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Tax Policy Options during Economic Downturn

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Adri A. L. Poesoro*

Obviously, during economic downturn, the right approach to drive economy forward is to increase government expenditure rather than increasing taxes. The Government of Indonesia tries to alleviate the economic downturn by increasing government expenditures and providing some tax incentives.

This paper will identify fiscal tools and mechanics, especially related to tax strategies, typically used by the authority. Rest of the paper will provide cross-country revenue collection strategies during economic crisis and describe Indonesia current and future economic outlook as well as identify fiscal policies recipes during downturn.

In the end, this paper concludes the composition of taxes and government spending which are important determinant for economic growth, also provides short-term and long-term policy recommendations.

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1. Introduction

THE GOVERNMENT OF INDONESIA TRIES TO ALLEVIATE THE ECONOMIC DOWNTURN BY INCREASING GOVERNMENT EXPENDITURES (I.E. BETTER BUDGET ABSORPTION, SOCIAL PROGRAM, REDUCE SUBSIDIES, ETC.) AND PROVIDING TAX INCENTIVES STRATEGIES.

Unlike 1997 and 2008 crisis, today market turbulence in emerging economies is markedly different from the previous crises. Developing countries repeatedly blame global environment (e.g. China economic growth slowdown; unresolved problems at the European Union; and possibility of an increase in the Fed Fund Rate) as the main culprits of their local currency depreciation and economic distress. Previous Asian Financial Crisis (AFC) was the result of policy or institutional problems originated in the emerging market countries compared to the Global Financial Crisis in 2008 started in the developed economies. Specifically for the AFC, macroeconomist identified source of the crisis linked to bad macroeconomic policy and governance, or weak institutions that lead to instability, low growth, high inflation, credit collapse and balance of payments problems[1].

After 1997 AFC, Indonesia has attempted to strengthen and develop its monetary and fiscal policies. Bank of Indonesia adopted inflation targeting with the band of 4.5 percent $\pm$ 1 percent. In addition, fiscal policy also becomes more prudent where it prohibits the fiscal deficit from exceeding 3 percent of GDP in a single fiscal year. Indonesia also regulates that its debt-to-GDP ratio should not exceed 60 percent. Moreover, Government of Indonesia (GoI) is continuously revamping the taxation systems by considering changes in economic structure and bureaucracy reform. Stability of price level and steady economic growth is the ultimate long-term sustainable goals. However, unstructured monetary policy such as for example overly strict monetary policy can squeeze economic growth and increase unemployment numbers. Meanwhile, unmeasured fiscal policy expansion can lead to budgetary deficits endangering macroeconomic stability.

During previous economic crises, emerging countries faced with budget and trade deficit as well as excessive government debt. Chronic fiscal deficits and excessive government debt create negative consequences of several kinds[2]. First, a fiscal deficit can force more borrowing, increasing the debt ratio and reducing productive investment. Second, with more bonds issued to cover the fiscal deficit, a crowding out effect will cramp productive investment by the private sector, in turn jeopardizing economic growth. Third, chronic budgetary deficit are classic harbingers of high inflation. Theoritically, budget deficit is reduced by increasing tax revenues or lessen the government expenditures. It is obvious that during economic downturn, the right approach is to increase government expenditure rather than increasing taxes. Or in other words, expansive fiscal policy is more suitable to drive the economiy forward. An increase in government expenditure has a positive impact on private consumption through several transmission mechanisms (e.g. direct transfers, investment in labor-incentive projects, subsidies for fertiizers and food program, etc). The sizable increase in nominal consumption growth, in the end, leads a positive contribution on the government's VAT and Personal Income Tax receipts. However, there was a debate on the effectiveness of fiscal stimulus, given the inability of the central government, as a whole, to execute the stimulus program and spend money properly. Under this circumstances, several developing economies preferred to focus on providing tax incentives such income tax cuts and tax holiday.

As described above, this paper aims to identify fiscal tools and mechanics, especially related to tax strategies, typically used by the authority to counter cyclically economic slowdown. The rest of the paper describes as follow: Section 2 provides cross-country revenue collection strategies during economic crisis. Section 3 describes Indonesia current and future economic outlook as well as identifies fiscal policies recipes during economic downturn. And, Section 4 concludes and provides policy recommendations.

1. AFC was classified by international monetary and finance economists as the first generation crisis where the source of the crisis is bad fundamental domestic economy due to mis-management of fiscal and monetary policies.

2. Trachlet, Virginia (2004),"Monetary and Fiscal Policies in Canada: Some Interesting Principles for EMU?" Working Paper 28, Bank of Canada.

2. Tax Policies during Economic Crisis: Literature Review

WHILE A DECREASE IN COMPLIANCE DURING THE SLOWDOWN MAY HAVE SOME COUNTERCYCLICAL EFFECTS ON THE ECONOMY, TOLERATING NONCOMPLIANCE IS NOT AN APPROPRIATE RESPONSE TO THE CRISIS BECAUSE IT IS DISTORTIONARY, INEQUITABLE, AND PERHAPS MOST IMPORTANTLY, HAMPERS THE REBUILDING OF TAX BASES OVER THE MEDIUM-TERM.

2.1 Fiscal and Monetary Policy-Mix

Disbursement in total government spending has been pro-cyclical to economic growth. The effectiveness of fiscal policy will depend on the pace of the disbursement of discretionary spending and macro prudential policies taken by the monetary authority. Several empirical studies have been conducted to determine the impact of monetary and fiscal coordination. A popular method involves game theory approach in ascertaining the absence of monetary and fiscal policy coordination.

Table 1 - Monetary and Fiscal Game Theory

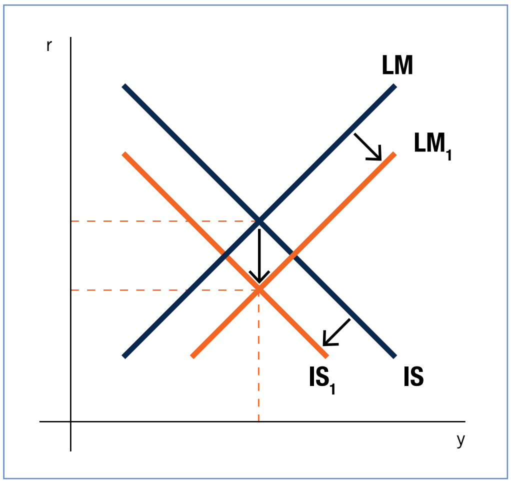
	Tight Monetary Policy	Expansive Monetary Policy
Tight Fiscal Policy	Tight Fiscal Policy	Low Inflation
Expansive Fiscal Policy	Less Employment	Moderate Inflation

Source: Bennet, H and Norman Loayza (2002),"Policy Biases When the Monetary and Fiscal Authorities Have Different Objectives", in the book Monetary Policy: Rules and Transmission Mechanism, Norman Loayza and Klaus Shmidt-Hebbel (ed.). Santiago, Chile, Central Bank of Chile.

