lessons that might be drawn for Indonesia's benefit.

The first decision was to provide for ample time for preparation of policy options and for drafting of actual reform legislation. A lengthy period would in fact be required for several reasons, not least of which was the need to compile reliable evidence on the impact of the existing tax system upon resource allocation, income distribution and economic growth. In the end it was this evidence that strongly conditioned the reform package in the direction of greater economic neutrality (see below). The decision to prepare actual draft legislation was a direct consequence of the author's own experiences in tax reform in Colombia, where the drafting team was able to detect inconsistencies in policy decisions in time to send back to decision-makers for resolution, before final drafts were prepared. As it turned out in Indonesia, substantial time and energies were in fact consumed in the process of converting tax policy decisions into actual draft legislation.

The second decision was strongly shaped by the first. In contrast to tax reform initiatives mounted in many other LDCs, the Indonesian effort would focus upon the entire tax system, including not only the tax structure but also the complex of mechanisms and institutions governing tax administration and compliance. This decision meant that the reform undertaking would include detailed consideration not only of issues related to tax rates and tax bases, but also the tax information system and the procedures governing tax administration and compliance.

The third decision was that the reform would be comprehensive in nature: it was intended to affect most important revenue sources, including foreign oil companies. The reform therefore embraced all income, sales and property taxes. The only tax sources left out of the scope of the reform program were taxes on foreign trade, primarily import duties. At the time, such taxes accounted for only one-twelfth of total central government revenues. Policy makers did not, in 1981, wish to complicate the issue of tax reform by getting into issues of tariff policy, regarded as troublesome matter for reform of trade, not tax policy. Policy-makers correctly judged that in the Indonesian context at least, reform of trade policies involved even greater bureaucatic and political difficulties than tax reform: fundamental changes in trade policy had yet to be enacted by early 1988.

The fourth decision related to the taxation of foreign oil companies. In particular, steps were to be taken to avoid disturbing the _status quo_ in oil taxation, so as to avoid a repeat of the acrimonious exchanges between the companies and the government in 1976, when the latter undertook the renegotiation of production-sharing contract arrangements in oil, so as to increase taxes due to Indonesia. (Gillis, 1980, p. 6) In response, most of the companies undertook sharp cutbacks in exploration in 1977, 1978 and 1979. The government did not wish another such confrontation. Accordingly, it was decided that oil companies with production-sharing contracts signed _before_ the effective date of the reform would be entitled to retain the tax treatment specified in those contracts. For contracts signed after the effective date of the tax reform, the new tax law would apply, but companies were to be assured that _total_ tax obligations to Indonesia (given prices and given production volumes) would not be materially changed by tax reform. Thus, any increase in income tax obligations arising from reform would be compensated by reduction in royalties or other levies; any decrease in income tax rates on oil companies would be made up by other levies upon them.

The fifth decision was that, to the extent possible, the reform would be contemporaneous in nature. It was intended that the entire set of reform proposals would be presented at one time, as a package, not as a separable set of initiatives to be proposed and implemented over several years. Moreover, it was decided that effective dates for new sales, income and property taxes would be as close together as possible. The basis for these timing decisions was a purely political judgement that a series of reform initiatives spread over time would stand a poorer chance of acceptance than one large reform package. This judgement proved to be only partly correct. Although income and sales tax reform were announced together, implementation of the latter was delayed for 15 months, and property tax reform was postponed for two years, until 1986.

A sixth decision had to do with the extent of foreign involvement in the reform program. Participation by bilateral and multilateral foreign aid donors was ruled out, even to the extent of not seeking their help in defraying any of the costs of preparing for reform. Use of expatriate technical assistance, however, was endorsed, given a critical shortage of Indonesians trained in fiscal economics, international tax law, tax accounting and computer science. Accordingly, the author was requested to organize a team of expatriates with such skills to direct research into topics considered critical for tax reform, and to prepare a draft reform package.

It was also decided that the group of foreign specialists would maintain a low profile, in sharp contrast to several previous tax missions organized for several other LDCs. In the end, 28 expatriates were involved over the next three years, only one of which resided in Indonesia for longer than 4 months at a time. (Gillis, 1986)

The final decision was that the Ministry of Finance would make substantial investments not only in the training of a new generation of tax officials to operate the new tax system over the remainder of the century but in a new, computerized tax information system. In accordance with the training objectives, a program was established wherein dozens of Ministry of Finance officials were to be sent abroad for advanced training not only in tax administration (primarily in Holland) but in economics, computer science and accounting (primarily in the U.S.). As of January 1988, the pipeline of new trainees remained nearly full, while over three dozen earlier trainees had already returned to take up new positions in the tax administration. The first step taken to establisn the new information system was the earmarking of funds for hardware.

B. Objectives

Characterization of objectives sought for any particular set of policy reforms is fraught with problems. To begin with decision-makers do not always clearly articulate, at the outset, any or all objectives to be sought from a given policy change. Rather, a clear expression of goals often emerges only toward the middle, or even the end of deliberations over reform. In addition, objectives often change over the course of investigation and discussion of reform programs: options that initially appeared feasible may be ruled out by the accumulation of evidence as to their likely effects, and vice-versa. Further, characterization of objectives for any given policy reform are often done after the fact, and the interpretation of the relative importance of different objectives may be unduly colored by the self-interest and/or other limitations of the observer responsible for the interpretation.

Attempts at characterization of the objectives of the 1983-84 Indonesian tax reform doubtless suffer from all of these problems. Nevertheless, scrutiny of this particular reform episode does suggest that four principal objectives were uppermost in the minds of decision-makers when preparations for tax reform began in early 1981. These goals come under four general headings: revenue, income distribution, economic efficiency, and tax administration and compliance.

1. Revenues: From Revenue Neutrality to Revenue Enhancement

By 1981, tax revenues from oil and LNG amounted to 15 percent of GDP, compared to but 3 percent just ten years earlier. Rapid growth in these revenues fueled a marked expansion in government spending across all sectors from 1971 to 1981, particularly in new programs in primary education, rural development and in large new infrastructure projects in electric power, steel, mining and transportation. Moreover, civil servants salaries were raised sharply as well. As a result, government spending as a percent of GDP rose from only 14.8 percent in 1971 to 23.8 percent in 1981. (Table 2)

The time was propitious for initiation of preparations for major tax reform, independently of short and medium term prospects for world oil prices. On the one hand, the government was spending nearly one quarter of GDP, and financing only one quarter of that spending with non-oil taxes (Tables 1 and 2). Thus, the economy was highly vulnerable to any downturn in oil prices over the next few years, particularly inasmuch as Indonesian oil production had already begun to decline in the late seventies. It was therefore clear that revenue-enhancing reform of non-oil would be essential in the event of near-term softening in world oil markets, because it was not expected that sharp reductions in government spending could be quickly enacted. (Gillis, 1985, p. 226)

On the other hand, a scenario involving rising real prices in world oil markets, regarded as likely by some institutions as late as April 1981 (World Bank, 1981), was also seen as conducive to fundamental tax reform with or without higher tax revenues. In the first instance, revenue-enhancing tax reform would allow the government to expand important, and previously underfunded, programs in health, education and rural development (all intensive in non-traded goods) without running undue risks of contradicting a severe case of so-called "Dutch Disease" (Gillis,1985), as actually befell Nigeria and other LDC oil exporters in the early eighties. Tax revenues from the enclave oil sector could not, in the absence of substantial liberalization of imports, be used to finance domestic social programs without fueling more inflation than deemed acceptable at the time. And the prospects for any significant liberalization of Indonesian trade were not bright in the early eighties. (Gillis and Dapice, 1985) In the second instance, continued strength in world oil markets would mean that tax reform could be revenue-neutral (or even revenue-decreasing) instead of revenue enhancing. Revenue-neutral tax reform with any base-broadening at all, would, at the low ratios of non-oil taxes to GDP characteristic of Indonesia in the seventies, mean lower tax rates, and therefore better chances for a politically acceptable tax reform supportive of economic neutrality.

