INDONESIAN INCOME TAX IN THE PERSPECTIVE OF REVENUES, EQUITY, AND EFFICIENCY

A dissertation submitted

by

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Abstract

This dissertation studies the development of Indonesian income tax in the period of 1984 to 2011 (the current state) from the perspective of tax revenue, equity, and efficiency, with three focus areas. The first area is the Indonesian income tax reforms. In this area, this dissertation points out three key features of the Indonesian income tax reforms taken place during 1984 to 2011: tax rates cutting, tax base broadening, and the shifting of tax system from the comprehensive income tax system towards the schedular tax system. Then, from the perspective of tax revenues, data shows that the Indonesian's income tax revenues in nominal term have increased considerably, however its income tax ratios remain low. This phenomenon indicates that even though the income tax reforms did have positive effects on increasing the income tax revenues, they were not the only factors for the steep increase of income tax revenues. This dissertation shows that Indonesian's relatively high inflation rates and high economic growth have considerably contributed to the steep increases of income tax revenues. The second area is the development of Indonesian tax policies on capital gains arising in the stock exchange. In this area, this dissertation notes that in comparison with the 1984 capital gains tax policy, the 1995 capital gains tax policy (the current policy) had advantages in promoting efficiency, however, it inflicted significant tax burden discrepancies between the capital gains earners (the stock market) and the ordinary income earners (the real sectors) and the gaps became wider along with the augmentation of the stock market. In year 2011, at 6 percent return on equity, this dissertation estimates that the ordinary income earners bore 30 times higher tax burden than those who earn capital gains from the stock exchange. The third area is tax return policies. In this area, this dissertation notes that the tax return policy have swung from the equity perspective in 1984 to a more pragmatic policy in 1995, and finally bounced back to the equity side in 2001. Furthermore, data reveals that the 2001 tax return policy, which obliged employee type individual taxpayers (EITs) to file tax returns, posted an obvious weakness from the efficiency side; the significant increase of individual tax returns in the period of 2001-2010 did not proportionately followed by the individual tax revenues. Even more, in several years, a paradoxical situation existed in which number of tax returns had negative relation with tax revenues. Finally, this dissertation concludes that the income tax reforms and tax policy changes during 1983-2011 had positive impacts in increasing Indonesian income tax revenues, however there were mix results concerning the equity and the efficiency of the tax system. In some areas, such as capital gains tax in the stock exchange, the Indonesian income tax system has shifted from the equity oriented system to a more efficiency oriented system. However, in some other areas, such as tax policy changes on tax return obligations have a contrary implication in which the tax system moved from a more efficiency oriented system to a more equity oriented system.

Publications and Conference

Two topics of this dissertation have been published in referee journals and one topic was presented in an international conference:

- Indonesian Tax Return Policy in the Perspective of Revenue, Equity, and Efficiency. Published in the Journal of East Asian Studies. Volume No.11 March 2013.
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Abbreviations

ASEAN	Association of Southeast Asian Nations
DGT	Directorate General of Taxes
EIT	Employee type individual taxpayers
EIT-ME	Employee type individual taxpayers who receive incomes from more than one employer or other sources
EIT-OE	Employee type individual taxpayers who receive incomes solely from one employer
IMF	International Monetary Fund
LTO	Large Taxpayer Office
MTO	Medium Taxpayer Office
OECD	Organization for Economic Co-operation and Development
STLG	Sales Tax on Luxury Goods
STO	Small Taxpayer Office
VAT	Value Added Tax

Chapter 1

Introduction

1.1. Background

After the Indonesian's oil golden era have faded away in the 1980s, tax revenues have gradually taken the place of oil as the main source of Indonesian state revenues and recently, in the fiscal year 2011, revenues derived from taxes reached Rp873.75 trillion or 72.76 percent of the total state revenues. However, the current level of tax revenues inevitably has to be increased further to reduce government dependency on debts in financing its expenditures. One source of tax revenues that has the possibility to be increased further is the income tax. In 2011, it contributed Rp431.98 trillion or 49.44 percent of the total tax revenues.

The current income tax's performance in providing funds for the government cannot be separated from the efforts that have been taken by the government to increase income tax revenue and maintain its sustainability, including tax policy changes and income tax reforms. In the course of Indonesian income tax, a fundamental tax reform has been taken in the year 1983 in which the tax assessment system was changed from the official tax system to the self assessment system, and the income tax structure was simplified by abolishing several types of taxes on incomes and as a replacement, a single comprehensive income tax system was introduced. However, this big overhaul was not the end of tax regulation changes; several further tax policy changes have been conducted.

Tax policy changes and tax reforms definitely are not only motivated by the need for revenues but they are also triggered by many other motives such as, to improve the fairness of tax burden sharing among the people and to make tax collection becoming more effective and efficient. In most cases, the effects of tax policy changes and tax reforms cannot be contained into one single target without effecting the equity and efficiency of a tax system; tax policy which are deliberately aimed to increase tax revenues, in its implementation, not only might affect tax revenue itself but also the balance of equity and efficiency of tax system. Likewise, a tax policy aimed to improve the equity of tax system affects not only the tax equity but might also affect tax revenues and the efficiency of tax system. This condition has made efforts to achieve a sound tax system becomes a challenging stuff. Even more, in the case of the equity and efficiency, they are as though two sides of one coin. If the efficiency is pushed to an extreme point, then the equity will be in precarious. Similarly, if the equity is pushed to an extreme point then the tax system will be much more complicated.

The changes of the balance of the equity and efficiency can be seen in the development of Indonesian income tax and tax policy changes during 1984 to 2011. For instance, tax policy on capital gains arising in the stock exchange have made the Indonesian income tax system shift from the equity oriented system to a more pragmatic system. However, tax policy changes on tax return obligations have a contrary direction as it have caused the tax system to move from more efficiency oriented policy to a more pro equity oriented policy.

Studies on the areas of income tax reforms, capital gains on the stock exchange, and tax return policies in Indonesia have been sparse and limited. In the case of studies on Indonesian tax reforms some are worth mentioning here. Bird (2004), in highlighting tax reform processes in several developing and transitional countries, pointed out several distinctive features of the 1980's Indonesian tax reform influencing the course of the 1983 tax reform's processes including the sense of belonging, adequate time in preparing and evaluating policy options, and conducive political situation. Heijj (2007) studied the processes and the parties involving in the 1983 tax reform. Then, Rizal (2011) elaborated the Indonesia tax administration reform 2001-2008 from the governance point of view. He noted that governance is an essential element to improve tax administration, and the success of a tax reform is determined not only by the reform at tax offices but for a great extent also by the reform at the government as a whole.

Nevertheless, thus far, studies on Indonesian tax reform which specifically focus on the "income tax" reforms during 1984-2011 cannot be found. Therefore, this dissertation aims to fill this gap by elaborating the purposes of income tax reforms and the impact of income tax reforms on income tax revenues during year 1984-2011.

Then, in the case of tax return policies, some people believe that excessive tax return policies have taken parts in raising tax collection costs and creating unnecessary burden to society. These situations have triggered several studies on the possibility to reduce or even to abolish tax return filing obligation with varied results. For example, Leigh (2007) in Australia suggested that it would be beneficial to exempt most Australian taxpayers from tax returns filing obligation. On the other hand, Davidson (2009) argued differently; he pointed out the benefits of obliging people to file tax returns are greater than its costs. Meanwhile, study by Gale (2007) in the United States of America suggested that the idea to implement no-tax return systems would require considerable adjustments in self assessment tax regime. In the case of Indonesia, thus far, studies on tax return policies could not be found. Therefore, the present study through qualitative analysis attempts to provide an insight about Indonesian tax return policies from the perspective of equity and cost-efficiency of the tax system, and simultaneously investigates the impact of the tax return policies on the primary goal of taxation which is to raise tax revenues.

Then in the case of capital gains tax, some people support capital gains taxes but the others challenge them. The adversaries of capital gains taxes mainly contend that capital gains taxes do not support economic growth as they discourage people to make investments (e.g., Campbell, 2009; Lucas, 1990). On the other hand, the advocates of comprehensive income tax system see from another perspective. They argue that taxing capital gains equal with other kind of incomes is needed to maintain the fairness of a tax system (Haig-Simons as cited by OECD, 2006). Then, in another spectrum, some other people took a moderate view considering that capital gains are different with ordinary income in nature so that in taxing capital gains, they believe that several adjustments are needed to bring taxes on capital gains on a par with the taxes on ordinary income.

However, thus far, study on the capital gains tax policy's impact on tax burden differences between ordinary income earners and capital gains earners, and the development of Indonesian capital gains tax policy cannot be found. Therefore, this dissertation aims to elaborate the Indonesian tax policies on capital gains from year 1984 to 2011, and to locate the position of the Indonesian current capital gain tax policy compared to international practices. Then it aims to analyze the development of the Indonesian's stock exchange after the implementation of the 1995 capital gains tax policy. In the last this dissertation aims to estimate the tax burden discrepancy between real sector and capital market during 1995-2011.

1.2. Tax Equity and Efficiency

Tax equity and efficiency issues have become the bywords among executives, legislatives, and public in striving for a sound tax system. Generally, equity principle is viewed from how fair tax burdens are shared among people. Furthermore, it is widely accepted that people with similar economic level should pay a similar amount of tax (horizontal equity) and people with higher economic level should pay higher tax (vertical equity). These equities refer to "ability-to-pay" concept as elaborated by Smith (1776) in his book The Wealth of Nations. He said, "The subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the state."

Another issue is the efficiency in collecting taxes. Most literatures define efficiency in two different ways. First, efficiency is defined as cost efficiency which means that tax should be collected at low cost as possible. Smith (1776) mentioned "Every tax ought to be so contrived, as both to take out and to keep out of the pockets of the people as little as possible, over and above what it brings into the public treasury of the state." Tax collection cost refers to all costs above tax payments that are incurred by both taxpayers (compliance costs) and tax offices (administration cost), in order to fulfill the requirements stated on tax regulations and to administer the tax itself. The tax collection cost efficiency can be improved by reducing costs that incurred in taxpayers' side, in tax offices' side or the both sides. In taxpayers' side, compliance costs cover expenses such as stationery, printing, copying, stamp, transportation, and non monetary aspects such as time spent, anxiety, opportunity costs. In tax offices' side, administration costs covers all costs and expenses for running in tax offices such as facilities, employees' expenses, utility expenses, compliance checking expenses, and other expenses. Second, efficiency is defined as economic efficiency. It means that the tax system should be neutral to ensure that investment decisions take into account the best location from an economic perspective, Stiglitz (1999). Of both point of view of efficiency; cost efficiency and economic efficiency, this dissertation will focus on the efficiency from cost efficiency point of view. Thus, for the rest of this dissertation the term "efficiency" is used to refer to cost efficiency in collecting taxes.

1.3. Research Purposes

This research aims to study the development of Indonesian income tax in the period of 1984-2011 (the current state) in conjunction with the development of Indonesia's income tax revenues, and the issue of tax equity and efficiency with three focus areas: capital gains tax policies on shares traded in the stock exchange, tax policies on tax return, and Indonesian income tax reform. In elaborating the development of Indonesian income tax, the research also analyzes the merits and demerits of income tax policies which have been implemented and provide policy recommendations to improve the performance of Indonesian income tax system.

Furthermore, each of the three focus areas above has specific purposes that can be listed as follows. First, in studying the Indonesian income tax reforms, the research's purposes are:

- To elaborate the Indonesian income tax reforms during year 1984 to 2011 which include the purposes of the tax reforms, the changes on the income tax laws, and the impact of the tax reforms on income tax revenues.
- To discuss current condition of Indonesian income tax system and suggest policy recommendations.

Second, in studying the capital gains tax policies on shares traded in the stock exchange, the research's purposes are:

- To elaborate the Indonesian tax policies on capital gains from year 1984 to 2011, and comparing them with the capital gains tax practices in several selected countries.
- To estimate the tax burden discrepancy between real sector and capital market as the impact of different tax treatment on the capital gains and the ordinary incomes.
- To elaborate the merits and demerits of tax policies and suggest policy recommendations.

Third, in studying the Indonesian tax return policy, the research's purposes are:

- To elaborate the Indonesian tax return policies from year 1984 to 2011 in the perspective of equity and cost-efficiency of the tax system.
- To investigate the impact of the tax return policies on tax revenues.
- To elaborate the merits and demerits of tax policies and suggest policy recommendations.

1.4. Research Methodology

This research requires a combination of comprehension on Indonesian income tax law, the development of Indonesian income tax, and the related international tax practices. Therefore, the initial step of the research is to collect and gain an understanding on the Indonesian income tax law and regulations, then the second step is to collect academic literatures and international tax practices on various issues related to the topics of the research including the tax return policy, capital gains tax policy on the stock exchange, and the income tax reform. At the end, to analyze the effect of tax policy changes on the Indonesian income tax revenues, efficiency and equity, relevant data are collected from various sources including the Directorate General of Taxes of Indonesia, Ministry of Finance of Indonesia, Indonesian Bureau Statistics, Indonesian Central Bank, the World Bank, the IMF, and the OECD.

1.5. Dissertation Structure

The dissertation comprises of five chapters and two appendices. Chapter 1 describes the background, tax equity and efficiency definitions, purposes, and methodology of the research. Chapter 2 discusses Indonesian income tax reforms. Chapter 3 explores the development of the Indonesian capital gains tax policies and discuses their impact on the tax burden fairness between ordinary income earners and capital gains earners. Chapter 4 presents the development of the Indonesian tax return policies and how they affect the fairness and efficiency of Indonesian tax system. Chapter 5 contains conclusions and recommendations. Appendix 1 gives information about Indonesian taxation in brief. Appendix 2 elaborates tax principles.

Chapter 2

The Indonesian Income Tax Reforms and Income Tax Revenues

2.1. Introduction

In this world, change is a necessity and that is also the case for tax system. A sound tax system should be able to adapt to dynamic economic situation and more importantly it should be able to generate adequate tax revenues. The extent to which a tax system should be transformed in order to suit the changes on tax environment could be varied; in some situation, the changes could be in a matter of adjustments which do not affect the overall tax system, but in other situation the changes could be fundamental to the tax system. Indonesian taxation has experienced both partial and comprehensive tax reform. Partial tax reforms have been implemented more frequently then the comprehensive or fundamental one.

A fundamental tax reform has been taken in the year 1983 in which the tax assessment system was changed from the official tax system to the self assessment system, and the income tax structure was simplified by abolishing several types of taxes on incomes and as a replacement, a single comprehensive income tax system was introduced. However, this big overhaul was not the end of tax reform process in Indonesia. Several further tax reforms have been conducted.

After the 1983 tax reform, the Indonesian government has carried out several tax reforms that can be classified as tax regulation reform and tax administration reform. The income tax regulation reforms have been conducted for four times; in 1991, 1994, 2000 and 2008. Then one tax administration reform has been conducted during 2001-2008.

The current income tax's performance in providing funds for the government is the result of the efforts that have been taken by the government to increase income tax revenue and maintain its sustainability, including income tax reforms. Recently, in the fiscal year 2011, revenues derived from taxes reached Rp873.75 trillion or 72.76 percent of the total state revenues. However, the current level of tax revenues inevitably has to be increased further as the country faces the problem of debts and budget deficits. One source of tax revenues that has the possibility to be increased is the income tax. In 2011, it contributed Rp431.98 trillion or 49.44 percent of the total tax revenues.

However, despite those tax reforms and the current substantial contribution of income tax revenues in the Indonesian national budget, still there is a room to increase income tax revenues further as reflected from the Indonesian's low income tax ratios and low taxpayers' compliance rate. Therefore, the question is what measures should be taken in the near future by Indonesian government in order to increase income tax revenues as a way to reduce the Indonesian's debt dependency problem?

Studies on Indonesian tax reforms have been sparse. Some are worth mentioning here. Bird (2004), in highlighting tax reform processes in several developing and transitional countries, points out several distinctive features of the 1980's Indonesian tax reform which influenced the course of the tax reform's processes, which includes such as; sense of belonging, enough time to preparing and evaluating policy options, and conducive political situation. Heijj (2007) studies the process and the parties which involved in the 1983 tax reform. Then, Rizal (2011) elaborates the Indonesia tax administration reform 2001-2008 from the governance point of view. He notes that governance is an essential element to improve tax administration, and the success of a tax reform is determined not only by the reform at tax offices but for a great extent also by the reform at the government as a whole. Nevertheless, thus far, studies on Indonesian tax reform which specifically focus on the "income tax" reforms during 1983-2011 cannot be found.

Therefore, based on the information above, the aims of this chapter are twofold. The first is to elaborate the Indonesian income tax reforms during 1983-2011; the purposes of the tax reforms, the direction of changes on the Indonesian income tax, and the development of income tax revenues. The second is to analyze the elements of the tax system which are essential to improve Indonesian income tax system.

Finally, the rest of this chapter is organized as follows. Section 2.2 provides literatures review and overview of Indonesian income tax reforms. Section 2.3 elaborates income tax reforms and the development of income tax revenues. Section 2.4 discusses the measures to increase income tax revenues. Section 2.5 contains conclusions.

2.2. Tax Reform Literatures and Overview of Indonesian Income Tax Reforms

There are various purposes of which a country carries out tax reforms, and the most common purpose of tax reforms is to increase tax revenues (Heijj, 2007). It is also the case for Indonesia, the need to increase tax revenues is the foremost goals of Indonesian income tax reforms among several other reasons such as to improve the equity of a tax system, to attract investment, to accelerate economic growth, to improve tax certainty, and to simplify tax systems.

In the period of 1983-2011, Indonesian has made several tax reforms that can be classified based on its scale as fundamental tax reform and piecemeal tax reform, and they can also be classified, based on which areas of the tax system that being reformed, as tax regulation reform and tax administration reform.

A fundamental reform was taken in year 1983 in which a) the tax structure was simplified by abolishing and merging three separate taxes on income (corporate tax, personal income tax and interest, dividend and royalty tax) into a single comprehensive income tax, and b) the official assessment tax system was replaced with self assessment system. This fundamental tax reform was followed by four piecemeal income tax regulation reforms that are marked with the changes in the 1983 income tax law. The following is the list of the 1983 income tax law and its amendments:

1. The Law of the Republic of Indonesia Number 7 of 1983 concerning Income Tax, which came into force on January 1, 1984.
2. The Law of the Republic of Indonesia Number 7 of 1991 concerning the amendment of the 1983 Income Tax Law, which came into force on January 1, 1992.
3. The Law of the Republic of Indonesia Number 10 of 1994 concerning the amendment of the 1983 Income Tax Law as lastly amended by Law Number 7 of 1991, which came into force on January 1, 1995.
4. The Law of the Republic of Indonesia Number 17 of 2000 concerning the third amendment of the 1983 Income Tax Law, which came into force on January 1, 2001.
5. The Law of the Republic of Indonesia Number 36 of 2008 concerning the fourth amendment of the 1983 Income Tax Law, which came into force on January 1, 2009.

Table 2.1 presents the purposes of each of the income tax reforms conducted during 1983-2011 which are to increase tax revenues, to improve tax equity, certainty, simplicity, efficiency, neutrality, and investment.

From the Table 2.1, it can be seen that the tax revenue motive is among the most frequent cited goals of Indonesian income tax reforms. As an exception, only in the 1991 income tax reform tax revenue was not directly mentioned as the goal of the tax reform; the tax reform emphasized more on attracting investments and accelerating growth particularly in remote areas by introducing several tax incentives in the form of: investment allowance, accelerated depreciation and amortization, extended loss carried forward, and lower tax on dividends. Definitely, this measure might sacrifice income tax revenues in the short run but in the long run, it is believed that the incentives will attract investments and lift up Indonesian economy and at the end it will increase tax revenues. Therefore, even though the 1991 tax reform did not directly aim to increase tax revenues in the short run but still in the long run the yield of providing tax incentives was expected to have positive effects on tax revenues.

Table 2.1: The Income Tax Reforms' Purposes 1983-2011

Purposes	1983	1991	1994	2000	2008	Total
Tax Revenue	v	-	v	v	v	4
Equity	v	v	v	-	v	4
Certainty	v	-	v	v	v	4
Simplicity	v	-	v	-	v	3
Efficiency	-	-	-	v	-	1
Neutrality	v	-	-	-	v	2
Investment (Tax Incentive)	-	v	v	v	-	3
Total	5	2	5	4	5	

Source: the 1983 income tax law and its amendments.

In order to achieve the goals of each tax reform listed in the Table 2.1, varieties of changes on the income tax law which includes the changes on tax treatments on fringe benefits, assets depreciation, dividends, interest incomes, capital gains in the stock exchange, loss carried forward, tax installment, tax incentives, bookkeeping, tax treatment on business reorganization, tax rates, withholding mechanism, tax subjects, and many other changes have been made. To simplify the long list of changes made in the income tax law, the changes can be narrowed into four key areas: the tax rates, tax objects and tax subjects, tax incentives, and tax collection system.

In the area of tax rates, Indonesia has cut the income tax rates several times during 1983-2011. The highest tax rate for individual and corporate taxpayers for the tax year 1984 to 1994 was 35 percent, and it was reduced to 30 percent in the 1994 income tax reform. Tax rate cut also occurred in the 2008 tax reform in which the highest tax rate for corporate taxpayers was reduced from 30 percent to 28 percent. Then, once again in the tax year 2010, the tax rate for corporate taxpayers was reduced further to 25 percent, and the tax rate could go down to 20 percent for certain listed company, and 12.5 percent for small size corporate taxpayers.

The changes and the trends of the income tax rate above shows that Indonesian income tax reforms during 1984-2011 have embraced tax rate cutting approach. This tax rate cut approach is not particular to Indonesia. It has become a phenomenon worldwide as this situation also occurred in many countries. For instance, similar situation can be found in European Union and G7 countries, the statutory rates have fallen on an average of 50 percent in the early 1980s to under 35 percent by 2001 (Devereux, et al., 2008).

Other areas of income tax law that have been changed and amended several times are the objects and the subjects of income tax. For instance, in the 1994 income tax reform, in order to be able to minimize tax evasion, the scope of taxable incomes was made wider by introducing a new provision that made possible tax offices to tax any increase of taxpayers' wealth originated from unreported incomes. In the 2000 income tax reform, the income tax object was wider by making certain inter-corporate dividends as taxable incomes. Then, in the 2008 income tax reform, the surplus received by Indonesian central bank became taxable.

Therefore, from this fact, it can be seen in the term of tax bases that Indonesia has taken tax base broadening approach. This approach is popular in many countries with the reason that this approach will be able not only to increase income tax revenues but also increase tax compliance, administrative simplicity, equity and economic-efficiency (OECD, 2010).

The next area of tax changes is tax incentives. Indonesian tax policies regarding tax incentives have moved from the policy opposing tax incentives to the policy that accepts tax incentives. In the 1983 income tax reform, policy makers choose to uphold the equity principle of the tax system rather than granting tax incentives for certain groups of taxpayers which create unfairness in the tax system. However, starting in the 1994 tax reform, policy makers took another position by making tax incentives granting for certain taxpayers became possible and the reason behind this policy change was that in a notion that the tax incentives were needed to boost economic growth, and to accelerate investment in remote areas.

Another key change that has shaped the Indonesian income tax system is the change on the tax collection system. The 1983 income tax reform significantly embraced the comprehensive income tax system as the opposite of the schedular tax system. In the 1983 income tax law, all incomes were combined altogether and were taxed as one unit. However, starting in the 1994 tax reform, the comprehensive tax system was gradually shifted to the scheduler tax system. This shifting had been taken by the government with the several reasons including 1) to reduce administrative burdens for the taxpayers and tax offices as well, 2) to make tax collection simpler, and 3) to accommodate the economic and monetary developments.

Starting in 1994 income tax reform, certain incomes such as income from shares traded in the stock exchange and income from transferring of land and buildings are taxed separately with different tax rates and mechanism. Then, in the 2008 tax reform, the lists of incomes that are taxed separately become longer. Nowadays, the lists of income include interest income paid by cooperatives to their individual members, lottery prize, venture capital funds' incomes from the transfer of partner company' shares, incomes received by construction companies and real estate companies, land and building rental income, bond interest income, and income received by certain small size businesses.