Bennet and Loayza assumed that there are two policy options in each policy authority, namely tight and expansive policy. If both authorities opt for tight policy, inflation will low but with fewer jobs for the workforce. If both authorities decide on relaxed policy, inflation will be high and unemployment low. Additionally, if one of the policies is tight and other is expansive, both inflation and unemployment will tend to be moderate. The Nash Equilibrium in this game, therefore, consists of a tight monetary policy and a relaxed fiscal policy; and tight fiscal policy and expansive monetary policy. However, in the long run the combination of expansive monetary policy (e.g. lowering BI rate to spur credit growth) and tight fiscal policy (e.g. increase effort to increase and improve tax collection) has a healthier outcome in comparison to tight monetary policy combined with relaxed fiscal policy. This is because the policy leads to crowding in of investment from the private sector and possibility to generate more outputs (see Figure 1 below).

To understand the conclusion from the matrix, one should also take into account timing of policy execution and stage of the economy. Although from the model, a combination of expansive monetary policy and tight fiscal policy is the right option, it applies only in the long run. In the short and medium terms, the government might use expansive fiscal policy to bring the economy to its potential level; and maintain sizeable monetary policy to stabilize inflation and currency fluctuation.

Figure 1 - Sustainable Policy Mix in the Long-Run



Note: IS stands for Investment and Saving (Fiscal Policy); whereas LM is Liquidity of Money (Monetary policy). r is real interest rate and y is GDP (Gross Domestic Product). Theoretically, as real interest rate decrease, private investment will increase as the cost of fund of borrowing will be lower.

Based on the Marginal Efficiency of Investment (MEI), a decline of real interest rate will spur more credit growth by enticing more firms to borrow and generating their investments for further economic growth. This is what famously known as "private sector crowding-in'. In addition, degree of capital mobility affects monetary-fiscal policy effectiveness. Private and bank flows especially in the emerging economies surge as a response of higher short-term interest rate. Although capital inflows increased substantially and more permanently in Indonesia after GFC, tight monetary policy during this time of the year will not necessarily be the same results due to different global economic conditions where US economy is much better than 7 years ago and commodity prices remain weak hurting countries' exports.

Global Financial Crisis (GFC), occurred in 2008 due to subprime mortgage crisis originated in the United States of America. The country experienced a sharp decrease in growth from 2.1 percent in 2007 to 0.4 percent (2008) and contracted to minus 2.4 percent in 2009. World economic growth slides from 5.2 percent in 2007 to minus 0.6 percent in 2009. Following the global contraction and tight liquidity in the global market, global trade volume also abated. When the global trade volume decreased, exports from all countries slowed. As a result, emerging markets and developing economies also experienced a significant decrease, including Indonesia[3]. Unlike the US and developed countries, growth in emerging market economies fell, but still within positive level from 6.1 percent in 2008 to 2.4 percent 2009[4].

Although the effect of GFC to the global economy, Indonesia still maintained its growth by 4.5 percent (2009) and became the third fastest growing G-20 after China and India. During that period, Indonesia economy was also supported from resilience domestic demand[5]. Economic growth in Indonesia was particularly depending on household and government consumption. Therefore, policies to foster household consumption and government expenditure become important to bolster the economy growth especially during the economic downturn. Aaron *et al* (2004) indicate that the government consumption can create job opportunities amounting to as much as 19 percent of total job opportunities[6]. The Government of Indonesia usually tries to alleviate the downturn by increasing government expenditures (i.e. better budget absorption, social program, reduce subsidies, etc.) and providing tax incentives strategies. During GFC, almost 60 percent of the Indonesian fiscal stimulus package was allocated to income tax cuts. Indonesia Ministry of Finance cut personal income tax from 35 percent to 30 percent and corporate income tax from 30 to 20 percent. Futher, economists call this government action as a counter-cyclical policies. Keynesian stream economics argues that increasing government expenditure with constant or decreasing tax rates will stimulate aggregate demand.

Basri and Raharja (2011) suggested that fiscal stimulus through tax cuts can be relatively more effective in Indonesia for three reasons: (i) Indonesian households consume more and saving less – higher marginal propensity to consume; (ii) spending behaviour is likely to be influenced by current income, rather than permanent income; (iii) higher consumptions supported by large working age populations.

2.2 Tax and Economic Growth

There were, previously, studies that identified the link between tax collections and economic growth. Results of the studies were varied where some researchers, such as Agell, Lindh and Ohlsson[7]; and Easterly and Robelo[8] found weak relationship between the two variables. However, other papers done by Skinner[9]; Arnold et al[10]; and Gemmel, Kneller, and Sanz[11] showed that there was a robust and significant relationship between taxes and growth. Skinner found that increase of personal income and corporate tax rates had a negative impact on economic growth;

3. Basri, M.C and Rahardja, S (2011),"Mild Crisis, Half Hearted Fiscal Stimulus: Indonesia During the GFC", in Ito, T. And F. Parulian (eds), Assessment on the Impact of Stimulus, Fiscal Transparancy and Fiscal Risk, ERIA Research Project Report 2010-01, pp. 169-2011, ERIA.

4. IMF (2010),"Wold Economic Outlook, October 2010".

5. The share of total indonesian exports of goods and services in national account as a percentage of GDP was 29 percent. This is much lower than Singapore (234 percent), Taiwan (74 percent) or Korea (45 percent).

6. Aaron, Carl, Lloyd Kenward, Kelly Bird, Mihir Desai, Haryo Aswicahyono, M. Chatib Basri, Tubagus Choesni (2004),"Strategic Approach to Job Creation and Employment in Indonesia", paper prepared for the USAIS mission, Jakarta.

