Who pulled the strings? A comparative study of Indonesian and Vietnamese tax reform

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5. THE 1983 INDONESIAN INCOME TAX REFORM

5.1 INTRODUCTION

In 1983, Indonesia adopted a radical tax reform package which came into force in 1984–86. The new tax laws replaced a complicated system of colonial corporate and individual income tax laws as well as the 1951 sales tax law. The main public reason for passing this legislation was to increase non-oil-related tax revenue[43] and thus reduce dependence on oil revenue (Asher 1997) (Booth 1992, p.41).

This chapter analyses the 1983 income tax law-making against the background of the political environment in Indonesia. It does not pay specific attention to the VAT, a tax that also formed an important part of the reform.[44] The chapter aims to provide an insight into who and/or what influenced this tax reform. It also discusses the limitations faced by policy-makers and the role of various influential actors in this particular law-making process.[45]

The main aim of this chapter is to examine who and what influenced the tax law reforms, including interest groups, media, the government, political parties and foreign advisers.

The chapter starts with an introduction to Indonesia, followed by an analysis of its government structures and law-making processes during the time of this case study. It then provides an historical overview of Indonesian taxation and examines the background of the 1983 tax reform. These aspects together form the setting in which the actual reform took place, which is subsequently discussed. The chapter concludes with an update on tax law developments after 1983, followed by some conclusions.

5.2 INDONESIA: COUNTRY BACKGROUND

More than one thousand islands make up the Republic of Indonesia. The country is rich in resources, particularly in oil. In 1998, 200 million people were living in Indonesia, the majority (around 60%) on the island of Java. The country is divided along racial, ethnic, religious, class and regional lines. The ethnic Chinese minority in Indonesia counts for less than 5% of the population but controls more than 70% of the Indonesian economy.

After more than three centuries of Dutch colonial rule, Indonesia became independent in 1945. The Dutch came to the Indonesian archipelago as spice traders

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43 In oil-exporting countries, tax revenue are often divided into non-oil tax revenue and income tax revenue from the oil and gas sector Asher, M. G. (1997). Reforming the tax system in Indonesia. Tax reform in developing countries. W. Thirsk. Washinton, D.C, The World Bank, Regional and Sectoral Studies..

44 VAT, by its very nature, is a totally different tax than income tax or corporate tax. Ultimately, VAT bears on individual consumers of goods and services. Often those who pay are not fully aware of their tax burden This means that the tax law making processes of VAT are very different to corporate and individual income tax law making.

45 As mentioned in 1.3, It is important to emphasize that since the tax reform processes of the 1980s in Indonesia, much has changed in the Indonesian tax laws. The principal purpose of the study is to develop a model for understanding such tax reform processes.

at the end of the 17th century, aiming to secure control of the major ports of northern Java and the main (spice) trade centres of the other islands.[46] By the middle of the 18th century, the Dutch colonisers politically controlled most of Java. During the 19th century, pressured by economic demands and foreign competition, the Dutch felt their loose control over the outer islands was no longer sufficient. They wanted closer control and a uniform administration and this led to severe conflicts with local forces. At the beginning of the 20th century, the Dutch claimed control over the entire Indonesian archipelago. This control lasted until the Second World War, when Indonesia was occupied by the Japanese (Schwarz 1994, pp. 1-24).

In 1945, Sukarno, leader of the independence movement, proclaimed the nation's independence, but the Dutch Government refused to accept. It was not until 1949 that the Netherlands, after years of military action, finally handed over power. Sukarno, a prime figure during the conflicts with the Dutch, became the first president of an independent Indonesia (Schwarz 1994, pp. 1-24). Under the new Constitution, the People's Consultative Assembly (MPR)[47] was established.[48] The MPR exercises the sovereignty of Indonesia, which resides with the people. The MPR meets at least once every five years[49] and has the authority to enact and to amend the Constitution. It also provides the broad outlines of national policy. It includes members of the House of Representatives (DPR, the Indonesian version of parliament), representatives from the various regions of Indonesia, political parties, and delegates from 'functional groups' such as labour unions, the military and co-operative societies.

In practice, the parliamentary democracy that followed after independence was often disorganised and far from effective. Many politicians simply lacked experience (Schwarz 1994). The government had an anti-Western foreign policy, rejected Western aid and withdrew from the IMF, and World Bank. In its domestic policies, the government nationalised most foreign businesses and exercised extensive price controls (Nasution 1983).

In 1965 an attempted communist coup led to the collapse of the Sukarno era.[50] General Suharto emerged as the leading figure of the armed forces, suppressing the coup. In what amounted to a successful counter-coup, Suharto established himself as president and took governmental control in 1966. Suharto's regime, backed by the Indonesian army, lasted for more than three decades until 1998, and is often labelled the 'New Order'. The regime has been criticised for restricting political freedoms, for human rights abuses, and for corruption. At the same time, during this era the standards of health, education, housing and transport improved. Over the last 40 years, Indonesia has had no outspoken enemies and has fought no wars. Since the late 1980s there have been increasing pressures for more democracy and openness.

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46 During the Dutch occupation of Indonesia, Indonesia was better known as the Netherlands Indies, a term not used in the text to avoid any confusion. The Netherlands Indies had its own government established and controlled by the Dutch.

47 *Madjelis Permusjawaratan Rakjat*.

42 The constitution was written in July and August 1945, when Indonesia was emerging from Japanese control at the end of World War II. It was abrogated by the Federal Constitution of 1949 and the Provisional Constitution of 1950, but restored on July 5, 1959 (http://en.wikipedia.org/wiki/Constitution_of_Indonesia).

49 Since 2000, the sessions are held annually.

50 The coup is still subject to much speculation and it is still not clear who was involved and what exactly happened, including the role of the army during the coup and Suharto's role in particular.

In 1998, President Suharto stepped down as president in the midst of economic crisis and political turmoil and Indonesia began its first steps on the road to a return to democracy.

In 1966, when Suharto took control, the Indonesian economy was near collapse. His government immediately introduced an economic stabilisation and rehabilitation program to re-establish order in Indonesian society and to stimulate economic development. Part of the agenda was to restore a balanced budget and from 1967 onwards all budget decisions were centralised in the Ministry of Finance. The government believed that in order to realise this program, popular participation in politics had to be strictly limited. The roles of the MPR and the DPR were greatly restricted. In 1967 the government gave itself the power to appoint one-third of the members of the MPR and one-fifth of the members of the DPR. Suharto wanted to ensure that the parliament would approve his policies and not offer alternative ones; in effect parliament became a toothless tiger (Schwarz 1994, pp.30-32). As Suharto stated, “With one and only one road already mapped out, why should we then have nine different cars?” He added: “The general elections must serve the very purpose for which they are held, that is, to create political stability. Only these kinds of elections are of value to us.” (Schwarz 1994, p.32). [51] Suharto initiated the party organisation Golkar as the regime’s parliamentary vehicle. Civil servants were forced to vote for the Government’s party Golkar and the establishment of other political parties was curtailed.

The economists[52] Mohammed Sadli, Emil Salim, Subroto, Ali Wardhana and Widjoyo were appointed to carry out Suharto’s economic program and acted as personal economic advisers to Suharto. Widjoyo and Wardhana were the two key people in charge of the tax reform. In 1962, he received a PhD in the US at the University of California at Berkeley (as part of a Ford Foundation program to train economists). From 1968 to 1983, Wardhana was Indonesia’s Minister of Finance. He then became Coordinating Minister for Finance and Industry from 1983 to 1988. He later held several positions within the World Bank and the IMF. Widjoyo was based at the national planning board, called *Bappenas*, developing economic policies. These economists remained Suharto’s advisers or members of his cabinet for many years, and according to Bresnan, Suharto’s stable relationship with these five experts was exceptional (1993, p.73). Suharto and his team were in charge for more than 25 years, and during this period there were no major ideological changes (Winters 1996, p.xiv).

The economic advisers, also known as the ‘technocrats’, were not the only actors attempting to shape Indonesia’s government policies. There was a group of so-called economic ‘nationalists’ who believed that the government should play a large role in the economy and should give more support to indigenous businesses. This group did not have much economic power but definitely had political power. The third group, widely known as the ‘cronies’, consisted of people who were close to President Suharto and included his relatives, as well as some of Indonesia’s very wealthy, often

[51] Since 1971, the DPR has comprised 460 members (this was recently increased to 500). Of those, formerly 360 (now 400) are elected representatives from the various political parties. The president appoints 100 members from non-military and military functional groups.

[52] Most of them were university professors.

Chinese, businessmen, such as Bob Hasan and Liem Sioe Liong. A large majority of the wealthiest ethnic Chinese businessmen owe their entry and subsequent success in business to high-powered government officials (Schwarz 1994). They had the advantage of being close to the president, but at the same time they had to operate in a tactful way, since Chinese businessmen are the subjects of considerable racial hostility from most Indonesians.

The economic advisers were all but one educated in the US.[53] Wardhana's study in the US and this seems to have had a great influence on his perception of, and approach towards, the largely US-dominated advisory team. The advisers had the full support of organisations such as the World Bank, IMF, USAID and Indonesia's creditors group (known as the Inter-Governmental Group Indonesia, IGGI). They shared the same economic ideology, with an emphasis on free markets, transparency and balanced budgets. After the political turmoil in 1965, an IMF team returned to Indonesia in July 1966 and, a month later, a World Bank mission arrived to assess which imports were most needed. Their representatives worked closely with the technocrats and a signal was sent to the international community that this economic team would have a strong influence on economic policies under President Suharto (Winters 1996).

After 1965, when the economic ministers started to implement their policies, Indonesia had an investment climate similar to that of its neighbouring countries, one relatively open to foreign investors. This started to change in the second part of the 1970s because of the oil boom. The government received plenty of revenue from oil resources and was therefore less responsive to the technocrats' wishes to improve the investment climate to lure investment capital. The nationalists' political influence increased and large investments of government capital were made in domestic industries. During this period, Suharto gradually increased his political control. It was not until 1982 that the Indonesian government began again to seek to improve the competitiveness of the country's investment climate when it became clear that an influx of capital was required to stimulate the Indonesian economy (Winters 1996). But, at the same time, the regime did not make the elimination of corruption a priority. On the contrary, corruption became institutionalised, with army officers and their (often Chinese) business partners as the main beneficiaries (Schwarz 1994). The 'level playing field' view promoted by the technocrats did not go down well with the beneficiaries of the policy of favouritism. Although the technocrats exercised significant power, it was definitely not unlimited. They were given room to introduce regulations to improve the investment climate in Indonesia, but they did not have the power to make real changes in the way the Indonesian bureaucracy operates. As expressed by Wardhana, "Our frustration is that we have control over part of the game but we can't win the game unless other parts play along," (Schwarz 1994, p.77).