Besides the regulation reforms, Indonesia has also embarked on tax administration reform aiming to improve the effectiveness of the tax offices' operations so that tax revenues can be increased sustainably. The 2001-2008 tax administration reform has changed the organization structure of Indonesian's tax offices from the tax base to the functional base organization structure segmented with the taxpayers' size; large, medium, and small taxpayers. The changes on the tax office organization structures are conducted simultaneously with changes in the organization culture, ethics and the working procedures.

The tax organization structure changes are not particular to Indonesia. McCarten (2006) observed that it has been a trend in the last decades that countries changed their tax organization structure from the tax base organization to the functional base organization, and he argued that changing organizational design was the key to effective tax administration reform.

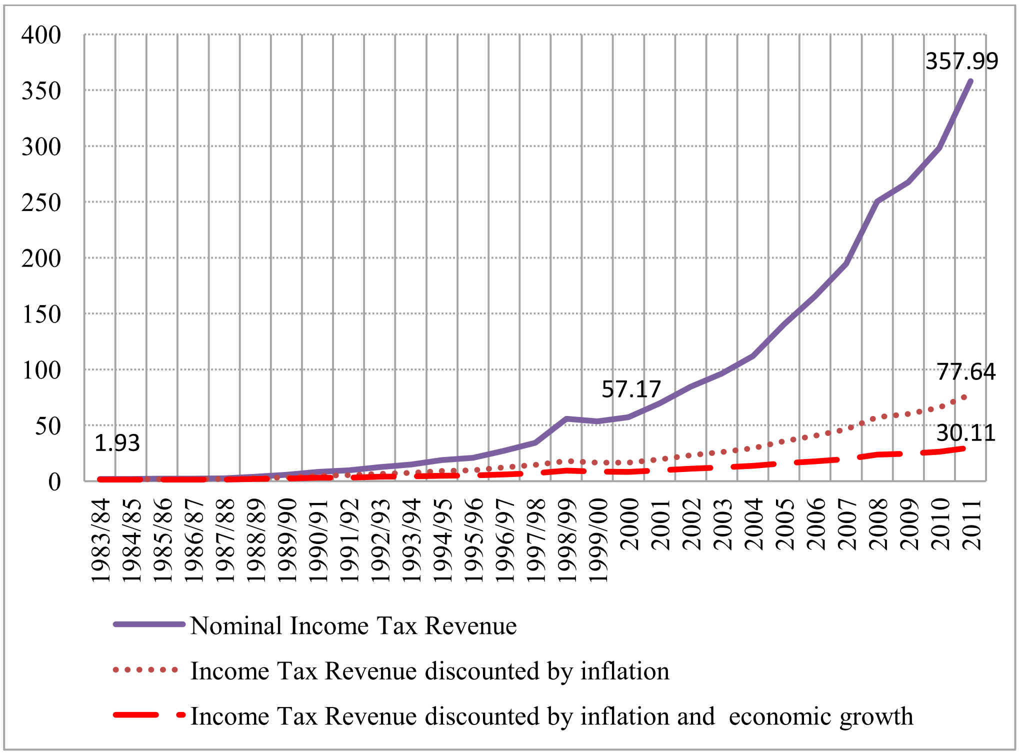
Finally as a summarize of the discussion above, the government of Indonesia has conducted five income tax regulation reforms and one tax administration reform in the period of 1983-2011 as efforts to improve the equity, certainty, simplicity, efficiency, neutrality, economic growth and tax revenues. The tax regulation reforms have crafted the direction of the Indonesian income tax development which are 1) there was the decreasing trend of income tax rates, 2) the income tax bases became broader, and 3) the tax collection system have gradually moved from comprehensive tax system toward schedular tax system. Then, tax administration reform has changed the organization structure of Indonesian's tax offices from the tax base to the functional base organization structure segmented with the taxpayers' size and planted with organization values and code of ethics.

2.3. Income Tax Revenues and the Tax Reforms

As previously mentioned, in the period of 1983-2011, Indonesia has conducted five tax regulation reforms which primarily aimed to increase income tax revenues. The fundamental one was taken in the year 1983, and the four piecemeal regulation tax reforms have been conducted in year 1991, 1994, 2000, and 2008. Beside regulation reforms, Indonesia also has embarked on tax administration reform during 2001-2008. To assess the impact of the tax reforms on the income tax revenues, this dissertation uses two parameters; income tax revenues and income tax ratios during 1983-2011.

To begin with, Figure 2.1 shows that during 1983-2011 the income tax revenues have increased significantly in nominal term from Rp1.93 trillion in 1983/84 to Rp357.99 trillion in year 2011 or in other words it was folded more than 185 times in the last 28 years. In Figure 2.1, we can see that after the 1983 tax reform, income tax revenues have steadily increased year by year, except in 1999/00 in which the income tax revenue was lower than the previous year. However, in overall, in the period of 1983/84 to 2000 the income tax revenues grew substantially from Rp1.93 trillion in 1983/84 to Rp57.17 trillion in 2000 or in average it has grew 23.3 percent annually. The positive trend has continued to the current state, in the period of 2000-2011, the income tax revenues have increased considerably from Rp57.17 trillion in 2000 to 357.99 trillion in 2011.

Figure 2.1: Nominal Income Tax Revenues and Income Tax Revenues Discounted by Inflation and Economic Growth 1983/84-2011 (in trillion Rp)



Source: The discounted income tax revenues are writer's calculation based on:
a. Nominal income tax revenues data are from government financial notes
b. Inflation data and economic growth are from the World Bank

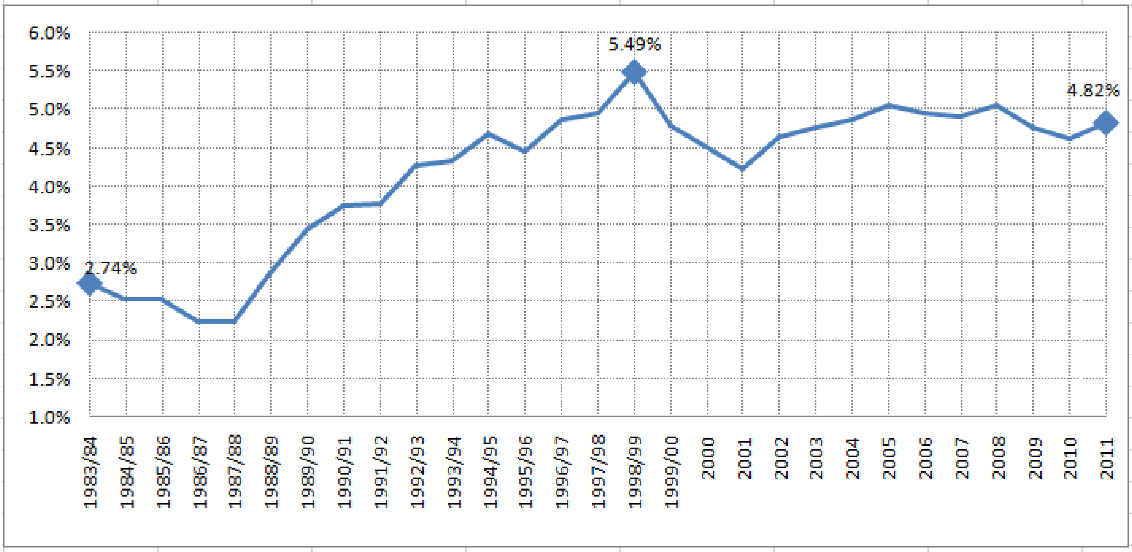
The positive trend of the Indonesian tax revenues in nominal term indicates that the income tax reforms during 1983-2011 have succeeded in achieving the goal to increase tax revenues. However, using nominal tax revenue as a parameter to assess tax reforms contains a weakness as it does not put into account the inflation and economic growth factors which also affect the amount of tax revenues collected, especially in a country with relatively high inflation rate and economic growth such as Indonesia.

Therefore, in the next part, this dissertation elaborates the data of income tax revenues by putting into consideration both the inflation rates and economic growths. First, in order to clear out the effect of inflation on the development of Indonesian income tax revenues, the data will be discounted with inflation. Second, to clear out the effect of both inflation and economic growth on the development of Indonesian income tax revenues; the nominal tax revenues will be discounted by inflation and economic growth.

Figure 2.1 shows that if the inflations are put into consideration the income tax revenue increases during 1984-2011 will be 45.9 times from Rp1.93 trillion in 1983/1984 to Rp77.64 trillion in 2011. This increase is much lower compared to the 185 times increase in nominal term. Then if the inflation and economic growth are put into consideration, the increases of the income tax revenues became much more moderate as shown by the dashed line in the Figure 2.1, the 2011 nominal tax revenue Rp357.9 trillion will reduce to Rp30.1 trillion if economic growths and inflations are put into consideration. Similarly, the average of annual growth of the income tax revenues downed to 12.11 percent compared to 22.13 percent average growth in nominal term. Likewise, the income tax revenues only folded about 19 times in the period of 1983/84-2011 compared to about 185 times in nominal term. Therefore, based on this data, it can be argued that the tax reforms are not the only reasons for the steep increase of the tax revenues, but Indonesian's high inflation rate and high economic growth were the factors that influences why the income tax revenues increased significantly.

The second parameter that will be discussed to assess the outcome of the tax reforms is the development of income tax ratio. The income tax ratio measures the income tax system's ability to generate revenues relative to gross domestic product. Figure 2.2 presents the development of the Indonesian's income tax ratios during 1983/84 to 2011. We can see that, despite the fluctuation, the tax ratios have moved in a positive trend. Based on the trend, the tax ratio movement can be divided into two periods; 1983/84 to 1998/99 and 1998/99 to 2011. The income tax ratios have increased higher in the first period than the second period. In the first period, the income tax ratio increased from 2.74 percent in the beginning of the 1983/84 budget year to 5.49 percent at the end of 1998/99 budget year. Then in the second period 1998/99-2011, the tax ratios tended to move flatly. On average, the tax ratio in the second period was 4.82 percent. Furthermore, in the recent years, income tax ratios were in upswing line after the decreased in year 2009 and 2010. The income tax ratios increased from 4.63 percent in 2010 to 4.82 percent in 2011.

Figure 2.2: Income Tax Ratio 1983/84-2011



Sources: Income tax ratios are writer's calculation (excluding income tax on oil and gas);
Income tax revenues data are from Indonesian Government Financial Notes and National Budget;
GDP data are from Indonesian Government Financial Notes, National Budget and Economy and Finance Statistic of Indonesian central bank.

The movement of the Indonesian's income tax ratios affirms that the increases of the tax revenues are affected not only by the tax reforms but also by the enhancement of Indonesian's gross domestic product. Therefore, even though the tax revenues have increased significantly in nominal term, the income tax ratios do not increase accordingly. This condition is a challenge and opportunity for Indonesia.

The current Indonesian's income tax ratio (4.82 percent in 2011) was relatively low compared to the international practice. As a comparison, the lowest income tax ratio in the OECD countries in 2010 was held by Mexico at 18.85 percent. In addition, five countries with the highest income tax ratio have the ratio more than 40 percent. They were Denmark with 47.6 percent, Sweden 45.52 percent, Belgium 43.51 percent, Italy 42.92 percent and Norway 42.90 percent. [1]

Furthermore, as the income tax is one of the main sources of the Indonesian tax revenues, its performance significantly determines the performance of tax revenues collection in a whole. Therefore, the low level of Indonesian's income tax revenue compared to gross domestic product eventually has brought down the Indonesian's tax ratio. In 2011, Indonesian's tax ratio

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[1] OECD's Revenue Statistics-Comparative Tables. Retrieved from http://stats.oecd.org/Index.aspx?QueryId=21699

was 11.77 percent, which was the lowest tax ratio among the five biggest economies in the South East Asian Countries (Indonesia, Thailand, Malaysia, Singapore, and Vietnam).

Based on the discussions above, it can be summarized that the income tax reforms have positive effects on the increase of income tax revenues. The income tax revenues in nominal term have reached more than 185 times in the period of 1983/84-2011. However, the significant increases of the nominal income tax revenues were influenced more by the Indonesian high inflation rates and economic growth. Data shows that if the income tax revenues are discounted by inflation and economic growth, the steep increase of the income tax revenues become much moderate in which the income tax revenues grew at 12.11 percent annually and reached 19 times in the period of 1983/84-2011. Furthermore, in term of income tax ratio, Indonesian income tax ratio was increased but despite its improvement still it is far below the international practice.

2.4. Improving the Income Tax's Performance

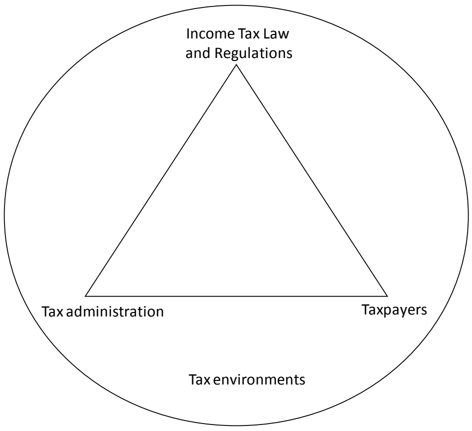
The Indonesian's low income tax ratio can be interpreted from two perspectives. In one perspective, it indicates that there is a need to fix the problems of the current income tax system but in another perspective, low income tax ratio can be seen as a blessing for Indonesia as it gives a hope that income tax revenue has a potential to be increased further. In improving income tax system, there are wide range areas in which the improvements can be made. The improvements might be made on the area of tax law, tax regulations, law enforcement, tax services, tax authorities' professionalism, tax organization structure, tax information system, public tax awareness, public trust, government governance practices, and many other options that can be made endlessly.

Therefore, in order to map in a more systematic way which part of income tax system that may need more attentions in efforts to raise income tax revenues, this dissertation introduces a simple model of income tax as shown in Figure 2.3. The model divides income tax system into four areas: income tax laws and regulations, tax administrations, taxpayers, and tax environments.

As previously discussed, in the period of 1983-2011 Indonesia have conducted five income tax reforms which dwelled on the efforts to refine tax law and regulations so that the tax law and regulation can catch up and accommodate the changes in where the tax system exists. The provisions of income law and regulations concerning the objects, the subjects of income tax, tax rates, tax incentives, and collection system have been changed and amended several times, in order to achieve the target of income tax reforms which mainly will encircle the issue of how to increase tax revenues. These changes, if we look at the model of income tax system introduced in the Figure 2.3, are fallen in the area of income tax law and regulations.

Furthermore, besides the regulation reforms, Indonesia have also embarked on tax administration reform during 2001-2008 in which one of the results was the changes of the Indonesian tax office organization structure from the tax base to the functional base organization structure. If we look at Figure 2.3, the changes on the organization structure are fallen in the area of tax administration. As for the other two areas of income tax system; the tax payers and tax environment got less attention this far in the Indonesian income tax reforms.

Figure 2.3: A Model of Income Tax System



Source: Writer

The income tax reforms that have been taken place in Indonesia gives a lesson learnt that, among several available options of future tax reform, taking another tax regulation reform to increase tax revenue might be not the best choice in the current time as the room to lift up income tax revenues significantly through regulation reform has become limited. It is because in tax regulation reform, there are two primary approaches that can be taken to increase tax revenues: tax rate increase and tax base expansion. Both of them have their own difficulties to be implemented in Indonesia for the current time. Tax rate hike policy may not only raise resistance from the public but also may make Indonesia less attractive for foreign investments as income tax rate cut is a trend around the world. Likewise, tax base expansion become difficult to be implemented in Indonesia as almost all any potential tax subjects and tax objects have been covered in the current income tax legislation.

Therefore, the future efforts to increase income tax revenues have to be brought to other areas of income tax system rather than the area of income tax law. Observing the current Indonesian's condition, there are two prominent issues related with the efforts to increase income tax revenues that are interesting to be discussed: public tax awareness and compliance, and the professionalism and integrity of tax authorities and other bureaucracies.

Public tax awareness has been a persistent problem in Indonesia as reflected from its remain low numbers of registered taxpayers. For instance, in year 2011, there were 19.9 million registered individual taxpayers[2] out of 108 million employment people (BPS, 2011). This figure shows that a large portion of Indonesian society did not comply with the tax regulations which require people who earn incomes to register themselves to tax offices. This is surprising as penalty consequences for those who do not register themselves are quite severe. Tax law regulates that taxpayers who willfully do not register themselves shall be punished with 6 months up to 6 years imprisonment, and a fine of at least 2 times but no more than 4 times of the amount of tax payable that are not paid or under paid.

Furthermore, to improve public tax compliance requires a fine combination of persuasive and repressive approaches over a sustained period of time. Both approaches have positives and negatives. The persuasive approaches are relatively cheap but they might be not scares enough for those who deliberately want to evade paying taxes. On the other hand, the repressive approaches have deterrence effects but they have limitations in the scope of taxpayers that can be audited and investigated due to the limitation of the resources of tax offices. Therefore, to address the segment of people who are still in the tax-unknowledgeable level, persuasive approach is more favorable than the repressive one and to the segment of people who already have understanding about taxation but consciously avoid paying taxes repressive approach will be more suitable than the persuasive one.

In the case of Indonesia with its huge number of unregistered taxpayers, persuasive approaches to increase public tax awareness and tax revenues are needed, particularly as the ability of tax offices to conduct tax audit and investigation are limited. As a picture, in 2011, number of tax audits completed was so small compared to number of taxpayers; it was 39,644[3] or 0.18 percent of total taxpayers.

Furthermore, efforts to increase public tax awareness should be tailored depending on the segment of people being targeted. For instance, to address general people as a starting point, the government should set up measures to plant the understanding about the importance, benefits and the role of taxation to the people. Then at a higher level, a more detail tax knowledge should be spread according to the need of each segment of taxpayers in order to make them able to fulfill their obligations in accordance with tax law and regulations.

[2]2011 DGT Annual Report page 128
[3] 2011 DGT Annual Report page 66

Another issue of Indonesian tax system is related to the tax authorities' professionalism and integrity which determine the successful of tax law and regulations implementation. The issues of corruption have been reiterated many times since the 1983 tax reform. However, the problem still exists though the spread of corruptions becomes narrower lately. In the 2001-2008 tax administration reform, several measures have been taken to improve tax employees' integrity and professionalism such as raising the remuneration, introducing code of conducts, organization values, strengthening internal control, improving the transparency of operating procedures, and establishing internal audit unit. The results are quite convincing. For instance, a survey conducted by ACNielsen in 2005 (during the tax reform process) showed that the taxpayer's satisfaction index in large tax offices reached 81 point. The achievement was encouraging because at that time tax offices were perceived as corrupted institutions and more surprisingly the achievement was able to surpass the public satisfaction level in countries that were considered have better public services such as Australia (74), Hong Kong (71), India (78), and Singapore (76). Then in 2010, Indonesian Corruption Eradication Commission gave a score 9.82 out of 10 scale for the tax offices' initiative to promote anticorruption. Recently, in 2013, the tax offices received the acknowledgment from one research institution as one of the most trusted government unit in Indonesia.

However, despite the improvement, several corruption scandals mostly in the form of bribery and extortion still occurred. In 2011-2012, Indonesian corruption eradication commission has arrested several tax employees on corruption cases that widely draw people's attention. These cases for some extent have spoiled the people's trust toward tax offices that some people urge taxpayers to boycott tax payments. Looking at the adverse impact of corruption cases to the public trust and the eagerness of people to pay taxes voluntarily, the efforts to curb or deter corruptions in tax offices have to be continued and strengthened.

Moreover, to gain public trust, the implementation of good governance practices should not be limited to the tax offices because public trust is a result of the actions, attitudes, and performances of all government units which influence people's compliance toward law (Torgler, 2007). Therefore, it will be less effective if the improvement in professionalism and integrity only limited on the tax offices as people also demand good services from other government units, and assurances that tax money are collected fairly and disbursed appropriately. Improvement in bureaucrats' services, the availability of public goods and services such as on the fields of education, transportation, and health will flourish people's eagerness to pay taxes.

Based on the discussions above, it can be concluded that in order to increase income tax revenues, it would be better for the government to improve other elements of the tax system rather than taking another tax regulation reform. Improvement in the area of public's tax awareness, tax authorities' integrity and professionalism, the implementation of governance practice in various Indonesia's bureaucracies, and the consistency in implementing the tax law will be essential to increase income tax revenues.

2.5. Conclusions

In the period of 1983-2011, Indonesia has conducted five income tax regulation reforms which primarily aimed to increase income tax revenues. The fundamental one was taken in the year 1983, and four piecemeal regulation tax reforms have been conducted in year 1991, 1994, 2000, and 2008. Beside regulation reforms, Indonesia also has embarked on tax administration reform during 2001-2008.

The above tax reforms have crafted several characteristics on the development of Indonesian income tax system. Firstly, the tax reforms have embraced income tax rates decreased. For instance, the highest corporate income tax rate reduced from 35 percent in the tax year 1984 to 25 percent in the tax year 2010. Secondary, the tax reforms have widened the income tax base by expanding the incomes that fall into the categories of taxable incomes. Thirdly, the tax reforms have gradually moved the tax collection system from comprehensive income tax system toward schedular tax system.

The income tax reforms have positive effects on income tax revenues; however, they were not the main factor of the steep increase of tax revenues. This dissertation shows that Indonesian's relatively high inflation rates and high economic growth during the period of 1983/84 -2011 have significantly contributed in the steep increase of the income tax revenues. As a consequence, even though there was a steep increase of nominal income tax revenues, Indonesian's tax ratio remains low.

Finally, studying from Indonesian income tax reforms, it can be learned that having a sound income tax law and regulations is a foundation to generate optimal income tax revenues. However, in reforming income tax system, it is also equally important to improve other elements of income tax system including the taxpayers, tax administration, and tax environment. In the case of Indonesia, improving public tax awareness, tax authorities' professionalism and integrity, and governance practice in various Indonesian's bureaucracies will be essential to increase income tax revenues.

Chapter 3

Taxation on Capital Market:
The Imbalance Tax Burden Issue of Indonesian Capital Gains Tax on Shares Traded in the Stock Exchange

3.1. Introduction

Indonesian's capital market has grown significantly in the last two decades. In year 2011, market capitalization reached Rp3.537 trillion placing the ratio of market capitalization to gross domestic product to stand at 47.68 percent[1]. As the size of the stock exchange becomes substantial, the taxation aspects of the market, including the tax burden balancing issue between people who earn incomes from the real sectors: industries, trading, and services (ordinary income earners) in one side, and capital gains earners in another side, become a concern for many including policy makers as it is not only affects the fairness of a tax system but also may affect capital allocation in Indonesian economy. Furthermore, imbalance tax treatments between the real sectors represented by ordinary incomes tax treatments and the capital market represented by the tax treatment on the capital gains on shares traded in the stock exchange has put taxation in un-neutral position that a sound tax system should strive to avoid.

The imbalance tax burden between the real sectors and the capital market does exist as a result of different tax treatments imposed on each of them. Definitely, this is not particular to Indonesia. The practices are widespread around the world, and this phenomena cannot be entirely separated from a whole picture of tax treatments on capital gains, which covers a wide spectrum of capital gains such as capital gains from lands, building, machinery, precious metals and financial assets, in which people have different views in how to treat them.

Some people support capital gains taxes, but the others challenge them. The adversaries of capital gains taxes mainly contend that capital gains taxes do not support economic growth as they discourage people to make investments (e.g., Campbell, 2009; Lucas, 1990). On the other hand, the advocates of comprehensive income tax system see from another perspective. They argue that taxing capital gains equal with other kind of incomes is needed to maintain the fairness of a tax system (Haig-Simons as cited by OECD, 2006). Then, in another spectrum,

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[1] $\dfrac{\text{2011 market capitalization}}{\text{2011 gross domestic product}} = \dfrac{3{,}537{,}294.2 \text{ billion}}{7{,}419{,}187.1 \text{ billion}} = 47.68\ \%$

Sources:

- 2011 market capitalization from Statistik Pasar Modal 17-21 September 2012 [the Capital Market Statistic Sept 17-21, 2012] page 14, the Ministry of Finance of Republic Indonesia.
- 2011 gross domestic product from Indonesian Bureau Statistic

some other people took a moderate view as they believe that capital gains should be taxed but the taxes should be different with the taxes on the ordinary incomes. They consider that capital gains are different with ordinary income in nature so that in taxing capital gains, several adjustments are needed to bring them on a par with the taxes on ordinary income.