In the end, the decision to move ahead on reform was made prior to the emergence of evidence of any clear downward trends in world oil prices. Immediate revenue enhancement was not the objective; no fiscal crises loomed at the time. Rather, plans were for implementation of a more or less revenue-neutral reform package for the near term with broader tax bases and lower tax rates. The base-broadening measures were nevertheless expected to render the tax system capable of quick and substantial revenue improvements through relatively small rate increases, should the need arise in the future. Therefore, it was expected that the reform would prepare the tax system to respond to possible future fiscal crises that would surely result from any significant weakening in the world oil market. This future arrived rather more quickly than expected. By the time the reform package was proposed to Parliament in late 1983, it was evident that some combination of drastic cutbacks in spending and sharply revenue-enhancing tax reform would be required to forestall a series of budget deficits that threatened to be upwards of 10 percent of GDP.

Matters steadily worsened over the next three years. By mid 1986, world oil prices had dropped to levels viewed as unthinkable five years earlier: average export prices, at only about $13.00 per barrel, were one third the peak price in 1981. With government oil revenues critically dependent on oil prices, tax collections from the oil/LNG sector quickly sank to just over 5 percent of GDP (Table 1), or one-third that of 1981. Expenditure cutbacks and tax reform contributed, in virtually equal measure, to the shrinkage of the potential budget deficit: the spending ratio fell by 3 percent of GDP, the tax ratio rose by 3 percent of GDP.

By 1987, austerity measures had reduced projected government spending from one quarter to little more than 17 percent of GDP, while the tax reform, in combination with mild recovery in oil prices pushed the overall tax ratio to just above 15 percent. These developments, together with relatively small foreign aid grants, reduced the projected budget deficit to a manageable 1.8 percent of GDP. (Table 2)

By early 1988, Indonesia had, virtually alone among large oil-exporting LDCs, managed to restructure economic policies to cope with a new phase of substantially lower oil prices, now over half a decade in length. Moreover, this was done while domestic inflation was held in check throughout; inflation exceeded 10 percent only in 1983, and even then was limited to 12 percent. Further, while growth slowed markedly, the economy continued to grow throughout the period following the end of the second oil boom in 1982, a year when real GDP declined. Since then, and until 1986, real GDP growth averaged just under 3.2 percent per year, or about double the rate for all lower middle income LDCs over the same period. (World Bank, WDR, 1987, Table 2)

The tax reform was but one of several policy measures that, at least until 1988, allowed Indonesia to deal with the post 1981 collapse in oil markets with limited inflationary consequences and continued, if slowed, economic growth. The contribution made by the tax reform to this outcome extends well beyond that made by the apparent revenue results: in relatively short order, a 50 percent increase in the ratio of non-oil taxes to GDP was attained. (Table 1) A non-negligible share of the contribution of tax reform to continued growth, it may be argued, came in the form of reduced costs of administration and compliance and the lower effeciency costs associated with the much greater simplicity in tax laws and uniformity in tax rates brought by the reform.

2. Distributional Neutrality and Absolute Impoverishment

Since 1966, Indonesian economic-policy makers have been less concerned with rectifying problems of relative impoverishment (uneven distribution of income across income classes) than with alleviating absolute impoverishment: raising levels of living of the poorest 40 percent of society. There have been at least two reasons for the past emphasis on reducing absolute rather than relative impoverishment.

First, in the half decade or so after the national economic collapse in 1965-66, maldistribution of income was not perceived as a significant problem, because the poverty of those years was widely shared by groups across society. The precarious existence of millions of rural households, especially in Java, was seen as the most urgent social and economic problem; the imperative of alleviating absolute impoverishment therefore dominated all equity objectives. In turn, programs and policies intended to promote rural development were believed to be the most effective measures for reducing rural poverty. Subsidies and transfers from the central government budget were viewed as appropriate tools for securing this objective. Budget subsidies for fertilizer and kerosene, both intended largely to help low income rural households, grew rapidly from 1967 through 1981. Together these subsidies were equivalent to upwards of seven percent of government tax revenues by the late seventies. (Gillis,1980, p. 51-54) Central government transfers to county and village governments (the Kebupaten and DESA programs) rose steadily as well. Further, a very sharp expansion in primary education programs after 1973, particularly in rural areas, had the effect of doubling the percentage of the age cohort 5-12 attending school by 1980. Certainly in the minds of policymakers, expansion of primary education was regarded as a critical step for reducing absolute impoverishment in the long term, especially among rural households. These measures met with some success, even by the standards of many critics of post-1966 economic policy. (Collier,et.al.,1982)

But while the budget was deemed important as a tool for rectifying problems of income distribution, emphasis was almost wholly on the expenditure side, not the tax side. While it was expected that the tax system could provide for growing revenues for finance of programs designed to deal with poverty, particularly rural poverty, tax instruments were not regarded *per se* as useful in reducing relative impoverishment through leveling down of high incomes. Pessimism over the role of taxation in income redistribution stemmed primarily from widespread recognition of very serious and long-standing weaknesses in tax administration. Moreover, empirical studies conducted under the research program for the tax reform indicated that decades of emphasis upon redistributive tax policies had accomplished little in the way of income redistribution in Indonesia. For example, the effective rate of income tax for the top 5 percent of the income distribution was only 4 percent in 1981, although tax rates applicable to income in this group were 50 percent. (Gillis, 1985)

Ineffectuality of the tax system in promoting redistribution was also a consequence of defects in the tax structure. Income, sales and property taxes prevailing before the 1983 reform were riddled with exclusions and exemptions. Although proponents of many of these provisions had actually sought to justify them on grounds of reducing income inequality, the effects were generally otherwise. Items excluded or favored under the income tax were received overwhelmingly by the wealthiest one fifth of the income distribution: housing and auto allowances, free use of vacation homes, physicians fees, interest income and salaries of civil servants.

The failure of progressive rates of income and sales taxes in securing significant income redistribution was apparent from an incidence study carried out in 1982-83 for the reform program. While this study, like all incidence studies everywhere, suffers from significant methodological and data limitations, it is nevertheless the most comprehensive ever undertaken for Indonesia. Results indicated that the poorest third of the population paid five percent of their income in taxes, a share not much below that of all higher income groups up to the richest decile. And even in the richest decile, taxes were only 9 percent of income except for the top quarter of this group (the top 2 percent of the income distribution) for whom the effective tax rate was estimated at 13.6%. And it is to be noted that this figure for the topmost 2 percent was largely a consequence of the assumption that the <u>entire</u> burden of both personal income taxes <u>and</u> export taxes was borne by this most affluent group. (Gillis, 1985).

In view of Indonesian fiscal experience since 1966, and in light of such conclusions on fiscal incidence as were available, policymakers came to view the appropriate income distribution goal for tax reform as that of insuring that changes in the taxation would not make the poor worse off, primarily by placing that low income households outside the tax net, to the extent possible. The tax side of the budget, then was not to be used as an active tool for redressing problems of relative impoverishment. Nevertheless, decision-makers and their advisers believed, in the end, that the tax reform as enacted would nevertheless result in marked increases in the share of taxes paid by the upper two deciles, if for no other reason than the reduction of evasion and avoidance expected from base-broadening and drastic simplification of the system. Moreover, the architects of reform believed that the sharp reduction in income tax rates that became a prominent feature of the reform package would have a progressive impact, becuase of two factors. First, the rate reductions were made possible by elimination of exemptions that primarily benefitted upper income groups. Second, because the reform removed the poorest 85% of households from the income tax base, the new income tax would have been progressive, <u>even</u> if it had been imposed at a flat rate of 30% (as originally proposed).