Unlike other countries, Indonesia does not have many politically powerful societal actors. Oil companies and other large enterprises exert a certain influence, but the same cannot be said of the majority of Indonesian businesses, especially smaller

[53] Prof. Dr. M.A. Subroto received his education at the Faculty of Economics at the University of Indonesia and McGill University, Montreal, Canada.

sized businesses that are not in a position to consider relocation and have little say in policy matters (Winters 1996).

The institutional structure of the state, especially of those institutions responsible for economic policy, remained remarkably unchanged in this period. At the same time, the country steadily increased its integration into international markets of all kinds, particularly during the 1980s (Winters 1996, p.xi).

After Suharto came to power, the independence of the provinces (other than Java) declined and so did the role of political parties. During the late 1960s and 1970s, political opposition was steadily destroyed by the Suharto regime. The regime demonstrated that it would not hesitate to use force against anybody who dared to oppose it regardless of whether they were the urban and rural poor or middle and upper class figures of Indonesia. This factor is very important when analysing the tax law-making in the 1980s. The fact that there was little opposition is to a large degree the result of fear that opposing the regime in any visible way would not be tolerated.

5.3 GOVERNMENT STRUCTURES AND LAW-MAKING PROCESSES BETWEEN 1975–90

During the New Order period, the Indonesian government was centralised and hierarchical and important strategic decisions regarding the 27 Indonesian provinces were made by the national government in Jakarta. Most financial resources used by the provincial and local governments came from the central government. Executive power rested with the president of the republic. As already mentioned, in the period 1975 to 1985, Suharto gradually increased his political control and increasingly prevented criticism from coming to the surface (Schwarz 1994). The result was that Indonesian law-making became more and more authoritarian and centralised. Even if it appeared that ministers acted rather autonomously, no official law-making policy of any weight was adopted without the approval of President Suharto. The success of different competing groups in gaining access to the political agenda and achieving implementation of their agenda was dependent on the president's appraisal of the consequences of a proposal for his own political strategy for retaining power (Winters 1996). This was exactly the line of reasoning the team of economic advisers would use to exert their influence. They would point out to Suharto that not implementing certain economic policies or measures could destabilise his regime. Ensuring economic growth and the elimination of poverty were two key elements for stability, and convincing factors for Suharto`s economic advisers to use in their efforts to persuade him of their case.

Non-governmental actors such as orthodox Muslim leaders, nationalist politicians, progressive academics and liberal economists were all excluded from the political process and were dissatisfied with the political ground-rules created by Suharto. But criticising the president was unwise in a country where political opposition was not tolerated. Instead, these actors used the indirect method of criticising those close to the president. The technocrats, lacking any political party backing, were an easy target for many non-governmental actors to promote their views and channel their resentment (Schwarz 1994). In addition, if one set of actors lost influence, another group of actors would gain. For example, an often-used tactic by the nationalists was accusing the technocrats of leaning too heavily on foreign advisers. In some instances this tactic worked and weakened the position of technocrats and increased the power of the nationalists over Suharto's policies.

Law-making processes

There are various forms of law-making in Indonesia (Damian and Hornick 1972). As in many other countries, 'constitutional' issues are not just resolved in the formal constitution but also in other sources of law, such as MPR decrees (King 2001, #369). A decree of the MPR generally outlines national policies in the legislative and executive areas of government. Those related to legislation have to be implemented in the form of statutes while those concerning executive policies have to be implemented by Presidential Decree. In addition to statutes, there are government regulations promulgated by the president to implement a statute. Furthermore, there are Presidential Decisions to implement the Constitution, a decision of the MPR, or to implement a government regulation. Moreover, other regulations, often announced by a minister, implement regulations of a higher order.

Very important in the legislative process are statutes enacted by the DPR. They are passed for the purpose of implementing either the Constitution or a decree of the MPR. The president also has emergency power to promulgate 'regulations in lieu of statute' which are of the same rank as statutes but must be withdrawn unless approved by the DPR at its next session. One of the main features of Indonesian statutes is their broad and general character (Damian and Hornick 1972). Often, statutes leave details to lower executive measures, effectively authorising lower levels of government to exercise significant law-making powers.

The various stages of the legislative process involving statutes include the following steps:

1. The president or a minister takes the initiative for new legislation. A committee is established within the relevant ministry.

2. A draft is discussed with the senior staff of the relevant ministry and, if applicable, internal/external consultants.

3. The draft is then sent to the secretary of the president (the State Secretariat).

4. The president approves the draft.

5. The draft then goes to the DPR and members of parliament invite the relevant ministry to explain the draft and often the minister or senior staff of the ministry give the explanations.

6. A parliamentary committee is formed, generally consisting of about 30 members.

7. The committee discusses the draft, article by article, and amendments are made.

8. The draft is approved by parliament.

9. The draft is sent to the president for ratification.

In the legislative process, it was, and still is, quite common for foreign advisers to play a role. As pointed out by Winters:

> Those familiar with Indonesian nationalism and pride might be surprised to learn that top policy-makers are extraordinarily comfortable using foreign consultants to draft the country's legislation. My own observations and direct experience confirm that as late as 1991 American consultants were still drafting major Indonesian legislation (tax reform, capital markets, trade deregulation etc) (1996, p.61).

5.4 HISTORICAL OVERVIEW OF THE INDONESIAN TAX SYSTEMS

General

The history of the Indonesian tax systems can be divided into three periods: the pre-colonial period, the colonial period and the post-colonial period. The main emphasis here is on the development of the income tax system over the centuries. It is important to realise that in the past it was common that tax collectors received part of the taxes collected, a practice, although illegal since the 1950s, that is still in fact prevalent. Moreover, for many centuries, it has been common to pay additional fees, on top of the official fee payable, to various government officials. These fees, often labelled by foreign observers as bribes, are paid to ensure receipt of a particular government service, varying from obtaining documents from a police department, licenses from the motor vehicle department, to the working permits from the immigration departments. The amounts, though small, are crucial to prevent delays.

More recently, additional payments of a different kind apply to contracts with the government. In this case, the amounts paid to government officials are much more substantial[54] and are paid by companies eager to obtain government contracts. Foreign and domestic companies pay enormous amounts of money to secure government work. These payments can be made in the form of an equity share in the company involved (Schwarz 1994). During the Suharto era there was no political will to change these practices and, on the contrary, many of Suharto's relatives and close business friends were involved in this way of doing business.

Pre-colonial period

The mobilisation of labour to harvest the resources of the seas and land forms the core of the tax system in pre-colonial Indonesia. The pre-colonial Javanese dynasties

[54] In some cases, up to 15% of the contract value.

operated on this system of taxes paid in kind (Schwarz 1994, p.3). The payment could be made in rice or pepper or in labour such as building roads or palaces, personal services to the king and other officials, and military service.

Colonial period

From 1830 onwards, the Dutch started to make a serious effort to exploit Indonesian resources. During the colonial period existing taxes were reshaped and a range of new taxes was gradually introduced. The main flow of total colonial revenue, however, came from non-tax revenue, including government trade monopolies in salt, opium and pawnshops and the sale of natural resources (forestry, coal and tin). Moreover, the Dutch colonial government received profits from public enterprises such as the railway and bus services, harbour works, post and telegraph services, and electricity. This changed in the period 1900–41, which was marked by an increasing tax burden on indigenous Indonesians. Taxes gradually took over the predominant role in government revenue (Booth 1980). In 1900, 38% of total revenue found its source in tax; in 1939 this was 63% (Booth, O'Malley et al. 1990). This increase was at the expense of revenue from monopolies and the sale of products. The period also saw a decline in revenue from land tax combined with an increase in excise and income taxes.

Tax under Dutch rule can be divided into four separate periods (Paauw 1954). The first period, 1620–1800, was characterised by exclusive economic access to Indonesia by the Dutch East India Company. Taxes did not play an important role in government finance during this period and were limited to some commercial profits. But the Company imposed heavy levies on the local population via the 'quota and supply' system. Towards the end of the 18th century, the colonial government continued the tradition of payments in kind. These payments could be in the form of work on agricultural land (*Heerendiensten* or statute labour) or performing village duties. On Java, more so than on the other islands, significant payments in kind were made in the form of village duties (Booth 1980).

The second period, 1800–70, included levies on the sale of certain goods such as opium, liquor and tobacco, and on certain activities, for example, the slaughtering of cattle and the sawing of wood. This period also saw the start of a heavy reliance on land taxes,[55] introduced during the short British occupation of Java (1811–16). But the British attempt to create a uniform land-tax system failed and after return to Dutch rule, the Dutch decided that the system was not generating the desired revenue. They changed the tax system from cash payments to payments in kind under the so-called culture system. Under this system, local farmers had to pay tax in the form of a share of their production of agricultural export crops. Moreover, farmers were obliged to sell their remaining export crops to government collection agencies at below-market prices (Paauw 1954).

Additional to these taxes was compulsory labour on government plantations for very low wages. The culture system was abolished in 1861; during its life span a minimum of 20% of total village cultivatable land had been used for government purposes

[55] In the 19th century land became a more important commodity followed by the increasing importance of minerals.

(Paauw 1954). After 1861, the agricultural sector continued to carry a major tax burden with high levels of export duties on agricultural products. Rubber plantations especially bore the brunt of this tax. Moreover, the agricultural sector was a major consumer of imported goods subject to import duties, thus increasing their overall tax exposure.

The major shift of opening Indonesia to private capital marked the beginning of the third period in 1870. The Dutch introduced levies on foreign enterprises in the form of enterprise and business licence fees. This period saw a gradual move away from land taxes to taxation of the non-rural sector (Paauw 1954).