7. Agell, J., T. Lindh, and H. Ohsson (1997)," Growth and the Public Sector: A Critical Review Essay", European Journal of Political Economy. 13 (1). Pp. 33-52.

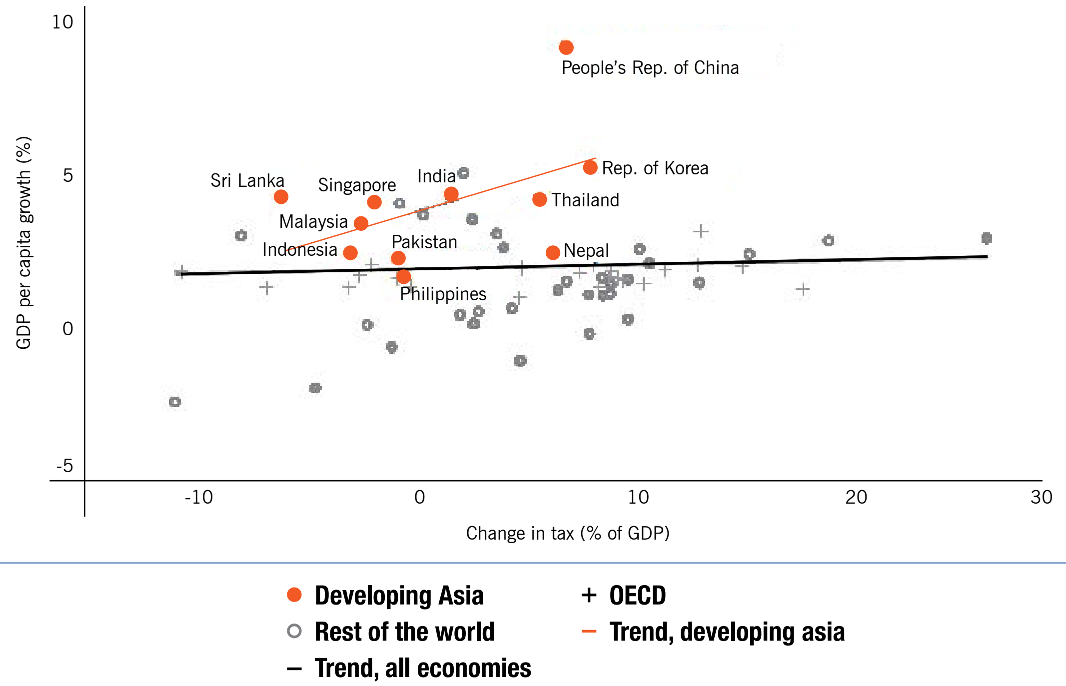
8. Easterly, W. And S. Rebelo (1993)," Fiscal Policy and Economic Growth: An Empirical Investigation", NBER Working Paper NO. 4499. Cambridge, MA: National Bureau of Economic Research.

9. Skinner, J. (1987)," Taxation and Output Growth: Evidence from African Countries", NBER Working Paper Series NO. 2335. Cambridge, MA: National Burau of Economic Research.

10. Arnold, J. M., B. Brys, C. Heady, A. Johansson, C. Schwellnus, and L. Vartia (2011),"Tax Policy for Economic Recovery and Growth", *The Economic Journal*. 121 (February). pp. F59–F80.

11. Gemmell, N. and J. Au. 2012. Government Size, Fiscal Policy and the Level and Growth of Output: A
Review of Recent Evidence. *Working Paper in Public Finance* 10/12. Wellington: Victoria
Business School.

Figure 2 - Relationship GDP per Capita Growth and Change in Tax Ratio



Source: Acosta-Ormaechea and Yoo (2012) in Abdon, A., Estrada., GB., Lee, M., and Park, D.(2014),"Fiscal Policy and Growth in Developing Asia", ADB Economics Working Paper Series, No 412.

whereas the effect of changes in sales and excise tax rates exert limited effects to both output growth and investment. King and Rebelo[12] identified that appropriate tax policies can potentially have a positive impacts to long-term growth.

Figure 2 plots the relationship between tax ratios and GDP per capita growth from 1970 to 2011 for 13 developing Asian economies, 25 high-income OECD economies, and 33 economies from other regions. The trend indicates no clear association between GDP per capita growth and changes in tax ratios given the presence of outlying observations, but the trend in developing economies indicates that there may be a positive association between growth and taxation. It is, however, difficult to model the relationship between the two given that it is likely endogenous. While government taxation may impact growth, higher growth may also lead to higher taxes[13]. Acosta-Ormaechea and Yoo (2012) analyzed the impact of changes in tax composition on long-run economic growth for low, middle, and high-income economies. Their estimation corrected for possible endogeneity arising from the simultaneous relationship between tax burden and growth. While tax burden affects growth, changes in growth may also lead to changes in the tax level or structure.

Specifically for the case of Indonesia, fiscal stimulus through tax incentives packages would have had a larger impact on the economy during the crisis compared to an increase in government spending. One factor that support this argument is most corporation and households in Indonesia are myopic and less focus on forward-looking decision. They will adjust their consumption and investment decision to the government policies that affect directly to them. Second factor is the government's capital spending, such as increasing infrastructure spending, might have a desirable impact on the economy in the latter periods. Third factor is exports, mostly commodity exports, plays a major role in boosting private consumption. Therefore, as discussed earlier, a package of tax incentives combined with greater social spending should have been an effective strategies in stimulating the economy.

Most of this section will explore most of the content from the paper written by John

12. King, R. G. and S. Rebelo (1990),"Public Policy and Economic Growth: Developing Neoclassical
Implications", *Journal of Political Economy*. 98 (5). Part 2: The Problem of Development: A
Conference of the Institute for the Study of Free Enterprise Systems. pp. S126-S150.

13. Estrada *et al* (2014)

Brondolo[14] where he analyzed deeply on the challenges and policy options of collecting taxes during an economic crisis. In the paper, he elaborated that tax administration encounters growing compliance risks involving such issues as tax arrears, loss-reporting business, and tax withholding, and growing shadow economy. At the same time, tax administration requires to provide taxpayers with additional support and assistance to help them cope with their obligations. While a decrease in compliance during the slowdown may have some countercyclical effects on the economy, tolerating noncompliance is not an appropriate response to the crisis because it is distortionary, inequitable, and perhaps most importantly, hampers the rebuilding of tax bases over the medium-term[15].