3. Economic Neutrality

Indonesian tax policy in the three decades prior to 1984 was purposefully non-neutral in orientation. The tax system was viewed not only as a means of raising revenues, but as a useful tool for guiding private consumption, investment and employment decisions to ends sought by the state. Tax exemptions and differentiation of tax rates were the preferred techniques for securing desired non-neutralities. Favored activities or pursuits were provided tax incentives, primarily in the form of reduced, often zero, rates. Disfavored activities and products were ineligible for such incentives, or in some cases subjected to special rates of tax higher than those generally applicable to taxed undertakings.

By 1981, thirty years of active pursuit of non-neutralities in taxation had yielded a tax system so interlaced with complex tax incentive arrangements as to be almost inadministerable. Some were similar in structure to incentive schemes commonly used in other countries; some were peculiar to Indonesia. The former included tax incentives to promote foreign investment. to encourage domestic investment in specified activities and to attract both foreign and domestic investment to so-called "backward" regions. With these "common" incentives solidly in place by 1970, it was but a short step to furthur proliferation of tax incentives over the next decade. These ranged from the unusual to the truly bizarre: tax incentives to encourage development of a national stock market, to purchase life insurance, to encourage construction of bowling alleys, to finance travel of chess players, and to use public accountants.

By 1981, it had become clear to many within the government that whatever useful social purposes served by the system of tax incentives - and there is scant evidence that useful purposes were in fact served - the attendant costs had become unacceptably high. These costs were measured not only in terms of tax revenues thereby foregone, but in terms of the administrative difficulties involved in operating the a system overloaded with incentives. (Gillis, 1985, p.245-249)

By 1982, decison-makers were in any case already predisposed to discard as unworkable most of the elaborate system of tax preferences that had evolved over the previous two decades. By 1983, this predisposition had changed to a strong preference for economic neutrality in the tax structure, owing to results of several studies of tax incentives undertaken for the reform. These studies indicated the wastes and complexities of not only the more bizarre types of tax incentives (the incentive to "go public" and thereby promote a premature stock market, the incentive for using public accountants) but the most hallowed incentive of all: tax holidays for promotion of foreign investment. (Gillis, 1986)

Accordingly, economic neutrality came to be a central emphasis of the reform package as presented to the Parliament in late 1983. Stress on neutrality was most evident in the shift toward more uniformity in tax rates, the complete abandonment of tax incentives and the broadening of the tax base. In turn, these measures made possible the general lowering of income and sales tax rates, furthur advancing the goal of neutrality and the reduction of economic waste.[1]

4. Administration and Compliance

The impetus for tax reform in Indonesia did not originate within the tax administration itself. On the contrary, there was initially no significant support for reform among any of the senior officials responsible for assessment and

[1] The architects of the Indonesian tax reform believed that, certainly in the Indonesian context, a shift toward more uniform taxation was tantamount to a shift toward more "efficient" taxation. But "uniformity" was never confused with "optimality."

collection of taxes. Heavy inflows of oil tax revenues from 1973-81 meant minimal pressure for better tax collection performance; tax administrators had little incentives for undertaking changes of any kind, as large numbers of them had come to enjoy financial prosperity well beyond that supportable by official salaries for civil servants. Except for the most senior officials, installed in 1981, the tax administration remained ambivalent if not hostile to the reform program right up to the time it was implemented.

Nevertheless, the relevant decision-makers in the Ministry of Finance and in the rest of the cabinet were acutely conscious of quite serious shortcomings in the tax administrative machinery. They therefore decided that a major objective of the reform would be that of improving the administration of taxation and facilitating taxpayer compliance, and in the process, curbing needless costs of collection and payment and reducing the scope for corruption. The means adopted for achieving this objective were three-fold:

a) Drastic simplification of tax laws.

b) Establishment of a new, computerized tax information system.

c) Reform of tax procedures (rules and regulations governing filing, penalties, assessments, etc.), with stress on the need for depersonalization of tax administration.

Simplification would have been a significant emphasis of the 1983 reforms even in the absence of any explicit decision to seek fundamental improvements in tax administration and compliance. The decision to deemphasize the role of the tax system in income redistribution, as well as the shift toward greater economic neutrality in taxation would by themselves have required reduced complexity in tax laws and regulations. But in addition, simplification was seen as a *sine qua non* for major improvemnts in tax administration. It was expected that simplification would reduce the scope for corruption, since complexities and ambiguities in tax law were used by tax collectors and taxpayers alike to cloak their transgressions. Simplification was also expected to foster improved taxpayer compliance by increasing certainty in tax collections.

Finally, simplification of income and sales tax law was required in order to make tractable the task of revamping and modernization of the tax information system. Efforts to computerize some of the operations of the Ministry of Finance extended all the way back to 1971. All those initiatives were stillborn, however, partly because they were seen as threatening to some groups within the tax administration and partly for a purely mechanical reason. Some upper level officials of the tax administration had long opposed installation of computerized systems on grounds that the system would likely be under the control of other agencies within the Ministry, rather than the tax department. Furthur, the cash registers used to record taxpayer payments at local treasury offices around the nation had space for only nine digits, an insufficient number to allow utilization of a workable system of taxpayer identification numbers. This mundane problem was solved by a fortuitious 1981 decision - unrelated to the tax reform initiative - by the Budget Bureau of the Finance Ministry to purchase new electronic cash registers capable of handling 16 digits, more than enough to accomodate a useable taxpayer identification number. It was at this point, and over the objections of most senior officials of the tax administration, that the final decision was taken to make substantial investments in hardware, software and foreign expertise in the construction of a new computerized tax information system that would allow not only vastly improved master tax files, but speedier and more systematic monitoring of collection collection performance.

Reform of taxpaying procedures was not viewed as a critical need in the initial stages of preparation for this tax reform. But as the architects of the reform came to understand the importance of procedural reform, this too became an important priority. Tax procedures include provisions specifying how taxpayers shall comply with their tax obligations as well as the administrative structure governing the execution of responsibilities of tax officials. Specific examples of tax procedures include those governing assessment and refund of taxes, timing of payments, filing of returns, collections of arrears, objections and appeals and fines and penalties.

These procedures varied from tax to tax, and many had gone unrevised for decades. Furthur, the levels for many fines and penalties had been set in the fifties and sixties, so that inflation had eroded any deterrent effect they once may have had. (example: 6 months in jail, or a fine of 1,000 rupiahs - U.S. 75 cents.) Other penalties were set at such unrealistically high levels as to be unenforceable. It soon became clear that a completely new law, consolidating all procedures for all taxes, would be required as an essential complement to new laws to govern income and sales tax structure. Two themes were to shape this new law on procedures: simplification, as also planned for the tax structure, and depersonalization of tax administration. Depersonalization in the first instance involved a general reduction in discretionary authority in the hands of tax officials. It also involved a reduction in the frequency of direct contacts between taxpayers and tax officials. Instead, greater reliance would be placed on withholding methods, and electronic data processing of taxpayer information sent to district offices. Finally, depersonalization required a shift from the decades-old tradition of official assessment of tax liabilities to self assessments by taxpayers. The move toward self-assessment was also supportive of other aims of procedural reform. With self-assessment, the number of direct contacts between taxpayers and officials -- and therefore the number of opportunities for collusion - is less. Also, the shift toward self-assessment reduced the routine workload on tax officials, allowing for more and better audits of cases promising high revenue payoffs.