This trend became pronounced during the fourth period which commenced in 1920. In 1867 land taxes contributed 49% of total tax revenue but by 1929 this had decreased to 11%. Over the same period there was also a move away from revenue from export sales towards tax revenue.[56] Although the colonial government made serious attempts to increase the revenue flow from income tax, the major bulk of tax revenue came from indirect taxes, especially import duties (see Table I). Other indirect taxes included excise taxes on liquor, petroleum products, matches, tobacco and sugar.[57] Furthermore, there were capital assets taxes, slaughter taxes, export duties largely levied from agricultural products, stamp taxes, motor vehicle tax, lease and permit tax, and taxes on the transfer of property. Table 1 outlines the different sources of tax revenue during the first four decades of the 20th century. It is important to realise that tax payments in kind, such as labour and rice, are not included in the table, although they formed a significant part of the overall tax burden.

[56] Indonesia's revenue structure during the period 1900–40 is similar to that of its neighbouring countries during this era, with a large part of revenue coming from non-tax sources. For tax revenue one can see a decline in land taxes and an increase in trade taxes and excises (Booth, A., W. J. O'Malley, et al., Eds. (1990). Indonesian Economic History in the Dutch Colonial Era. New Haven, Connecticut, Yale University Southeast Asia Studies.).

[57] This is not a complete list, but covers the most important indirect taxes. Minor taxes not mentioned in this list include, for example, dog taxes, lottery taxes and permits for Chinese dice games.

Table 1. **Percentage Breakdown of Colonial Tax Revenues 1901–1940 (percentage of total tax revenue)**

YEAR	INCOME TAXES	NATIVE LAND TAX	URBAN LAND TAX (a)	HOUSE & PROPERTY TAX	EXPORT TAXES	IMPORT TAXES	EXCISES	OTHER (b)
	Personal / Corporate							
1901–5	8	32	4	2	3	18	10	23
1906–10	13	26	4	2	3	20	12	20
1911–15	20	21	3	2	3	23	11	17
1916–20	22	16	3	1	3	23	9	24
1921–25	37	9	2	1	3	19	7	22
1926–30	15 17	11	2	1	4	25	11	14
1931–35	21 5	13	2	2	4	22	18	13
1936–40	16 16	8	2	1	12	18	21	6

Source: (Booth 1980, p.93)

a) Land tax paid by urban property owners.
b) Includes war profit tax, transfer tax, stamp duties, slaughter taxes and other miscellaneous taxes.

Income tax

Up until 1920, under Dutch rule there were two tax systems, one for indigenous Indonesians and one for Europeans living in the colony. Further, the tax systems of the trade centres, Java and Madura, were different from those in other parts of Indonesia.

Indigenous income taxes until 1920

As mentioned earlier, during their brief period of occupation (1811–16), the British introduced two new taxes, a tenement tax on non-agricultural land owned by indigenous people and a tax on agricultural land. After return to Dutch rule, the tenement tax was extended to non-indigenous people of Asian origin. In 1839, it was converted into a business tax with an exemption for farmers (Mansury 1984). The rate was 2% of income from trading, business, personal and professional services above a certain threshold. This tax applied until 1905 when it was replaced by a tax on business and other income. This new tax had a tax-free threshold combined with progressive rates and applied to indigenous and non-indigenous Asians living in Indonesia. Exemptions were given to government officials and those who paid land tax. From 1907 onward, corporations with indigenous or Asian shareholders had to pay a tax that was levied on all income derived from agriculture, manufacturing, trading activities and the provision of services. And although there were some differences, the overall tax structure was quite similar for the outer islands.

Taxes for Europeans living in Indonesia until 1920

Europeans living in Indonesia had their own personal tax system as well as a patent tax. This patent tax targeted income in the form of money or goods and the applicable rate was 2%. In 1908 an income tax replaced the patent tax for Europeans residing in Indonesia. Non-residents were also subject to the tax for income received from Indonesia. Over the years, the rate increased to 8% by 1918. During the First World War, in 1916, the Dutch government launched a tax on war profits which was abolished in 1919.

The 1920 unified Income Tax Law and the 1925 Corporation Tax Ordinance

The 1920 tax reform was a major overhaul of the previous system and especially the income tax law was seen as a milestone in modern taxation (Mansury 1984). It unified the separate tax systems for indigenous and European residents in Indonesia and introduced the principle that the tax was levied on net rather than gross income.[58] It worked on the assumption that the income earned on a particular date (1 January of each calendar year) was a fair representation of the income earned throughout the year and this income was accordingly taxed. Any excess or shortfall would be rectified in the tax assessment of the following year.

All residents of Indonesia earning above the tax-free threshold were subject to this new income tax (principle of domicile), although there was no definition of residency in the law; this being left to the interpretation of the tax administrators. Individuals as well as companies or any other commercial entity were subject to the Income Tax Law. Non-residents receiving income from Indonesia were also subject to this law (based on the source principle). The rates were progressive for individuals and flat for companies at 6%. However, there was a higher rate of 10% on so-called excess profits.[59]

The new law had only a short life. The government appointed several consecutive tax reform committees to decide whether there should be a separate income tax for

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[58] As pointed out by Mansury (Mansury (1984). "A bird's eye view of Indonesian income taxation history." Asian-Pacific Tax and Investment Research Centre Bulletin(12). Although the government aimed at unifying the income tax systems for indigenous Indonesians and Europeans in Indonesia, this was not entirely realised. The land rent system as an income tax for indigenous Indonesians from land revenue remained applicable for Java and Madura, Bali, part of Kalimantan and South Sulawesi.

[59] Excess profits were defined as distributed profit that exceeded 8% of the paid-up capital Ibid..

corporations, and if so what their tax base and rate structure (progressive or proportional) should be (Mansury 1984). The committees made several recommendations, including the abolition of the higher excess-profit tax rates and a preference for a flat tax rate of 10%. This resulted in the Corporation Tax Ordinance of 1925, an ordinance that, although subject to various modifications, remained in place until the 1983 tax reform. The ordinance dealt with issues such as accounting principles, depreciation for tax purposes and the revaluation of assets.

The 1932 Personal Income Tax Law

With the promulgation of a separate corporate tax system in 1925, it seemed logical to revamp that part of the 1920 Income Tax Law part that related to individuals. The modern provisions for corporations in the 1925 ordinance regarding depreciation and accounting principles could equally apply to individuals but the 1920 Income Tax Law did not deal with these issues. Furthermore, the government aimed to coordinate the personal income tax with the system in the Netherlands so as to avoid double taxation for those with income in both countries. Such coordination would also mean that Dutch case law in the area of personal income tax could be used in Indonesia. Nevertheless, it took many years before a new personal income tax law was introduced. There were delicate topics to be resolved such as the appropriate rate structure, the tax-free threshold and the collection system.[60]

In 1932 a new Personal Income Tax Law was finally introduced. It retained the domicile principle for residents of Indonesia and the source principle for non-residents. A novelty, however, was the inclusion of a time test: any person residing in Indonesia for more than 365 days would be classified as a resident for tax purposes. Those residents leaving the country for less than 365 days were still considered tax residents of Indonesia.

There was much discussion about the level of the tax-free threshold (Mansury 1984). Under the 1920 Income Tax Law, the threshold was 120 guilders and the government decided to keep the same limit under the new 1932 law. This increased the number of people in the lowest tax brackets without producing much extra revenue and at great administrative expense. Moreover, paying income tax is often perceived as politically sensitive, in contrast with indirect taxes that often go unnoticed by those paying them. Although the advisory team suggested increasing the tax-free threshold, the colonial government decided otherwise. In defence of this decision, the government pointed out that “it was the obligation of everyone in society to contribute to the government”.

But the reality was different. The tax burden increased significantly, especially at the beginning of the economic crisis in the 1930s. Indigenous Indonesians were the main contributors to land tax, export and import tax, and excises on petroleum products, matches, tobacco and sugar. These were taxes that were relatively inelastic in relation to changes in indigenous income (Booth 1980). If taxes paid in the form of labour or rice were considered, the burden was even heavier on indigenous Indonesians during this last part of the colonial period.

[60] Moreover, the government was awaiting the outcome of commissioned research on the tax burden. Ibid.

The 1935 Wage Tax Ordinance

In 1935, the first system of withholding tax was introduced with the Wage Tax Ordinance. The employer collected the tax when wages were paid out to employees. If the wages were low, for example for servants, a system of wage tax stamps applied. The withholding tax, though efficient in theory, caused many headaches with insufficient administrative capacity to ensure payment, especially when low incomes were involved (Mansury 1984).

Post-colonial period 1940–81

During the Second World War, the Japanese government replaced the Personal Income Tax Law with the 1944 Transitional Tax Law. Meant as a temporary measure only, the Transitional Tax largely followed the principles of the 1932 Personal Income Tax, although there were some differences, including the change from a fictive to a real assessment system. This meant that the definite tax assessment would not be issued until after the end of the taxable year. A provisional tax could be levied based on the income earned in the previous taxable year. It also meant the abolition of the time test for determining tax residency.

After the independence of Indonesia in 1945, the newly established government stipulated that all existing laws would remain in place until further notice. In 1957, the Indonesian Government renamed the 1944 Transitional Tax the 1944 Income Tax. In 1961, the Wage Tax Ordinance was added to the 1944 Income Tax. The 1925 Corporate Tax Ordinance remained in place. In 1967 the system of advance payment of taxes changed, as a result of Law No. 1 1967. Under this law, the system of provisional tax assessments issued by the tax authorities was no longer applicable for tax payments during the taxable year. Instead, corporate taxpayers had to self-assess what their income during the year was going to be and pay the right amount of taxes to the Treasury, the so-called MPS system.[61] Under this new system, on average the monthly corporate tax payable was 1% of gross revenue or sales. However, the rate could be different based on the type of business (Mansury 1984). In addition to the MPS, the MPO system was introduced, paying taxes on behalf of others.[62] Various organisations, such as government agencies, were appointed as MPO withholding-tax collectors. They had to withhold a certain amount of corporate taxes when paying for the purchase of goods. The rate for MPO payments was 2% of sales. Both MPO and MPS were in fact systems of prepayments of corporate taxes, with a credit available for the taxes due at the end of the taxable year.