The difference views on how to tax capital gains[2] also occur in Indonesia as it can be seen in the Indonesian's capital gains tax policy changes. In 1984, policy makers chose a policy to tax the capital gains arising in the stock exchange similar with the ordinary incomes. Then, in 1995, policy makers switched the policy by taxing capital gains separated from ordinary incomes. Surely both policies have their own merits and demerits, and effects on tax burden differences between the capital market and the real sectors which eventually may influence investment decisions.

Furthermore, in relation to investment decisions, it is generally accepted that when several possible investment choices including the choices between investing in the real sectors and investing in the stock exchange are given, people tend to choose the one which gives a higher expected return assuming that all of the investment choices have the same level of risk. As the expected returns are affected by taxes, it is plausible to think that the high tax burden gap between the real sectors and the capital market might influence investment decisions which eventually might affect capital allocation at national level.

Therefore, studies to analyze the tax burden differences created by the capital gains tax policy will be beneficial not only for investors in making investment decisions but also for policy makers in reshaping a policy that promotes a level playing field[3] for the stock exchange and the real sectors. In the case of Indonesia, creating a level playing field is worth to be considered particularly for the current time in which Indonesian's stock market has been mature enough to compete with the real sectors. However, thus far, study on the Indonesian's capital gains tax policy and its impact on the tax burden differences cannot be found.

Based on the discussions above, the aim of this study is threefold. The first is to elaborate the Indonesian tax policies on capital gains from year 1984[4] to 2011, and to locate the position of the Indonesian's current capital gain tax policy compared to international practices. The second is to analyze the development of the Indonesian's stock exchange after the implementation of the 1995 capital gains tax policy. The third is to estimate the tax burden

[2] For the rest of this dissertation, the terms "capital gains" and "capital gains arising from shares traded in the stock exchange "will be used interchangeably to refer to "capital gains arising from shares traded in the stock exchange".
[3] A playing field is said to be level in taxation if taxes do not influence people's decision whether to invest in the real sectors or in the stock exchange.
[4] In year 1984, Indonesia embarked in a fundamental tax reform in which the tax structures were changed and the self assessment tax system was introduced.

discrepancy between real sector and capital market during 1995-2011 and discuss the merits and demerits of the 1984 and the 1995 capital gains tax policies.

Finally, the rest of this chapter is organized as follows. Section 3.2 provides an overview of the capital gains tax treatments in several countries. Section 3.3 describes the development of Indonesian's capital gains tax policies. Section 3.4 explores the Indonesian stock exchange development, capital gains tax policies, and tax revenues. Section 3.5 discusses the tax burden discrepancy, the merits and demerits of the 1984 and the 1995 capital gains tax policies, and policy implications. Section 3.6 contains conclusions.

3.2. Capital Gains Tax Treatments

Various tax treatments concerning the capital gains arising in the stock exchange are implemented around the world, ranging from exempting the capital gains to taxing them similar with those of ordinary incomes. In practical, the differences among capital gain tax treatments can be roughly clustered into four areas. The first area lies on the owners or recipients of the capital gains; several countries differentiate the tax rates for capital gains received by individual taxpayers and corporate taxpayers. The second is on the holding period; some countries treat short term and long term capital gains differently. The third area is on the number of shares; some countries have different capital gains tax treatments based on the substantiality of shares holding. The next difference is on the tax base; some countries tax the capital gains based on the gains, but the others imposed the tax based on the sales value.

Table 3.1 shows the varieties of tax treatment on capital gains in six member countries of ASEAN plus five Asian countries/tax jurisdictions with big stock exchanges for the tax year 2011. Indonesia and Philippines use sales price instead of gains as a tax base, though the tax rates are different; Indonesia imposes 0.1 percent and Philippines imposes 0.5 percent. Then, Vietnam uses two tax bases; the sales price and the gains. In the case of recipients, Japan and China apply different tax rates on capital gains received by individuals and capital gains received by corporate. Furthermore, India exempts long-term capital gains but taxes the short term capital gains. Korea treats unsubstantial and substantial shares holding differently. It exempts the capital gains arising from unsubstantial shares holding and taxes the substantial stock holdings; the tax rates are 20 percent and 30 percent based on the holding periods. Meanwhile, Hong Kong, Malaysia, Singapore, and Thailand exclude the capital gains from their taxation net. However, in the case of Malaysia and Singapore, apart from the capital gains exemption, there are 0.3 percent and 0.2 percent stamp duty imposed on the stock buyer respectively.

Table 3.1: The Maximum Tax Rates on Ordinary Incomes and the Tax Rates on Capital Gains Arising from Shares Traded in the Stock Exchange for the Tax Year 2011

No.	Country	Ordinary Incomes		Capital Gains on Stock Traded in the Stock Exchange
		Individuals	Corporates	
1	Indonesia	30%	25%	0.1% of the sales price.
2	Malaysia *	26%	25%	Exempt.
3	Philippines	32%	30%	0.5 % of the sales price.
4	Singapore *	20%	17%	Exempt.
5	Thailand	37%	23%	Exempt.
6	Vietnam	35%	23%	0.1% of the sales price or 20% of the net gains.
7	China	45%	25%	20% for individuals; 25% for corporates.
11	Hongkong	15%	16.5%	Exempt.
9	India	30%	32.45%	15% for short term; Exempt for long term.
10	Japan	50% **	38.01% **	10% of net gains for individuals; 38.01% for corporates.
11	Republic of Korea	38%	24.20%	Exempt. 20% for short term and 30% for long term if: > holding 3% of shares capital, or > 10 billion won of total market value.

Source: KPMG, Deloitte, and other sources.
Note: *) Malaysia and Singapore impose 0.3% and 0.2% stamp duty respectively.
**) Japan's tax rates include prefectural and municipal's taxes on incomes.

Despite the varieties on capital gains policies, it still can be seen that all of the countries listed in the Table 3.1 implement capital gains preferential tax treatment in which they tax capital gains less than ordinary incomes; the difference lies on the significance of preferential tax treatment. For instance, in Indonesia, capital gains are taxed at 0.1 percent of the sales price while the ordinary incomes are taxed progressively and the highest rate for individuals is 30 percent of the net taxable income; in China, capital gains are taxed at 20 percent for individuals while the maximum individual tax rate for ordinary incomes is 45 percent.

Furthermore, from the Table 3.1, we can see that Indonesian's capital gain tax rate is relatively low that it is almost similar with those of in the countries which exempt capital gains from their tax net. Comparing to neighboring countries such as Singapore, Malaysia who are known as "free capital gains tax regime", the total taxes (capital gains plus stamp duty) imposed on shares traded in Singapore and Malaysia are even higher than the total taxes imposed in Indonesia. In this sense, there is a paradoxical situation in which Indonesia as capital gain tax regime taxes stock transactions in the capital market less than countries which choose not to tax capital gains.

3.3. The Development of Indonesian Capital Gains Tax Policies

In Indonesia, the taxing of capital gains and ordinary incomes are regulated under the provisions of the income tax law that came into effect in January 1, 1984 as a part of a package of tax laws introduced in the 1983 Indonesian tax reform. At the beginning period of the 1983 tax reform, both capital gains and ordinary incomes were taxed progressively as one unit of income. However, the policy was changed in year 1995 in which capital gain on shares traded in the stock exchange was taken out from the basket of the comprehensive income. Since then capital gain has been taxed separately. This policy change marks a new era of capital gains tax in Indonesia as it may divide Indonesian taxation period into two periods: a) 1984 to 1994 and b) 1995 to 2011 (the current state).

Table 3.2: The Development of Tax Policies Regarding the Capital Gains on Shares Traded in the Stock Exchange

1984-1994	1995-2011	
	Year 1995 to April 1997	May 1997 to 2011
Capital gains arising from stock transaction in the stock exchange are taxed similarly with ordinary incomes.	Capital gains arising from stock transaction in the stock exchange are taxed at 0.1 percent of sales price and 5 percent additional tax is applied for founder shares.	Capital gains arising from stock transaction in the stock exchange are taxed at 0.1 percent of sales price and 0.5 percent additional tax is applied optionally for founder shares.
Self assessment system.	Withholding tax system, however, taxpayers have to report stock transactions in the annual income tax returns.	

Source: article 4 of the Law of the Republic of Indonesia Number 7 of 1983, article 4 paragraph 2 of the Law of the Republic of Indonesia Number 10 of 1994, Government Regulation Number 41 of 1994, and Government Regulation Number 14 of 1997.

Table 3.2 shows the summary of tax treatments on capital gains arising in the stock exchange after the 1983 tax reform to the year 2011. In the first period (1984-1994), the 1983 Income Tax Law, for some degrees, followed a comprehensive income tax system; all types of incomes were taxed as one unit whether they were ordinary incomes or capital gains. This is reflected from the 1983 Income tax law's definition of incomes which covers "any increase in economic capability that are received or accrued by a taxpayer, whether originating from Indonesia or from abroad, in whatever name or in whatever form, that can be used for consumption or to increase wealth, including … d) gains from selling of an asset"[5]. However, the implementation of the comprehensive income tax system was not without exceptions. One exception was made on savings interests; in year 1984 the government exempted savings

[5] See Article 4 Paragraph 1 of the Law of the Republic of Indonesia Number 7 of 1983 concerning Income Tax.

interests from income tax in order to boost public savings[6] aimed as a source of funds for investments.

The following example illustrates a tax calculation for a corporate taxpayer who earned capital gains and ordinary incomes during 1984-1994. ABC Corporation, in its fiscal adjusted income statement for the year 1990, recorded: 1) net operating income Rp60.000.000, 2) dividend Rp100.000, and 3) Rp300.000 gain on shares traded in the stock exchange. As a note, in 1990, progressive tax rates were imposed on corporate taxpayers. Thus, the ABC Corporation's tax payable would be:

Net operating income ………………………………….. Rp60.000.000
Dividend ………………………………………….… Rp 100.000
Gain on shares traded in the stock exchange ………… Rp 300.000
Taxable income ……………………………………….. Rp60.400.000
Tax payable:
Rp10.000.000 x 15% = Rp 1.500.000
Rp40.000.000 x 25% = Rp10.000.000
Rp10.400.000 x 35% = Rp 3.640.000
Tax payable ………………………………………. Rp15.140.000

From the calculation above, it can be seen that the capital gains' tax rates implicitly depend on a taxpayer's level of ordinary incomes. If ordinary income reaches the third income tax bracket, then the capital gains will be taxed at 35 percent and if it is in the first bracket, then the capital gains will be taxed at 15 percent. Thus, under the 1983 income tax law, capital gains could be taxed at 0 percent, 15 percent, 25 percent or 35 percent depend on a taxpayer's level of incomes.

In the second period (1995 to 2011), capital gains on shares traded in the stock exchange are taxed separately (the 1995 capital gains tax policy)[7]. Taxpayers who sell shares in the stock exchange pay 0.1 percent tax based on the sales value, and for the founder shares there was an additional 5 percent tax.

Later on, in relation with the founder shares, in May 1997, the government reduced the tax rate from 5 percent to 0.5 percent, and the imposition was optional. Optional means that taxpayers can choose whether to pay the additional 0.5 percent tax, or they may just skip them. If they choose to pay the additional 0.5 percent tax, then, they have to pay them at the latest one

[6] See Government Regulation of the Republic of Indonesia Number 37 Year 1983 regarding Income Tax on Interests of Savings Deposits and other-Savings.
[7] See Government Regulation of the Republic Indonesia Number 41 Year 1994 regarding Income Tax on Income from Sale Transactions in Stock Exchange.

month after the initial public offering[8]. Otherwise, they have to pay taxes on capital gains at the same rate as ordinary incomes when the capital gains are realized.

The following examples illustrate the tax calculations under the 1995 capital gains tax policy. Example 1: On November 1, 2011 taxpayer A purchased 1,000 shares of XYZ Corporation at Rp1.500 per share. He/she sold them on November 2, 2012 at Rp1.600 per share and made Rp100.000 profit. Upon this transaction, he/she had to pay capital gains tax Rp1.600.000 x 0.1%=Rp1.600.

Example 2: On November 2, 2011 taxpayer B purchased 1,000 shares of XYZ Corporation at Rp1.600 per share. He/she sold the shares on Dec 3, 2012 at Rp1.400 per share and made Rp200.000 losses. Even though, in this transaction taxpayer B was in loss, he/she still had to pay "capital gain" tax Rp1.400.000 x 0.1%=Rp1.400.

Besides the tax rate and the tax base changes, the 1995 capital gains tax policy made a fundamental change in the tax assessment system. Previously, the capital gains earners fulfilled capital gains tax through pure self tax assessment system meaning that they calculate the amount of tax payables, pay the taxes and submit tax returns by themselves. The system was changed to the withholding tax assessment system, in which, the stock exchange was pointed as the tax withholder which is responsible to withhold and deposit the taxes.

3.4. The Indonesian Stock Exchange Development, Capital Gains Tax Policies, and Tax Revenues

Indonesian stock exchange's development can be traced back to the Dutch colonial era. In which, on December 14, 1912, *Amsterdamse Effectenbuers* established a stock exchange branch in Jakarta, Indonesia (Bapepam 1999). However, in the earlier year of independence, the stock exchange became inactive and even for several years it has been closed. On August 10 1977, the Indonesian government reactivated the market with two purposes; distributing incomes to a wider people through public shares ownership and raising capitals from the public so that the financing sources do not depend merely on the banking sector[9]. However, not until 1987 when government issued several policy packages to vigorous the market, the Indonesian stock market has increased significantly (Cole 1992). Several key points of the policy packages were 1) allowing foreign investors to buy maximum 49 percent of total stock emission, 2) imposing 15

[8] See Government Regulation of the Republic Indonesia Number 14 Year 1997 regarding the changing on Government Regulation Number 41 Year 1994 regarding Income Tax on Income from Sale Transactions in Stock Exchange.

[9] See the Financial Government Note 1978-1979 page 60.

percent tax on savings interests[10], and 3) allowing the establishment of private securities exchanges. Then various measures, in the following years, such as automatic trading system in 1995, script-less trading in 2000, and remote trading system in 2002 also contributed to the advancement of the stock market.

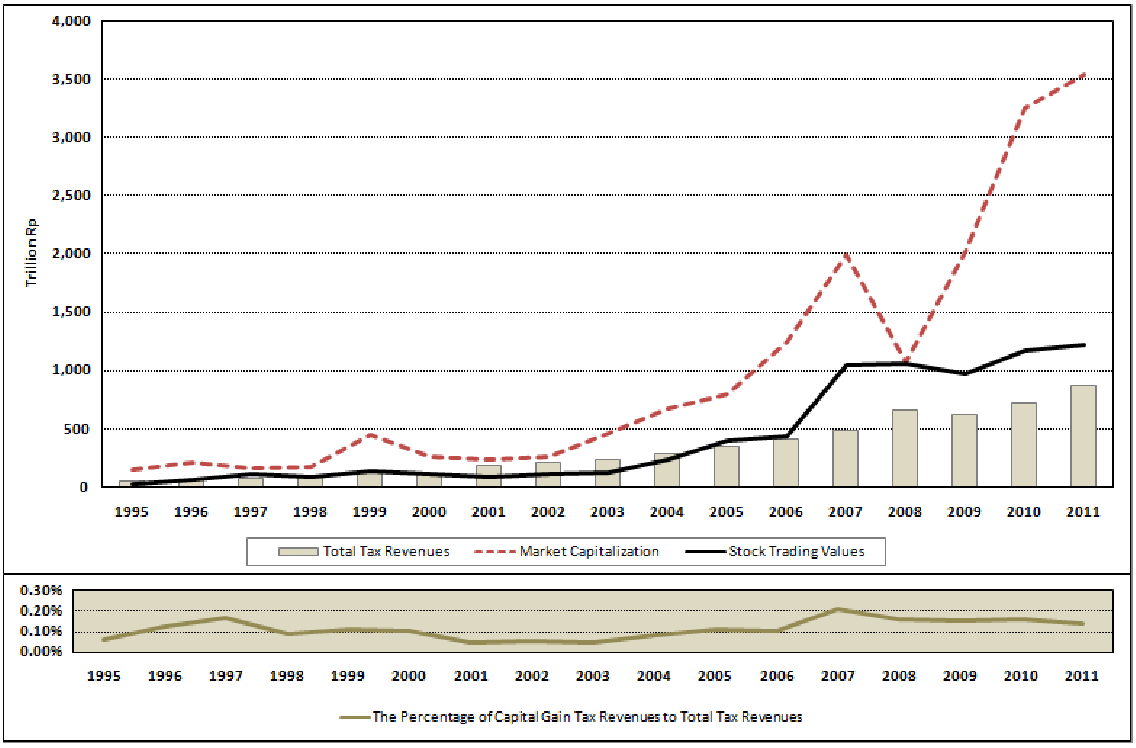
Despite the many factors, tax policies' influences on the stock exchange's development cannot be neglected. The 1995 capital gains tax policy provided a conducive for the stock market to grow through its low tax rate and simple tax procedure. Data shows that, in 1995, the market capitalization grew by 46.6 percent from Rp103.8 trillion to Rp152.2 trillion, and increased further in 1996 by 41.2 percent to Rp215.0 trillion. Similarly, the stock trading values rose by 134 percent from Rp25.5 trillion at the end of 1994 to Rp32.4 trillion at the end of 1995 and increased further to Rp75.7 trillion in 1996. However, the tax policy itself could not help the market to run away from the regional and global crises. The 1997-1998 Asian financial crises also hit the Indonesian stock exchange and plunged the composite index by 25.62 percent in year 1997.

Furthermore, in 2001 in order to collect more tax revenues, government took a further step by increasing the interest tax rate from 15 percent to 20 percent[11]. This policy was taken into consideration that the banking sector has been well established and has enjoyed saving preferential tax treatment for so long. This policy turned out to be a blessing for the stock exchange. The stock exchange has experienced rapid growths since then, and one of the results was the total amount of money invested in the stock exchange was able to surpass the amount of saving in the banking sector. In 2011, the amount of money invested in the stock market (market capitalization) was Rp3.537 trillion while the savings amount in the banking sectors was Rp2.736 trillion.

[10] See the Government Regulation of the Republic of Indonesia Number 13 Year 1988 regarding Income Tax on Interests of Savings Deposits, Certificate Deposits and Savings.

[11] See the Government Regulation of the Republic of Indonesia Number 131 Year 2000 regarding Income Tax on Interests of Savings Deposits, Savings, and Bank Indonesia Certificates.

Figure 3.1: Market Capitalization, Stock Trading Values, Total Tax Revenues, and Stock Trading Tax Revenues 1995-2011(in trillion Rp)



Sources:

- The market capitalizations and the stock trading values data are from the Capital Market Statistic-Bapepam.
- The total tax revenues data are from financial notes and national budgets 2002, 2007, 2011, and 2012.
- The capital gains tax revenues are calculated based on the Government Regulation number 42 Year 1994.

In a whole picture, in the period of 1995-2011, Figure 3.1 shows that despite the market's upturn and downturn, the market has grown significantly. At the end of 2011, the market capitalization reached Rp3.537 trillion or increased for about 34 times from Rp103,8 trillion at the beginning of year 1995. Similarly, total stock trading value also increased significantly. It grew by 47 times from Rp25,5 trillion at the beginning of year 1995 to Rp1.223 trillion at the end of year 2011. This progress has brought the ratio of market capitalization to gross domestic product reached 47.68 percent at the end of 2011, and along with that the amount of money invested in the stock market (market capitalization) has outpaced the savings amount in the banking sectors. All of the figures indicate that the stock exchange was not a minor element of Indonesian economy anymore; it has become an important source of capitals for Indonesian economy.

However, in spite of the stock exchange's significant growth and the tremendous amount of money invested in the stock exchange, the stock exchange's contribution to tax revenues remained insignificant. The lower part of the Figures 3.1 shows that, from 1995 to 2011, the capital gains tax revenues from the stock trading in the stock exchange fluctuated somewhat around 0.07 percent to 0.21 percent of the total tax revenues and in 2011, the tax revenue from the stock trading was only 0.14 percent of the total tax revenues.

3.5. Discussions

3.5.1. The Tax Burden Discrepancy of the 1995 Capital Gains Tax Policy

In this section, this dissertation elaborates the tax burden discrepancies between the capital gains earners and the ordinary incomes earners as the effect of the 1995 capital gains tax policy in two approaches. The first approach explores the discrepancies at micro (individual taxpayer) level by comparing the profit margin imposed on capital gains earners and the deemed profit margin imposed on ordinary income earners. The second approach explores the discrepancies at macro (country) level by comparing tax revenues generated under capital gains provision and tax revenues generated under ordinary tax provisions.

Starting with the first approach, the capital gains' tax rate and tax base are different with the ordinary incomes' tax rates and tax base. The capital gains tax rate is 0.1 percent imposed on the sales value, and the individual ordinary income tax rates are progressive starting from 5 percent at the lowest to 30 percent at the highest imposed on the net income. The difference on the tax base; "sales value" for capital gains and "net income" for ordinary incomes makes tax burden discrepancy comparison between these two kind of incomes cannot be done directly.

However, we can take a round way in order to calculate tax discrepancy by calculating profit margins at which the amount of tax in both schemes; a tax imposed on "sales value" or a tax imposed on "net income" is the same. It can be illustrated by the following transaction, taxpayer A sold a cloth at Rp100.000 and made Rp2.000 profit or in other words he/she made 2 percent profit margin. This transaction can end up with the same amount of tax whether the tax base is the sales value or the net income. First, if we apply the formula of current capital gains tax; 0.1 percent tax on "sales value", then the tax will be 0.1% x Rp100.000 = Rp100. We can read this example as "a taxpayer who made Rp100.000 sale will be taxed Rp100". Second, if we apply the formula of ordinary income; the 5 percent tax on net income, then the tax payable will be calculated as tax rate multiplied by net income or 5% x Rp2.000 = Rp100. We can read this example as "a taxpayer who made Rp2.000 profit will be taxed Rp100". This illustration shows that 0.1 percent tax rate imposed on "sales value" and 5 percent tax rate imposed on "net income" will create the same amount tax if the profit margin is 2 percent.

Therefore, since the tax rates of capital gains and ordinary income cannot be used directly in calculating the tax burden discrepancies, first we need to calculate the profit margins imposed on the capital gains earners then comparing them with the deemed profit margins imposed on ordinary incomes earners. The profits margin imposed on capital gains earners can be calculated as follows:

$$P = C \div O \quad [12] \qquad (1)$$

Where

C = Capital gain tax rate.

O = Ordinary income tax rate.

P = Profit margin.

The formula above is developed as follows. If we look at the illustration in the previous page, taxpayer A will bear the same amount of tax, no matter what formula being applied whether it is based on sales value or based on net income, as long as the profit margin of the transaction is 2 percent. Firstly, based on sales value, tax is calculated as follows; 0.1% x sales value or 0.1% x Rp 100,000= Rp 100. Secondly, based on net income, tax is calculated as follows: 5% x (profit margin x sales) or 5% x (2% x Rp 100,000) = 5% x Rp2000 = Rp100. It shows that we can calculate the profit margins which create the same amount of tax whether the tax is imposed on sales value or on net income.

Based on the equation (1) we can calculate that 5 percent ordinary income tax rate imposed on net income will have the same tax revenue impact with 0.1 percent capital gains tax rate imposed on sales value if the capital gains earners earn 2 percent profit margin. In other words, by taxing capital gains earners at 0.1 percent means that he/she will have the same amount of tax burden with the 5 percent tax rate of ordinary income earners who makes profit 2 percent. Moreover, at 15 percent ordinary income tax rate, the profit margin imposed on the capital gains earners is 0.7 percent. At 25 percent ordinary income tax rate, the profit margin imposed on the capital gains earners is 0.4 percent. Then, at 30 percent ordinary income tax rate, the profit margin is 0.3 percent.

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[12] The formula is developed as the following:

$$R_1 = R_2$$
$$C \times S = O \times (S \times P)$$

Where

R_1 = Tax revenues under the capital gains provisions.