II. Elements of Tax Reform

A. Overview: The Old System and the Reformed System

The essence of the old tax system was that of extreme complexity stemming from decades of attempts to manipulate tax rates and tax bases to achieve non-revenue goals. Framers of did not abjure non-revenue goals such as income distribution and economic efficiency. Rather the new system reflected the view that these goals are best furthured by a tax system oriented primarily toward raising of revenues. Accordingly, the tax reform involved heavy stress upon simplification both of tax structure and tax administration. Simplification in structure required extensive broadening of the base of both income and consumption taxes, with reliance upon much greater uniformity of tax rates than had prevailed at any previous period in modern Indonesian history.

The centerpiece of the reform, certainly from the point of tax revenue implications, was the replacement of an outdated sales tax, riddled with exemptions and complicated by use of eight different rates, by a crude form of value-added tax (VAT). The VAT is one of the simplest ever adopted anywhere in the world. It is imposed at a flat rate of 10% on all taxable transactions. Because this particular tax is at present a manufacturer's-importer type of VAT, the base excludes all retailers and most wholesalers, while embracing all imports. Moreover, as originally adopted, there were no exemptions by product category.

Neutrality objectives dominated income tax reform proposals. Economic neutrality goals were to be furthured not only through very significant base-broadening and a shift toward generally lower and more uniform tax rates, but by the dismantling of all tax incentive programs. And in the short run, income tax changes were expected to be revenue-neutral at worst, or mildly revenue-enhancing at best. The income tax proposals were designed to be distributionally neutral only in the sense that income tax reform did not seek to achieve much in the way of "leveling-down" of higher incomes. Rather, the focus was upon "leveling-up," through income tax exemption of all but the uppermost levels of the income distribution. To illustrate, prior to the reform, a worker with a spouse and three children was liable for income tax once his income exceeded approximately U.S. $1,000. The reform, by raising sharply the level of personal exemptions, meant that this same worker could earn almost U.S. $3,000 before becoming liable for income tax.

Administrative, neutrality as well as revenue objectives were emphasized in property tax reform: a new Land and Buildings Tax replaced seven different land-tax ordinances, including a misnamed "tax on wealth." The property tax, like the income and sales taxes, is collected and administered by the central government, but property tax revenues are partially assigned to subnational governments.

B) Internal Indirect Taxes

Prior to the tax reform, the internal indirect tax system consisted of three principal elements: a sales tax of the turnover type extending through the manufacturing stage, sumptuary excise taxes on tobacco, beer, sugar and spirits, and assorted stamp duties. Together, these taxes accounted for about 11% of total tax revenues, or about 2.3% of GDP. (Table 3)

Basic decisions about indirect tax reform were made by July of 1981. The excise system, the fourth largest source of revenue, was working reasonably well; accordingly, a decision was made to leave these levies unchanged. Stamp taxes, insignificant revenue sources in any case, were to be abolished except for a small number that were easily enforced. The prinicpal focus of indirect tax reform was to be upon the sales tax.

The antiquated turnover tax utilized in Indonesia had been discarded by virtually all countries well before 1980. The inherent defects of this form of sales tax (Due, 1957) were compounded in Indonesia by an extreme degree of rate differentiation, involving eight tax rates ranging from 1% to 20%. Largely because of a complicated exemption structure, the tax was also unproductive of revenue. In other LDCs, sales taxes typically account for 20-25% of revenue (Ahmad and Stern, 1987) and 4% to 5% of GDP (Tait, Gratz and Eichengreen, 1987). But in Indonesia, the sales tax accounted for only 5% of total tax collections and about 1% of GDP.

TABLE 3

Indonesia: Tax Structure
Pre- and Post- Reform

	1983			1986		
	Billions Rupiah	Percent Total Tax Revenue	Percent of GDP	Billions Rupiah	Percent Total Tax Revenue	Percent of GDP
I. Internal Indirect Taxes	1,670	10.9%	2.3%	4,129	27.0%	3.9%
A. Sales Taxes	830	5.4	1.1	2,942	19.2	2.8
B. Excises	775	5.1	1.1	991	6.5	0.9
C. Stamp Duties and other	65	0.4	0.1	196	1.3	0.2
II. Taxes on Foreign Trade	661	4.3	0.9	885	5.8	0.8
A. Import Duties	557	3.6	0.8	820	5.4	0.7
B. Export Duties	104	0.7	0.1	65	0.4	0.1
III. Income Taxes	12,331	80.5	16.7	8,019	52.4	7.5
A. On Oil/LNG Firms	10,398	67.9	14.1	5,559	36.4	5.2
B. Non-oil Income Taxes (a)	1,785	11.7	2.4	2,189	14.3	2.0
C. Interest, Dividends and Royalty Tax	148	0.9	0.2	271	1.8	0.3
IV. Property Taxes	132	0.9	0.2	238	1.6	0.2
V. "Non-Tax" Revenue (b)	520	3.4	0.7	2,022	13.2	1.9
TOTAL REVENUE	15,314	100%	20.8	15,293	100.0	14.3%
Non-oil Revenue (omits III-A)	(4,916)	32.19%	(6.7)	(9,734)	(67.3)	(9.1)

(a) For non-oil Income Taxes, the share for corporate income taxes in 1986 GDP was 1.4%. The share of individual income taxes was less than half as high, at only 0.6% of GDP.

(b) Primarily dividends from government-owned enterprises for 1983. 1986 figure includes temporary windfall from surplus on domestic oil operations.

SOURCE: Department of Finance, Government of Indonesia

Policy-makers quickly settled upon a reform option involving a crude form of value-added tax having most, but not all of the significant features of value-added taxes used in Europe. The principal departure from the European model was that the Indonesian tax was initially confined to the manufacturer-importer level, in contrast to European VATs (and those of nearly twenty LDCs) which extend all the way through the retail level. This was done because of the severe administrative difficulties that would have been involved in bringing hundreds of thousands of wholesale and retail firms within the scope of the VAT. The new sales tax law, however, allows extension of the VAT to the wholesale and retail levels whenever the tax authorities deem it administratively feasible, but almost certainly not before the year 2000.

At the time of its enactment, the structure of the Indonesian VAT was the simplest of any such tax in operation anywhere in the world. The VAT adopted by Bolivia in May 1986, however, appears almost as simple (American Chamber of Commerce, 1986). The Indonesian tax, like that of Bolivia, is imposed at a uniform rate of 10% on all taxable goods, whether imported or of domestic origin. VAT is assessed on imports in the customs house on the tariff inclusive value of imports. All imports were initially subject to tax, but by 1988, a limited number of capital good imports and raw materials had been awarded partial relief from VAT liability: VAT on these items may be postponed until a later date, typically when the project commences operation.

In other cases, VAT liability is "suspended" on imports.[2] And in a limited number of cases, the VAT on the delivery and/or importation of certain taxable goods is borne by the government; as a practical matter such goods are exempt.[3]

The Indonesian VAT, like those used in the European community, is imposed on the destination principle, employs the tax credit method of collection, and is intended to be a levy on consumption. Because the implications of each of these features are discussed at length in other sources (Gillis and Conrad, 1984; Conrad, 1986; Gillis, 1985) the present article provides only a brief discussion of their significance.

Destination principle taxes are intended to free exports from indirect tax burden, while fully taxing all imports in the country where they are consumed. A tax-credit type of VAT may be collected without ever computing a firm's value-added. A taxable firm merely applies the VAT tax rate to all its sales to find tentative taxes due in any given period, say one month.