In 1959 a withholding tax on dividends was introduced. This tax was broadened in 1970 to include interest, dividends and royalties. As with the other withholding taxes, this tax involved a prepayment of the tax liabilities due after the taxable year.[63]

These tax laws, especially the Corporate Tax Ordinance of 1925, knew various amendments over the years, and gave birth to large numbers of decrees, regulations,

[61] MPS stands for *Membayar Pajak Sendiri*, calculating and paying one's own tax.
[62] MPO stands for *Memugut Pajak Orang*, withholding other taxpayers' tax.
[63] Unless the receiver was a non-resident of Indonesia. In such a case the withholding tax was final.

amendments, circulars etc. It became confusing for both tax administrators and taxpayers to work with these laws. The Ordinance, for example, had an extensive system of tax incentives and privileges. The tax incentives were used to promote investment in favoured industries such as export and the development of less developed regions. In order to finance this expensive system, the overall corporate and individual tax rates remained high during the first part of the Suharto era.

In the late 1960s state-owned enterprises were important contributors to corporate tax revenues. When Suharto came to power, his government made a serious attempt to increase tax revenue from other sources, especially revenue from customs duty collection, income tax and proceeds from excise and sales taxes (Nasution 1983). These efforts had some results. Still in 1983-84, state-owned enterprises contributed half of the corporate income tax collected (Asher and van Eeghen 1987, p.134). In 1980 1.2 million individuals paid income tax (219,000 self-employed taxpayers and an estimated 1 million tax payers who paid tax under the withholding tax system), of the estimated 11 million that should be paying income tax (of a population of 147 million at the time) (Asher and van Eeghen 1987, p.134)

The overall tax revenue increased during the period 1969–79, even if oil-related tax revenue is excluded. The domestic tax ratio, including oil, increased from 7.1% in 1968 to above 18% in 1976–77. When oil is excluded, the ratio grew from 6% to more than 8% (Nasution 1983). The modest increase in overall non-oil tax revenue (excluding corporate income tax revenue from oil companies) in the period 1969–79 can be explained by various factors. First, there was an improvement of collection rates in personal income tax and indirect taxes; second, Indonesia experienced a high inflation rate in the 1970s as well as a real growth of the economy. Third, various new taxes were introduced, including the 1969 sales tax on imported goods.

Even though there was an increase in non-oil-related tax revenue, the bottom line was, that during the first 15 years of the New Order, most tax revenue came from oil companies. In the second part of the 1970s oil and gas revenue counted for more than 10% of GDP. Non-oil tax revenue was around 8%. After the second oil boom in 1978, oil and gas revenue had risen to over 16% in 1981 while non-oil tax revenue fell to 6.6%. In 1981 foreign aid accounted for 3.4% of GDP (Nasution 1983).

Indirect tax revenue grew at a similar pace to the overall growth of the economy. The direct taxes, such as personal income tax and corporate income tax, did not generate much revenue. This was partially caused by tax incentives, including corporate income tax holidays, varying from two-to-six years, while the shareholders of those companies did not have to pay Indonesian taxes on the dividends received during the period of the company's tax holiday. Those companies not qualifying for the tax holidays could be eligible for an investment allowance. The allowance was a deduction from taxable profits of 20% of the amount invested spread over four years at 5% annually. Further incentives were available for companies to sell their shares to the public, to use public accountants to audit returns, and to promote development of co-operatives. Some companies were eligible for accelerated depreciation and there were generous carry-forwards of losses for newly established companies. Any losses incurred could be carried forward for four successive years.[64] If the losses were incurred during the first six years after establishment of the company, these could be carried forward for an indefinite period.

But the advantages of tax holidays and tax incentives are often exaggerated as illustrated by a case study in a 1980 World Bank report on Indonesia (World Bank 1980). Those foreign companies enjoying tax holidays in Indonesia complained that they were still subject to a withholding tax levied on traded commodities. Although this tax was meant to be a prepayment of the corporate tax liabilities at the end of the taxable year, it was a final tax for those companies that had been granted a tax holiday. The result is that the actual benefits of tax holidays were significantly lower than appeared. Moreover, the additional fees and levies collected by various government departments were definitely not subject to any tax holiday, adding to the overall costs of doing business.

Another feature of the Indonesian system was the so-called ‘target system’, mentioned above, that has prevailed in the Indonesian tax system for many centuries (Lerche 1980, pp.34-51). In 1999, the system was still in place. Tax revenue is collected according to this system. When the government prepares its annual budget, targets are set for tax revenue. The targets are set at the top, and in the lower ranks tax administrators have to meet these targets, which are not always realistic and in line with the economic conditions of a particular region. Local tax collectors adopt the principle of ‘taxation by negotiation’, subject to tax regulations and the targets set (Nasution 1983).

Prior to the oil boom, the Indonesian tax structure was quite similar to many other developing countries, with a heavy reliance on indirect taxes. In 1966, indirect taxes accounted for 80% of total tax revenue. By 1977–78 this had decreased to less than 25% due to the huge increase in oil-related tax revenue. However, as a percentage of non-oil tax revenue, indirect taxes still accounted for 76% in the financial year 1977–78 (Glassburner 1979). Overall, the tax system in the 1970s was regressive due to this heavy reliance on indirect taxes. Even though the personal income tax was very progressive, it only accounted for 3% of total tax revenue.

In 1979, Glassburner pointed out that if Suharto was serious about his policy aim of stability, growth and equity, the last one, equity, needed attention, a view shared by Nasution (1983). Non-regressive or progressive taxes ought to be further developed to tax the income of the Indonesian wealthy and to reverse a disturbing trend of regressive taxes in the first 15 years of New Order policy. Glassburner believed that the corporate and personal income tax laws at the time were not sufficient to achieve this.

> The present structure of and rate schedule of the personal and company income taxes is such that enforcement is all but impossible, even if the competency and incorruptibility of the tax collectors were above reproach (Glassburner 1979, p.312).

[64] In most countries carry-forward of losses is only allowed for a limited number of years.

5.5 BACKGROUND OF THE 1983 TAX REFORM

The 1970s were not conducive to a major overhaul. Oil prices were booming. Oil revenue was so high that the relevant government ministers did not see any urgency to reform the tax system. Although Indonesia accounted for only 6% of OPEC production, oil accounted for two-thirds of Indonesia's exports. But the oil boom also made clear that there were great disadvantages from the sudden inflow of external funds because the economy could not absorb this inflow without inflation.

This dependency on oil did not escape the attention of international organisations. There were various attempts and proposals to reform the tax system by the IMF and the World Bank. In the 1960s and 1970s, year after year, their reports paid attention to problems in the tax area, but the comments were generally broad and the advice was quite general, without going into detail about how to reform the existing tax system (Lerche 1986, p.179).

It is important to understand that organisations such as the IMF and World Bank had an immediate interest in reforming Indonesia's tax system. Since Suharto came to power, Indonesia depended significantly on foreign aid as a source of government revenue, and the multilateral agencies wanted to see some certainty that Indonesia would be able to repay those debts. In 1970, Musgrave, an international tax expert and public finance specialist, prepared an extensive assessment of the tax system, which was reviewed by an IMF mission in 1974. The German government initiated a technical assistance study on organisational reform in the tax area in 1978–79. This was followed by a German development aid project to reorganise and computerise part of the tax system. German assistance came on the scene once again in the 1980s with the implementation of the 1983 tax reform. The project then focused on tax administration.

In 1979 Ali Wardhana acknowledged the need for tax reform to decrease the dependency on oil revenue (Winters 1996, p.164). As Lerche points out (1986, p.172), this was, in the middle of the oil boom, a farsighted and fortunate conclusion. Although Wardhana was the crucial initiator of the tax reform, the reform would not have been possible without Suharto's support. Although Suharto did not want to be bothered with the details, he approved the reform in principle.[65]

One of the problems was that there were only a few people within the Ministry of Finance who had the expertise required to assist in the reform.[66] The education statistics for that period illustrate the problem. In 1980, only 0.1% of people over the age of 14 in Indonesia had completed post-secondary education. In Malaysia this percentage was 10 times higher and in Australia it was even 100 times higher with

65 Interviews with former Director General of Taxation and Minister of Finance Mar'ie Muhammad, tax and legal adviser Greg Churchill, and retired senior tax official Hadikusumo.

66 Interview with Dr Lloyd Kenward, former IMF representative in Indonesia and economic adviser on various aid projects in Vietnam and Indonesia, 27 November 2005. As Kenward pointed out: "In those days very few senior public servants had received tertiary education let alone studied abroad and there were simply very few people in Indonesia who were able to assist."

close to 10% of the population receiving tertiary education[67] (Barro and Lee 2000). This may partly explain the large number of foreign advisers used in the drafting of the new tax legislation. An additional reason as suggested by Lerche was that the Ministry of Finance preferred foreign advisers during the drafting stages to avoid the leaks and lengthy discussions that would have occurred if domestic consultants, academics, businessmen etc. had been included (Lerche 1986, p.183).

As mentioned earlier, the use of foreign advisers was an easy target for the nationalists. And with the growth in domestic confidence in the late 1980s and with the Indonesian economy booming, many, especially American, advisers were sent home. Using foreign advisers can be an easy way of ‘scapegoating’. At the end of the day, those in government could always say that they relied on foreign advice and any mistakes made could be blamed on the advisers involved. The use of foreign advisers can also be used as a shield against any criticism, using the status and expertise and perceived objectivity of foreign consultants as a defence against any pressure from local groups.

5.6 THE ESTABLISHMENT OF THE TAX REFORM STUDY PROJECT

In early 1981, Wardhana took the initiative to overhaul Indonesia’s tax system. As Minister of Finance, he was in charge of overseeing the Directorate General of Taxation. The government, and Wardhana in particular, did not want to give the impression that it was overly influenced by one particular organisation such as the IMF. It did not want to rely on the tax model of one particular country or donor. Indonesia’s financial decision-makers were open to learning from other countries’ experiences, for example the Shoup mission in Venuzuela and Liberia, and the Musgrave–Gillis mission in Columbia (Gillis 1985, p.77).

Although the major reason for the reform was, to raise non-oil tax revenue, there were additional goals. They included the streamlining of the tax laws, improving the tax administration in order to provide better services and increase efficiency, and reducing tax-induced distortions in the allocation of resources and achieving economic neutrality (Harberger 1988, p.32). Moreover, it was crucial that the poor not be made worse off as a result of the reform (Asher 1990, p.16) .