R_2 = Tax revenues under the ordinary incomes provisions.

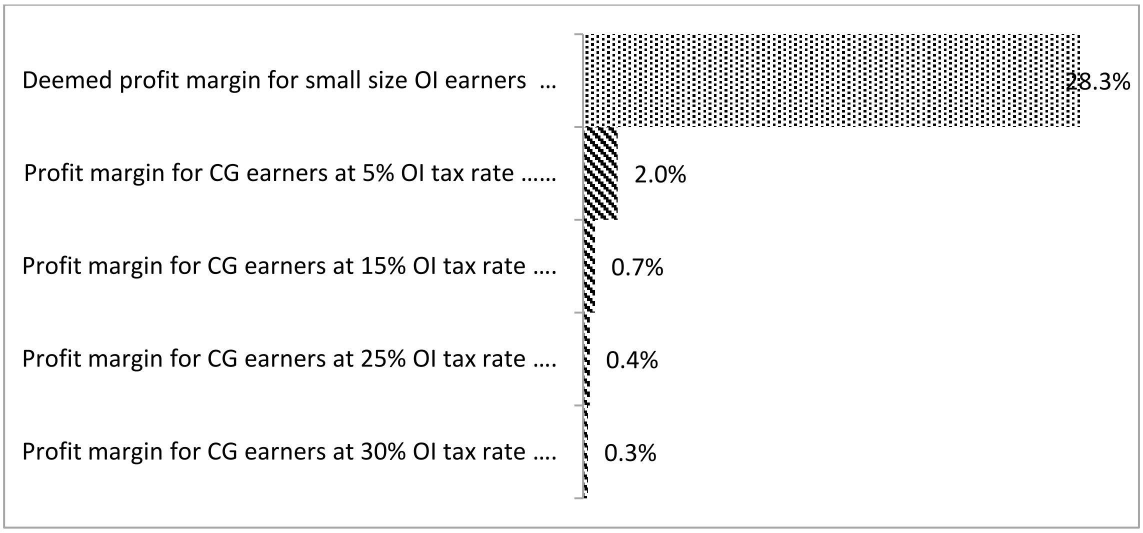
C = Capital gains tax rate.

S = Sales.

O = Ordinary income tax rates.

P = Profit margin.

Figure 3.2: The Comparison of Deemed Profit Margin Imposed on Ordinary Incomes Earners and Profit Margins Imposed on Capital Gains Earners



Source: writer's calculation based on the Director General of Taxes Decree number 536/PJ./2000, and Government Regulation Number 41 Year 1994

Figure 3.2 portrays the comparison of deemed profit margin imposed on ordinary Incomes earners and profit margins imposed on capital gains earners. It shows that the higher ordinary income tax rates, the lower the profit margins imposed on the capital gains earners and compared to the deemed profit margins imposed on the ordinary income earners, the profit margins for capital gains earners are exceptionally low. The average deemed profit[13] imposed on retailers is 28.33 percent as stated in the Director General Decree Number 536/PJ./2000. On the other hand, the capital gains earners are implicitly deemed to earn profits ranging from 0.3 percent to 2 percent. By comparing the 28.33 percent with the 0.3 percent to 2 percent, the tax burden discrepancies of these two types of incomes sources reaches 14.2 to 94.4, in other words, the ordinary incomes earners have 14.2 to 94.4times higher tax burden than the capital gains earners. Therefore, this comparison shows that the 1995 capital gains tax policy, at a micro level, has created a significant tax burden discrepancy between ordinary incomes earners and the capital gains earners and bring tax fairness problem to the tax system.

In the following part, this dissertation explores the tax burden discrepancy from another point of view which is by comparing the tax revenues generated under capital gains provision with the tax revenues generated under ordinary tax provisions by assuming that the same amount of money invested in the stock exchange is invested in the real sectors. The first step is to calculate the capital gains tax revenues generated under the 1995 capital gains tax policy and

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[13] Article 14 (2) Income Tax Law regulates that small size individual taxpayers may calculate net incomes by using deemed profit mechanism.

the second step is to estimate the ordinary incomes tax revenues. To begin with, the capital gains tax revenues are calculated by using the stock trading data as the 1995 capital gains tax policy regulates that capital gains tax is calculated by multiplying stock sales value with the tax rate. Thus, under the 1995 capital gains tax policy, the capital gains tax revenues (b_1) can be calculated as follows:

$$b_1 = s \times t_1 \quad (2)$$

Where s is stock trading values and t_1 is tax rate for capital gains on shares traded on the stock exchange.

Then the second step is to estimate the ordinary incomes tax revenues. The income tax law regulates that the ordinary income tax is calculated by multiplying the net fiscal income with the tax rates. Therefore, the estimated ordinary incomes tax revenues (b_2) can be calculated by using the following formula:

$$b_2 = (e \times r) \times t_2 \quad (3)$$

Where e is the average equity, r is return on equity ratio (ROE), and t_2 is the average progressive tax rate.

Based on the equation (3) in order to calculate the estimated ordinary incomes tax revenues, we need to find the average equity, ROE and the average tax rate. In this dissertation, the average equity data is taken from the average market capitalization data assuming that the same amounts of money invested in the stock exchange (market capitalization) are invested in the real sectors (equity).

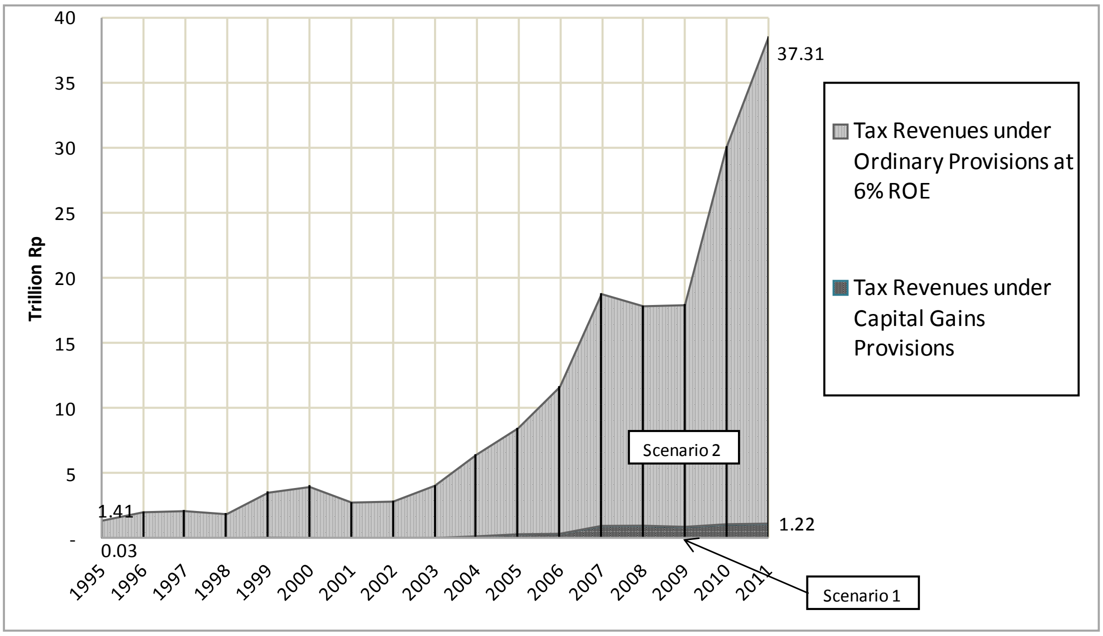
Based on the equations (2) and (3), we can calculate two tax revenue scenarios. The scenario 1, the money is invested in the stock exchange and the scenario 2, the money is invested in the real sectors. "The money" data are taken from the market capitalization data. Then, in calculating tax revenues, two assumptions are used. First, an investor, in order to not lose the value of money, has to put his/her money in an investment that has a return at least the same as inflation rate. To fulfill this requirement, the ROE used in this simulation is 6 percent, the Indonesian's average inflation rate in year 2007-2011[14]. Second, to make the calculation simpler, the average individual tax rate will be used.

Afterward, we can compare the tax burden discrepancy between ordinary incomes earners and capital gains earners. For instance, in 1995, the scenario 1 will generate Rp0.03 trillion tax revenue (1995 total stock sales value x 0.1%), and the scenario 2 will generate Rp1.41 trillion tax revenue (1995 market capitalization x 6% x 18.33%). In 2011, the scenario 1's tax revenue is Rp1.22 trillion, and the scenario 2's tax revenue is Rp37.31 trillion. These show that the

[14] Source: the Central Bank of Indonesia. 2012.

capital gains tax provisions (scenario 1) generated extremely low tax revenues compared to the tax revenues generated under ordinary incomes tax provisions (scenario 2).

Figure 2.3: The Comparison of Estimated Tax Revenues under Ordinary Income Provisions and under Capital Gains Provision for 1995 – 2011 (In trillion Rp)



Source: Writer

Figure 2.3 presents the tax revenue comparison under the two scenarios from year 1995 to 2011. In the year 1995, the beginning year of the 1995 capital gains tax policy introduction, the tax burden gap between scenario 2 and the scenario 1 was only Rp1.38 trillion but the gap have became wider year by year as the size of stock market increase. In year 2011, the gap increased to Rp36.09 trillion which brought the tax burden imposed on the real sectors 30 times higher than the tax burden imposed on the stock market.

3.5.2. The Merits and Demerits of the 1984 and the 1995 Capital Gains Tax Policies and Policy Implications

Both the 1984 capital gains tax policy and the 1995 capital gains tax policy have their own merits and demerits that can be discussed from the tax fairness, tax collection costs, tax compliance, tax certainty and tax revenue. To begin with, the tax fairness issue. The 1984 capital gains tax policy which treated capital gains arising in the stock exchange the same as the taxation of ordinary incomes had a strong feature on the fairness side; theoretically both horizontal and vertical equity of tax principle were prevailed. Horizontally, it imposed the same amount of tax on the people who make money in the stock exchange and on the people who make money in the real sectors as long as they had the same level of income. Then, vertically, it made people bear different amount of tax if they had a different level of incomes.

On the other hand, the 1995 capital gains tax policy faced the problem of tax unfairness as the effect of different tax treatment between capital gains and ordinary incomes. The 1995 capital gains tax policy inflicted unfairness to the tax system in two ways. First, the tax unfairness was occurred in the stock exchange as a consequence of taking stock transaction value as the tax base. As a result, it might happen that people who borne a loss in the stock exchange, who were not supposed to pay taxes under a pure income tax system, still had to pay tax. It definitely violates the vertical equity of tax principle in a sense that people with different level of income should bear different tax burden.

Then, the tax unfairness was also triggered by the different tax rate imposed on capital gains and ordinary income. In this case, the 1995 capital gains tax policy might make people with the same level of income bear different level of tax burden that violated the horizontal equity of tax principle. As previously elaborated, at micro (taxpayer) level, it is estimated that, at the same level of income, the ordinary incomes earners (real sectors) might end up pay 14.2 to 94.4 time higher taxes than the capital gains earners. Likewise, at macro (national level), the discrepancy were considerably high, and the gaps have increased year after year along with the stock exchange's growth. By assuming that the same amount of money invested in the stock exchange is invested in the real sector with 6 percent return on equity, ordinary incomes earners may bear 30 times higher tax burden than the capital gains earners.

Furthermore, tax policy which creates significant tax burden discrepancy between real sectors and the stock exchange might be not the best policy to overcome the differences on the characteristic of capital gains and the ordinary incomes particularly in relation to the short-term/speculative stock transactions. It is because the speculative stock transaction characteristics are no longer congruent with the characteristics of normative capital investment in the terms of intention and the impact of inflation on the transactions.

The issues of inflation effect and intention are frequently mentioned as the reasons why capital gains should be taxed differently with the ordinary incomes. Capital gains normatively arise because of the capital asset holding period which are relatively longer so that inflations contribute to the increase of the value of capital asset which do not reflect an increase in the real value of the assets. For example: a taxpayer bought a house at $100,000 at the beginning of year 1 and after that the house price increased. At the end of year 1, it is worth $105,000 or increased by 5 percent. However, this increase could not beat inflation rate, for instance 8 percent. Therefore, instead of earn real gains the taxpayer's inflict with negative real incomes. In real terms, his wealth has fallen by $3,000. In addition, holding capital assets generally meant to be held for the operation of entity rather than for selling them in the short term. These two features are not belonged by the short-term/speculative stock transactions in the stock exchange. People doing this short transaction mainly motivated to get profit in a relatively short term and their intention in doing this transaction is to sell them as soon as possible as the profit target achieved. From this we can see that short term stock transactions are more like an ordinary trading activities rather than capital transactions. Therefore, it raise the question about the appropriateness of taxing the short-term/speculative stock transactions at a significant lower rate compared to the tax rates for the trading transactions in the real sectors which undermines the fairness of Indonesian tax system.

The second is tax compliance and tax collection costs issues. The pure self assessment tax system used by the 1984 capital gains tax policy had a challenge in tax compliance as tax collections depending more to the willingness of taxpayers to pay taxes rather than by embedded controlling system such as that exists on the withholding tax system. The withholding tax system deployed by the 1995 capital gains tax policy had several benefits. First, it provided better tax compliance as tax offices dealt with a more accountable party which was the stock exchange as an agent to withhold taxes for every stock sales transaction. Second, the withholding tax system reduced the number of taxpayers that tax offices had to supervise and scrutinize. This trend would reduce tax collection costs and improve tax collection efficiency.

The third is tax certainty issue. The tax calculation and procedures offered by the 1995 capital gains tax policy were relatively simple: the tax was calculated by multiplying the tax rate with sales value; all tax deposits were conducted by the stock exchange; taxpayers (investors) only had to report the summary of their transactions in annual tax returns. This simple tax calculation and procedures reduce tax uncertainty and the possibility of tax disputes between taxpayers and tax authorities. Thus, not surprisingly, data shows that among 29,845 adjudicated tax disputes during 2008-2012, there is no any single tax dispute between tax authorities and taxpayers in the area of capital gains tax in the stock exchange[15].

Comparing to the ordinary income tax treatment, the valuable simplicity feature of the 1995 capital gains tax policy does not show up on the taxation for the ordinary income earners. The ordinary incomes earners have to deal with more complex tax procedures and regulations which in most cases are not straightforward and not easy to comprehend. To fulfill their tax liabilities, they have to deal with myriad tax regulations including the need to comprehend the regulations about taxable and non taxable incomes, the deductible and non-deductible expenses, the depreciation rules, loss carry forward rules, tax reporting and payments rules, and many other regulations.

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[15] See Indonesian tax court decisions during 2008-2012.

The fourth is on tax revenues. There are no data available on how much the capital gains tax revenue generated during 1984-1994. Theoretically, the 1984 capital gains tax policy produced higher tax revenues as it imposed higher tax rate than the 1995 capital gains tax policy. However, looking at the Indonesian's low tax compliance rate reflected from Indonesia's low tax ratio (in 2002-2011, the Indonesian tax ratio ranged from 11 percent to 12 percent[16]), it indicated that the tax offices might be not able to collect tax from the stock exchange effectively as tax offices have less control on the self assessment system and it is more difficult to collect tax without an adequate credible third party data which made them depends more on the taxpayers' willingness to pay taxes.

On the other hand, the 1995 capital gains tax policy had better controlling mechanisms in collecting taxes. However, due to its low tax rate, the amount of tax collected from the stock exchange remained low. Data shows that in spite of the stock exchange's significant growth and the tremendous amount of money invested in the stock exchange, the stock exchange's contribution to total tax revenues remained insignificant. In 2011, the capital gains tax revenue from the stock trading in the stock exchange was only 0.14 percent of the total tax revenues. It was far from matching with the ratio of market capitalization to gross domestic product which reached 47.68 percent[17].

Considering the positives and negatives of the 1984 and the 1995 capital gains tax policy, this dissertation suggests that it is beneficial for the government to keep implementing the withholding tax mechanism feature of the 1995 capital gains tax policy. However, there are complicated issues regarding the low tax rate of the 1995 capital gains tax policy. A capital gains tax rate increase is needed to ease the problem of significant tax burden imbalance between real sectors and the stock exchange within Indonesian's economy. However, on the other hand, Indonesia cannot ignore the capital gains tax practices in other countries as the changes on the capital gains tax in one country influences investors in deciding the places to where they will put their money.

Therefore, this dissertation suggests that it is beneficial for the government to increase the capital gains tax rate but in increasing the tax rate, it should consider the competitiveness of the Indonesian stock exchange. As comparison in among ASEAN countries, Indonesian capital gains tax rate (0.1 percent) is lower than Philippines (0.5 percent), similar with the Vietnam (0.1

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[16] See the Directorate General of Taxes' 2011 Annual Report page131.

[17] $\frac{\text{2011 market capitalization}}{\text{2011 gross domestic product}} = \frac{\text{3,537,294.2 billion}}{\text{7,419,187.1 billion}} = 47.68\ \%$

Sources:

- 2011 market capitalization from Statistik Pasar Modal 17-21 September 2012 [the Capital Market Statistic Sept 17-21, 2012] page 14, the Ministry of Finance of Republic Indonesia.
- 2011 gross domestic product from Indonesian Bureau Statistic

percent), but higher than Malaysia's (exempting), Singapore's (exempting), and Thailand's (exempting). In addition, in the case of Malaysia and Singapore, they imposed higher stamp duties than Indonesia which make the total taxes imposed on the Malaysia and Singapore's stock exchanges are higher than the capital gains tax imposed in the Indonesian Stock Exchange (see table 3.1).

Finally, the issue of tax burden discrepancy between the real sectors and the capital markets is not merely Indonesian's case. It occurs globally so that the awareness and cooperation among countries to solve this problem is essential, and this dissertation realizes that it is not an easy task to achieve agreements on this issue as each country has its own interests, problems, opinions and needs. However, bringing the "capital gains and ordinary incomes" issue to the international level may attract policy makers' attention in many countries to look back whether providing significant low tax rate in the capital market especially for short-term/speculative stock transactions is an appropriate policy or not?

3.6. Conclusions

After the 1983 tax reform, Indonesian taxation on capital gains arising in the stock exchange can be divided into two periods: a) 1984 to 1994 and b) 1995 to 2011 (the current state). In the first period, the 1984 capital gain tax policy deployed self assessment tax system and the capital gains on shares traded in the stock exchange were taxed as one unit with ordinary incomes. Then, in the second period, the 1995 capital gain tax policy uses the withholding tax system and the capital gains are taxed separately, at 0.1 percent of sales value.

Both tax policies have their positives and negatives. The 1984 capital gains tax policy has a strong feature in fairness, but it has weaknesses on tax collection costs efficiency and tax compliance. On the contrary, the 1995 capital gains tax policy provides better tax collection efficiency, tax compliance, and tax certainty but it has a problem on the fairness issue. This dissertation notes that at micro (taxpayer) level, the ordinary incomes earners (in this case the small size retailers) might end up pay 14.2 to 94.4 time higher taxes than the capital gains earners. Accordingly, at national level, the discrepancy was also substantially high and it became wider along with the capital stock augmentation. This dissertation estimates that, at 6 percent return on equity, ordinary incomes earners bear more than 30 times tax burden as high as those imposed on the capital gains earners.

The low tax rate of the 1995 capital gains tax policy provides a conducive tax environment for the stock exchange to grow. Data shows that, during 1995 to 2011, Indonesian stock exchange has improved significantly; the market capitalization increased by 33 times. Furthermore, in 2011, the ratio of market capitalization to gross domestic product reached 47.68

percent and the amount of money invested in the stock exchange has exceeded the amount of savings in the banking sectors. However, at the same time, the low tax rate of the 1995 capital gains tax policy could not raise significant tax revenues. From 1995 to 2011, the capital gains tax revenue remains low fluctuated around 0.07 percent 0.21 percent of the total tax revenues.

Considering the positives and negatives of the 1995 capital gains mentioned above, this dissertation suggests that it is better for the government to keep implementing the withholding tax mechanism in collecting tax from the stock exchange as it promotes higher tax compliance and lower tax collection costs. However, the low tax rate of the 1995 capital gains tax policy creates a significant tax burden discrepancy between real sectors and the stock market. Therefore, in order to ease the problem, tax rate increase in the stock exchange is worth to be considered without neglecting the competitiveness of the Indonesian stock exchange.

Finally, the tax burden discrepancy between real sector and stock market also occur in countries which implement capital gains preferential tax treatment. Therefore, further studies on the appropriateness of the low capital gains tax rate on the stock exchange, in particular the low tax rates for the short term/speculative stock transactions in other countries will be useful in reshaping healthy tax policies in the future.

Chapter 4

Indonesian Tax Return Policy
in the Perspective of Revenue, Equity, and Efficiency

4.1. Introduction

It is reasonable that in collecting tax, the tax revenues earned have to be much bigger than the cost to collect them. Since so long, the need to implement more efficient tax system has risen in many jurisdictions. Numerous studies to promote more efficient tax systems have been conducted. Some tried to estimate the compliance cost, such as Slemrod (1984), Blazic (2004), and Moody (2005). The others analyzed the efficiency of tax administrations by comparing the administration costs, such as Ishi (2004). It is believed that the lower the collection cost per dollar of revenue earned, the more efficient the tax system is.

The tax collection cost is affected, for some extent, by almost all tax policies, and tax return policy is one of them. Nowadays, various tax return policies are implemented around the world. Based on tax return policies, countries can be grouped hypothetically into; 1) countries that require all of their taxpayers to submit tax returns, 2) countries that exclude certain group of taxpayers from the tax returns submitting obligation. For example, some countries exclude: a) taxpayers whose incomes are below a certain amount, b) taxpayers who are taxed through withholding mechanism.

Excessive tax return policies have taken parts in raising tax collection costs and creating unnecessary burden to society. These situations have triggered several studies on the possibility to reduce or even to abolish tax return filing obligation with varied results. For example, Leigh (2007) in Australia suggested that it would be beneficial to exempt most Australian taxpayers from tax returns filing obligation. On the other hand, Davidson (2009) argued differently; he pointed out the benefits of obliging people to file tax returns are greater than its costs. Meanwhile, study by Gale (2007) in the United States of America suggested that the idea to implement no-tax return systems would require considerable adjustments in self assessment tax regime.

In setting up an appropriate tax return policy, along with tax revenues, tax policy makers should consider the equity and efficiency aspects of tax revenues collection. Definitely, it is a big challenge. Equity and efficiency are as though two sides of one coin. If the efficiency is pushed to an extreme point, then the equity will be in precarious. On the other hand, if the equity is pushed to an extreme point then the tax system will be much more complicated. For example, in raising tax revenues, the head tax may be the most efficient tax as in such a system, every person would pay an equal lump-sum tax (Moody, 2005); thus, it does not need a complicated tax calculation. However, it has an obvious flaw that it neglects the ability to pay as one of the tax concepts in determining the existence of equity in taxation.

In the case of Indonesia, thus far, studies on tax return policies could not be found. Therefore, the present study through qualitative analysis attempts to provide an insight about Indonesian tax return policies from the perspective of equity and cost-efficiency of the tax system, and simultaneously investigates the impact of the tax return policies on the primary goal of taxation which is to raise tax revenues. Furthermore, this chapter will center on individual annual income tax returns policies after the 1984 tax reform to the year of 2010.

The rest of chapter is organized as follows. Section 4.2 elaborates the qualities of a sound tax system in particular the equity and efficiency of a tax system. Section 4.3 provides an overview about tax returns, and the development of tax return policy in Indonesia. Section 4.4 discuses the tax return policies in the perspective of the equity and efficiency, the statistic of tax returns, and the paradox of tax returns and revenues, and it also elaborates the positives and negatives of the 2001 tax return policy and policy implications. Section 4.5 contains conclusions.

4.2. The Qualities of a Sound Tax System

Scholars, tax experts, policy makers, and tax institutions for so long have come up with various concepts about qualities of ideal tax systems. For instance, Smith (1776) elaborated four qualities of a good tax system that were equity, transparency, convenience, and efficiency. Stiglitz (1999) described five commonly accepted properties of a sound tax system which are: economic efficiency, administrative simplicity, flexibility, political responsibility, and fairness. In 2004, the European Commission-Common Consolidated Corporate Tax Base Working Group- issued a paper that elaborates eight general tax principles for the corporate income tax which are: vertical equity, horizontal equity, efficiency/neutrality, effectiveness, simplicity & transparency & certainty, consistency & coherence, flexibility, and enforceability.