Brondolo encourages tax agencies to develop a tax compliance strategy that is structured around several objectives in responding to the crisis: (i) expanding assistance to taxpayers; (ii) refocusing enforcement on the highest revenue risks; (iii) introducing legislative reforms that facilitate administration; and (iv) improving communication and outreach programs. Some measures such as tax amnesties and moratoria on audits are counterproductive and should be avoided as he mentioned.

Additionally, he recommended tax administration in one's country to keep in mind a number of key points. First, early warning of emerging compliance risks is crucial for their mitigation. Second, a high-level group needs to be established within the tax agency to coordinate the development of the crisis strategy. Third, government support for tax administration is more important than ever during a crisis. Finally, tax agencies should align their near-term compliance strategies and medium-term modernizations plan. Table 2 below describes reasons of an increased risk of noncompliance during the crisis.

Table 2: Greater risk of Non-Compliance[16]

No	Possible Scenarios
1	During tight credit conditions, taxpayers may be tempted to use tax evasion and withheld from their customers or employees as an alternative source of financing for their operations
2	As the probability of bankruptcy imminent, taxpayers perceive the downside risks of tax evasion to be minimal compared with the potential upside gains (avoiding bankruptcy).
3	Shifting in structure of the economy from formal to informal where compliance is likely to decline and hard to monitor.
4	Taxpayers' believe that during the crisis, tax administration to be less stringent in enforcing the tax laws and making it less risky or more socially acceptable to evade tax.

During an economic stress, many firms face severe financial difficulty that may harm their businesses and probably resulting in permanent business shut down. Tax administration may help keeping alive firms through several measurements including advance payments[17], accelerating tax refunds, tax payment installment and payment extensions. In terms of tax refunds, some countries recently introduced reforms that can be done more quickly. Tax laws in many countries stipulates that allow finally distressed taxpayers to install their tax liabilities payments. The installments typically range from one to two years during with time interest accrues but late payments penalties are most likely waived. However, it is important to scrutinize the performance of each business during this economic stress before they can join into this installment program.

Furthermore, during the crisis some tax administrations provide assistance to taxpayers. Two good examples of this approach are the Australian Taxation Office (ATO) small business program and the IRS volunteer income tax assistance program. The ATO helps business filling tax registration and comply with their tax obligation and improve their business record keeping. During the crisis, ATO also

14. Brondolo, John (2009),"Collecting Taxes during and Economic Crisis: Challenges and Policy Options", IMF Staff Position Note.

15. Brondolo, John, *ibid*.

16. Previous studies linked a negative correlation between taxpayers' filling and reporting compliance with the unemployment rate. There was also a study shows that corporate income tax evasion is negatively correlated with access to credit, suggesting that compliance can be expected to decline when an economic donwturn is combined with tight credit conditions.

17. Advance payments are calculated not on the basis of the previous year's tax liability but estimates based on current year revenues and expenses.

identifies taxpayers considered at risk for financial distress and contacting them by phone to offer assistance before they have failed to meet a tax obligation[18]. In 2008, the United States enacted the Economic Stimulus Act, which provided tax rebates to low- and middle-income households as part of stimulus payments to more than 100 million taxpayers. However, experience that should be considered when designing a tax rebate program is it can be handled more easily in countries where individuals refunds are a normal part of the tax system.

Tax enforcement is also another program that needs to be strengthened during distress environment. It requires enhanced enforcement in six directions as shown in table 3 to cope with compliance.

18. Borondolo, *op cit.*

Table 3 - Enforcement and Strategies

No	Enforcement	Strategies
1	Safeguarding revenue collection from large taxpayers	• Consolidating the number of large taxpayer office (LTO) and ensuring that they report directly to a senior headquarters official instead of through a regional tax office; • Reviewing the selection criteria for assigning taxpayers to the LTO to ensure that the LTO controls at least 60 percent of the tax base; • Increasing the number of LTO staff, particularly auditors, in line with any increase in the number of taxpayers assigned to the LTO; • Shifting the focus of the LTO audit program towards industries most affected by the crisis and making greater use of issue-specific audits to broaden audit coverage; • Introducing or expanding the use of industry specialist at the LTO, including for financial products, valuation, and computer-aided audit methods as well as for complex issues that span industries, such as transfer pricing, thin capitalization, and tax losses.
2	Securing tax withholding	• Broadening audit coverage for tax withholding; • Assigning higher priority to recovery of arrears involving these taxes; • Enhancing the exchange of information with other agencies (e.g. customs, social insurance funds) that play a role in administering tax withholding; • Reviewing and increasing penalties.
3	Intensifying arrears collection	• Ensure early detection of tax arrears and establish appropriate time standards for follow-up; • Maintain the quality and timeliness of tax arrears data; • Target enforcement efforts on recoverable arrears; • Leverage the telephone context center to place outgoing debt collection calls; • Write off arrears deemed unrecoverable; • Implement proper organizational and staffing arrangements for collection enforcement, including a greater organizational focus for large tax debt,; • Be vested with a full set of enforcement powers.
4	Giving greater attention to loss-reporting businesses	• Verifying doubtful claims, particularly in cases of larger claims; • Determining whether the conditions and limitations have been correctly applied for carrying forward, carrying back, and transferring losses; • Checking for possible manipulation of losses by consolidated groups and partnerships.
5	Enhancing the scrutiny of cross-border transactions	• Developing a targeted audit program to address cross-border evasion; • Expanding the number of audits of international issues, increasing the number of international tax auditors (particularly within the LTO), and providing greater technical guidance to auditors on international issues; • Increasing disclosure requirements on international transactions; • Publishing warnings on specific international tax planning schemes that are deemed to improperly exploit loopholes in the tax laws; • Promoting the exchange of information with the country's anti-money laundering agency to verify compliance and identify aggressive international tax practices; • Entering into tax information exchange agreements with other jurisdictions and effectively using this information for control purposes; • Introducing a voluntary disclosure program that encourages taxpayers to declare previously unreported income in offshore accounts.

No	Enforcement	Strategies
6	Containing the growth of the cash economy	• Identifying high-risk sectors and developing an understanding of taxpayer behavior in those sectors; • Encouraging compliance through proactive and innovative measures; • An escalated regime of enforcement methods; • Partnership with relevant civic associations that may influence cash economy businesses.