Wardhana requested the assistance of the Harvard Institute for International Development, better known as HIID[68], during that same year, 1981. Indonesia became one of the biggest customers of HIID. This was a logical choice as the institute had advised the Indonesian government on economic issues since the early 1960s.[69] It had already had several advisers, including Malcolm Gillis, based in the Ministry of Finance in Jakarta. Wardhana asked HIID, and Gillis in particular, to organise a team of experts from around the world to assist in drafting completely new tax legislation and improve the tax administration.[70] The Indonesian Government paid all HIID expenses. It wanted

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67 As we will see later, during the tax reforms in Vietnam in the late 1980s–early 1990s, 1.4% of the population received tertiary education. No statistics are available for Vietnam for 1980.

68 In the 1960s HIID operated under its former name: the Harvard Development Advisory Service.

69 See Winters, J. A. (1998). "A review of 'Building a modern financial system: The Indonesian experience' by David Cole and Betty Slade." Journal of Asian Studies **57**(3): 908-09.

70 Internal report of HIID by C. Williamson Gray 1984.

to ensure that it was seen as independent in its selection of advisers. Had aid funds been used, the donor may have had influence over the appointment of foreign advisers.

HIID's approach was unique, as it not only included policy recommendations, but also involvement with the actual drafting of legislation. The HIID advisers, with Cheryl Williamson as the HIID resident coordinator in Jakarta, worked with Mr Salamun (until 1982, Sutadi[71]) and his Directorate General of Taxation. For three years this team worked together with Indonesian officials from the Ministry of Finance formulating options for tax reform and preparing draft laws. There were around 30 to 40 people from the tax department involved. Not all tax officials involved spoke English. Most correspondence and discussions between the team and officials of the Indonesian Ministry of Finance were conducted in English without translations or interpreters, excluding a large number of possible Indonesian participants.

The members of the HIID technical team included mainly economists (19 economists, 6 lawyers and 2 accountants/computer specialists). Of the 19 economists, 12 were from the US. HIID, together with the Indonesian authorities, included seven non-Americans — one of these was the Dutch economist S. Cnossen — to give the team a more international image.[72] Of the remaining six, most had lived, studied or worked in the US. All six lawyers involved were American-based and educated. The overall approach to the tax reform reflected the background of these advisers. The economists, mainly academics, mostly stuck to the principles outlined in chapter 3: confine the objective of taxes to producing revenue and aim for a tax system that would be neutral between economic choices and between economic activities. They had experience with the very complex US tax system, which many regarded with horror. They believed that interventionist tax policies would be more likely to create market failures than to correct them. Many of them believed that there was actually very little role for governments to play in correcting the markets (Winters 1996). Others believed that the government should deal with market shortcomings in other ways than via the tax system, such as through private sector competition policy or investment in areas such as education, infrastructure and research.

The tax reform study project was lead by a steering committee of senior officials from the Ministry of Finance, including Wardhana, Salamun and Committee Secretary Haryono. This committee formally took part in all decisions that dealt with key policy matters. Subcommittees were established to deal with income tax, value-added tax and tax administration. As we will see later in this chapter, the committees' memos often partially defended existing procedures and regulations in an attempt to balance the recommendations made by foreign advisory reports. In some instances, the memos echoed the foreign advice, but tailored it to the Indonesian situation, reflecting the influence of the committee members. But the internal memos between HIID consultants of the project clearly show that the subcommittees had little influence in the discussions with the articulate and highly experienced foreign advisers (Williamson 1984).

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71 Sutadi was Director General of Taxation from 1972 to 1982. In mid-1982 Wardhana ordered his replacement. Although Sutadi was formally included in the exchanges of information between the advisory team and the Indonesian Ministry of Finance, he did not play a major role. Various people urged his replacement to restructure the Directorate General and to curb rampant corruption. His successor was the well respected Salamun, who was more involved in the reform process than Sutadi.

72 Interview with S. Cnossen, March 1998. In this interview Cnossen emphasised that both HIID and Wardhana did not want to give any room for criticism that the team was dominated by Americans. Mainly for this reason other foreign advisers were invited to join the team.

5.7 STAGE 1: JANUARY TO JUNE 1981

At the beginning of 1981, eight ministerial-level decisions were made regarding appropriate strategies and tactics (Gillis 1985, p.228). Those responsible were the ministers involved in economics and finance, but they received informal advice and a wealth of information from the HIID advisers.[73] The decisions were partly based on the lessons learnt from tax reforms in other countries. They reflected tax policy approaches popular in the US in the 1960s and 1970s. The case studies used from other countries, especially Colombia, involved to a large extent the same American-educated economic advisers who were part of the HIID team (Gillis 1994).

First, it was decided that it was crucial to take enough time to complete the task; months would not be enough,[74] instead, years were needed to make the reform a success. The ministerial group did not expect any revenue shortfalls until late 1983, allowing them ample time to revamp the tax system.

Second, based on the 1968 Colombia tax reform experience, it was decided that tax policy decisions needed to be converted into laws immediately in order to avoid technical problems later on. In the process of drafting, any inconsistencies or problems that came up could be resolved straight away. Thus, it was scheduled that after the second year of technical studies, a team of lawyers would convert the policy decisions into legislation. Envisaging that all technical studies would be completed within two-and-a-half years, an additional three months was allocated to complete the drafting process.

The entire reform process had a 33-month schedule (Gillis 1985, p.228). Inspired by the Colombian experience, the team decided that in addition to the economists on the team, it was important to include a number of lawyers to convert the tax policies into draft legislation (Lerche 1986, p.180).

The third decision related to the use of foreign advisers. Based on the experiences in Colombia, the group decided that to ensure the appropriate implementation of the new laws, it was important to involve senior officials in the reform. A steering committee of senior government officials (with limited capacities in the English language) was designated from the various parts of the Ministry of Finance. The task of the committee was to monitor and participate in the work of the expatriate technical team.

Fourth, a decision was made for a low-key approach to reform. This meant that it was not desirable to have a large contingent of foreign advisers 'on the ground'. The general procedure was that the foreign experts would liaise with the resident consultants: Williamson for the specific legal issues and Gillis for the main part of the work. The HIID experts would work on a fly-in fly-out basis and were often no longer than one or two weeks in Indonesia to assess the situation, mainly in the period

[73] Gillis, fully appreciating the notion of 'local ownership', gives the impression he was only one of the many players in the reform process. See, for example, Gillis, M. (1984). Macro and Micro Impact of Tax Reform in Indonesia. Boston, Harvard Institute for International Development. The reality was that he was the most important foreign adviser who enjoyed the confidence and respect of Indonesian key decision-makers. And he was involved in the initiatives to start the reform in the first place.

[74] This was in contrast to the rather quick tax reform process in Colombia, Japan, Bolivia and Liberia.

1981–83. In most cases, Gillis summarised the advice/memos from the various foreign advisers and sent the summaries to Wardhana and Salamun.

An implication of the low-key approach was that there was to be no public discussion. The foreign economists on the team agreed with this approach as they believed public discussion would only complicate their task and increase the risk of ending up with less simple tax laws, as various groups would attempt to lobby for particular tax incentives. But the real pressure to treat the draft laws as state secrets came from the government, including Wardhana.[75]

A fifth decision concerned the training and education of tax officials. Because the project allowed for plenty of time, this aspect could be incorporated. It was decided that the tax department needed more capable staff and about 20 or 30 people were sent abroad in the late 1970s and early 1980s to prepare for the tax reform package. Most of these officials received their further education in Europe (especially the Netherlands) and the US and most returned in 1984. They were heavily involved with the subsequent implementation of the 1983 reform, but were not key players in the policy-making leading to the new tax legislation.

The sixth decision was to start from scratch, abolishing most existing tax laws. There were very few elements in the old tax system that needed to be maintained.

The seventh decision was another benefit of the longer time-frame: to address procedural and administrative issues as well as implementation within the reform framework. For this reason, the team of technical advisers needed to include data communication specialists, tax administrators and accountants.

The eighth decision was that, in contrast to many tax reform projects, there would be no single final report. Instead, technical studies on particular issues were presented to the policy-makers as soon as the studies were completed. This immediate feedback meant that adjustments could be made. According to Lerche, (1986, p.180) no preconditions or limits were set for tax innovations, allowing room for new ideas and experiments.

Finally the oil sector was explicitly exempt from the new income tax law. This sector had its own tax regime, outlined in the so-called production-sharing contracts.

5.8 STAGE 2: JUNE 1981 TO OCTOBER 1982

During this stage, a number of foreign consultants on the team made brief visits to Indonesia to obtain the information necessary to formulate their advice, especially in the period June to October 1981. From November 1981 to October 1982, further analyses were made in the US and Jakarta, with several consultants (including Bird and Wells) revisiting Indonesia for further research. During this period, consultants (including Perry, Andrew Quale, Cnossen, McLure) produced numerous memos on a variety of tax issues. The memos were sent to the HIID team leaders, Gillis and/or

75 HIID had worked in many other countries with, in some cases, extensive public debate during the reform (for example, in its various consultancy projects in Africa and Eastern Europe).

Williamson. It was mainly Gillis who liaised with the Ministry of Finance and Wardhana, in particular. See Table 2. below for the consultants used by HIID . The Table gives the background and qualifications of the advisers used. It is compiled based on information obtained from various sources (mainly internal memos from HIID). I am fully aware that the Table is incomplete as no further information has been available.