Multifaceted tax concepts brought by the scholars may seem bewildering. However, some ideas appear to have similarities even though the scholars addressed them in different ways and terminologies. Based on their relative positions to the pole of taxpayer's interest or to the pole of state's interest, the concepts can be put into two groups. The concepts of equity, certainty, and convenience are relatively closer to the taxpayers' interest rather than the state's interest. It is because he or she, as a person who, bears the tax that a taxpayer would likely put significant concern on the fairness of the tax burden sharing, the certainty of the amount of tax, and convenience in paying taxes.

On the other hand, the concepts of cost efficiency, economic efficiency, flexibility, political responsibility, effectiveness, enforceability have the inclination to the interest of states rather than the interest of taxpayers.

Among the many principles of a sound tax system, equity and efficiency have become the bywords among executives, legislatives, and public in striving for a sound tax system. Generally, equity principle is viewed from how fair tax burdens are shared among people and it is widely accepted that people with similar economic level should pay a similar amount of tax (horizontal equity) and people with higher economic level should pay higher tax (vertical equity). These equities refer to "ability-to-pay" concept as elaborated by Smith (1776) in his book The Wealth of Nations. He said, "The subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the state."

Furthermore, tax burden can also be viewed from another perspective; from the formal aspect of taxation, not from the material aspect or the amount of taxes taxpayers have to pay. It is because taxation can afflict people not only from the amount of taxes that they should pay, but also from the tax procedures that they have to undergo in order to pay the taxes. From this point of view, a tax system is deemed to be fair if there is equality in tax procedures burden no matter what the sources of incomes and the profession of the taxpayers are. Businessmen, professionals, employees and others, as long as they receive a similar amount of incomes, ideally shall be treated similarly.

Another issue in taxation is efficiency in collecting taxes. Most literatures define efficiency in two different ways. First, efficiency is defined as economic efficiency. It means that the tax system should be neutral to ensure that investment decisions take into account the best location from an economic perspective as Stiglitz (1999) stressed. Second, efficiency is defined as cost efficiency. It means that tax should be collected at low cost as possible. Smith (1776) mentioned "Every tax ought to be so contrived, as both to take out and to keep out of the pockets of the people as little as possible, over and above what it brings into the public treasury of the state."

Tax collection cost refers to all costs above tax payments that are incurred by both taxpayers (compliance costs) and tax offices (administration cost), in order to fulfill the requirements stated on tax regulations and to administer the tax itself. The tax collection cost efficiency can be improved by reducing costs incurred in taxpayers' side, in tax offices' side or the both sides. In taxpayers' side, compliance costs cover monetary expenses such as stationery, printing, copying, stamp, transportation, and non monetary aspects such as time spent, anxiety, opportunity costs. In tax offices' side, the administration costs cover all costs and expenses needed to make tax offices run such as facilities, employees' expenses, utility expenses, compliance checking expenses, and other expenses.

4.3. Tax Returns, Taxpayers, and Tax Returns Policies in Indonesia

4.3.1. Tax Returns

Indonesian general provisions tax law defines an income tax return as a form used to report tax calculations, tax payments, taxable objects or non taxable objects, assets, and liabilities in accordance with tax provisions[1]. There are two types of tax returns: interim tax returns and annual tax returns. Interim tax returns have to be submitted on a monthly basis; however, for eligible small businesses and taxpayers in remote areas, they may submit a combining interim tax return[2]. Meanwhile, annual income tax returns have to be submitted once a year. For individual taxpayers, annual tax returns have to be submitted no later than 3 months after the end of the tax year (March 31).

In the tax year 2010, three different forms of annual income tax returns were available for individual taxpayers:

a. Form 1770. For individual taxpayers who earn a) incomes from businesses or professional services, b) incomes from employments, c) incomes that are taxed with final withholding mechanism, or d) incomes from other sources.
b. Form 1770 S (simple tax return). For individual taxpayers who earn a) incomes from employments, b) incomes from other domestic sourced, or c) incomes that are taxed with final withholding mechanism.
c. Form 1770 SS (very simple tax return). For individual taxpayers who earn incomes solely from one employer; less than Rp60 million and they do not have other incomes except interest incomes from banks or cooperatives.

4.3.2. Taxpayers

Indonesian income tax is imposed on four groups of taxpayer: an individual, an undivided inheritance in lieu of the beneficiaries, an entity and a permanent establishment. Individual taxpayers consist of Indonesian citizens and foreigners who earn incomes from Indonesia.

Individual taxpayers can be classified into several categories. For instance, they can be categorized as resident taxpayers or nonresident taxpayers. The income tax law defines resident taxpayers as; 1) any individual who lives in Indonesia, 2) any individual who is present in Indonesia for more than 183 days within any 12 months period, or 3) any individual who

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1 See article 1 point 11 of the Law of the Republic of Indonesia Number 6 of 1983 concerning General Provisions and Tax Procedures.

2 See the Minister of Finance Regulation Number 182/PMK.03/2007.

intends to reside in Indonesia. Meanwhile, nonresident taxpayers are: 1) any individual who does not reside in Indonesia, or 2) any individual who is present in Indonesia for not more than 183 days within any 12 month period, who receives or earns income from Indonesia.

There are two distinctive tax treatments that are applied to each category above. First, resident taxpayers pay income taxes on a worldwide income basis which means that they have to pay taxes not only on Indonesia sourced incomes but also incomes from abroad, while nonresident taxpayers only pay taxes on Indonesia sourced incomes. Second, resident taxpayers have to submit annual tax returns, while nonresident taxpayers do not.

Furthermore, individual taxpayers can also be categorized based on their main active incomes:

a. The employee type individual taxpayers (EITs)

   The EITs are individuals who earn incomes through employment, for example, civil servants, private companies' employees, labors, part-time workers and outsourcing workers. They may earn incomes from one employer or multiple employers. Based on this, the EITs are grouped further into a) the EITs who receive incomes solely from one employer (EIT-OEs) and b) the EITs who receive incomes from more than one employer or other sources (EIT-MEs).

b. The self employed type individual taxpayers (SEITs)

   The SEITs are individuals who earn incomes from conducting businesses and professional activities. It includes sole proprietor businessmen, farmers, and professionals such as doctors, notaries, actuaries, accountants, engineers and lawyers.

   The main difference of the EITs and the SEITs lies on the tax payment fulfillment method. In monthly basis, the EITs' employment incomes are taxed through withholding mechanism while the SEITs incomes are taxed through self assessment system, though not without exception, several SEITs' incomes such as professional services are taxed by the combination of withholding and self assessment system.

4.3.3. The Development of Indonesian Tax Returns Policies

In year 1984, Indonesia embarked in a significant change of its tax system. At that time, a self assessment tax system was introduced which partly aimed to increase people's awareness and participation in taxation[3]. Since then, in terms of tax return policies, Indonesian taxation can be divided into three periods: a) 1984-1994, b) 1995-2000, and c) 2001-2011 (the current state).

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[3] See the Elucidation of the Law of the Republic of Indonesia Number 6 of 1983 concerning General Provisions and Tax Procedures.

Table 4.1 shows that, in the first period (1984 to 1994), the 1984 tax return policy regulated that all taxpayers including the EIT-OEs have to file annual income tax returns. In the second period (1995 to 2000), the 1995 tax return policy regulated that all taxpayers have to file tax returns, except for a) individual taxpayers whose incomes are equal or less than the amount of personal exemption and b) individual taxpayers who receive income solely from one employer (EIT-OEs). In the third period (2001 to 2011), almost similar with the 1995 tax return policy, the 2001 tax return policy regulates that all taxpayers have to file tax returns. However, the exception was reduced; the 2001 tax return policy only exclude one segment of taxpayers which is the individual taxpayers whose incomes are equal or less than the amount of personal exemption. Therefore, the 2001 tax return policy differs with the 1995 tax return policy in its treatment on the EIT-OEs; the 2001 tax return policy requires the EIT-OEs to file tax returns while the 1995 tax return policy exempted them.

Table 4.1: Tax Returns Filing Policies during 1984-2011

Year 1984 to 1994	Year 1995 to 2000	Year 2001 – 2011 (the current state)
All taxpayers have to file tax returns.	All taxpayers have to file tax returns, except for: • Individual taxpayers whose incomes are equal or less than the amount of personal exemption. • Individual taxpayers who receive income solely from one employer.	All taxpayers have to file tax returns, except for individual taxpayers whose incomes are equal or less than the amount of personal exemption.

Source: article 3 of the Law of the Republic of Indonesia Number 6 of 1983, article 3 of the Law of the Republic of Indonesia Number 9 of 1994, and article 3 of the Law of the Republic of Indonesia Number 16 of 2000.

From the three tax policies elaborated above, it can be seen that the main difference in the 1984, 1995, and 2001 tax return policies lies on the issue of whether an employee who works merely for one employer (EIT-OE) has to file annual income tax return or not.

4.4. Discussions on the Tax Return Policies

4.4.1. Tax Returns Policies in the Perspective of the Equity and the Efficiency

The three tax return policies mentioned previously have different implication on the balance of equity and efficiency aspects of Indonesian tax system. To begin with, the 1984 tax return policy emphasized more on the equity (fairness) as it treated all taxpayers in the same way; all of them had to submit annual tax returns. However, it had a main weakness on the efficiency issue (tax collection cost).

Under the 1984 tax return policy, theoretically, the percentage of the total tax collection costs to total tax revenues would be relatively high as all taxpayers have to file tax returns including those with incomes less than personal exemption meaning that there is no tax will be generated from them. This policy may result in certain cases that the amount of tax is lower than the tax collection cost. As an illustration, taxpayer ABC who is liable for Rp100 tax may have to spend much more money than the tax itself in order for him/her to fulfill his/her tax obligation including to submit a tax return. For instance, he/she has to spend Rp500 for stationery, printing, copying, stamp, and transportation expenses. Then, assuming that the tax offices spent Rp1 administration expense for each taxpayer then the total tax collection cost will be Rp501 which is much higher than the amount of tax received by the government. This simple illustration shows that the 1984 tax return policy may created a situation in which the total compliance cost plus administration cost are higher than the tax revenues, a condition that should be avoided by a sound tax system.

The next policy was the 1995 tax return policy. In the perspective of cost efficiency, the total tax collection cost under the 1995 tax return policy would be theoretically lower than the 1984 tax return policy. It is because the 1995 tax return policy excluded two segments of taxpayers which were obliged to file tax returns in the 1984 tax return policy. They are the low income taxpayers and the employee type taxpayers who received income solely from one employment (EIT-OEs). There are several efficiency reasons behind the policy excluding these two segments of taxpayers from tax return filing obligations. First, under the income tax law, taxpayers who earn incomes below the personal exemption do not have to pay taxes. Therefore, it will reduce number of tax returns with no tax on them which directly reduce tax compliance cost and administration costs. Second, the EIT-OEs' employment incomes are taxed through withholding mechanism meaning that these taxpayers have already paid taxes. Thus, as consequence, there are no additional tax dues that they have to pay and should report in annual income tax returns. Therefore, excluding the low income taxpayers and the EIT-OEs would reduce the tax collection costs as the 1995 tax return policy minimized the number of the zero or low payment tax returns.

However, despite its positive side in the efficiency the 1995 tax return policy faced the several challenges. The first is the implementation problem. The 1995 tax return policy had a serious problem in identifying the status of an employee type taxpayer whether he/she is an EIT-OE or an EIT-ME. This status is very crucial in the 1995 tax return policy as the EIT-OE does not have obligation to submit tax return while the EIT-ME has to submit tax return. The obscurity in identifying this status hampered tax offices in taking necessary actions if employee type taxpayers did not file tax returns. The second, the 1995 tax return policy reduced public tax awareness in particular the EIT-OE's tax awareness. As an illustration, Mr. A is an employee of XYZ Company. He usually only earns salaries, therefore, as an EIT-OE, by the regulation Mr. A does not have to submit tax returns. This situation run for many years that may make him does not aware about the tax return filing regulations well. Therefore, when, for a certain year, he occasionally received incomes other than incomes from an employment such as incomes from an informal business, he might be not aware that he has an obligation to submit a tax return. In a worse scenario, Mr. A does aware about his tax obligation, but he intentionally tries to evade paying taxes by pretending as though he is still an EIT-OE who does not have an obligation to submit a tax return.

If an employee type taxpayer (EIT) does not submit a tax return, unless data is available, tax offices will face difficulty in determining whether a taxpayer is an EIT-OE or an EIT-ME. It was an obstacle in upholding the 1995 tax return policy further. For example, the General Provisions Tax Law regulates that tax offices could issue the reprimand letters if taxpayers failed to submit tax returns[4]. However, since there is difficulty in identifying whether a taxpayer has an obligation to submit a tax return or not, then the process to issue a reprimand letter could be delay. In addition, this situation also created a possibility that tax offices may issue reprimand letters mistakenly meaning that it might be issued to a taxpayer who is by regulation does not have to submit tax return.

The last is the 2001 tax return policy (the current tax policy). It revoked the tax treatment privilege that EIT-OEs had enjoyed during the 1995-2000. The 2001 tax return policy only excludes one segment of taxpayers whose incomes are equal or less than the amount of personal exemption from the tax return filing obligation. As a consequence, all EITs whether they are EIT-OEs or EIT-MEs are treated similarly; all of them have to submit tax returns. Therefore, in the terms of tax equity, the 2001 tax return policy is closer to the equity side than the 1995 tax return policy.

In conclusion, the three tax return policies elaborated above have their own advantages and disadvantages. From equity and efficiency perspective of a tax system, they show that Indonesian tax system has shifted from emphasizing on equity in the 1984 tax return policy to a more pragmatic way as the 1995 tax return policy focused on efficiency. Finally in 2001 tax return policy it moved once again to equity side.

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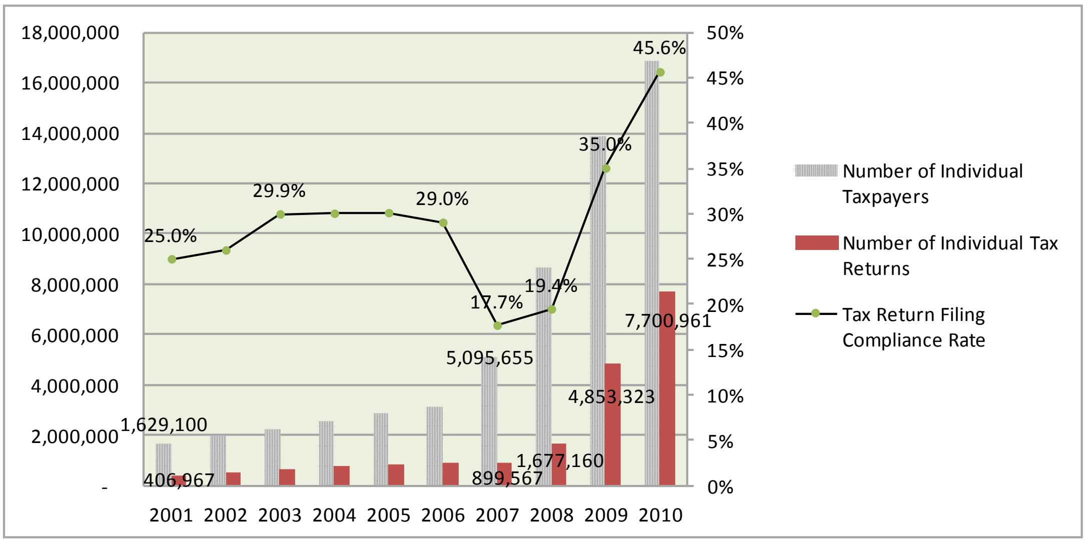
[4] See article 13 paragraph (1) b of the Law of the Republic of Indonesia Number 9 of 1994 concerning the Amendment of the Law of General Provisions and Tax Procedures.

4.4.2. Tax Returns Filing Compliance Rate

Tax return filing compliance rate is the ratio of the number of tax returns divided by the number of taxpayers. It measures the taxpayers' obedience level in submitting tax returns. As aforementioned, based on its tax return policy Indonesian taxation period can be divided into three periods: a) 1984-1994, b) 1995-2000, and c) 2001-2011 (the current state). In the last period, the 2001 tax return policy regulates that all taxpayers have to file tax returns except for individual taxpayers whose incomes are equal or less than the amount of personal exemption. This provision definitely will increase number of tax returns relative to the 1995 tax return policy.

Figure 4.1 shows the development of the individual tax return filing compliance rates. In the period of 2001-2007, number of tax returns increased but at slow paces; it increased 1.21 times from 406,967 at the end of 2001 to 899,567 at the end of 2007. On the other hand, number of registered individual taxpayers increased faster; it increased 2.13 times from 1,629,100 in 2001 to 5,095,655 in 2007. Consequently, even though the number of tax returns increased, they could not increase filing compliance rates substantially. The filing compliance rates remained low; fluctuating between 17.7 percent and 29.9 percent. These low levels of filing compliance rate pointed out that huge number of individual taxpayers did not observe the filing obligation. For instance, in 2006 and 2007, around 71.0 percent and 82.3 percent taxpayers did not file tax returns respectively. The low levels of filing compliance rate may also indicate that there were problems on 1) the taxpayer's obedience toward tax laws, 2) the law enforcement, or 3) the 2001 tax return policy itself.

Figure 4.1: The Individual Tax Return Filing Compliance Rates 2001-2010



Source: Writer's calculations.
Notes:
a) The number of individual taxpayers data are from:
- 2001-2008 from the tax handbook in numbers 2001-2009 -DGT (2010),
- 2009-2010 from the directorate general of taxes' annual report 2010-DGT (2011).

b) The number of individual tax returns data are from:
- 2001-2009 from the tax handbook in numbers 2001-2009 -DGT (2010),
- 2010 from unpublished raw data-DGT (2012).

Furthermore, in order to increase the compliance rate, in 2008, a program named "sunset policy" was launched. The sunset policy offered deduction or removal of administration sanctions for those of taxpayers who submit the unreported tax returns or the amended tax returns during the sunset policy period: January, 1 2008 to March 31, 2009. The sunset policy also guaranteed that there will be no tax audit on the taxpayers, unless there were data that showed that the submitted tax returns were incorrect[5].

Besides the sunset policy, several other measures had influenced the tax return filing compliance such as the 2001-2008 tax administration reform, simpler tax return forms, and the "drop box" program. The drop box program firstly implemented in 2009 as an innovation aims to boost tax returns submitted by making the processes easier. Normally, taxpayers have to go to a tax office to hand in their tax returns which make them have to spend some times and disburse some money in order to submit the tax returns. Then, in the tax office, they have to spend some more times waiting for the tax officers checking the completeness and other formal aspects of

[5] See article 37A of the Law of the Republic of Indonesia Number 28 of 2007 concerning the Third Amendment of the Law of General Provisions and Tax Procedures and article 37A the Law of the Republic of Indonesia Number 16 of 2009 concerning the Fourth Amendment of the Law of General Provisions and Tax Procedures.

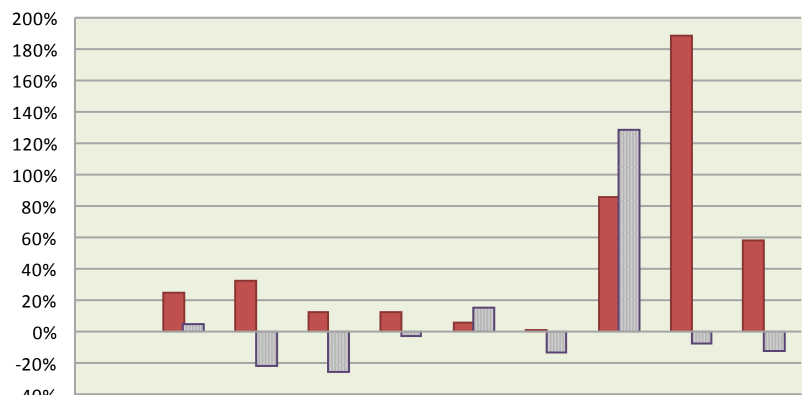
the tax returns. For busy taxpayers, this situation creates certain problems as they have a limited time to spare; and for low income taxpayers, it is a problem as they have to spend some money in submitting tax returns. To minimize these hassles, during peak seasons (in March for individual taxpayers), tax offices set up “drop boxes” in the shopping malls, business centers, office buildings, factories, and other busy places. At the drop boxes, the tax return receiving processes are relatively faster as tax officers do not have to perform detail checking as in the tax offices. Thus, taxpayers will spend shorter times, and in addition, they can choose any location that is most convenience to them in submitting tax returns.

The sunset policy and other measures mentioned above had managed to increase the number of tax returns and the compliance rates in 2008 and 2009. Figure 4.1 shows that, in 2008, the number of tax returns increased from 899,567 to 1,677,160 or increased by 86.44 percent. Furthermore, in 2009, it increased to 4,853,323 or increased by 189.4 percent. Along with that, the increases on the number of tax return have improved the filing compliance rates. The filing compliance rates increased from 19.4 percent in 2008 to 35.0 percent in 2009. This increasing trend continued in year 2010 in which the filing compliance rate improved to 45.6 percent. Thereupon, after the implementation of the 2001 tax return policy, the number of tax returns increased 17.92 times from 406,967 tax returns in 2001 to 7,700,961 tax returns in 2010.

4.4.3. Tax Returns and Revenues Paradox

The soaring numbers of tax returns has raised a question on “how did the increase of tax return affect tax revenues?”. Intuitively, the answer is if the number of tax returns increases then the tax revenue will increase as well. However, in reality the relations do not always be like that as presented in Figure 4.2. Figure 4.2 exhibits the relation of number of tax returns and individual income tax revenues during 2001-2010. It shows that in several years the increases in tax returns submitted were followed by increases in tax revenues and it also shows that in several other years the increases in tax returns submitted were not followed by the increases on tax revenues. For instance, in year 2002, 2006, and 2008 the increase on the number of tax returns had positive relations with the increase on tax revenues. In 2002 the number of tax returns increased by 24.8 percent and tax revenues increased by 4.7 percent. In 2006 the number of tax returns increased by 5.5 percent which was followed by the 15.6 percent increase of tax revenues. Similarly, in 2008 the number of tax returns increased by 86.4 percent, and the tax revenues increased by 129.1 percent.

Figure 4.2: The Comparison of the Percentage Change of Number of Individual Tax Returns and Individual Income Tax Revenues 2001-2010



	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Δ Tax Returns		24.8%	32.4%	12.6%	12.5%	5.5%	0.2%	86.4%	189.4%	58.7%
Δ Revenues		4.7%	-21.7%	-25.8%	-2.6%	15.6%	-13.2%	129.1%	-7.2%	-12.3%

Source: Writer‘s calculations.
Notes:
a) The number of individual tax returns data are from:
- 2001-2009 from the tax handbook in numbers 2001-2009 -DGT (2010),
- 2010 from unpublished raw data-DGT (2012).

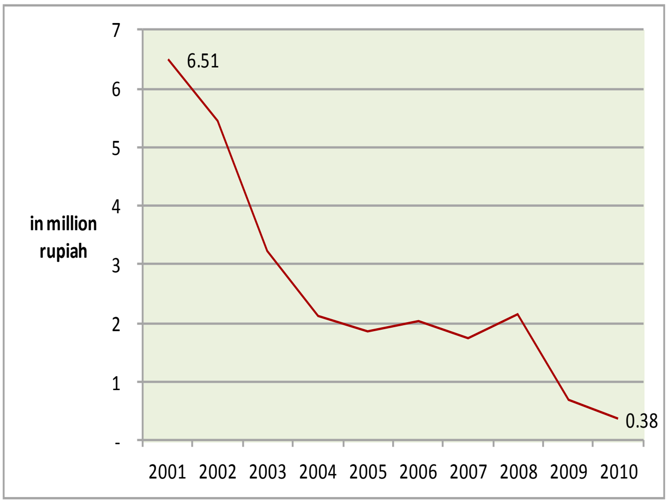
b) The individual income tax revenues data are from:
- 2001-2009 from the directorate general of taxes’ tax revenues statistic –DGT (2010),
- 2010 from the central government financial report 2010.