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2 As in the Benelux countries, VAT liability may be deferred for machinery imported for projects with long gestation periods. The Indonesian system allows defferal for one to five years, or until the project begins commercial operation. In addition, raw materials and equipment imported for use in export manufacture may qualify for "suspension" of VAT, which for all practical purposes amounts to exemption. All departures from universal application of the VAT to products are summarized in Directorate for Indirect Taxes, Department of Finance, "Special Provisions Regarding Value-Added Tax." (Jakarta, 19th May 1987).

3 These modifications were all adopted in 1986. Goods eligible for this treatment include low-cost housing, goods for the armed forces, cattle and poultry feed, and water.

The firm then subtracts (credits) taxes it has paid on its purchases against tentative taxes due on sales. The difference is the amount owed by the firm to the government. Finally, a consumption type VAT is one under which VAT paid by a firm on its purchases of capital equipment is treated exactly like VAT paid on raw materials and fuel: all such VAT taxes may be credited against VAT due on sales. In this way, the VAT base may be confined to consumption. If, on the other hand, taxes paid on capital equipment were not creditable, the base of the VAT would be gross income, not consumption (Shoup, 1969).

Finally, the Indonesian VAT as adopted in 1983 differed from all others utilized by other countries (except Bolivia) through 1987 in one very important respect: the VAT law allows neither exemptions nor zero-rating of any manufactured products consumed domestically.[4] (The Bolivian VAT allows no exemptions.) It is important to note, however, that the base of a manufacturer's tax such as that used in Indonesia does not extend to such items as unprocessed food or other staples that do not go through a manufacturing stage.

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[4] Cattle feed and poultry feed are not subject to VAT but, strictly speaking, are not exempt as such (see footnote 3). While there are no exemptions by product category, VAT is not collected on the sales of "small" enterprises (firms with an annual turnover of less than US $5 thousand or total capital level less than US $8 thousand).

Since such items are outside the tax base, and inasmuch as up to half of the consumption of the poorest 60% of households has been in the form of unprocessed food, then the application of a uniform tax rate involves little risk that the VAT, as now constituted, involves significant burdens for the poor, as long as agricultural producers do not make use of significant amounts of taxable inputs other than fertilizer, the sale of which is highly subsidized through the budget.[5]

The VAT as described in the foregoing paragraphs contains few of the features that have bedeviled sales tax administration elsewhere. The same uniform tax rate applies to all taxable commodities. Moreover, the 1984 sales tax law prohibits use of differentiated rates, but does allow the government to move the uniform rate, (initially 10%) to as high as 15% or as low as 5%, depending on revenue needs. Both the absence of exemptions by product category and the reliance on a uniform rate were intended to eliminate uncertainty as to what is taxable under the VAT, and at what rate.

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5 Where agricultural firms do make significant use of inputs and machinery taxable under the VAT, they may actually seek to register for VAT, inorder to credit taxes paid on their purchases against taxes due on sales.

The prospects for successful operation of the new VAT were aided immensely by the fact that nearly sixty percent of the base of the tax passes through three bottlenecks that are easily accessible to the government, and therefore the tax administration: the customs house, sales of refined petroleum products by PERTAMINA (the state oil enterprise)[6] and sales of the 200-odd government owned enterprises whose sales would be taxable under the new tax law. Given these bottlenecks, the tax administration is in a position to collect more that half the potential VAT revenues with minimal expenditure of adminstrative resources, thereby enabling enforcement efforts to be focused on the remaining, less accessible portions of the tax base.

Administrative feasibility was a critically important consideration in adoption of this simple tax since it was intended that the VAT furnish at least 60 percent of any incremental revenues expected from tax reform. But policy makers recognized that whatever the administrative, revenue and neutrality arguments in favor of a flat rate tax with virtually no exemptions, the political acceptability of such a tax would be limited; belief in the efficacy of rate differentiation in taxation was simply too widespread to ignore.

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6 The decision to include refined petroleum products in the VAT base was made at some political costs, as gasoline, kerosene, and similar products were never subject to the old turnover tax. But once that decision was made, it was apparent that with a uniform rate, and virtually no exemptions, the VAT would be among the simplest and most collectible of any tax ever implemented anywhere.

Accordingly, in order to improve the political acceptability of the reform package, a special separately administered "luxury" sales tax was devised. This tax was to be applied to sales of a very limited number of income-elastic products at rates of 10 and 20 percent. Taxable products included stero sound systems, autos, firearms, aircraft, cameras, and yachts. These items would also be subject to the ordinary VAT as well, so that "luxury" items carry an indirect tax burden two to three times higher than "non-luxuries." Altogether, the items subjected to the special higher rates of luxury tax constitute much too small a proportion of total consumption to generate substantial tax revenues, and account for too low a share of the spending of the rich to achieve much income redistribution. Nevertheless, the luxury tax has thus far served to protect the integrity of the uniform rate VAT, and for that reason its political role in the success of the reform has been much larger than its limited revenue significance.

C) Income Taxes

Prior to the reform, the Indonesian income tax structure consisted of two separate taxes on individuals and firms.

The tax on individuals, called the Pajak Pendapatan (PPd) was imposed at steeply progressive rates beginning at 5% and rising to 50% on a base riddled with exemptions and exclusions.[7] The tax on business firms, the Pajak Perseroan (PPs) was also applied at graduated rates of 20%, 30% and 45%. A special income tax regime applied to the operations of foreign oil companies. Methods for determination of tax liabilities of oil companies were spelled out in contracts between them and the government oil company. The essence of taxes on oil companies was that all levies combined were intended to capture 85% of their net income (after deduction of all allowable costs). As noted, companies with contracts signed before January 1, 1984 continued to be subject to tax provisions in force before that date.

Non-oil income taxes were not major sources of total revenue prior to 1985. Non-oil income taxes were but 2.4% of GDP in 1983; personal income tax revenues by themselves were less than one-half of one percent of GDP (Table 3).

Poor revenue performance of these income taxes was attributable partly to structural defects and partly to administrative shortcomings. The PPd left untaxed or lightly taxed large chunks

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[7] The PPd rate was 5% on taxable incomes equivalent to U.S. $188 (1986), and reached 50% on taxable incomes in excess of US $14,030 (US $1 = 1,282 Rupiah in 1986). For the PPs, the 20% rate applied to annual profits below US $19,5000 (1986). The highest rate of 45% was imposed on all profits in excess of US $39,000.

of individual income, including virtually all fringe benefits, interest, virtually all capital gains and pensions all of which flowed primarily to the top half of the income distribution. Income from cooperatives however, was also exempt, benefitting some low-income families. The most anomolous of exemptions was that for income of civil servants. Thus tax collectors themselves were not subject to income taxes. Deductions as well as exemptions tended to favor the relatively wealthy: interest expenses were deductible even though interest income was untaxed; deductions were also allowed for life insurance premiums and pension contributions, even though insurance proceeds and pensions were untaxed.

The base of the business income tax (PPs) had been similarly eroded over the years. The most significant factor in the narrowing of the PPS, however, was the availability of very generous tax incentives for private firms, both foreign and domestic. Largely because of the presence of these incentive programs, private sector firms typically were responsible for less than 1/3 of total business income tax collections over the period 1970-1980; the twenty-five largest government-owned firms (excluding the state oil enterprise, PERTAMINA) were the source of nearly 2/3 of company tax collections. The incentive programs suffered from several serious defects, all of which have been examined in some detail elsewhere (Gillis, 1985, p. 246-248). They were expensive in terms of revenue, biased in favor of capital intensive investment and discriminatory against smaller firms.

They also gave rise to intractable problems in tax administration and were generally ineffective in achieving their central objective of attracting beneficial investments to Indonesia in general and to so-called backward regions within the country.