Table 2. List of HIID advisory team[76]

Economists	Experience in Indonesia	Advisory role in reform process	Affiliation at time of consultancy	Reports written
Ralph Beals — US				International tax and excises
Richard Bird — Can	None	Income taxes Taxation and the agricultural sector Framework for tax reform	University of Toronto	The revenue target system (28-8-81) Revenue targets revisited (10-7-82)
Sijbren Cnossen — NL	Substantial	Internal indirect taxes Tax administration measures to support tax reform Framework for tax reform	Erasmus University, Rotterdam	Together with John Due, sales tax and MPO (8-81) Tax arrears and enforcement measures (5-9-81) Design and drafting of tax procedures law
Robert Conrad — US	Substantial	Revenue forecasts: existing and reformed system Information systems Income taxes Natural resource taxes	Duke University (on leave 1981–83 at Harvard University)	Tax incentives for going public (20-8-81) Business income and withholding-tax systems Tax system analysis (8-81)
David Dapice — US				International tax
Jean Due — US	None	Taxation and the agricultural sector	University of Illinois	
John Due — US	None	Indirect taxes	University of Illinois	Together with Cnossen, sales tax and MPO (8-81) Export taxes
Sebastian Edwards — Chile	None	Framework for tax reform	Banco Hipotecario, Santiago, Chile	Export certificates (8-81) Pension payments to civil servants in Indonesia (8-81) International tax Taxation of interest
Malcolm Gillis — US	Substantial	Revenue forecasts: existing and reformed system Income taxes Internal indirect taxes Natural resource taxes Institution building (fostering tax planning and research) Framework for tax reform	Harvard University (HIID)	International tax Excises
Richard Goldman — US	Some	Taxation and the agricultural sector	Harvard University (HIID)	Clove market structure and taxation (31-7-81) Kretek industry: tax and related issues (8-81) Tax policy and market restriction on palm oil (8-81)
Dan Gressel — US	None	Framework for tax reform	University of Chicago	Preliminary projections of public savings 1982–83 (12-9-81) International tax
Arnold C. Harberger — US	Some	Framework for tax reform	University of Chicago	Influence of international oil prices (8-81) Indexing methods for tax purposes
Thomas Hart —	None	Revenue forecasts:	Duke University	Tax identification numbers

[76] This Table was drafted by the HIID team and used for internal purposes. The classifications of levels of experience were made by the HIID team.

US		existing tax system and reformed system Information systems in taxation Income taxes Internal indirect taxes Institution building (fostering tax planning and research)		
Glenn Jenkins — Can				Debt- equity ratios for deductibility of interest payments
Dietrich Lerche — Germany				Property tax Estimating the revenue impact of selected product taxes
Charles McLure — US				Together with Wells, further issues on tax incentives for foreign investment (6-8-82) Designing a simple income tax (18-8-82) Taxation of interest
Richard Musgrave — US	Some		Harvard University (emeritus) University of California, Santa Cruz	
Dwight Perkins — US	None	Taxation and the agricultural sector	Harvard University — Director HIID	
Guillermo Perry — Colombia	None	Tax administration measures to support tax reform Income taxes Institution building (fostering tax planning and research)	Partner Meija, Millan and Perry, Bogota, Colombia (former director of national taxes, Colombia)	Personal income tax and related issues (9-81) Preliminary thoughts on personal income tax reform (2-82) Together with Williamson, potential number of personal income taxpayers, taxable income and tax vs present figures (2-82) Real estate and derived income tax and valuation of property
Sattya Poddar — Can				
Carl Shoup — US	None	Wealth tax Framework for tax reform	Colombia University (emeritus)	Net wealth taxation and suggestions for general framework of tax system (17-9-81) Possibilities of a flat tax
Emil Sunley — US	None	Tax administration measures to support tax reform Information systems in taxation Institution building (fostering tax planning and research)	Until June 1981: Deputy Assistant Secretary, US Treasury After August 1981: Haskins and Sells	Tax administration, taxpayer identification, master tax files and other issues (8-81) Deductibility of depreciation.
Louis T Wells — US, specialised in business administration		International tax issues	Harvard University	Tax incentives for offshore plants (24-7-81) Tax provisions in geothermal contracts (31-7-81) Tax incentives for foreign investment (28-7-81) Together with Quale, taxation of financial institutions (1-82) Together with McLure, further issues on tax incentives for foreign investment

Lawyers				
James Clad — NZ	Substantial	Taxation and the agricultural sector Legal issues Income taxes	1980–81 Centre for International Affairs, Harvard University (on leave from NZ Foreign service)	Tax administration
Edward Craft — US				
Andrew Giffen — US				
Cheryl Williamson Gray — US	None	Income taxes Internal indirect taxes International tax issues Taxation and the agricultural sector	Harvard University	Together with Perry, potential number of personal income taxpayers, taxable income and tax vs present figures (2-82) Potential for using PEDA data to assess PPd and PKk (5-3-82) International aspects of Indonesian income taxation (22-3-82) The PBDR: its application to international and domestic transactions (6-4-82) International taxation: an introduction to the issue of transfer pricing between affiliated parties (4-82)
Karl Price — US				
Andrew Quale — US	None	Income taxes International tax issues Natural resource taxes Legal issues	Coudert Brothers (law firm), New York	Together with Wells, taxation of financial institutions (1-82) Accounting International tax
David Rosenbloom — US				
David Smith	Substantial	Tax administration measures to support reform Legal issues	Harvard University	
Stanley Surrey — US		Legal issues Framework for tax reform Tax administration measures to support reform International tax issues	Harvard University	
Accountants and Computer Scientists				
Barbara Burton — Can				
Malcolm Lane — US				

The discussions on the new Income Tax Law

Although there were several meetings with the Indonesian members of the subcommittee on income tax (as explained earlier various subcommittees were established to deal with the different taxes), most discussions took place between the HIID consultants themselves or between Wardhana and one or more HIID consultants.[77] Gillis and Williamson were the main interface between the foreign

[77] Interview with S. Cnossen, 16 March 1998.

advisers and the key Indonesian players. Most foreign advisers did not communicate directly with the Indonesian experts involved. Instead they would report to Williamson or Gillis. It was not uncommon for Gillis to organise a meeting between Wardhana and two foreign consultants who held different views on a particular income tax issue. It was then up to Wardhana to make the final choice.[78]

Because the whole reform was conducted at a very low visibility level, outside groups did not have much opportunity to exercise any influence. This would have been a very delicate matter anyway, as political opposition was not tolerated and many players depended on the goodwill of the government in one way or the other. Cronies of Suharto were undoubtedly not very worried about the changes in income tax law since Suharto could be expected to protect their interests. As Schwarz later pointed out (1994, p.65), “Protection from the tax office is one form of patronage that Suharto uses to secure the loyalty of influential members of the Indonesian elite.”

Key recommendations for the new Income Tax Law

In 1982, HIID presented its summarised recommendations to the reform project’s leading steering committee of senior officials from the Ministry of Finance, including Wardhana, Salamun and Committee Secretary Haryonot. The key recommendations as well as further discussion regarding the proposed Income Tax Law are examined below.

Unified income tax law

The advice of foreign advisers to unify the corporate and individual income tax systems under one income tax law was quite unique. Most countries have two separate laws for the different groups of taxpayers. The move was largely driven by the desire for simplicity: one unified tax law would be easier to administer than two separate tax laws.

The income tax subcommittee was less convinced and expressed its concern that not enough research had been done to justify the move towards a unitary system. But Wardhana agreed with the foreign advice.

Tax incentives

In their early memos, the consultants advised the abolition of most, if not all, incentives, including tax holidays and exemption from dividend tax for foreign investors, accelerated depreciation schemes, generous carry-forward provisions and reduced rates for companies going public. The advisers were convinced that simplicity and overall lower rates were the keys to success and that it was unnecessary to have specific tax incentives or tax holidays.[79] They believed that these actually played only a very limited role in the decision-making of mobile investors.

The advisers used the findings of a survey among American investors in Indonesia to support their view. The survey results indicated that tax incentives did not play an

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78 Interview with S. Cnossen, 16 March 1998.

79 See chapter 3: Tax Policy and Tax Reform Processes.

important role in attracting foreign investment.[80] The findings of the survey were used to convince government officials who had expressed concerns.

According to Winters (1996, p.168), the tax reform planners and policy-makers were very concerned with the reactions of mobile investors to cancellation of specific tax incentives. In reality, it was mainly the Indonesian participants in the reform process who expressed this concern. Large domestic and foreign investors, hearing rumours about the proposed changes, pressed policy-makers to listen to their issues, but the HIID team dismissed their concerns. Smaller private investors were not too worried, as they viewed the tax incentives as measures favouring foreign investors. The subcommittee on income tax expressed its concerns about cancellation of all tax incentives, but they did not succeed in convincing Wardhana. He agreed with the foreign advisers to abolish all incentives.

But the concerns from the Indonesian side were expressed again when the laws were tabled in parliament. Minister of Finance Prawiro, who succeeded Wardhana in 1983, defended the move by echoing the opinions of the foreign consultants. It is interesting that in communication with the outside world, policy-makers depicted the research conducted on this topic as a wide, in-depth, multinational survey. As we have seen, the survey conducted was in fact not that broad, but the conclusion seems valid as explained in chapter 3. In addition, foreign investors, often in joint ventures with local partners, perfectly understood that the Indonesian way of paying taxes was often ‘taxation by negotiation’, an area where their joint venture partner would take charge, knowing the rules of the game.[81] This casts doubt on the usefulness of tax incentives if informal incentives can be negotiated anyway. And tax holidays or incentives do not diminish the, often costly, additional charges levied by various government officials (including tax officials).[82]

In any event, the parliament accepted the explanation given by the Minister of Finance and the new 1983 tax law abolished all income tax incentives. Those tax incentives with unlimited duration which were in force prior to the 1983 Income Tax Law expired as of 1 January 1984. However, the 1983 Income Tax Law did not prematurely terminate pre-existing incentives with a limited duration.

[80] Internal memo by Wells and McLure to Gillis, summarised by Gillis and forwarded to Wardhana and Salamun. The factors affecting investment decisions of foreign investors (in order of importance) were:
1) political stability
2) size of Indonesian market
3) economic growth
4) production costs
5) government development programs
6) tax incentives
7) government regulations
8) increase in per capita income
9) access to raw materials
10) domestic competition
11) import substitution policies
12) fear of loss of export market
13) size of Asian market

[81] In 2005, this is still the case in my experience. Although foreign companies are subject to corporate tax rules, there is still a lot of scope for negotiation.

[82] Foreign investors mainly complained in the late 1970s about the large sums of money that had to be paid to customs officials (World Bank (1980). Indonesia: Country Report. US, Word Bank.).

Lower tax rates

According to Gillis, the use of higher tax rates to increase revenue was never considered (Gillis 1985, p.222). This was much in line with the prevalent tax policy views in the US at the time; according to Williamson. One reason for this was that sharply progressive tax rates give a strong incentive for widespread tax evasion (Williamson 1984, p.7). [83]

Undoubtedly these views were shared by most, if not all, the American-trained advisers on the team. Gillis stresses though that:

> Income tax rates under the new Indonesian system are … comparable to those contained in the Bradley-Gephardt Bill proposed in 1983 for the United States. Inspiration for the Indonesian income tax reform, however, arose not from any worldwide movement toward flat-rate income taxes, but recognition of the futility, in the Indonesian context, of unenforceable high progressive rates of tax (Gillis 1985, p.222).