However, the positive relations between the number of tax return and the tax revenues did not always occur. Figure 4.2 shows that paradoxical conditions occurred in year 2003, 2004, 2005, 2007, 2009, and 2010. At those years, the numbers of individual tax returns increased, but these could not generate higher tax revenues. On a contrary, tax revenues dropped to lower amounts. The phenomena became especially clear in 2009 and 2010. In 2009, the number of tax return increased significantly by 189.4 percent, but tax revenues decreased by 7.2 percent. Similarly, in year 2010, the number of tax return increased by 58.7 percent, but once again tax revenues downed by 12.3 percent.

Besides the paradoxical condition, another issue on the relationship between the number of tax returns and tax revenues is about the tax returns’ ability to bring revenues. After the 2001 tax return policy implemented, the tax returns’ ability to bring revenues, in average, have plunged. Figure 4.3 shows that the average tax revenues per an individual tax return in 2001-2010 were in a decreasing trend. In 2001, individual tax returns in average generated Rp6.18 million tax revenues; however, it was decline ever since. In the last three years, the average tax payables reported by individual taxpayers in their annual tax returns have plummeted significantly. The average tax payables reported in 2008, 2009, and 2010 tax returns were

Rp2.15 million, Rp0.69 million, and Rp0.38 million. Thus, the average tax payables reported in the 2010 tax returns had dropped 17.07 times compared to those reported in the year 2001 tax returns.

Figure 4.3: The Average Tax Revenues per an Individual Tax Return 2001-2010



Year	Number of Individual Tax Returns	Individual Income Tax Revenues in billion Rp
(1)	(2)	(3)
2001	406,967	2,648
2002	507,965	2,773
2003	672,370	2,172
2004	756,864	1,612
2005	851,190	1,570
2006	898,036	1,815
2007	899,567	1,575
2008	1,677,160	3,608
2009	4,853,323	3,347
2010	7,700,961	2,935

Source: Writer‘s calculations.
Notes:
a) The number of individual tax returns data are from:
- 2001-2009 from the tax handbook in numbers 2001-2009 -DGT (2010),
- 2010 from unpublished raw data-DGT (2012).

b) The individual income tax revenues data are from:
- 2001-2009 from the directorate general of taxes’ tax revenues statistic –DGT (2010),
- 2010 from the central government financial report 2010.

There were several factors that may explain why the paradox of tax returns and revenues occur. First, most of the individual taxpayers are employee type individual taxpayers (EITs); from January to September 2010, new register EITs were 2.5 million out of 2.8 million total of new registered individual taxpayers or about 89 percent[6]. Hence, the biggest part of the individual tax returns was EITs’ tax returns which did not generate sizeable additional tax revenues unless the EITs had substantial other non-employment incomes. As aforementioned, the EITs’ incomes: salaries, wages, and other employment incomes are taxed through withholding mechanism in every paycheck they received. Therefore, at the end of the year, for the EIT-OEs, the tax dues will be zero; no additional tax payment should be made. However, for the EIT-MEs, certainly, they have to pay additional taxes on their other incomes.

Second, several tax policy changes have contributed to the lower amount of tax revenues, for instance, the changes on the personal exemption. During 2001-2010, the government had

[6] Director General of Taxes in one press interview. <http://us.bisnis.vivanews.com/news/read/181824-2010--jumlah-wajib-pajak-bertambah-2-8-juta>.

increased the amount of personal exemption three times: in 2005, 2006, and 2009. In 2005, there was a sharp increase in the personal exemption. For instance, the personal exemption for a single taxpayer increased by more than 300 percent, from Rp2,888,000 to Rp12,000,000; for married with no child taxpayers, it increased 206 percent from Rp4,320,000 to Rp13,200,000[7]. The personal exemption was also increased in 2006 and 2009, the personal exemption for single taxpayers increased by 10 percent and 20 percent respectively.

Another policy pushing down tax revenues was income tax rate structure change. In the tax year 2009, the government reduced the highest individual income tax rate from 35 percent to 30 percent and changed the income tax bracket. Moreover, previously the highest tax rate (35 percent) was applied on income above Rp200,000,000; in the 2009 tax rate changes, the highest tax rate (30 percent was applied on income above Rp500,000,000. Similarly, the interval of income bracket for the lowest rate (5 percent) was increased from Rp25,000,000 to Rp50,000,000.

Third, some taxpayers naturally try to minimize their taxes, or even evade paying taxes especially if the possibility to be caught is low. This is also the case in Indonesia, though there is no complete data about the amount of tax avoidance and evasion, some wealthy taxpayers, including the EITs had managed to avoid paying taxes properly.

These three factors, high number of EITs, tax rate reduced, and tax evasion and avoidance have made difficult for Indonesia to increase its tax ratio. As comparison to international practices, Indonesian tax ratio was 11.06 percent[8] in 2010 which was much lower than the average tax ratio of OECD countries, 33.8 percent (OECD, 2012).

4.4.4. The Positives and Negatives of the 2001 Tax Returns Filing Policy and Policy Implication

In self assessment tax system, the tax return is a fundamental legal document in which a taxpayer declares that all incomes, tax calculation, and tax payments have been reported in accordance with tax laws and regulations. Thus, in the future if there are unreported incomes or irregularities detected by tax offices then the document will become a legal starting point for tax offices to scrutinize and request taxpayers' accountability.

Requesting people to submit tax returns is beneficial to increase public tax awareness as it encourages people to search, learn and accustom to taxation, in particular the parts that have direct relation with them such as how to fill a tax return properly, how to pay taxes and their tax rights and obligation. In contrary, if people are not obliged to submit tax returns, their concern

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7 See Minister of Finance Regulation Number 564/KMK.03/2004.
8 See the 2010 DGT Annual Report page 101.

about taxation become lower as taxation issues do not touch them directly. Thus, at national level obliging people to submit tax returns is indispensable for a nation development as it increases people's consciousness that they do share in financing the government disbursements. Therefore this consciousness is beneficial not only to increase people control on how government spend the tax money, but also encourages people to exercise vigilance over government's performances which eventually will be beneficial in fostering good governance as a fundamental requirement for a country's prosperity.

The 2001 tax return policy provides several positives things. First, it promotes the equity in the tax system and increases tax awareness. By only excluding the low-income taxpayer, it puts all taxpayers including the EIT-OEs in the same tax treatment. Thus, the only thing that makes people treated differently in term of tax returns submitting obligation is the level of their income; if they earn incomes above the personal exemption then they have to file tax returns. The EIT-OEs, EIT-MEs, SEIT, all have to file tax returns if their incomes exceed the personal exemption. Therefore, there is no difference on tax returns filing obligations among the taxpayers. For instance, a businessman who earns Rp10 million incomes and an employee who earns the same amount of income will have the same obligation in submitting a tax return.

The significant increase on the number of tax return from 406,967 in 2001 to 7,700,961 in 2010 might reflect that the 2001 tax return policy, for some extent, has managed to reduce the number of people who have been able to eschew from the tax office administration nets. The increase numbers of tax returns eventually promote the equity in the tax system as the tax burden is spread to a larger number of people.

The 2001 tax return policy also has positive side in the term of implementation. The 2001 tax return policy is relatively easier to be implemented compared to the 1995 tax return policy. As previously mentioned, under the 1995 tax return policy, there was a difficulty in determining whether a tax payer is an EIT-OE or an EIT-ME. The problem did not appear in the 2001 tax return policy. Under the 2001 tax return policy, the tax offices did not need to differentiate whether an employee was an EIT-OE or an EIT-ME to determine whether he/she had an obligation to submit tax return or not as both of EIT-OE and EIT-ME had to submit tax returns. Therefore, if an employee type taxpayer did not submit a tax return, tax offices could take further necessary actions soon as for sure that was a tax violation.

However, despite its advantages the 2001 tax return policy also has a couple of weaknesses. Its main drawback is in the tax collection cost-efficiency. First, there was a big gap between the increase on tax collection costs and the increase on tax revenues. By assuming that the tax collection cost increases proportionally with the increases on the number of tax returns, then, during 2001-2010, the tax collection cost might increase by about 17 times similar with the increase on the number of tax returns. However, in fact, the tax revenues only increased by 0.2 times. Thus, it can be argued that the 2001 tax return policy is less efficient compared to the 1995 tax return policy.

Second, the quality of tax return decreased; the average tax payables reported by individual taxpayers in their annual tax returns have plummeted significantly. It decreased from Rp2.15 million in 2008 to Rp0.69 million in 2009, and to Rp0.38 million in 2010. In addition, the average tax payables reported in the 2010 tax returns has dropped significantly, 17.07 times, compared to those reported in 2001 tax returns.

Third, the 2001 tax return policy has put a considerable operational burden to tax offices to handle the quick increases in the number of tax returns. From 2008 to 2010, the numbers of tax returns increased by 7.56 times or 6.8 million, but many of them, unfortunately, were the zero or low payment tax returns[9]. On the other hand, tax offices' capacity to handle them did not change as quickly as the increases on the number of tax returns. For instance, the number of employees only increased by 0.05 times from 31,269 in 2008 to 32,741 in 2010[10]. This condition might reduce the service quality of tax offices, and it also could reduce tax offices' ability to monitor a more potential taxpayers.

The previous discussions show that each tax policy that has been implemented in Indonesia has the positives and negatives. The 1995 tax return policy has positives on lowering tax collection cost or in other words it facilitates better tax efficiency. However, it has negatives in term of tax equity and relatively difficult to be implemented well. On the other hand, the 2001 tax return policy has positives on promoting tax equity, increasing public tax awareness, and relatively easier to be implemented. However, it also has negatives on the efficiency of tax system as it requires higher tax collection costs. This situation shows that there is a trade of between pursuing equity and efficiency in a tax system.

Therefore, considering the importance of the equity of a tax system, the invaluable of public tax awareness, and the practicality of the 2001 tax return policy added with the low level of Indonesian tax ratio, this dissertation suggests that it is better for the government to keep implementing the 2001 tax return policy. However, several measures should be taken to minimize its negative effects. For instance, first, establishing special procedures to administrate and follow up the EITs' tax returns. This special procedure is needed to differentiate the tax return management for potential taxpayers and non potential tax payers so that tax office resources allocated to manage the EITs tax return can be minimized. It will eventually make tax

9 Director General of Taxes in a seminar. <http://www.republika.co.id/berita/ekonomi/keuangan/11/05/21/llj4uf-bukan-anda-kan-diperkirakan-50-juta-wajib-pajak-belum-tunaikan-kewajibannya>.

10 See directorate general of taxes' 2008 and 2010 annual reports.

offices able to put more energy in supervising potential taxpayers. Another possible measure is to promote electronic filing. This will reduce processing times in particular the key-in process. Then, in order to increase the number of submitted tax returns; tax offices have to simplify the EIT's tax return forms and keep improving the tax returns submitting process. Lastly, in order to increase the individual tax revenues, tax offices should put more focus on assessing tax payment of the self employed individuals and medium to high wealth employees.

4.5. Conclusions

After the implementation of self assessment tax system in 1984, Indonesia tax return policies can be divided into three periods: a) 1984 to 1994, b) 1995 to 2000, and c) 2001 to 2011 (the current state). Indonesian tax return policies swung from the equity perspective in 1984 to a more pragmatic policy in 1995, and finally it bounced back once again to the equity side in 2001.

The main difference in 1984, 1995 and 2001 tax return policies lies on the issue of employee type individual taxpayers who earn incomes from one employer (EIT-OEs). In 1984 policy, EIT-OEs were obliged to submit tax returns, then in 1995 they were waived, and in 2001, they are once again obliged to submit tax returns.

Data reveals that there is a weakness on the effectiveness of the 2001 tax return policy (current tax return policy) in raising tax revenues. During 2001-2010, number of tax returns increased for about 17 times but individual tax revenues only increased by 0.2 times, and it also dotted by the occurrences of paradoxical situation in which number of tax returns had negative relation with tax revenues.

However, despite its weakness on the efficiency side, the 2001 tax return plays crucial roles in promoting the equity in the tax system, increasing the tax awareness, and it is relatively easier to be implemented compared to the 1995 tax return policy. Considering all of these and the low level of Indonesia's tax ratio, this dissertation suggests that it is worth for the government to keep implementing the 2001 tax return policy, but several measures should be taken to minimize its negative effects.

The dilemma in choosing between the equity of a tax system and efficiency in collecting tax from the EITs may also occur in countries which implement the self assessment tax system. Therefore, further researches in this area will be beneficial to enrich the understanding on how similar or different tax return policies are running in other tax jurisdictions that will be useful in reshaping tax return policies in the future.

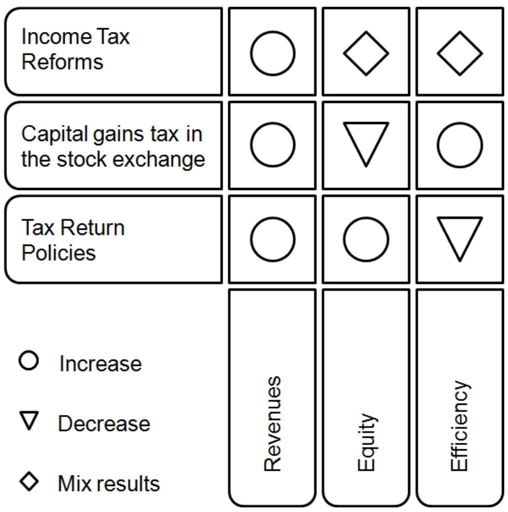
Chapter 5

Conclusions and Recommendations

5.1. Conclusions

This dissertation studies Indonesian income tax development in the period of 1984 to 2011 from the perspective of tax revenues, equity and efficiency, with three focus areas which are: income tax reforms, tax policies on capital gains arising in the stock exchange, and tax policies on tax return. Figure 5.1 depicts a summary of discussions made throughout this dissertation on how income tax reforms and tax policy changes in the period of 1984 to 2011 affected Indonesian income tax revenues and the balance of equity and efficiency aspect of the Indonesian income tax system.

Figure 5.1: The Changes of Indonesia Tax from the Perspective of Tax Revenues, Equity and Efficiency



Source: Writer

First, the top layer of the Figure 5.1 portrays the impact of the income tax reforms during 1983-2011 on the development of income tax revenues, the equity, and the efficiency of the Indonesian income tax system. In the perspective of revenues, income tax reforms implemented during 1983-2011 have managed to increase income tax revenues in particular in nominal term in which the income tax revenues have increased from Rp1.93 trillion in 1983/84 to Rp357.99 trillion in year 2011 or in other words it was folded more than 185 times in the last 28 years. However, they were not the main factors of the steep increase of tax revenues. This dissertation notes that besides income tax reforms, Indonesian's relatively high inflation rates and high economic growth during the period of 1983-2011 were the factors behind the steep increase of the income tax revenues.

Regarding the direction of the income tax reforms, this dissertation found that the income tax reforms implemented during 1983-2011 have several characteristics. Firstly, the tax reforms have embraced income tax rates reduction approach. For instance, the highest corporate income tax rate was in decreasing trend: 35 percent in 1984, 30 percent in 1994, 28 percent in 2008, and 25 percent in 2010. Secondly, the tax reforms have widened the income tax base by expanding the incomes that fall into the categories of taxable incomes. Thirdly, the tax reforms have gradually moved the tax collection system from comprehensive income tax system toward schedular tax system.

Then, in the perspective of equity and efficiency, the 1983-2011 income tax reforms have yielded mix results. In some part of the tax system, the tax equity has been better off but in some other parts tax equity was decreased. Similarly, the efficiency has increased in some parts of tax system but in some other parts it was decreased. However, as a whole the current Indonesian income tax is featuring with a lower tax equity compared to those of the 1984 income tax system as reflected with the increasing numbers of income types, such as certain interest incomes from cooperatives, lottery prizes, venture capital funds' incomes from the transfer of partner company' shares, incomes received by construction and real estate companies, land and building rental incomes, bond interest incomes, and incomes received by certain small size businesses, that were taken out from the comprehensive tax system net and are taxed separately which makes tax system are prone to tax unfairness.

Second, in the area of capital gains tax policies in the stock exchange, the middle layer of Figure 5.1 shows that the capital gains tax policy change in 1995 has managed to increase tax efficiency by lowering tax collection costs, but on the other hand it has reduced the equity of the Indonesian income tax system. This dissertation notes that at micro (taxpayer) level, the ordinary incomes earners (in this case the small size retailers) might end up pay 14.2 to 94.4 time higher taxes than the capital gains earners. Accordingly, at national level, the discrepancy was also substantially high and it became wider along with the capital stock augmentation. This dissertation estimates that, at 6 percent return on equity, ordinary incomes earners bear more than 30 times tax burden as high as those imposed on the capital gains earners.

The low tax rate of the 1995 capital gains tax policy has positive effect on the stock exchange development. Data shows that, since the implementation the 1995 capital gains tax policy, Indonesian stock exchange has expanded significantly; the market capitalization was increased by 33 times in the period of 1995 to 2011. Furthermore, in 2011, the ratio of market capitalization to gross domestic product reached 47.68 percent and the amount of money invested in the stock exchange has exceeded the amount of savings in the banking sectors.

The expansion of the stock exchange has simultaneously increased the amount of tax revenues generated from the market. However, despite the increase of tax revenues, the low tax rate of the 1995 capital gains tax policy could not substantially raise the contribution of the stock exchange to the total tax revenues. From 1995 to 2011, the capital gains tax revenue fluctuated around 0.07 percent 0.21 percent of the total tax revenues.

Third, in the area of tax return policy, the lower part of Figure 5.1 shows that tax return policy change in 2001 has managed to increase the equity of Indonesian income tax system. Besides that, compared to the 1995 tax return policy the 2001 tax return also had several positive features such as better public tax awareness and easier to be implemented. However, the 2001 tax return policy had a weakness on the effectiveness in raising tax revenues. This dissertation shows that during 2001-2010, number of tax returns had increased for about 17 times but individual tax revenues only increased by 0.2 times, and it also dotted by the occurrences of paradoxical situation in which number of tax returns had negative relation with tax revenues.

To summarize, the income tax reforms and tax policy changes during 1983-2011 had positive impacts in increasing Indonesian income tax revenues, and there were mix results concerning the equity and the efficiency of the tax system. In some areas, such as capital gains tax in the stock exchange, the Indonesian income tax system has shifted from the equity oriented system to a more pragmatic system. However, in some other areas, such as tax policy changes on tax return obligations have a contrary direction as it have caused the tax system to move from more efficiency oriented policy to a more pro equity oriented policy. However, looking at the list of incomes that were taken out from comprehensive income tax system and be taxed separately, the current Indonesian income tax system as a whole bends more on efficiency and effectiveness rather than on the pro-equity approach of the 1984 income tax system.

5.2. Recommendations

Based on discussions throughout this dissertation, policy recommendations are divided into three areas. The first is regarding the future measures needed to increase Indonesian income tax revenues. As previously elaborated in chapter 2, various efforts have been conducting in Indonesia in order to increase income tax revenues including income tax reforms. In the period of 1983-2011, Indonesia has conducted five income tax regulation reforms which primarily aimed to increase income tax revenues. The fundamental one was taken in the year 1983, and four piecemeal regulation tax reforms have been conducted in year 1991, 1994, 2000, and 2008.

Beside regulation reforms, Indonesia also has embarked on tax administration reform during 2001-2008.

Thus far, the income tax reforms have managed to increase income tax revenues in nominal term significantly from Rp1.93 trillion in 1983/84 to Rp357.99 trillion in year 2011. However, the current level of income tax revenues inevitably has to be increased further in order to sufficiently support government spending.

To increase income tax revenues, this dissertation notes that among several available options of future tax reform, taking another tax regulation reform to increase tax revenue might be not the best choice for Indonesia in the near future as the room to lift up income tax revenues significantly through regulation reform has become limited. Two approaches to increase tax revenues in regulation reforms: tax rate increase and tax base expansion have their own difficulties to be implemented for the current time. Tax rate hike policy is hard to be implemented as it may not only face resistance from the public but also may make Indonesia less attractive for foreign investments as income tax rate cut policy has been adapted by many countries around the world. Similarly, tax base expansion is difficult to be implemented in Indonesia as almost all any potential tax subjects and tax objects have been covered in the current income tax legislation. Therefore, this dissertation suggests that future tax reforms should focus on improving other areas of income tax system. In the case of Indonesia, improving public tax awareness, tax authorities' professionalism and integrity, governance practices in various Indonesia bureaucracies, and consistency in implementing the tax law will be essential factors to increase income tax revenues in the future.

The second, regarding capital gains tax in the stock exchange, this dissertation suggests that it is better for the government to keep implementing the withholding tax mechanism in collecting tax from the stock exchange due to its positive features. The withholding tax system deployed by the 1995 capital gains tax policy in taxing capital gains arising in the stock exchange had several benefits compared to the pure self assessment tax system. First, it provided better tax compliance as tax offices dealt with a more accountable party which was the stock exchange as an agent to withhold taxes for every stock sales transaction. Second, the withholding tax system reduced the number of taxpayers that tax offices had to supervise and scrutinize intensively. This trend would reduce tax collection costs and improve tax collection efficiency. Third, tax calculation and procedures of the 1995 capital gains tax policy were relatively simple: the tax was calculated by multiplying the tax rate with sales value, tax calculation, tax withheld, tax deposits, all were conducted by the stock exchange so that taxpayers have a lesser contact with tax offices. They only had to report the summary of their transactions in annual tax returns. This simple tax calculation and procedures have reduced tax uncertainty and the possibility of tax disputes between taxpayers and tax authorities. Data shows that among 29,845 adjudicated tax disputes during 2008-2012, there is no any single tax dispute between tax authorities and taxpayers in the area of capital gains tax in the stock exchange.

However, despite its strength on the tax collection mechanism, the 1995 capital gains tax policy did have a problem which lied on its low tax rate which has created a significant tax burden discrepancy between real sectors and the stock. This dissertation notes that at micro (taxpayer) level, the ordinary incomes earners (in this case the small size retailers) might end up pay 14.2 to 94.4 time higher taxes than the capital gains earners. In order to ease this problem, this dissertation suggests that a tax rate increase in the stock exchange is worth to be considered. However, in choosing an appropriate tax rate, government should consider carefully the tax rate imposed on other countries' stock exchanges so that the tax rate hike will not damage the competitiveness of the Indonesian stock exchange.

The third is regarding tax return policy. The 2001 tax return policy provides several positives things. First, it promotes the equity in the tax system and increases tax awareness. By only excluding the low-income taxpayer, it puts all taxpayers including the EIT-OEs in the same tax treatment. Thus, the only thing that makes people treated differently in term of tax returns submitting obligation is the level of their income. Second, the 2001 tax return policy has managed to increase the number of individual tax return significantly from 406,967 in 2001 to 7,700,961 in 2010. This is a healthy condition for Indonesia in order to increase income tax revenues as it managed to reduce the number of people who have been able to eschew from the tax office administration nets and promoted the equity in the tax system as the tax burden is spread to a larger number of people. Third, the 2001 tax return policy was relatively easier to be implemented rather than the 1995 tax return policy in which the tax offices did not need to differentiate whether an employee was an EIT-OE or an EIT-ME to determine whether he/she had an obligation to submit tax return or not as both of EIT-OE and EIT-ME had to submit tax returns.

Therefore, concerning tax return this dissertation suggests that it is worth for the government to keep implementing the 2001 tax return policy, but several measures should be taken to minimize its negative effects. For instance, first, by establishing special procedures to administrate and follow up the EIT tax returns. The special procedures are needed to minimize resources needed to manage these less revenues tax returns. Another possible measure is to promote electronic filing. This will reduce processing times in particular the key-in process. Then, in order to increase the number of submitted tax returns; tax offices have to simplify the EIT tax return forms and keep improving the tax returns submitting process. Lastly, in order to increase the individual tax revenues, tax offices should put more focus on assessing tax payments of the self employed individuals and medium to high wealth employees.