Source: Brondolo, John, 2009

3. Indonesia Economic Outlook and Tax Policy Measurements

WHILE AT THE FISCAL SIDES, MINISTRY OF FINANCE COORDINATES WITH OTHER LINE MINISTRIES EXERCISE FISCAL STIMULUS POLICIES TO LEVERAGE CURRENT STATE OF DOMESTIC DEMAND.

Emerging markets including Indonesia remains fragile to the current uncertain global financial and economic environment. World main commodity prices plunge to the lowest in the last five years, mainly from less-than- expected China's economy growth. According to the latest publication of the World Bank[19], the projected 2015 economic growth will only be at the level of 4.7 percent or below the Government of Indonesia's official figure at around 5 to 5.2 percent. Ministry of Finance and Central Bank of Indonesia has intensified coordination through policy mix. At the monetary sides, BI (Bank of Indonesia) maintains tight monetary policies by keeping its rate at the same level (7.5 percent) for over four months and also implements macro-prudential approaches to improve the economy such as lowering loan-to-deposit ratio as to escalate credit growth and purchase of SBPU (Surat Berharga Pasar Uang – money market securities through open market operations. Additionally, there is limited scope for Bank Indonesia to loosen monetary policy, given sticky inflation of above 7 percent in recent months, persistent external vulnerabilities, and uncertainty with respect to US Federal Reserve Action in the near term. However, BI, repetitively, mentions that it should strengthen its policy coordination intensively with the government to control inflation and output volatility; and commints to be more transparent in its communication strategy.

While at the fiscal sides, Ministry of Finance coordinates with other line ministries exercise fiscal stimulus policies to leverage domestic demand. Main drivers of domestic demand, i.e. private consumption and fixed investment, keep at a positive growth although at the slower pace compared to the previous year. Private consumption expenditure grew at a moderate 4.7 percent (year-on-year) for a second quarter of 2015. This compares with an average growth rate of 5.4 percent *y-o-y* in 2012 to 2014 that have translated into weaker consumer sentiment and lower household spending this year. Moreover, imports also contracted significantly due to weak domestic demand. In addition, sluggish demand of our commodity products from China created lingering problem with our exports. The economic stimulus from higher public infrastructure spending is expected only towards the end of 2015 with limited impact on GDP growth in 2015.

In terms of challenges and policy options related to tax collection, Indonesia has been contemplating and exercising different strategies over the last decades. After the Asian Financial Crisis in 1998[20], the Government of Indonesia has been conducting four major tax reforms initially as a response of the crisis where those focus on modernization of tax administration. According to Rizal (2012)[21], any government needs to take into account the concomitant tax administration reform, since weak tax administration will become obstacle for achieving the objective of tax reform. The objective of the reform is to create more public trust in the Directorate General of Tax (DGT), more productive and accountable tax officer, and better tax compliance. Even after a decade of tax reform, tax noncompliance and corruption still cause major constraints to the effectiveness and efficiency of tax collection. In Indonesia, problems with tax noncompliance and corruption are pervasive and common.

The level of noncompliance in Indonesia is quite high and, in most cases, will increase during the crisis. One of the modernization program's guiding principles for improving compliance is to make the tax system easy for taxpayers to comply with[22]. According to the IMF (1998), the current tax system poses major compliance burdens for

19. The World Bank (2015),"Indonesia Economic Quarterly", July.

20. The crisis erupted in Thailand around July 1997. Thailand was heavily relied upon short-term capital flows to finance its economy. These conditions were also accompanied by lax regulation on investment and corrupt bureaucracy.

21. Rizal, Yond (2012),"Lessons from Indonesian Tax Administration Reform Phase 1 (2001 – 2008): Does Good Governance Matter?"

22. Rizal (2012), *op cit*.

taxpayers in terms of uncertainties in the laws and countless regulations, complex tax returns, excessive information reporting requirements, and poor taxpayer services[23]. These costs discourage voluntary compliance and have contributed significantly to the large numbers of taxpayers who, intentionally or unintentionally, fail to fulfill their tax obligations.

To improve taxpayer's compliance, the DGT has formulated and implemented strategies on program and activity that can keenly increase taxpayers' attentiveness and voluntary compliance, especially for the non-compliance taxpayer and effective law enforcement[24]. For a system based on self-assessment to be effective, taxpayers must believe that if they or their competitors fail to comply with their tax obligations, there is a reasonable chance that they will be detected and fined. Once they are caught, sanctions will be imposed and are sufficient to offset the potential benefits of noncompliance[25].

Transformation of an ICT system is very important key factor that will enhance transparency and improve tax compliance rate. The DGT has also developed the data processing center that gathers data from tax returns, tax payments, and third-party reports. Improvement in an ICT system has also shortened the filling process and reduced interfaced communication between tax authority and payers. In essence, an increase in tax revenue may come from sustainable administration reform that can overcome the present shortcomings such as inadequate legislation, poor organization, inefficient human resources of DGT, and pervasive corruption. However, external factors such as changes of economic trends would also have a tremendous impact to tax revenue. The current reform has led on the improvement in the number of registered taxpayers. The number of registered taxpayers increased significantly from 2.52 million in 2001 to around 4 million in 2005.

In 2005, the DGT launched a crash program on 10 million of Tax Identification Number (TIN). Millions of new taxpayers were netted on this program through data of property and car ownership, credit cards, and other financial transactions. Sunset Policy, classifies as revision amnesty that granted by the GOI to noncompliant in 2008, contributed to the increasing number of taxpayers of around 5.36 million people and as much of IDR 7.46 trillion. However, as of January 2009, the ratio of stop filer is pretty high at approximately 47.39%[26].

As abovementioned, this year the government has conducted various fiscal and monetary mix policies to anticipate challenging global economic trends that affecting Indonesia's economy. Following budget revision in January 2015, the government needs to execute its reform agenda that are particularly focusing on infrastructure, maritime, agriculture, and social programs. Effective execution of the budget will require increasing in budgeted revenues. However, the government will likely face the challenge of adjusting spending to account for lowers than expected realized revenues. Tax revenue accounted only 94 percent of the 2014 revised budget target of IDR 1,635.4 trillion.