In fact it seems that income taxes in Indonesia are unenforceable regardless of their rate because of severe problems of a tax administrative nature.

Lower corporate and individual income tax rates became one of the key features of the new Income Tax Law. The former corporate tax law had three corporate tax rates, the highest being 45%. The individual Income Tax Law had 19 different rates, the highest being 50%. Under the new law, three tax brackets were introduced, varying in the range 15–35%. For individuals, the tax threshold was doubled, so that the number of taxpayers would be greatly reduced. The advisers argued that broadening of the income tax base (in other words including more sources of income, eliminating exemptions of certain income and reducing tax deductions) and better law enforcement would more than compensate in overall tax revenue for the reduced tax rates. The subcommittee on income tax, however, did not agree with the proposed changes. It commented that "the progressive rates proposed are not steep enough and are not fulfilling the spirit of the corporate income tax to impose progressive tax as a tool to redistribute income".[84] Moreover, they were concerned that lower tax rates would not generate the revenue required from the corporate world. However, the committee did not influence the views of Wardhana and the final version of the new tax law was in accordance with the proposals outlined by the foreign advisers.

Deductible costs and fringe benefits

The value of fringe benefits, such as company cars, housing, recreational activities, club memberships etc. were deductible by the employer (and not taxable in the hands of employees) under the old corporate tax law. Under the new proposals of the advisory team, fringe benefits were no longer tax deductible at the corporate level (but remained not taxable as far as employees were concerned). This was a major simplification of the old system, but at the same time a concern for many corporate

83 Williamson argues that steep progressive tax rates lead to tax evasion in many developed nations, an assumption often accepted and used and much in line with tax-policy thinking in the US in the 1970s (see chapter 3). No one disputes that extremely high income tax rates will increase evasion. However, there seems to be little difference in tax evasion in developed countries whether the top individual income tax rate is 60% or 50% or whether the maximum corporate tax rate is 45% or 35% (Williamson, 1984, p.206).

84 Memo signed by Mansury, date unknown.

taxpayers (Awanohara 1983, p.56).[85] The new rules for fringe benefits would have no effect on government bodies, which could still pay their employees fringe benefits. These bodies did not pay corporate tax, so the abolishment of corporate tax deductions for these benefits did not affect them. Their employees would continue to receive these fringe benefits. For this reason, the advisory team pushed quite hard to have in-kind benefits provided to civil servants included in taxable income. Many received significantly less wages than their colleagues in private industry, but this was compensated with significant fringe benefits. The HIID advice made sense, as it would tax different sorts of individual income equally. However, their recommendations would have created significant upheaval within the civil service. Fringe benefits in the form of free education, domestic and overseas trips etc. formed an important part of civil servants' salary packages. The salary itself was often barely enough to support an average family, and side revenue from other activities was used to make ends meet. Wardhana knew very well that his power was limited, and decided against this aspect of the proposal, so the taxation of fringe benefits for civil servants did not appear in the final version of the proposed tax law.

The new tax approach to fringe benefits created concern when the draft law was tabled in parliament. Members of parliament suggested that this approach was contrary to Indonesian paternalistic culture in which it is common that an employer provide housing, cars and travel. However, the concerned members of parliament did not receive support from the economic ministers and senior bureaucrats, who argued that the new proposal was a core part of the new Income Tax Law and would enhance a policy of 'clean wages' (Williamson 1984, p.17-9). Prawiro persuaded parliament to accept the new fringe benefit tax system.

Taxation of foundations and co-operatives

Foundations (*yayasan*) are widespread in Indonesia. In mid-1983, according to World Bank estimates, one-sixth of all rupiah time deposits were owned by *yayasans* (this was more than the total of deposits held by all private enterprises) (Williamson 1984, p.32-4). Under the old tax laws, those *yayasan* that did not exclusively serve the public interest would be liable for tax. In practice, *yayasan* never registered for income tax purposes. Their finances were beyond any scrutiny by the state. For this reason, foundations were very useful vehicles to avoid tax.[86] Many foundations had the support of provincial governors, prominent business people, religious groups, state-owned enterprises and well known local citizens. In addition, many *yayasans* were established and controlled by the Suharto family (Leith 2002, pp.69-100). In theory they were set up to provide funds for charity, in reality they were established to evade taxes and accumulate wealth (Aditjondro 2000), blurring the demarcation between public and private funds. Suharto and his inner circle controlled the five largest *yayasans* in Indonesia.[87] And according to Aditjondro, an outspoken Suharto critic who spent decades researching the regime's business dealings, a large portion of the *yayasans'* funds were used to purchase controlling shares of companies for

[85] An exception was made for companies active in remote areas.

[86] Foundations are known in many countries as a useful vehicle to avoid tax liabilities.

[87] Dakab, Dharmais, Supersemar, Tritura, and Amalbhakti Muslim Pancasila were the five largest (Aditjondro, G. (2000). Chopping the global tentacles of the Suharto oligarchy: Can Aotearoa (New Zealand) Lead the Way? Indonesia, New Zealand, University of Newcastle.).

Suharto family members, friends, political allies and business associates (Aditjondro 2000).

The draft Income Tax Law did not really solve this problem. It specifically exempted certain forms of income received by foundations from tax and no longer exempted them from the requirement to file a tax return.[88] Foundations are only taxable in respect of profits from a business or enterprise not exclusively serving the public interest, but the term 'public interest' is not defined in the law. Williamson pointed out that defining this term is "a task that will be important in the future for limiting abuse of this exemption" (Williamson 1984, p.32-4). Her report indicates that it was politically not feasible to have a more stringent tax regime for foundations.

For co-operatives, a similar situation existed. Under existing law, profits were tax exempt for the first five years of operation; during the next five years reduced tax rates were available. The tax office lacked instruments to investigate and exercise control over co-operatives, resulting in large tax evasion schemes. The advisory team suggested treating co-operatives like companies, with one exception. A deduction would be given for actual refunds made to members of income earned exclusively from services to the members.[89] But the final version tabled in parliament was quite different. A tax deduction for income earned exclusively from services to the members for the co-operative would be available *before* any refunds were made to the members. Thus, the new provision did not give any fiscal incentive to pay out the income made to the members. This actually meant that co-operatives could accumulate large amounts of profit without paying any tax. Co-operatives, often linked to government departments and the Suharto circles, formed an important part of the economy, and were a sensitive area for government policy. Policy-makers were all too aware that this investment form had to be treated with great care.[90]

Simpler pay-as-you-earn system and withholding-tax system

A cornerstone of the new system was the new withholding-tax mechanism. Employers were required to withhold taxes upon payment of salaries to their employees. Moreover, organisations were required to withhold tax from any payment in the form of dividends, interest, rent, service fees and royalties made to any other entity. These proposals were not controversial. Although the subcommittee for income tax did have some concerns, it agreed with the overall principle.

Taxation of income of civil servants

Under the old tax regime, civil servants were effectively exempt from paying income tax.[91] Formally, the government paid income tax on behalf of its employees; civil servants would receive their income net of any taxes payable. In addition, the latter received significant benefits in-kind that were also tax exempt. Under the proposed legislation, civil servants would be fully liable for income tax. The foreign advisers argued that those working for the government, especially, should be the first rather

[88] That means that they can formally be audited by the tax department to scrutinise the nature of their business.

[89] Income earned from unrelated activities would be fully taxable.

[90] As described by Aditjondro: (Aditjondro, G. (2000). Chopping the global tentacles of the Suharto oligarchy: Can Aotearoa (New Zealand) Lead the Way? Indonesia, New Zealand, University of Newcastle.

[91] This system goes back a long way, as in 1905 the income tax law exempted civil servants from paying tax on their salary.

than the last to pay tax. This was accepted in the new law. However, fringe benefits in the form of housing, travel and food, often a major part of income, would not be included in taxable income (see above under ‘Deductible costs and fringe benefits’). Moreover, civil servants received a pay raise to compensate for the taxation of their income.

Interest on time deposits

The taxation of interest on time deposits turned out to be one of the major hurdles in the tax reform process. Under the previous tax regime, interest paid by domestic banks on deposits was fully tax exempt in the hands of the receiver. This exemption was based on a 1973 decree issued by the Ministry of Finance. There were also exemptions for some other forms of interest payments (Williamson 1984). For example, interest paid on bonds issued by the State Highway Authority was tax exempt under ministerial decree. The reform team advised that interest should be fully subject to income tax and included this in the draft law submitted to parliament. But this part of the law became the only concession made due to pressure from the parliament. Giving in to pressures from financial circles, parliament approved the law with interest taxable in principle, but added a provision leaving the issue of the taxation of interest on time and savings deposits to be decided by governmental regulation (Williamson 1984; Gillis 1994). A subsequent decree was issued that exempted interest of time and saving deposits from income tax until further notice (Gillis 1994). This created a major economic distortion, since dividend was taxed but interest on time deposits was exempt, clearly favouring one investment form over another.

Looking behind the scenes, it becomes clear that larger interests were at stake. The state-owned banks relied heavily on the in-flow of money from time deposits. These money flows were lent to large corporations (often related to the Suharto family) for investment projects (Schwarz 1994, p.151). Private banks considered these projects too risky, so it was very important for the corporations to be able to secure the funds from state-owned banks. The taxation of time deposits would jeopardise the steady flow of funds available to lend to these companies. State banks, however, were not the only beneficiaries of the exemption; representatives of the Private National Banks Association (*Perbanas*) also welcomed the exemption from income tax as a useful instrument to mobilise funds.

Conference, October 1982

Late in 1982 (22–23 October), HIID organised a conference in the US to discuss various aspects of the new tax laws with consultants and Indonesian officials (mainly those on the steering committee). During this conference consensus was reached on a number of topics. Much time was spent on discussions surrounding the existing sales tax and the proposed value-added tax.

5.9 STAGE 3: NOVEMBER 1982 TO SEPTEMBER 1983

During this stage final adjustments were made to the consultants' reports and all the tax reform proposals were discussed with the steering committee. The committee, under the strong leadership and influence of Wardhana, had been kept up-to-date through the whole period of the reform and accepted the proposals made. So the drafting teams started their work and finalised the draft laws by mid-1983.