Notwithstanding these serious difficulties, the political leadership generally viewed the incentive programs as having been successful. It was reasoned that since generous tax incentives had been available in Indonesia since 1967, and since the period 1967-81 had been a period of rapid growth and development, then tax incentives must have contributed to this prosperity. While this claim was not supported by any reliable evidence, it was clear by 1983 that abandoning tax incentives would be politically difficult. But any worthwhile reform would require first and foremost the substantial broadening of the income tax base, and significant base-broadening could not occur unless income tax rates could be reduced at the same time. And there was no possibility that income tax rates could be sharply reduced as long as tax incentives were widely available.

The constricting effects of the incentives on the tax base become clear from research studies done in 1982-83. Inspection of the tax records of 900 larger foreign and domestic firms indicated that only about 12 percent of the foreign firms and 8 percent of domestic firms paid the maximum 45 percent rate of income tax (Gillis, 1985). This information on the revenue foregone and other evidence on the inefficacy of tax incentives in Indonesia led policymakers to the conclusion that income tax reform would be futile as long as the incentives remained. While the reform that was taking shape contained important innovations in the taxation of fringe benefits, the tax treatment of depreciation and the taxation of pension funds and life insurance, it was doubtful that these measures could be implemented without lower tax rates than prevailed before the reform. And lower tax rates would not be possible if tax incentives were maintained.

At this critical point, in June-July 1983, proponents of reform settled on an approach for securing acceptance of fundamental alterations in income taxes. This approach was employed in lobbying both the Chief Executive and the Parliament on behalf of tax reform. Since tax incentives were widely perceived as having been useful, it was unwise to argue against the use of incentives per se. Rather, the lobbying effort would have to be couched in terms of <u>replacing</u> the existing incentive program with <u>another</u>, more effective one. Therefore the proponents of reform took the position that the most effective program of income tax incentives would be that of <u>generally lower</u> tax rates for all activities <u>in place of</u> the <u>differential</u> incentives offered from 1967-1983.

However, the effort to abolish differential incentives ran some significant political risks. Embedded within the tax legislation were some near-sacred incentives for constituencies of some political importance to any government in Indonesia. The success of the initiative depended upon the elimination of all differential tax incentives. Retention of any incentive would severely weaken the case for refusing others. Among the apparently untouchable incentives were those for cooperatives.[8] Moreover, the Minister for Cooperatives was an influential and persuasive person with clear access to the President. If he were to successfully argue that cooperatives should continue to benefit from favorable tax treatment, other pressure groups seeking tax incentives could point to the incentive for cooperatives as an exception that should be available to them also.

In view of these considerations, the architects of reform placed a high premium on securing the Minister of Cooperatives' support for abolition of all special tax incentives. This support was in fact granted after the Minister was convinced that as a practical matter, even absent the incentive, taxes on members' income from bona-fide cooperatives would be low or nil if, as planned under the reform, tax exempt income for typical households was increased by nearly 3-fold, through sharp increases in personal exemptions.

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8 Cooperatives were, under the old law, fully exempt from income tax for their first five years of operations, and nominally subject only to a 20% tax rate after the exemption period. As a practical matter, however few if any cooperatives paid any significant income taxes.

Having secured the support of the President and the rest of the Cabinet, the policymakers then took the entire set of tax proposals to the Legislature. Within a few weeks, agreement was secured from key legislative committees and the reform package was adopted nearly as initially proposed, with two significant exceptions discussed below.

Emerging from this process was a single income tax called the <u>Pajak Penghasilan</u> (PPh). The new law applies to the income of all business firms and individuals, thereby ending one of the most serious shortcomings of the old income tax structure, where different tax laws applied to individuals and firms respectively. This feature had led to substantial inequities between different forms of business organization (corporations, partnerships, etc). All deductions available to firms are also available to individuals; only individuals, however, can claim personal exemptions. Foreign oil companies with contracts signed before Jan. 1, 1984 are not, however, subject to the PPh on operations governed by such contacts.

Although the reform was planned with two income tax rates in mind (15% and 30%), the process of political compromise yielded in the end a three tier rate structure of 15%, 25% and 35%.[9] As a result, Indonesian tax rates on personal income became the lowest in Southeast Asia, and among these nations only Thailand had a tax rate on business income as low as that of Indonesia. However, foreign firms remitting dividends to the home office abroad are subject to a 20% tax on the amounts remitted, so that the effective tax rate for repatriated income is 48%.[10]

Quite apart from ending tax incentives for business firms, the new law ends the favored treatment of several types of income and deductions formerly available to individuals. Long-term capital

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9 The rate structure is as follows (Rupiahs converted to dollars at 1986 exchange rates:

Taxable Income Slabs	Tax rate on each Slab
US$ 0 - 7,794	15%
US$ 7795 - to 38,971	25%
US$ 38,972 and above	35%

10 The 20% withholding tax can be lowered by tax treaty.

gains were made taxable for the first time,[11] as were fringe benefits to employees, civil servants salaries and pension income. Other income items formerly lightly taxed were subjected to full taxation. These included rental income, short-term capital gains, honorariums, and leave and educational allowances. Inasmuch as virtually all these income items are concentrated in the upper tenth of the income distribution, these changes introduced greater progressivity into the tax law.

One of the most controversial aspects of the reform was the tax treatment of interest on bank deposits. Interest was fully exempt from taxation under the old income tax structure. Policy-makers recognized that exemption of interest was inadvisable on several counts, as long as interest costs continued to be allowed as a deduction. Under such circumstances, exemption of interest provides great scope for tax evasion, is costly in terms of tax revenue, complicates the administration of income taxes, is inimical to healthy financial development, and favors high relative to low income families (Gillis, 1985). The draft income tax law as presented to the Legislature therefore provided for full taxation of interest income. Strong pressure from financial and industrial

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11 No one expected the taxation of capital gains to result in significant revenue anytime this century. Rather, gains were made taxable only to protect the rest of the income tax, in order to prevent taxpayers from converting ordinary income into capital gains that formerly went untaxed.

circles, however, resulted in a compromise wherein interest remained taxable in principle, but would continue to be exempt, by regulation, until further notice. This was a serious omission from the point of view of supporters of reform, but it was the only significant setback prior to enactment of the new law.

D) Property Taxes

Although most of the key decisions on property tax reform were made before 1984, enactment of new legislation for property taxes was postponed until 1986, to allow the government to concentrate on the implementation efforts upon the rest of the reform package.

Property taxation in Indonesia dates back to the very early stages of Dutch Colonialization in the 1600's. (Kelley, 1987, p.8). Historically, the most important property tax has been the Contribution for Regional Development (Iuran Pembargunan Daerah, or IPEDA) which applied to both rural and urban properties. The nominal tax base of the IPEDA was annual rental value (yield) of land. The basic rate for IPEDA was 0.5% of yield, but in practice, different rates applied to different types of land.[12] Exemptions riddled

12 Rural non-forest land and estates were subject to progressive rates. Taxes on forest land were assessed at 20% of logging royalties. Special negotiated rates also applied to mining lands. For urban land, a 50% exemption applied to residential property.

the system,[13] and property valuations were seriously out of date. As a result, the IPEDA was not a significant source of revenue in the two decades prior to 1986. By 1983, the tax accounted for less than 1 percent of total tax revenue and only 0.2% of GDP (Table 3).

Midway through preparations for tax reform, in 1983, decision-makers decided to collapse all property and wealth taxes into one single levy, with a vastly simplified IPEDA at the core. This decision was reflected in the new Land and Building Tax (Pajak Bumi Dan Bangungan, or PBB) enacted in 1986. This tax replaced not only the IPEDA, but also a widely evaded central government Net Wealth Tax, a substantial "Household" tax and four other land-based taxes. The principles of uniformity and generality governing income and sales tax reform were carried through also to property tax reform.