Lower value-added tax (VAT) growth was a major contribution to the weak performance of revenue in 2014. VAT collection growth in 2014 was only 5.8 percent, relative to an 18.8 percent average for 2009 to 2013 and only 85.1 percent relative to the revised 2014 Budget target. Recent announcement to extend tax holiday from the current 10 years to a maximum 20 years intends to attract more foreign direct investments and support employment creation. Eventually, an increase in employment leads to positive private consumption growth and provide multiplier effect to VAT revenues. The government also considers implementing cash transfer program to help the poor and push private consumption as an engine of growth.

At the end of this year, the government sets a relatively optimistic target of IDR 1,489 trillion for tax revenue as stated in the revised budget. In the first five month of 2015, total revenue only reached IDR 533.4 trillion or represents only 30.3 percent of the annual target, compared with an average of 35.3 percent in the last five years. Nominal tax revenue declined by 1.3 percent *y-o-y* in January to May 2015, in sharp contrast to the targeted increase of 30 percent for a full year in the 2015 revised budget[27]. Revenues from all major tax categories contracted, with the exception of non-oil and gas income taxes, which contributed a positive 3.5 percentage points to the nominal year-on-year growth of total revenues.

Moreover, during half period of 2015 receipt from value added tax (VAT) declined by 4.7 percent *y-o-y*, contributing to one percent *y-o-y* to overall nominal revenue growth. This in line with the weaker growth of domestic consumption and drops in imports during the first quarter of

23. The Government and National Parliment are currently in the process of revising Tax Law which will be enacted in 2016.

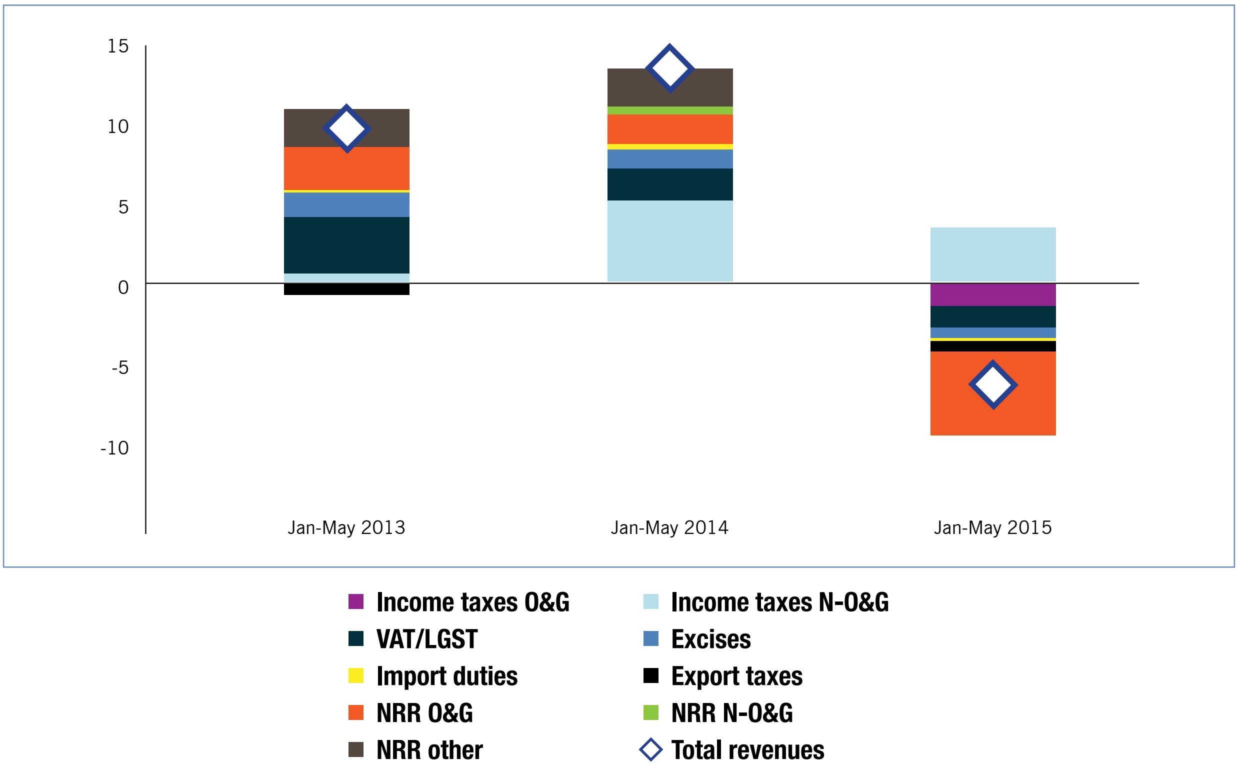
24. Rizal (2012), *op cit.*

25. Directorate General of Tax, Ministry of Finance (2003),"Strategic Paper of the DGT, Ministry of Finance Decree No. 85/KMK.03/2003.

26. Ratio of stop flier is the ratio between the number of registered taxpayers who stopped filing their return and keep filling their return. Among the effective registered taxpayers, not all of them report their taxes correctly as reflected in the result of the tax audit. However, there were many cases of accidently under-reporting tax filling.

27. World Bank, *op cit*, page 12.

Figure 3 - Tax Revenue Growth Trends



Notes: O&G stands for "oil and gas", N-O&G is "non-oil and gas". LGST is "luxury goods sales tax"; NTR is "Non-tax revenue"; NRR is "natural resource revenues"; "NTR other" includes all non-tax revenues other than those from natural resources. Source: Ministry of Finance, World Bank Calculation 2015.

2015. Furthermore, export tax collection sharply diminished as commodity prices such as CPO have remained below the verge. Slower GDP growth also leads to feebler personal income tax and final withholding tax relative to 2014. In an effort to reach the revenue target, the government has announced a number of policies. Some are already implemented such as the reduction of certain luxury goods and improve tax administration and compliance such as e-tax invoicing, improvement of tax auditing process focusing on certain business (e.g. corporations using transfer pricing, oil and gas companies and coal mining companies) and wealthier taxpayers, and a six-month overseas travel ban on tax debtors issued in December 2014[28]. The government also waives of interest and fines on onshore tax arrears and late tax payment submission.