Finally, in relation to future researches, the problem of tax burden discrepancy between real sectors and the stock exchange, the dilemma in choosing between the equity of a tax system and efficiency in collecting tax from the EITs, and the challenging in choosing an appropriate income tax reforms are not the issues or problems merely faced by Indonesia. Therefore, this dissertation suggests that researches on these three areas in the setting of other countries will be beneficial as benchmarks and lesson learnt in reshaping healthier tax policies in the future.

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Appendix 1

An introduction to Indonesian Taxation

1. Introduction

The supreme base of tax collection in Indonesia is the article 23A of the 1945 Indonesian Constitution stipulating that taxes and other compulsory levies required for the needs of the state have to be regulated by law. Then in relation to law formation, the power to formulate the law lies on the House of Representatives (the embodiment of people) as stated in the article 20 paragraph 1 of the Constitution which reads as the House of Representatives holds the power to form laws. Therefore, under these two articles, it is clearly seen that a tax only can be imposed in Indonesia after obtaining people's consent.

Based on the parties who do administrating the taxes, Indonesian's taxation can be classified into two groups: central government taxes and local government taxes. This classification is similar and follows the Indonesian's government structure which consists of central and local government; in 2009, the local governments consist of 33 provinces and 497 regencies/cities[1].

Local government taxes are regulated under the Law of the Republic of Indonesia Number 28 Year 2009 Concerning Local Tax and Levies; shortly named as Local Tax Law. The local tax law regulates the types of taxes and levies that can be collected by local government. They are limited to the specific stated taxes which consist of 5 (five) provincial taxes and 11 (eleven) of regency/city taxes. Provincial taxes consist of motor vehicle tax, motor vehicles title transferring duties, motor vehicle fuel tax, surface water tax, and cigarette tax. While regency/city taxes consist of hotel taxes, restaurant tax, entertainment tax, advertising tax, street lighting tax, non-metals-and-non-stone-minerals tax, parking tax, groundwater tax, swallow's nests tax; land and building tax on rural and urban area, and acquisition of rights on land and building duties.

Local Government Tax

a. Provincial Tax
   1. motor vehicle tax
   2. motor vehicles tittle transfering duties
   3. motor vehicle fuel tax
   4. surface water tax
   5. cigarette tax

b. Regency/City Tax
   1. hotel taxes
   2. restaurant tax
   3. entertainment tax
   4. advertising tax
   5. street lighting tax
   6. non-metals-and-non-stone-minerals tax
   7. parking tax
   8. ungroundwater tax
   9. swallow's nests tax
   10. land and building tax on rural and urban area
   11. Duties on the acquisition of land and building rights

[1] See the 2009 list of provinces, regencies/cities by the Directorate General of Autonomy, Indonesian Minister of Inland Affairs

Of the many types of local taxes stated in the local tax law, local governments have the right to select type of taxes to be applied in their respective regions and set the tax rates within the range of minimum and maximum rates set forth in the local tax law. This condition has made possible that the local taxes and tax rates applied in one region may vary from one region to another region.

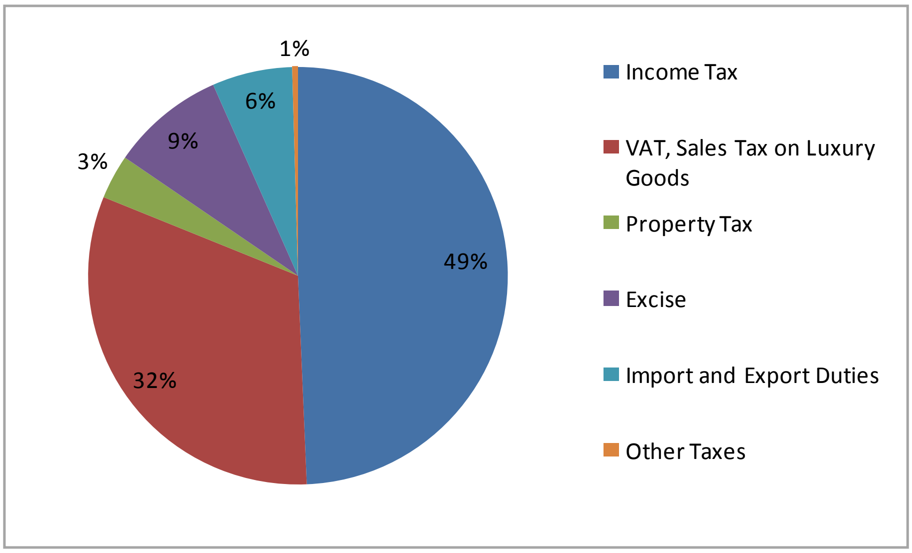
The next category of Indonesian taxes is central government taxes which consist of: 1) income tax, 2) value added tax and sales tax on luxury goods, 3) stamp duty, 4) property tax on plantations-forestry-and- mining, 5) excise, and 6) international trade tax.

Central Government Taxes

1. Income tax
2. Value added tax and sales tax on luxury goods
3. Stamp duty
4. Property tax on-plantations-forestry-and- mining
5. Excise
6. International trade tax.

The central government taxes play an important role in Indonesian's national budget as they have been the main sources of revenues for the Indonesian government since year 1989. In 2011, they contributed 72.26 percent of the total national revenues; income tax contributed Rp357 billion or 49.36 percent of total tax revenues; value added tax contributed 31.88 percents; excise, 9.15 percents; international trade tax, 4.00 percent; property tax, 3.95 percents and other tax (stamp duties), 0.55persents[2].

Figure A1.1: Tax Revenues by Sources, Fiscal Year 2011



Source: Writer based on the Indonesian Bureau Statistic's data

There are two government units in charge of administering the central government taxes in Indonesia. They are the Directorate General of Taxes (DGT) and the Directorate General of

[2] Indonesia Bureau of Statistic, Indonesia Budget Statistics 2006-2012

Customs and Excise (DGCE). Both units are under the Ministry of Finance of the Republic of Indonesia. The DGT collects and administers four types of taxes namely: 1) income tax, 2) value added tax and sales tax on luxury goods, 3) stamp duty, and 4) property tax on plantations-forestry-and-mining. While the DGCE collects and administers the excises, import and export duties, and other taxes.

2. Income Tax

Indonesian income tax is governed by the Law of the Republic of Indonesia Number 7 Year 1983 concerning the income tax which was amended lastly by the Law Number 36 Year 2008; shortly known as the Income Tax Law. The income tax law took effect for the first time in January 1, 1984 as a replacement of three different tax laws regarding taxes on income, namely 1) the 1924 corporation tax ordinance, 2) the 1944 income tax ordinance, and 3) the 1970 tax laws on interest, dividends, royalty.

2.1. Subject and Non-subject of Income Tax

Indonesian income tax is imposed on four types of tax subjects which are 1) an individual, 2) an undivided inheritance in lieu of the beneficiaries, 3) an entity and 4) a permanent establishment. Individuals and undivided inheritance are regrouped as individual tax subjects and entities and permanent establishments are regrouped as corporate tax subjects.

Tax subjects can also be categorized as resident or nonresident tax subject. For individuals, resident tax subject are defined as "any individual who resides in Indonesia, or any individual who is in Indonesia for more than 183 days within any 12 months, or any individual who is in Indonesia and intends to reside in Indonesia". For corporate, resident tax subject are defined as "any entity that is established or domiciled in Indonesia".

Several entities and individuals are excluded from tax subject, namely:

a. A diplomatic mission;
b. The officials of diplomatic and consular mission, other foreign officials and individuals who work for and stay with them at their official residence, provided they are not Indonesian citizens, nor receive or accrue income other than from the performance of their official duty in Indonesia, and the counterpart country does a reciprocal treatment;
c. International organizations approved by Minister of Finance provided that: 1) Indonesia is a member of the international organization; 2) they do not conduct business or engage other activities to earn income from Indonesia, except from providing loan to government that the fund of which comes from the contribution of its members;

d. The officials of the international organization as approved by Minister of Finance, provided they are not Indonesian citizens and do not conduct business or engage in any activities or employment to earn income from Indonesia.

2.2. Object of Income Tax

The object of income tax is income. The income tax law defines income as any increase in economic capability that are received or accrued by a taxpayer, whether originating from Indonesia or from offshore, in whatever name or in whatever form, that can be used for consumption or to increase wealth. It includes:

a. reimbursement or compensation with regard to employment and services, including: salaries, wages, allowances, honorarium, commissions, bonus, gratuity, pension, or other forms of remuneration, unless otherwise stipulated in income tax law;
b. prize from lottery, works or activities, and award;
c. net income;
d. gains from sale or transfer of property, including:
1) Any profit from property transferring to a corporation, partnership, and other entities in exchanged for shares or capital;
2) Gains derived by a corporation, partnership or other organization in property transferring to shareholders, partners, or members;
3) Benefits from liquidation, merger, consolidation, or takeover;
4) Benefits from property transferring in the form of grants, aid or donation, except from those that are given to a one degree-straight line blood relatives, and to religious bodies or educational agency or social agency or small businesses, including cooperatives that defined by the minister finance, as long as it is nothing to do with business, employment, ownership or control among the parties involved;
e. refunds of tax payments that have been deducted as an expense;
f. interest, including premiums, discounts and debt guarantee fee;
g. dividends, with the name and in whatever form, including dividends from insurance company to policy holders, and cooperatives' distribution of income;
h. royalties;
i. rental and other property related income;
j. receiving or obtaining periodic payments;
k. gains from a debt relief;
l. gains from foreign currency exchange rates;
m. difference due to assets revaluation;

n. insurance premiums;
o. contributions received or obtained by associations from its member.
p. additional wealth derived from income that has not been taxed yet.

2.3. Nonobject of Income Tax

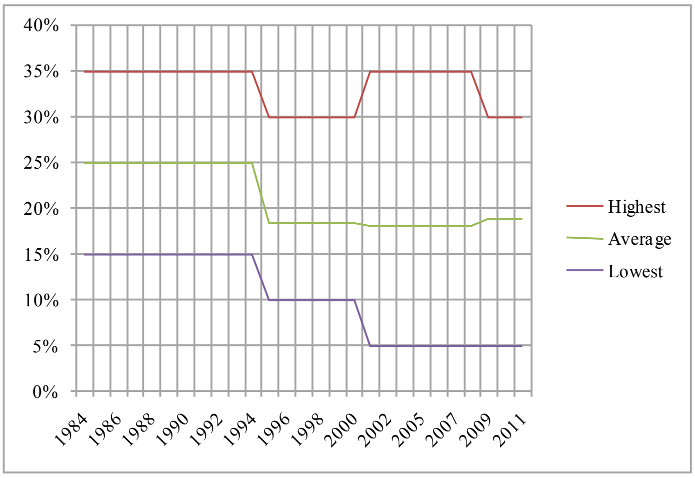
a. 1) aid, donation, including zakat received by amil zakat board or other amil zakat institutions established or approved by the government and eligible zakat recipients;
   2) gifts received by relatives within one degree of direct lineage, by religious, educational or social organizations, or by small businesses including cooperatives determined by the Minister of Finance; provided that there is no any business, work, ownership nor control relationship between the parties concerned;
b. inheritances;
c. assets including cash received by an entity referred to in paragraph (1) subparagraph b of Article 2, in exchange for shares or capital contribution;
d. consideration or remuneration in the form of benefits in kinds in respect of employment or services received or accrued from a taxpayer or the Government;
e. payments by an insurance company to an individual in connection with health, accident, life, or education insurance;
f. dividends or distribution of profit received or accrued by resident limited corporations, cooperatives, state-owned companies, or local state-owned companies through ownership in enterprises established and domiciled in Indonesia, provided that: 1) dividends are paid out from retained earnings; 2) limited corporations and state owned companies and local state-owned companies receiving the dividends must own at least 25% of the total paid-in capital and must have an active business in addition to the ownership;
g. contribution received or accrued by a pension fund approved by the Minister of Finance either paid by an employer or an employee;
h. income from capital investment of the pension fund referred to in sub paragraph g in certain sectors as determined by the Minister of Finance Decree;
i. distribution of profit received or accrued by a member of a limited partnership whose capital does not consists of shares, partnership, association, firma, or kongsi;
j. interest on bonds received or accrued by an investment fund company for the first five years beginning from the establishment of the company or the granting of business license;
k. income received or accrued by a venture-capital company in the form of profit distribution of a joint-venture company established and conducting business or engaged in activities in Indonesia, provided that: 1) the investee is a small or medium-sized enterprise or engaged in

activities in business sectors determined by the Minister of Finance Decree; and 2) the investee's shares are not traded in the stock exchange in Indonesia.

2.4. Income Tax Rate

The tax rate applied in calculating tax payable depends on the category of the taxable person. For individual taxpayers and undivided inheritance as a unit in lieu of the beneficiaries, they are taxed progressively. Since the 1984 tax reform, the structure of the tax rates has been changed for four times but the progressive tax rate remains uphold. Figure 2 shows the changes on the individual tax rates during 1984-2011. It shows that he highest tax rates was reduced from 35 percent in 1984 to 30 percent in 1995 and changed again to 35 percent in 2001. Then in 2009 the highest tax rate was reduced once more time to 30 percent. The lowest tax rate was reduced two times; from 15 percent in 1984 to 10 percent in 1995 and to 5 percent in 2011. In addition, the average tax rate was reduced from 25 percent in 1984 to 18 percent in 2001 and increased a little bit to 18.75 percent in 2009 as the result of tax bracket reducing from five income tax brackets in 2001-2008 to four income tax brackets in 2009.

Figure A1.2: The Changes of Individual Income Tax Rates 1984-2011



Source: Income tax law

Recently, starting on the 2009 tax year, as shown in the Table A1.1, the tax rate structure consists of four levels of income tax brackets with the tax rates of 5 percent, 15 percent, 25 percent, and 30 percent.

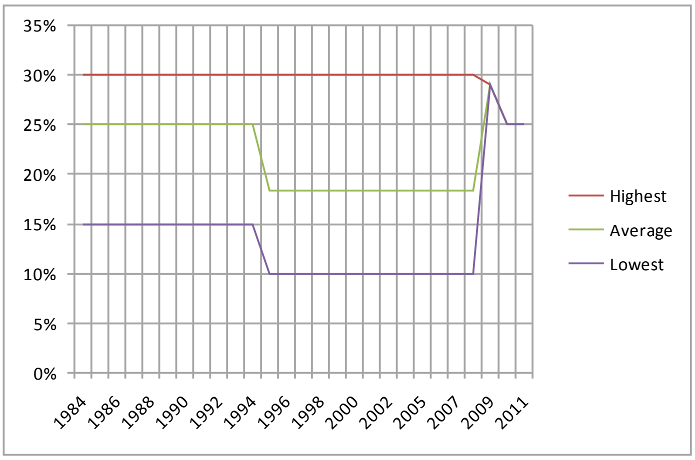
Table A1.1: The Income Tax Rate Structure 2009-2011

Taxable income brackets	Tax Rate
Rp50.000.000 (fifty million rupiahs) or less	5%
Over Rp50.000.000 (fifty million rupiahs) - Rp250.000.000 (two hundred and fifty million	15%
Over Rp250.000.000 (two hundred and fifty million rupiahs) - Rp 500.000.000 (five hundred	25%
Over Rp500.000.000 (five hundred million rupiahs)	30%

Source: Income tax law`

For corporation and permanent establishment, the tax rate structure was changed from progressive tax rate during 1984 -2008 to single tax rate since 2009. In the period of 1984 to 2008, the highest corporate tax rate has been maintained at 30 percent and the lowest tax rate has been reduced from 15 percent to 10 percent during 1995-2008. In 2009, the corporate tax structure was changed to flat tax rate 28 percent.

Figure A1.3: The Changes of Corporate Income Tax Rates 1984-2011



Source: Income tax law

Recently, starting tax year 2010, corporate taxpayers and permanent establishment are taxed at single rate 25 percents. Then, publicly-listed companies, which trade at least 40% (forty percent) of their shares on Indonesian stock exchanges and meet certain other requirements, may obtain 5% tax rates reduction compared to the normal rate. In the other words, eligible public company could be taxed at 20% tax rate. Then, Small corporate taxpayer with gross sales up to Rp 50,000,000,000 (fifty billion rupiah) will get tax tariff reduction by 50% (fifty percent) of the normal rate 25%. Lastly, for nonresident taxpayers, the income tax rate is 20 percent or tax treaty's applicable rate.

2.5. Tax Calculation

Taxable incomes for resident taxpayers include any income whether originating from Indonesia or from abroad, while for non-resident taxpayers, the income taxes are imposed only on the Indonesian sourced income. The taxable incomes for resident taxpayers and permanent establishments are calculated by deducting from gross income any deductible expenses and losses and for individual taxpayers personal exemption is also deducted. If the gross income after deductions resulted in loss, the loss may be carried forward to the 5 (five) successive years. The amount of personal exemption depends on taxpayers' marital status and number of dependents. For instance, in tax year 2011, the annual personal exemptions are as the following[3]:

a. Rp15.840.000 for bachelor individual taxpayers;
b. additional Rp1.320.000 for married taxpayers;
c. additional Rp1.320.000 for married taxpayers whose wife is working and they file a joint tax return;
d. additional Rp1.320.000 for each eligible dependent, maximum 3 persons. Eligible dependents are family members who are: related by blood or by marriage in direct lineage or adopted children.

Income tax is imposed on incomes earned for one year period. Income tax is calculated as follow:

1). for corporate taxpayers which include permanent establishment

Tax payables are calculated based on their taxable incomes after subtracted with all deductible expenses, losses, and loss carry-forward multiplied with corporate income tax rate.

Taxpayers only oblige to pay tax if they earn profits. Otherwise, they do not have to pay taxes. However, the definite annual profits or losses will only be certain at the end of the year when all transactions have been closed into financial statements. After preparing financial statements, taxpayers can calculate tax dues; the different between tax payable and tax credits; tax installments and taxes withheld by other parties. If the tax payable is bigger than the tax credits, taxpayers are required to make additional tax payment on the

[3] See Article 7 of the Law of the Republic of Indonesia Number 36 of 2008 concerning the Fourth Amendment of the Income Tax Law.

shortcomings. Otherwise, if the tax credits are bigger than the tax payable then taxpayers can claim tax refunds.

2). for an individual taxpayer

Tax payables are calculated based on their taxable incomes after subtracted with all deductible expenses, losses, loss carry-forward, and personal exemption multiplied with individual income tax rates.

2.6. Final Income Tax on Certain Incomes

In general, there are no differences on tax treatment of any incomes. All types of incomes: ordinary incomes, extraordinary incomes, business incomes, capital gains and etc, are combined altogether in calculating taxable incomes. However, there are certain exceptions in which several types of income are taxed separately. These kinds of income are mostly taxed with final withholding mechanism. It means that the withheld taxes are the definitive taxes for those incomes. Therefore, at the end of year, the incomes are not combined with other kinds of incomes and they do not affect the amount of tax payables at the end of the year. The incomes that are taxed with this final method are as follow:

a. interest incomes on deposits or savings account, interest income on bonds and sovereign bonds, and interest income paid by a cooperative to its individual members.
b. lottery incomes.
c. income from transaction of stock traded on Indonesian stock exchanges, and income received by venture capital company from selling or transferring of its shares in partner's capital.
d. incomes from property sales, income from construction business or real estate business, and land and/or building rental income.

2.7. Tax Collecting System

There are two income tax collecting systems in Indonesia; self-assessment system and withholding system. Self assessment system is applied to taxpayers who earn income from business activities: trading, industries and services. In self-assessment system taxpayers have to calculate and pay taxes by themselves without any prior notices from tax office. They have to pay monthly tax installments and submit monthly returns. Furthermore, they also have to file annual tax returns; at the end of March for individual taxpayers and at the end of April for corporate taxpayers.

The second system is withholding tax system. The withholding tax system involves three parties; government, taxpayers and tax withholders. The withholders, mostly the payer, have a legal duty to withhold or retained tax from the payments, and remit the tax to the government. This system is applied to several types of income, which includes; salary or payroll income, bank interest, rent income, royalty, dividend, lottery income, income on shares traded in stock exchange, and certain services.

3. Value Added Tax and Tax on Luxury Goods

Value Added Tax and Tax on Luxury Goods is governed by The Law of the Republic of Indonesia Number 8 Year 1983 concerning Value Added Tax on Goods and Services and Sales Tax on Luxury Goods as lastly amended by Law Number 42 Year 2009.

VAT/STLG went into effect on April 1, 1985 replacing the 1951sales tax. VAT levied on the value added arising on every stage: starting from manufacturers or importers till the stage of consumers. STLGs are collected one time at the manufacturer level or at the time of import.

VAT/STLG is a tax levied on domestic consumption (in the customs area), both goods consumption and services consumption. Therefore, goods not consumed in domestic area or in other words being exported are taxed at the VAT rate of 0 percent (zero percent). For imported goods, they are taxed the same as domestic goods which are taxed at 10 percent. In addition, several goods and services are not subject to VAT including staple goods, money, gold bullion, securities and etc.

STLGs are imposed on sales of luxury goods at the manufacturing level or at the stage of importation of luxury goods. The rates range from 10 percent to 200 percent depending on their classification.

4. Stamp Duty

Stamp Duty is governed by the Law of the Republic of Indonesia Number 13 Year 1985 concerning Stamp Duty. Stamp duty is imposed on any document bearing any meaning or intention, circumstance or a fact for a person and/or interested parties. In 2011, there are two rates of stamp duty applied which are Rp6.000 and Rp3.000 depending on the types of document and the amount cited in the document.

5. Land and Building Tax (Property Tax)

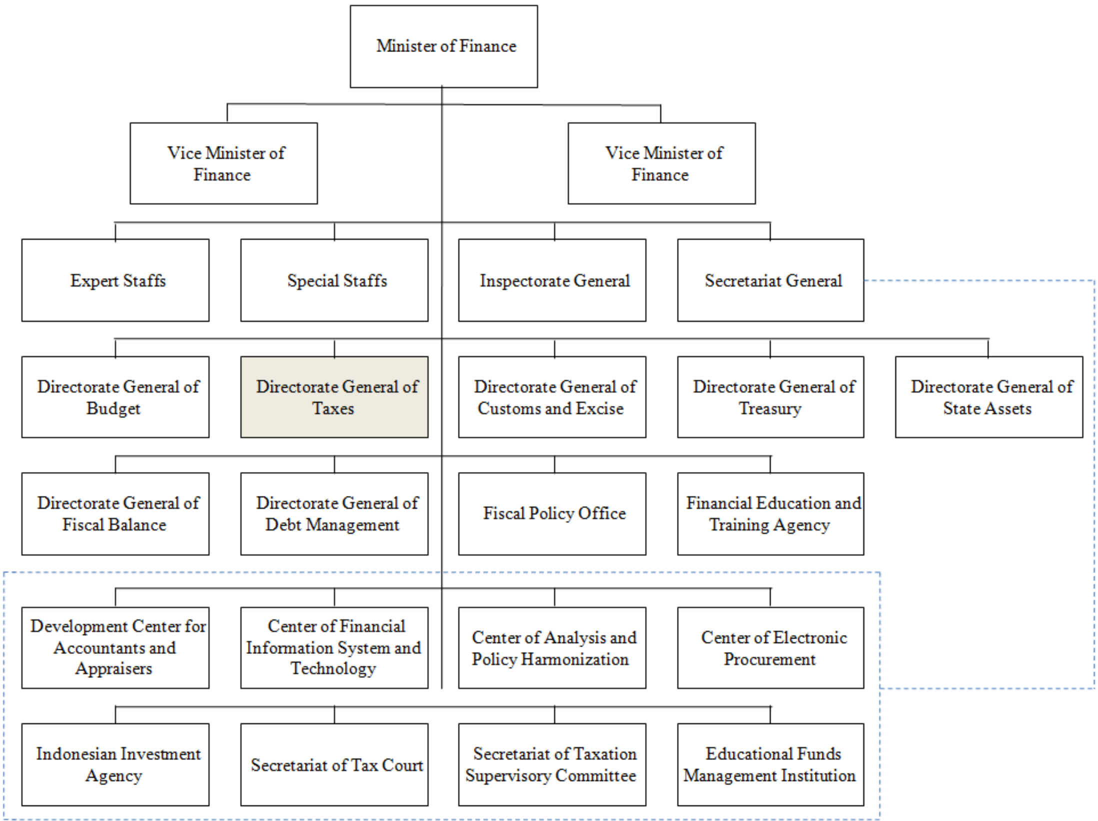
Land and building tax is governed by the Law of the Republic of Indonesia Number 12 Year 1985 concerning Land and Building Tax as amended by Law Number 12 Year 1994. The objects of the land and building tax are: 1) land including the surface and the underneath of the earth, and 2) building which means construction techniques planted or attached permanently to the ground and or to the waters.