Under the new tax, only one rate applies to all types of property. The tax base was switched from the annual rental value to capital market value of land and buildings, where capital market value is to be derived from arms-length transactions.[14] Further, urban

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13 The tax administration enjoyed wide latitude in granting exemptions by land use, by size of property, by ownership, and by value. (See Kelley, 1987)

14 To reduce transitional problems, the assessment ratio for 1986 was set at 20% of capital value, to be raised in steps, eventually to 100%.

land used for residential purposes is treated identically with that used for commercial purposes. The discretionary authority for granting of property tax exemptions was severely curtailed as a result of the 1986 reform. Exemptions are generally restricted to land owned by non-profit organizations, protected forests, national parks, traditional grazing land, diplomatic offices, international offices and graveyards. In addition, temporary exemptions are available for land affected by natural disasters.

The approach to income distribution issues in property tax reform was identical to that followed in income and sales tax reform: emphasis was upon rectifying absolute rather than relative impoverishment. For that reason, all buildings were granted an exemption of Rupiah 2 million, (US $1,600 at 1986 exchange rates). As a result, virtually all rural housing and a large share of low-income housing lies outside the tax base, enabling the tax administration to focus their efforts on higher valued properties (Kelley, 1987, p.13).

III. OUTCOMES

By early 1988, the new income tax system had been in place for four years; the new value added tax for nearly three, and the new property tax for one year. Enough experience has accumulated with the first two taxes to provide some basis for limited extrapolations for the future. There is enough early evidence of the impact of reform upon revenues, economic stability and tax administration to allow some tentative generalizations. But several more years will be required before informed judgements can be made about the income distribution and resource allocation implications of the 1983 reforms

A) Revenues

Evidence to date suggests that in revenue terms, the reform has been successful beyond expectations. The ratio of non-oil taxes to GDP in 1986 exceeded 9 percent for only the second time in Indonesian history, and was fully 50% greater than in 1984. This occurred in spite of a sluggish economy: with stagnant export income, rates of economic growth since 1981 have been less than half that of the seventies. As has been common in many other tax reform programs in other LDCs since 1970 (Gillis, 1987), the VAT was the principal source of incremental revenue. Table 3 shows that in only the second year of the existence of the VAT, nominal revenues from this source were 3.5 times the turnover tax it replaced and double the revenues accruing from non-oil income taxes. Moreover, the share of the VAT in GDP
(at 2.8%) was 2.5 times that of the old turnover tax.

The revenue performance of the VAT is all the more unusual given the low rate of the tax relative to similar taxes elsewhere. Most of the 20-odd LDCs using the retail VAT use a standard rate of between 10 and 15%, and in those countries the share of VAT collections in GDP has typically been between 2% and 4% (Ahmad and Stern, 1987, p. 61).

The Indonesian VAT, however, is a manufacturer's VAT imposed at a rate of 10%. The retail equivalent of this rate is about 5 or 6%, since a manufacturers-level tax does not generally include wholesale and retail distribution margins. Even so, the share of the Indonesian VAT in GDP is just about as high as in those countries imposing higher (retail equivalent) rates. The simplicity and uniformity of the Indonesian VAT may indeed account for much of its strong revenue performance relative to value-added taxes used in many other LDCs.

The new income tax was not expected to generate sizeable new revenues in the short term, partly because firms that had received tax incentives prior to 1984 still retained their privileges and partly because of long lead times expected for any significant strengthening of income tax administration. Even by 1986 and 1987 many firms were still in their tax holiday periods. In the event the share of non-oil income taxes in GDP actually declined from 1983 through 1986.

B) Economic Stability

In retrospect, the tax reform could not have come at a more propitious time. With another precipitous decline in oil prices in 1986-87, the absence of reform would have required even steeper cuts in government spending beyond the draconian measures implemented in those years, or (as noted in Section I) would have resulted in substantially larger deficits that actually occurred.

We have seen that the early revenue success of the tax reform was due almost wholly to indirect tax reform and in particular the VAT. The contribution of the VAT to revenues was, however, not the only way it affected stability. The VAT was implemented with almost negligible effects on the price level, contrary to the predictions of many businessmen as well as economists who claimed that introduction of the VAT would result in an acceleration of inflation. In this respect, the Indonesian experience with the adoption of the VAT was not inconsistent with that of nearly three dozen other countries for which studies of price effects of the VAT have been made (Tait, 1986 in Gillis, Sicat, and Shoup).

The introduction of the VAT in Indonesia not only had no impact on inflation (unsurprising to any competent economist), but the implementation of the tax had no noticeable effects on the price level. The introduction of the VAT in April 1985 coincided with a decline in consumer price indices in April and May. Moreover, domestic inflation for the next 12 months was well below that for the previous year.

Decision-makers had announced with some confidence in January and February of 1985 that the price level, not to mention the inflationary impact, of the switch to the VAT would be nil. Their confidence was due to two factors. First was their recognition of the fact that the VAT was to be substituted for a turnover tax that itself may have involved some price-level effects. Second, economic decision-makers were well aware that the rate of monetary expansion in the first quarter of 1985 had decelerated; they knew from long experience that domestically generated inflation arises from monetary expansion, not tax adjustments.

C) Tax Administration

It may be argued that the administration of taxes has improved since enactment of fundamental tax reform in the sense that with the introduction of the VAT, tax evasion has likely declined. Much of the revenue gains from the VAT are attributable to structural and procedural simplification and to the fact that sales tax reform was designed to take advantage of such "tax handles" as the domestic sales of the state oil monopoly, the customs house, and the larger government-owned manufacturing enterprises. It is difficult to misapply a uniform rate VAT to these easily accessible collection points. There has been, however, little evidence of improvement in adminstrative practices in the tax department, particularly in income taxation. And while the newly installed computerized tax information system will ultimately enable significant gains in collection and enforcement, its potential had barely begun to be exploited by 1987.

The system is still unfamiliar to most officials, and its implementation has been plagued by coordination problems as well as some residual resistance from within the tax administration.[15]

Consequently, the revenue potential of the VAT was placed in jeopardy in the first few months of its existence by administrative slippages and oversights. Although all taxable firms were required to register for the tax prior to April 1, 1985, only 25,000 had done so by that date. Concerted efforts were undertaken to rectify the problem, and by September 1985, 51,000 taxable firms had registered, about the number anticipated. But only 36% of registered firms were by then complying with the monthly filing requirement for the VAT, and no audits of any VAT taxpayers, even the largest thousand firms, had begun by 1986. However, decision-makers in the cabinet continued to apply pressure on the VAT administration to improve performance through 1986 and 1987. By mid-1987, progress was notable. By that time, the number of firms registered for VAT had increased by almost 50% over 1985, to 74,634. Moreover, plans were announced for expansion of VAT audits, to enable collections to increase by at least 20% for the year.

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15 In the early stages of VAT registration in 1984-85, district offices ignored central directives on registration procedures and failed to forward applications to become a VAT taxpayer to the computer sections of district tax offices, thereby reducing the utility of the Master file system for the 90% of VAT taxpayers who registered prior to correction of this problem.

Performance in income tax administration in the first three years of the reform was rather less promising, in spite of a much publicized "tax amnesty" designed to induce habitual tax evaders to enter the tax rolls. Under the amnesty, evaders were forgiven for past transgressions, provided they adhered to the law in the future.[16] Even so, non-oil income tax collections were running at only 40% of forecast amounts by late 1985. By mid-1986, it was clear that problems in income tax administration had begun to threaten the revenue objectives of reform, and at the very least had eroded seriously the credibilty of income tax reform.