The government is in the middle of uncertainty between its effort to increase tax revenue to meet the target and supporting economic growth. It appears clearly to numerous possible tax policy strategies taken by the government that are currently intended to support the economic growth while maintaing compliances such as jailing of large tax debtors; reduce taxpayers' non-taxable income to IDR 36 million/yearly; certain enterprises with gross turnover of not more than IDR 4.8 billion are subject to final tax at 1 percent turnover; public companies that satisfy a minimum listing requirement of 40 percent and other conditions are entitled to a tax cut of 5 percent off the standard rate at a flat rate of 25 percent; new taxes on new oil and gas production sharing contract holders; possibility of exercising apparent tax amnesty in 2016, etc.

In essence, the government is providing tax incentives for export-oriented firms and labor-incentive sectors. These strategies are done as complement to capital spending which is currently down by 18 percent *y-o-y* relative to the same period in 2014. As for 2016 Fiscal Year, the government has set its tax revenue target in the draft 2016 National Budget as shown in Table 4.

As shown in Table 4, domestic taxes accounts more than 95 percent of total tax collection where income tax and value added tax are the two largest component of domestic tax with around 50.1 and 40 percent, respectively (see Figure 4). The government sets tax revenue target based on 5.5 percent economic growth which needs extra efforts to accomplish it. It is not absurd to increase more than 0.5 percentage point within a year unless there is major breakthrough done by President Joko Widodo to force better budget absorption at the national and local level. Moreover, share of

28. Law No. 19/1997, Article 29-32 (in the World Bank's IEQ July 2015)

Table 4 - Tax Revenue for 2016 National Budget (IDR Trillion)

No	Description	RAPBN 2016
I	Tax Revenue	1.565
A	Domestic Taxes	1.524
	1) Income Tax	763
	2) VAT	573.6
	3) Property Tax	19.4
	4) Excise Tax	155.5
	5) Other Taxes	11.8
B	International Trade Taxes	41.7
	1) Import Tax	39.2
	2) Export Tax	2.89

Source: Nota RAPBN, 2016

property tax has been diminishing from 1.9 to 1.3 percent because of the central government's policy to relinquishing its authority to collect property tax to local government. Tax revenue target in 2016 is 14.8 percent higher than 2015 Budget. The number increases around 3 percent from the previous Revised 2015 National Budget. As mentioned, next year tax revenue realization will be a big challenge to the government.

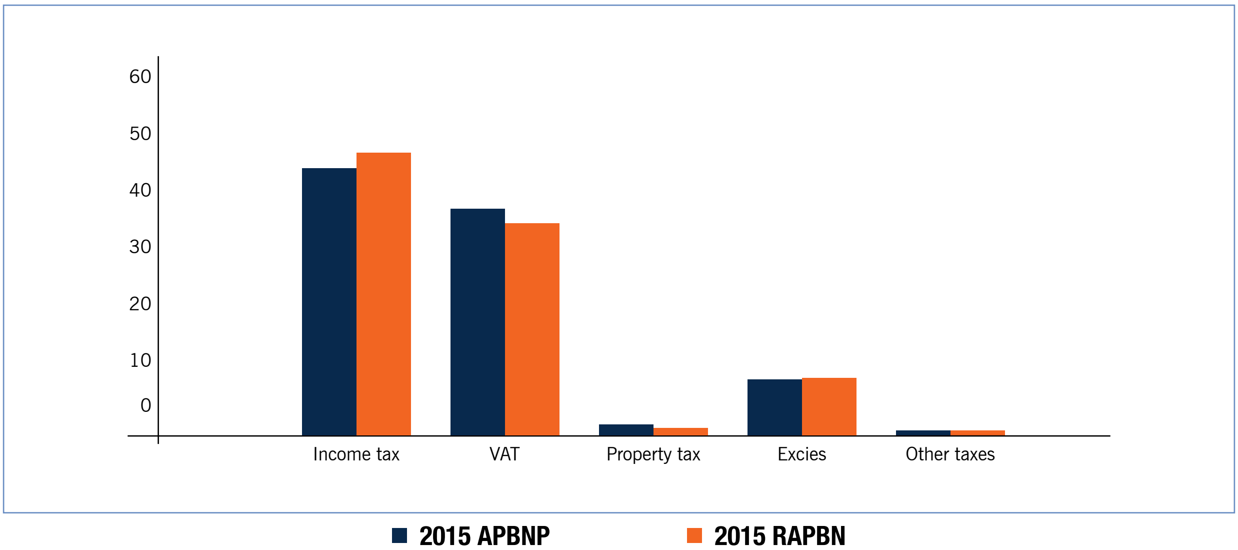
Revenues from all major tax categories up to the middle of 2015 was contracted, with the exception of non-oil and gas income taxes. The World Bank forecasted that tax revenue will only reach at around IDR 1,165 trillion or 78 percent of the revised budget. DDTC also predicted at the beginning of this year that tax revenue in 2015 will be at around IDR 1,288 trillion or 86 percent and in 2016 will stand at IDR 1,457 trillion or 95 percent to the draft 2016 Tax Revenue Budget. The government seems very ambitious in setting its target where it sets a 14.5 percent increases to the projected 2015 tax revenue realization.

The government takes several things into consideration in setting up the target such as better external and domestic economy conditions in 2016; implementation of the new tax regulations; as well as tax administration and organization improvement[29]. In order to accomplish the target, the government focuses on four strategies such as (see Table 5). These four strategies are mostly a continuation from the previous determined planned.

Given uncertain external environment, the scope and options to domestic economy policies remains limited. The scope of fiscal stimulus and monetary policy are constrained due to sticky inflation, weakening exports and purchasing power; as well as external vulnerabilities. Support from the expenditure side to the economy is still very low as a results of prolong procurement process in the most of line ministries leading to delays in disbursement. Capital expenditure at the local government level is also not performing well. Instead of putting in the productive sectors, local governments deposit their money in banks or buy central government bonds. On the revenue side, the government has already introduced important measures, such as electronic tax return submission and improvements in the income tax audit strategy.

29. Time-consistency policies are important in this matter as public will judge government's performance according to this.