Land and building tax is calculated by multiplying the object's taxable sales value by 0.5 percent. Taxable sales values are obtained from multiplication of certain percentages range from 20 percents to 100 percents depending on the object's status, with the object's market value.

6. Indonesian Tax Agency

The Directorate General of Taxes (DGT) is an echelon 1 unit of the Ministry of Finance headed by a director general. The DGT is responsible for collecting and administrating four types of central government taxes namely: 1) income tax, 2) value added tax and sales tax on luxury goods, 3) stamp duty, and 4) property tax on plantations-forestry-and-mining. The DGT is the biggest unit organization in the Ministry of Finance of Indonesia in term of number of employees; by December 2011, total DGT's employees were 31,736. Figure A1.4 presents the organization structure of the Ministry of Finance of Indonesia.

Figure A1.4: The Organization Chart of the Ministry of Finance



Source: http://www.kemenkeu.go.id/en/Page/orgchart

In year 2000s, the DGT has restructured its organization from tax base to functional base. The organization restructuring was initiated in 2002 by establishing a Large Regional Taxpayers

Office (LRTO) as a pilot project. The LRTO consisted of and supervised 2 large taxpayer offices (LTO).

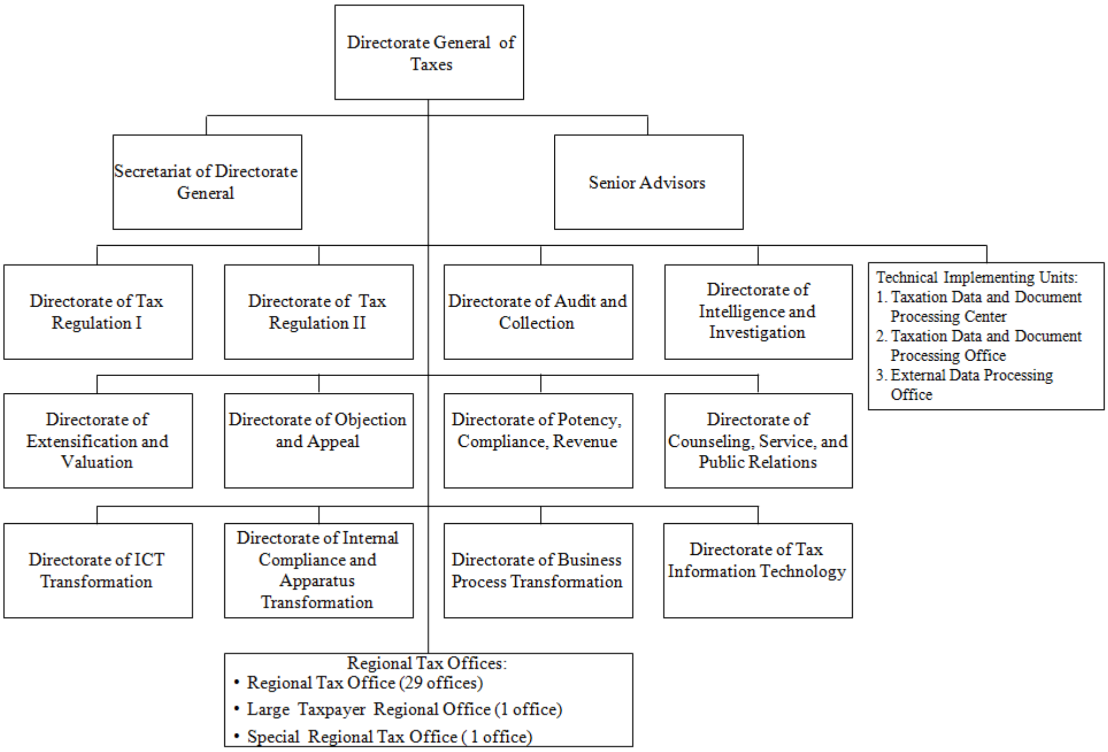
Compared to the ordinary type tax offices, the LTO is different in the areas of: organization structure, human resources, and code of conducts. The LTO's organization structure was based on functionality while the ordinary tax offices' structure was based on the type of taxes. The LTO consists of functional based sections, namely: service section, monitoring and counseling section, audit section, and collection section. Meanwhile, the ordinary type tax offices consists of tax based structured section, namely: corporate income tax section, personal income tax section, value added tax section, withholding income tax section, collection section, and objection section.

Then, at the beginning phase of the pilot project, the LTO also differed with ordinary tax offices in the area of human resources: a) LTO's employees were recruited from DGT's employees who passed several phase of tests, b) The LTO's salaries are higher than ordinary DGT's employees, and c) LTO's employees are required to observe a code of ethics. This pilot project was seen as a successful project; eventually all the DGT's units are transformed gradually to functional based. In 2003, the special regional tax office and its 10 special tax offices, namely: Foreign Capital Investment Tax Office, Listed Companies Tax Office, Permanent Establishment and Foreigner Tax Office implemented the organization restructuring. Then, Medium Tax Offices (MTOs) were established in year 2004 followed by the establishment of small taxpayer offices (STO) in year 2006 to 2008. The MTO and STO were formed by merging three ordinary tax offices: service tax office, tax audit and investigation office, land and building tax office. The process of organization restructuring was completed in year 2008.

Currently, the DGT consists of a head quarters and vertical operational units. The headquarters consisting of 1 Secretariat, 12 Directorates, 4 advisory experts; it is located in Jakarta. Vertical operational units are located in all over provinces consisting of 31 Regional Tax Offices (echelon 2 unit), 303 Tax Offices (echelon 3 unit), and 195 Tax Service, Counseling and Consultation Offices (echelon 4 unit). Besides that, the DGT has 3 data processing units located in Jakarta, Jambi, and Makassar. The complete organization structure of the DGT can be seen in the following Figure A1.5 to Figure A1.9.

Figure A1.5 presents the organization structure of the Headquarter of the DGT. The headquarters consists of 1 Secretariat, 12 Directorates, 4 advisory experts.

Figure A1.5: The Organization Chart of the Directorate General of Taxes

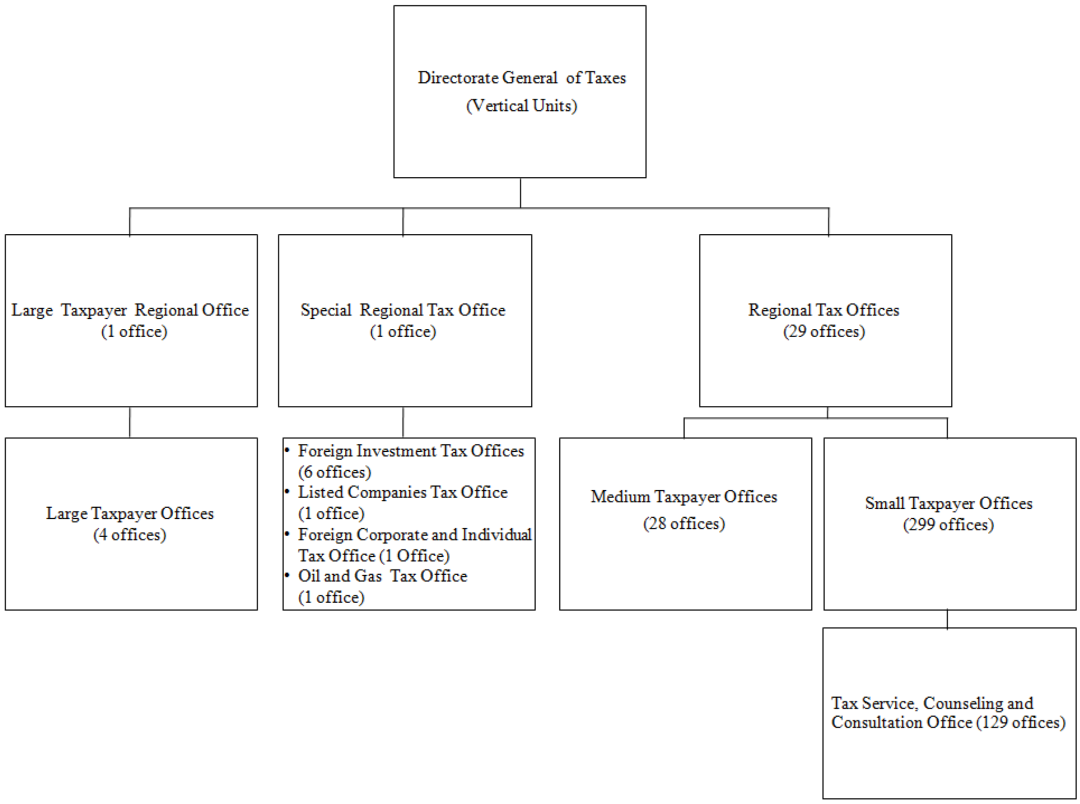


Source: Directorate General of Taxes' 2011 annual report

Figure A1.6 presents the organization structure of the regional tax offices. The regional tax offices are echelon 2 units of the DGT performing the tasks of coordinating, controlling, analyzing, and evaluating tax offices operations, and elucidation of the head office policies. There are three types of regional tax offices:

a. Regional Tax Office consists of 29 offices located throughout Indonesia.
b. Large Taxpayer Regional Office, one office located in Jakarta
c. Special Regional Tax Office, one office located in Jakarta

Figure A1.6: The Organization Chart of the Regional Tax Offices the Directorate General of Taxes



Source: Directorate General of Taxes

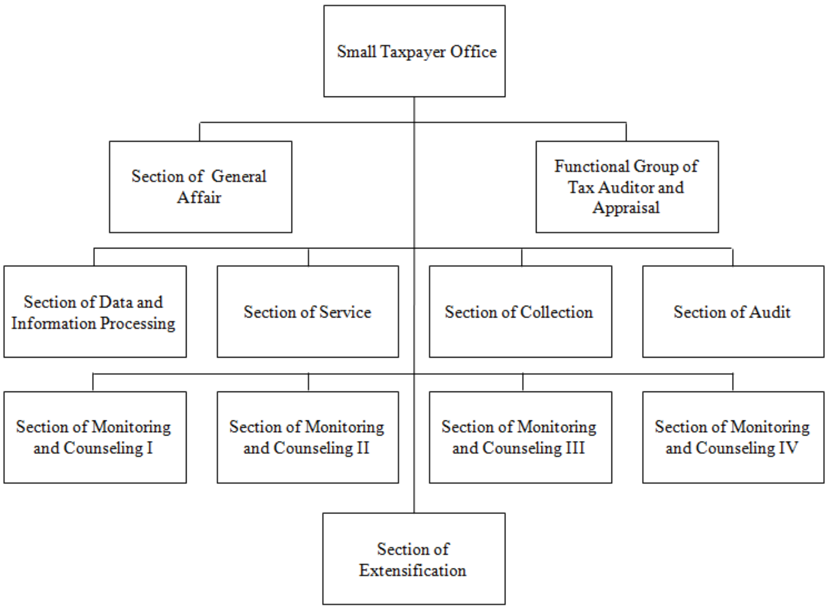
Figure A1.7 and figure A1.8 present the organization structure of the Tax Offices. Tax Offices are echelon 3 units of the DGT performing the functions of delivering services, counseling, and monitoring of taxpayers. Based on the taxpayer segmentations, Tax Offices can be differentiated into:

a. Large Taxpayer Office (LTO), administering national large corporate taxpayers, state-owned enterprises, and high wealth individuals;

b. Medium Taxpayer Office (MTO), administering large corporate taxpayers, foreign investment companies; permanent establishment and expatriates, and public listed companies; and

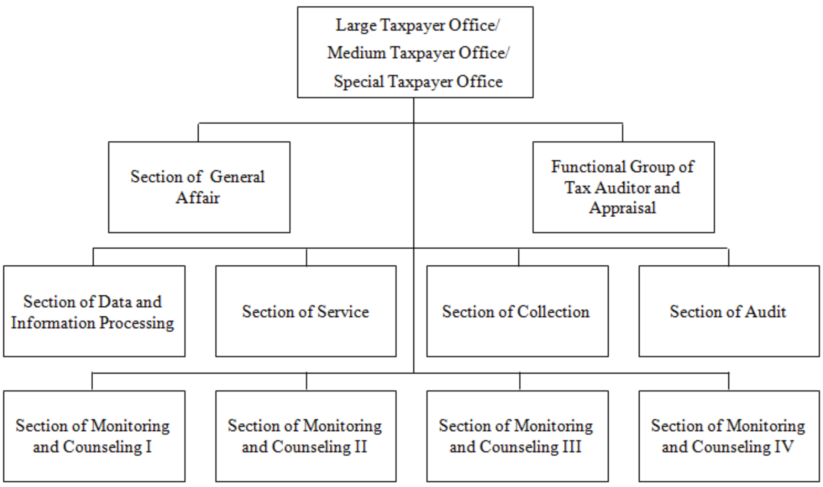
c. Small Taxpayer Office (STO), serving small individual and corporate taxpayers.

Figure A1.7: The Organization Chart of Small Taxpayer Office



Source: Directorate General of Taxes

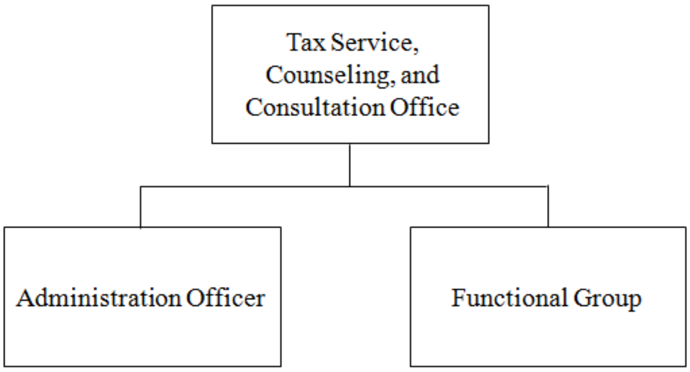
Figure A1.8: The Organization Chart of Large Taxpayer Office/Medium Taxpayer Office/Special Taxpayer Office



Source: Directorate General of Taxes

Figure A1.9 presents the organization structure of the Tax Service, Counseling and Consultation Office. The Tax Service, Counseling and Consultation Offices are the echelon 4 units of the DGT located in remote areas to undertake the taxation service, counseling, and consultation to taxpayers residing in its respective areas.

Figure A1.9: The Organization Chart of Tax Service, Counseling, and Consultation Office



Source: Directorate General of Taxes

Appendix 2

Overview of Tax Principles

For so long, quests for a better tax system have become great concerns for many. Scholars and tax experts have come up with various concepts about qualities of ideal tax systems. For instance, Smith (1776)[1] elaborated four qualities of a good tax system that were equity, certainty, convenience, and efficiency. Stiglitz (1999)[2] described five commonly accepted properties of a good tax system which were: economic efficiency, administrative simplicity, flexibility, political responsibility, and fairness. European Commission-Common Consolidated Corporate Tax Base Working Group (EU CCTB) (2004)[3] issued a paper elaborating eight general tax principles for corporate income tax which were: vertical equity, horizontal equity, efficiency/neutrality, effectiveness, simplicity & transparency & certainty, consistency & coherence, flexibility, and enforceability.

Various and multifaceted concepts or principles of sound tax systems proposed by scholars and tax experts may seem bewildering. However, if we look thoroughly, those concepts for some extent do share similarities even though they have been addressed in different ways and terminologies. This section tries to map and find common tax principles proposed by scholars and tax experts by comparing tax principles elaborated by Adam Smith, Joseph E. Stiglitz, and European Commission. As a result, this dissertation comes out with six common tax principles which were: equity, certainty, administrative efficiency, economic efficiency, flexibility, and international effect. Table A2.1 presents the comparison of tax principles proposed by Adam Smith, Joseph E. Stiglitz, and European Commission and the six common tax principles.

[1] Smith, A. (1776). Wealth of Nations. pp 676-678. The Pennsylvania State University (2005).
[2] Stiglitz, J E. (1999). Economics of the Public Sector. New York, NY: Norton & Company. pp 458-475.
[3] European Commission-Common Consolidated Corporate Tax Base Working Group (2004). General Tax Principles. Working Document.

Table A2.1: Tax Principles Comparison

Adam Smith (1776)	Joseph E. Stiglitz (1999)	European Commission (2004)	Common Tax Principles	No.
Equity	Fairness	Vertical equity	Equity	1
		Horizontal equity		
Certainty	--	Simplicity, Transparency, and Certainty	Certainty	2
Convenience	Administrative Simplicity		Efficiency	3
Efficiency	Political responsibility	Enforceability		
--	Economic Efficiency	Neutrality	Neutrality	4
		Consistency & coherence		
--	Flexibility	Flexibility	Flexibility	5
		Effectiveness	Competitiveness	6

Source: Writer based on the Wealth of Nations, Economic of the Public Sector, and EU CCTB's report.

The six common tax principles above can be elaborated more as follows.

1. Equity

Equity or fairness principle means that tax burden should be shared among people fairly. In general, there are two concepts of equity: horizontal equity and vertical equity. Horizontal equity means that people at the same economic level should pay the same amount of tax and vertical equity means that people with different economic level should pay different amount of taxes; the richer should pay higher tax. These equity concepts are known as the "ability-to-pay" concept. In pointing the equity principle of taxation, Smith (1776) asserted that "The subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the state." In the same nuance, Stiglitz (1999) reiterated that "a sound tax system should be, and should be seen to be, fair, treating those in similar circumstances similarly, and imposing higher taxes on those who can better bear the burden of taxation". Furthermore, the EU CCTB (2009) sees the fairness in the context of international taxation in which foreign companies should be treated discriminately.

Fairness is a core characteristic of a sound tax system. However, achieving an absolute fairness is almost impossible that there is no single tax system that can claim as a fair tax system. One cause is that the fairness has many dimensions; a tax system might be seen fair in one angle but become not fair if it is seen from another angle. Besides that, pragmatism in practical level also deters the efforts to achieve a sound tax system. Let's take taxing capital gains in the stock exchange as an example. In many countries, capital gains arising in the stock exchange and ordinary income are taxed differently. This unequal treatment, for one reason, has been taken due to the reasons of simplicity and easiness in collecting tax even though it creates unfairness in the tax system.

2. Certainty

Certainty means that tax system should ensure that the amount of tax which each individual is bound to pay, ought to be certain and not arbitrary. In pointing the certainty principle of taxation, Smith (1776) mentioned that the time of payment, the manner of payment, the quantity to be paid, ought all to be clear and plain to the taxpayer, and to every other person. Furthermore, he claimed that certainty in a tax system may reduce conditions that could foster insolence and corruption; he argued that that the certainty of what each individual ought to pay is, in taxation, a matter of so great importance that a very considerable degree of inequality, it appears, is not near so great an evil as a very small degree of uncertainty. The EU CCTB (2009) adds that certainty is desirable to assist business planning and to provide a degree of revenue certainty for government as it can predict tax payments and revenues.

3. Efficiency

Efficiency means that tax should be collected at low cost as possible which includes all costs that incurred by both taxpayers and tax agencies. Smith (1776) mentioned that "Every tax ought to be so contrived, as both to take out and to keep out of the pockets of the people as little as possible, over and above what it brings into the public treasury of the state." Similarly, Stiglitz (1999) emphasize that a sound tax system should have low costs of administration and compliance. Compliance costs include expenses such as stationery, printing, copying, stamp, transportation and non monetary aspects such as time spent, anxiety, opportunity costs. Administrative costs cover all costs needed to make tax office able to operate which include facilities costs, employees' expense, utility expense, compliance test expense and other expenses. It is widely believed that the simpler a tax system is, the lower the administrative or compliance costs is.

Furthermore, in collecting tax, convenience should be put into consideration. Smith (1776) mentions tax should be imposed at the time or in the manner, in which it is most likely to be convenient for taxpayers to pay it. Among many kind of taxes, payroll tax may be an example of tax that is imposed in convenience time; taxes are withheld when taxpayers are receiving their salaries. These points of time are considered as the most appropriate times to collect taxes. It is better than such as at the end of tax year when there is a possibility that the money have been disbursed or changed to another form of assets.

Furthermore, it is important to improve convenience tax environment because it influences the taxpayers' voluntary compliance. It could be understood that a taxpayer who really want to pay taxes voluntary but because of inconvenience in tax payment will make him/her reluctant to pay it. For instance, a taxpayer from remote area faces difficulties in paying taxes because, in order to do so, he/she has to take a long trip to a closer city where the bank or post office as the tax recipient institutions located. Surely this situation will hinder the voluntary compliance.

4. Neutrality (Economic Efficiency)

Neutrality means that tax system should be neutral to ensure that investment decisions take into account the 'best' location from an economic perspective. This principle is influenced by free market school of thought that economy would allocate resource efficiently and some taxes could alter the allocation of resource. Siglitz (1999) said that tax system should not be distortionary; if possible, it should be used to enhance economic efficiency. Similarly, the EU CCTB (2009) affirms that tax system should avoid "locational inefficiency" whereby investments are not placed where the productivity of capital is highest. However, in certain circumstances, tax policy may be used to correct 'market failures' whereby distortions or inefficiencies in a particular market economy can be 'corrected' by the use of specific tax incentives.

5. Flexibility

Flexibility means that tax system could be flexible enough to be adjusted with the changes of its environment. Stiglitz (1999) argues that the important aspect of the flexibility of tax system for purposes of stabilizing economy is timing; the speed with which changes in the tax policy can be implemented. The EU CCTB (2009) stressed the flexibility is essential as the market and business practices change over time so the tax base should be capable of change as well. However, the EU CCTB realizes that flexibility has a backward; too much flexibility can endanger certainty.

6. Competitiveness

Competitiveness means that a tax system of a country in this globalization era should notice tax burdens internationally. If tax burden is highly difference, investors may move their investments from the high tax burden country to lower tax burden country considering other factors, such as political situation, security, and infrastructures, are relatively similar.

This dissertation classifies the six common tax principles into two groups based on their relative closeness to the pole of taxpayers' interest or to the pole of state's interest. The first group is equity and certainty. The equity and certainty of tax system affect and directly can be felt by taxpayers. A fair tax burden sharing and the certainty on the amount of taxes and the tax procedures are among many things that taxpayers demand. This situation can be illustrated in the relation between a simple organization and its members. For instance the equity aspect; let's take a social organization with two members on it. In order to run the organization, the two members agree to share the organization's expenditures. Then, now comes the question on how the expenditures would be shared among them; surely they want a fair sharing. However, The discussion on how to divide the burden among them will take a consideration from both persons because to get a fair sharing sometimes is not easy as fairness may not merely mean that the expenditures should be divided in the same amount but it may consider other factors such as the wealth of each of them, the time dedicated to the organization and many others and most importantly it directly affect them personally.

On the other hand, if we look at from the organization's interest, the issue may lay more on how to collect enough money to pay the disbursement rather than the fairness of the proportion of the expenditures sharing. Similarly, this situation may occur in much more complicate organization such as a country; the relation between people and state. People will be more directly affected by the fairness of tax burden sharing rather than the state.

Then, the concepts of efficiency, neutrality, flexibility, and competitiveness are closer to the interest of government rather than to the interest of taxpayers. For instance, tax efficiency is a domain of government in their effort to gather money from the people. An efficient tax collection may reflect that the government runs its duty in good governance. On the other hand, taxpayers may not directly affected by the issue of efficiency in tax collection.

Finally, among 6 common tax principles, the equity aspect of tax system from the standpoint of taxpayers and the efficiency from the standpoint of the government as the core of a sound tax system are discussed more in this dissertation in analyzing the income tax policies changing in Indonesia in the area of capital gains tax policies in the stock exchange and tax return policies.