The Ministry of Finance decided to reverse these trends by creating, in June 1986, a special independent "strike force" of auditors, consisting largely of recent returnees from the overseas training program mounted as part of preparations for reform in 1981. Reporting directly to the Director-General of Taxes, the group consisted of 30 persons headed by a veteran official of proven capability.[17]

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16 The amnesty came in the forms of a Presidential decree issued in April 1984. It provided forgiveness on tax matters for all infractions prior to 1984, provided amnesty seekers came forward before 1985. When only a relatively small number of persons requested amnesty, the deadline was later extended to mid-1985.

17 Members of the strike force received an additional salary of about $400.00 per month.

The results of the activities of this elite group clearly demonstrated not only the presence of great "slack" in tax administration, but also the tremendous potential returns available from investments in targeted audits. Two dozen companies reporting zero or negative tax liability for 1985 were audited by this group between June 1986 and June 1987, at a cost of just under US $200,000 (Rp. 250 million). As a result, these firms were assessed US $68 million (Rp. 87 billion), in taxes, fines, and penalties (another US $5.9 million was still being disputed in 1988). The strike force, therefore, yielded a direct return that was 340 times the investment. Indirect returns, in the form of improved compliance from other firms not yet audited are unknowable, but were surely substantial.[18]

IV. LESSONS

Some fairly clear lessons can be drawn from the Indonesian experience with tax reform in the middle eighties. It is not, however, obvious that all of these lessons have much relevance for other times or other countries, or even, for that matter, Indonesia in the 1990's.

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18 Prospects for future specialized strike forces in tax administration are uncertain. Some members, including the head of the group, were subjected to clearly false libelous accusations, presumably from interests harmed by the undertaking.

The first and perhaps most important of these lessons applies to economic policies generally. The Indonesian experience with tax reform--indeed virtually all economic policy reforms in that country--attests to the critical importance of continuity, commitment, and competence among top economic decision-makers. The reform was conceived and nurtured by one member of the cabinet and implemented by him and three other current and former Ministers who served as persuasive champions of the reform package before the president, the Legislature and the public. All had served more or less continuously as officials in charge of economic policy since 1967: between these four people was a remarkable total of three-quarters of a century's experience as Ministers of the government. All four continued to serve in the cabinet through mid-March of 1988.

The track record of this economic team is widely recognized as a very good one; it is here argued that one reason it was good was precisely because it was long in more than one sense. More by experience than by training, this unusual group of officials developed a long-term perspective on economic policy that is rare enough among economists and rarer still among policy-makers. In times of prosperity and abundant financial resources, their influence waned, along with the need for hard policy choices for which the economic team was noted. Consequently, economic policies in the first and second oil booms, in 1973-75 and 1979-82 respectively, bear the stamp of other government officials having much shorter policy horizons. Such interludes were utilized by the economic team to plan alternative policies for coping with future rounds of economic adversity. The team was therefore prepared to respond to economic crises after 1982 not only with policies for short-term management, but also with a series of policy reforms focused upon restructuring of the economy in the medium to long-term.[19]

The Indonesian experience, then, suggests that competence and continuity in economic policy making is critical for success in policy reform in general and tax reform in particular. The

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19 A series of five major policy adjustments was carried out by the economic team in 1983 alone, only two of which can be characterized as examples of short-term crisis management policies. These two were first a freeze on government consumption in January and the cancellation and/or postponement in May of billions of dollars worth of large-scale governmental projects of a highly capital-intensive nature. The other reforms were focused primarily on longer-term structural adjustments. The first was a reversal in domestic energy policies in January 1983, involving a drastic reduction in subsidies to domestic energy consumption. The second was a major devaluation in March. The third was adoption of fundamental financial reform in June, involving liberalization of interest rate policies. The last was the tax reform.

usefulness of this lesson for other countries is not so apparent. While many countries may be blessed with an ample supply of competent economic analysts available for cabinet positions, not many (including, perhaps, the Indonesia of the future) can count on them staying in office long enough to duplicate the achievements of the Indonesian economic team of the past two decades.

The second lesson,not unrelated to the first, attests to the importance of distinguishing between tax reform initiatives that are politically impossible, and those that are merely politically difficult and then identifying approaches for surmounting such difficulties without expending energies on overcoming the impossible. Sensible tax reform of course requires avoiding measures that seek to attain the politically impossible however advisable these may be on economic, administrative, or equity grounds. In Indonesia these would have included a shift to a flat-rate income tax, the abolition of deductibility of interest in tandem with the exclusion of interest income from the tax base (Gillis, 1985), and incarcerations of tax evaders. Many other measures were widely alleged to be politically impossible but in fact turned out to only be politically difficult to one degree or another. Income tax incentives were alleged to be politically untouchable, as well as tax preferences for cooperatives and tax exemption of income of civil servants. In the end, incentives were abolished, preferences ended for cooperatives, and civil servants made taxable. In each case, the architects of reform invested considerable time and energies in overcoming political objections to each measure.

The third lesson that may be drawn from the Indonesian experience is that at least in developing country reform programs where revenue objectives are important, relatively heavier stress should be placed on indirect tax reform than upon income tax reform with all its inevitable complexities and limited coverage. Certainly the Indonesian reform would already be marked as something of a failure but for the revenue success of the VAT. This is not to argue against pursuit of fundamental income tax reform. It is to stress the inherently limited revenue potential of income tax reform, particularly personal income tax reform in most LDC's, both for reasons of administrative complexity and the relatively small proportion of the population with incomes high enough to be taxed.

A fourth lesson furnished by the Indonesian experience is the importance of designing tax reform to enable the tax system to do what it is best suited (the raising of revenues) rather than to seek goals for which is it ill-suited. Much of the revenue success of the reform, at least in its first three years, has been due to the fact that the reform program was not overloaded with non-revenue objectives, including explicit measures to redress income maldistribution or foster economic growth and stability. However, the revenue success of the reform has nonetheless contributed to both the alleviation of poverty and to economic stability.

Astute fiscal specialists (Shoup, 1969, Bird, 1987) have long stressed the revenue payoffs possible from investment in tax administration. A fifth lesson from the Indonesian experience is that such investments really can be made to pay very high returns. One dramatic example was the investment of US $200,000 in the operations of a special strike force in tax audit in 1986-87, an investment that brought a direct return of 340 times the initial outlay. Indeed, in the first year alone, this experiment yielded enough additional revenue to cover as well the costs of two other major investments in tax administration: the overseas training of about 75 young tax officials from 1981-1988, and the entire cost of all hardware and software used to date in the new computerized tax information system left by the tax reform.

A sixth lesson is that successful reform can be critically dependent upon the follow-up to reform. This was clearly the case in Indonesia where the tax administration itself was, except at the highest levels, less than fully supportive of reform. Policymakers found it essential to closely monitor not only the initial implementation of reform by the tax administration, but to apply continual pressure for improved performance in tax collections throughout the first three years after it was put into place.

A seventh lesson from the Indonesian reform merely confirms lessons available from experience elsewhere: adoption of a VAT by a country need not, and likely will not, have any significant impact upon that country's price level, and almost certainly will not lead to greater inflation.

The final lesson available from the Indonesian reform is that good economics does matter in debate over the shape of tax reform. To illustrate, Indonesian tax incentives were abolished not on grounds of abstract arguments but because the reform program made available empirical evidence clearly indicating the economic wastes and revenue losses associated with the incentives. The importance of ending tax incentives in the success of the reform cannot be overstated. Further, a flat rate VAT was adopted because it could be shown that even a relatively low rat of VAT could become a "money machine" provided the rate was uniform for all goods and provided the tax was collected on petroleum products and on imports.

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