Figure 4 - Percentage of Tax Domestic Revenue, 2015-2016



Source: Ministry of Finance, 2015

Table 5 - Tax Strategies 2016

No	Strategies
1	Improve tax payers' compliances mainly individual and firms.
2	Leverage tax ratio and tax buoyancy through expansion, intensification, stringent enforcement, better tax administration, improve regulation and capacity of DGT.
3	Expand tax coverage on several primary sectors such as mining, quarrying, trade, construction, and financial services.
4	Strengthening and widening tax data base, through: a) Digitalization of SPT and implementation of e-SPT & e-filling b) Implementation of e-tax invoice throughout Indonesia. c) Implementation of cash register and electronic data capturing (EDC) on line with tax administration; d) Synchronization data collection from other institutions.

Source: Nota RAPBN, 2016

There is also a possibility to further optimize the tax regime, improve corporate income taxation, and revise value-added tax exemptions to increase equity[30]. Government policies to eradicate tax evasion need to be strengthened without jeopardizing business environments. It is clear enough to conclude that Jokowi administration's main priority based on the recent economic policies package is to support private consumption and export, improve fixed investment growth to drive Indonesia's slowdown, and speed up government investment through line ministries and state-owned enterprises (SOE). This will, eventually, have a positive impact on the government tax receipts. However, the effectiveness of that package is still questionable as public still waits for the detailed policy actions to execute that package.

4. Conclusion and Policy Recommendation

4.1 Conclusion

In the aftermath of AFC and GFC, emerging economies including Indonesia again stands at a crossroads of global economic volatilities due to the weakening of China's economy; a growing probability of an interest rate rise in the US that could create short-term portfolio flows; plunging world commodities prices such as oil and gold; and lingering economic problems in the European Union. Ideally, developing countries' governments should respond by providing large fiscal stimulus programs related to public spending, subsidies, and tax policies (e.g. tax incentives) that helped the region out of the crisis. Fiscal policies, such as taxes and public expenditure, are used to counter-cyclically purposes and stabilize the economy.

30. See Indonesian Development Policy Review,"Avoiding the Trap", The World Bank, 2014.

The composition of taxes and government spending are important determinant for economic growth. Furthermore, the government should also made bold and firm decision to restructure the real sector of the economy including on how to improve the licensing system, the level of investment and the business climate. There are also other policies that provide a financial incentive for the promotion of exports or reduce interest rates to lower costs. At present, the lending rate in Indonesia is the highest among the ASEAN 5 countries. The labor market is distorted as the government has kept raising the minimum wage and provided generous unemployment benefits in a labor surplus economy[31].

For tax strategies, it should take into account that decreasing personal or corporate income tax than consumption tax can have better effects on long-term growth[32]. There are other factors that need to be considered, such as revenue sufficiency, equity, simplicity, and compliance[33]. In essence, there is a need to identifying not only policies that are fast generate domestic demand, but also policies that are fast to enact and involving fewer administrative and political processes to implement. The removal of tax barriers which hamper the effective functioning of financial and goods market can help countries exit from the crisis. This would include tax provisions which distort investor choices as to whether to invest directly or by means of collective

31. Nasution, Anwar (2014),"A Deteriorating economy amid distorted policies", the Jakarta Post.

32. Abdon, A., Estrada., GB., Lee, M., and Park, D.(2014),"Fiscal Policy and Growth in Developing Asia", ADB Economics Working Paper Series, NO.412.

33. Arnold, J. M., B. Brys, C. Heady, A. Johansson, C. Schwellnus, and L. Vartia. (2011),"Tax Policy for Economic Recovery and Growth", *the Economic Journal.* 121 (February). pp. F59–F80.

investment vehicles and tax provisions which act as a barrier to the use of different financial products which reduce the cost of capital[34].

The government also plan to give tax amnesty to offshore assets and income and would make immunity from all charges of financial crimes in exchange of repatriating assets to Indonesia. This effort considers additional revenues in the near future but carries the risk of moral hazard and non-compliance that could impede revenue realization in the future. It is highly recommended that the government synergize short- and medium-term target before implementing the policy. Furthermore, the government has introduced some fresh steps that include the introduction of electronic tax return submission, improving tax audit towards alleviating transfer pricing especially on big multinational corporations, and intensively supervise industries or businesses that are prone to tax evasion. One of the necessary conditions for the above efforts to be succesfully implemented is to have an increase ratio of tax officials to potential number of taxpayers.

4.2 Policy recommendations

In the end, the author divides policy recommendation based on the two possible timings – short and medium/long term. In the short term, the government needs to:

- Improve the quality of central and local government spending. These include, but not limited to: (i) identify the bottleneck and constraint of the government procurement processes and delays in the disbursement; (ii) strengthen collaboration and coordination of line ministries in structuring good budget planning (e.g. medium-term plan and the government yearly work plan as well as line ministries budget execution plans); (iii) improvement in government budget administration; (iv) consider and enhance fiscal risk and contingent liabilities calculation into the national budget preparation to accommodate uncertainty in macroeconomic indicators; (v) provide stick and carrots to the performance of local governments.

During 2010-2013 Fiscal Year, a one percent decrease of economic growth lower than the assumed figure would cause a larger deficit by around IDR 4.5 – 5 trillion. Depreciation of Rupiah and an increase in the 3 month SBI interest rate would also raise APBN deficit because the cost of APBN financing increases. Therefore, the government must apply policies that suit to fiscal sustainability and macroeconomic stability. Although effort to increase tax revenues would narrow the deficit; the effect to the whole economy in the short span would be counter-cyclical especially during economic slowdown. The government must surely apply relaxed fiscal policies through tax incentives, foster capital and social government expenditures to help domestic demand from decreasing further.

- Reallocating unproductive government expenditure to create more fiscal space and relocating items to productive sectors;
- Intensify government agenda on tax compliance focusing on large taxpayers during a crisis and enhance the scrutiny of cross border transactions; firm enforcement should be focused against businesses that have the capacity to pay but refuse to do so.

In the medium/long-term or after the economy survives from the crisis, the government could exercise what economists say as "Ricardian Equivalence" where the authorities would primarily and directly focus on tax collection enhancement and remove some of tax incentives previously enacted to compensate the amount of tax receipts forgone during the crisis. As abovementioned, this tight fiscal policy should be complemented with accommodative monetary policy. Combination of the two policies would crowd in private investment and further positively spur private consumption, exports and eventually the economy as a whole.

34. OECD (2009),"Strategic Response to the Financial and Economic Crisis", OECD Report.

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