According to Gillis (1989), June and July 1983 were critical months for the reform. The major hurdle was the proposed abolition of corporate tax incentives. Arguing against any form of corporate tax incentives seemed unlikely to be effective, since such tax incentives were widely perceived as useful. Instead, Gillis and his colleagues suggested presenting the law change as a more effective form of tax incentives because of its overall lower tax rates. The Minister of Co-operatives, especially, was a serious opponent of the new proposals. The team, as well as the economic ministers, feared that if he succeeded in obtaining specific incentives for co-operatives, other interest groups would follow suit. Therefore, the first step was to win his support. A great deal of persuasion was required to convince him that even without specific tax incentives, most co-operatives would not pay any taxes. After his approval was secured, the team obtained the support of the president and the rest of the cabinet before the drafts were tabled in parliament.

Approval by the parliament

Suharto's support for the new tax law package did not go unnoticed. The first signals of his approval came in July 1983 when Finance Minister Prawiro told the press that Suharto had asked him to seek immediately to amend the country's taxation law in a bid to increase efficiency in tax collection.[92] This was followed in mid-August by the president's 'State of the Nation' address to the DPR, during which he gave his support for the draft bills. He stated that "with the reform, the system will be more fair and fitting while the number of taxpayers will grow larger". In late August 1983, he met with DPR Speaker Amirmachmud and urged him to give the handling of the tax bills top priority.[93] The message was clear: the president had given his imprimatur to the reform package and DPR members were very much aware what this meant in terms of room to make major changes to the draft bills.

In November 1983, the parliament formed a special committee that worked for 35 days and approved the bills (Law on Income Tax, Law on Value-Added Tax and Sales Tax, Law on General Rules and Procedures of Taxation) with only a few significant changes or additions[94]. Members did not have much room to manoeuvre given the clear support of the president for the new law. Moreover, there was very little time for lengthy discussions or to raise the public support that one might assume would be needed for such drastic reform. The proposals were presented in parliament early in November 1983 and it was announced that the new laws should be applicable as of 1 April 1984. Some questions were raised by the committee, but

[92] *Jakarta Post*, 27 July 1983, p.7.
[93] *Jakarta Post*, 2 September 1983, p.1.
[94] Each committee member received Rp. 500,000 for his or her services. It is not uncommon for members of parliament to receive additional income for passing a new law through parliament. The payment for passing this law was not very high; converted according to currency rates at that time, about $US200.

according to lawyer Greg Churchill,[95] the debates were characterised by an attitude of 'the experts know best'. When members of the parliamentary committee questioned the draft laws, they were told that the expert advisers said that this was the best way, so they had to be accepted. HIID as such was not often mentioned. Instead, Prawiro stated in press conferences that the government had hired tax experts from various countries including Colombia, West Germany, Canada, the Netherlands and the US.

One of the small political parties, PDI, stressed the importance of a general basic tax law, which would provide a philosophical underpinning of all tax laws, as well as requesting concessions for social or religious expenditures. A spokesman for the faction argued that a clearly understood philosophical base should be included to increase tax compliance and that therefore a basic law was needed. Prawiro rejected this argument and stated that a basic tax law was not necessary because the tax bills already stipulated basic tax rules.[96] There were other concerns, as pointed out by Awanohara (1983, p.56):

> In parliament, one political organisation has argued against what it considers as too few income brackets and too low luxury taxes, as well as against taxing co-operatives. (…) Yet another group is worried about too strong sanctions against non-compliance. There is also a more generalised feeling that the new laws will once again give too much discretionary power to the finance minister and the director general of taxation.

But despite these concerns, in the second week of December the DPR passed the three bills (Law on Income Tax, Law on Value -Added Tax and Sales Tax, Law on General Rules and Procedures of Taxation). The timing of the new legislation was very fortunate, as the world price of oil started to slide gradually from the end of 1982 clearly demonstrating the need for alternative sources of government revenue. This made their introduction a lot easier.

Role and reactions of the Indonesian tax administration

The reactions to the new laws from tax administrators were generally rather hostile, partially because the depersonalisation and simplification of the tax system could reduce the additional revenue earned by tax collectors (Winters 1996, p.167). According to an economist at USAID, Gillis had a difficult time introducing the proposed reforms to the tax administration:

> The tax office, and all the vested interests associated with it, fought him tooth and nail. Only with the financial collapse of the government sector in 1983 was he finally able to gain some ground (Winters 1996, p.165).[97]

Moreover, many tax administrators felt that they were not properly consulted during the reform: This is illustrated by a letter sent by a tax administrator to the editor of the

[95] Interview 10 December 1997. Greg Churchill had been working in Indonesia for more than 20 years.
[96] *Jakarta Post*, 14 November 1983, p.7.

Indonesian newspaper *Republika* (2 March 1993).[98] This former senior tax official, Suharsono Hadikusumo, criticised the methods used in the 1983 tax reform. He wrote:

> a. In the first phase, they made new bills/changes in the old laws in English, based on their own surveys. The bills were handed to the Director General of Taxes.
> b. The Director General of Taxes had the bills translated into Indonesian. Teams of directorate officials were formed and assigned as counterparts for the consultants.
> c. Each team voiced its opinion on the bills at meetings with the Harvard consultants. Very fundamental opinions and original proposals from the teams were very hard for the consultants to accept and the final results showed very few changes from the drafts made by the consultants. Just look at the Indonesian version of the laws: many parts are just clumsy and rigid translations from the English.

Hadikusumo had a point that senior tax officials did feel left out. The available memos suggest that there was little effort made by most of the foreign advisers to communicate or discuss their advice directly with people of the Indonesian steering subcommittee on income tax. [99] No translations were made and Indonesian committee members struggled to understand what it all meant. These communication processes could have been conducted in a better way to obtain support from senior officers. The problem remained, though, that there was limited expertise in the tax office (few officials had received sufficient education and training), which made in-depth technical discussions between foreign advisers and the steering subcommittee difficult, and Hadikusumo did not address this problem.

Reaction from the public

Indonesia in 1983 had an authoritarian regime that did not tolerate opposition and this of course influenced public reaction. For example, the press, under strict government control, had to take great care in its reporting, especially when it involved sensitive issues such as the business dealings of the president's family or directly attacking a minister favoured by the president. It was not until late 1983 that newspapers started to report on the upcoming tax law changes. The press mainly summarised the statements made by Prawiro outlining the broad principles and emphasising the positive elements of simplicity and that overall lower tax rates would outweigh the abolition of tax incentives previously in place.

Most large domestic and foreign investors were located in Jakarta, which was strictly controlled by the central government. So even if larger businesses had had strong objections to the new legislation, they would have felt reluctant to express them.

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[97] It is important to keep in mind that in most organisational restructures there is a fear of change (Clegg, C. and M. Fitter (1981). "Organisational and behavioural consequences of uncertainty: A case study." Journal of Occupational Behaviour(2): 155-175.

[98] Translated by the US Embassy Translation Unit. Press summary and press review.

[99] I refer to the internal memos sent by HIID team members, a complete list of the memos is available in Appendix 1

Many, especially the larger domestic and foreign businesses,[100] were dependent on government contracts or licenses (for example, in the construction area, aid projects, the press and mining). By expressing criticism, they would jeopardise their future chances for government work or obtaining required government licences (Schwarz 1994; Winters 1996) ((Heij and Stromback 1997). Moreover, business was dominated by influential, often ethnic Chinese, corporate players who were used to striking their own deals with government departments based in Jakarta and/or with the president. Those who were in some way related to or linked with President Suharto were not too concerned about the new legislation. For them the practice of taxation by negotiation continued, with the enormous advantage of being close to the president. They did not expect very much to change under the new Income Tax Law.

Civil servants may increase their income by forcing people to pay illegal levies for particular government services, a common practice in various countries, including Indonesia. Especially small- and medium-sized indigenous Indonesian businesses lacked the power and the connections with high level bureaucrats to protect them against demands for such payments. This was one reason why most reactions from small- and medium-sized businesses to the announced tax reform were rather mild. Their financial burden would hardly be subject to change. With the tightening of the formal audit system, more supervisory control over tax officials, and abolition of tax exemption for civil servants, it was not unreasonable to fear that with less opportunity for illegal levies, any such opportunity left would see higher illegal fees. In addition, there were very few avenues to air concerns or represent the interests of smaller-sized businesses. The fact that the law-making process was so low-key, reduced most influences from this business community (as Gillis and Wardhana had intended).

Some in the business community felt that the simplification of the tax law could reduce the scope for creative interpretation by local tax officials. But the fact that so much detail of the new law was left to the discretion of the Ministry of Finance to deal with in further guidelines did not help to provide clarity. Some of these guidelines took years to be issued, while others never saw the light of day.

There was little protest in relation to personal income tax (apart from the taxation of civil servants discussed earlier). Fewer than 5% of individuals would actually earn enough to exceed the tax-free threshold. Those individuals were mainly the very rich and employees of large corporations whose taxes were withheld monthly.

5.10 MAJOR INCOME TAX LAW DEVELOPMENTS AFTER 1984

Non-oil income tax revenue increased remarkably (in absolute terms and as a percentage of GDP) after the new legislation was enacted in 1984 (Heij 1993, p.3) showing the success of the reform. In 1984 non-oil income tax revue as percentage of GDP was 2.4%, by 1990 this was 3.4%, a significant increase (Heij 1993, p.3-4). The majority of the increase of total tax revenue came from the 1983 income tax and the 1985 sales tax (after 1985 a value-added tax (VAT) was combined with a sales tax on luxury goods). With the introduction of the VAT in 1985, the revenue from

[100] In Indonesia a few large companies, whether private, state-owned, or foreign, dominate many industries. (Schwarz, A. (1994). A Nation in Waiting, Indonesia in the 1990s. St Leonards, Australia, Allen & Unwin.

sales tax increased dramatically from 5.8% of total tax revenue in 1984 to almost 20% in 1990; income tax revenue also rose significantly over that period (Heij 1993, p.3-4). The period 1990 to 1999 saw a further rise in revenue from both types of taxes.

We have seen that various issues were not dealt with in the 1984 Income Tax Law. The law did not deal with many detailed practical problems, for example, depreciation of assets, taxation of foreign fisheries businesses, financial institutions and shipping companies, special tax rules for investment fund companies and venture capital companies, and guidelines regarding deductibility of head office costs (Heij 1993, pp.1-14). It was left up to the Minister of Finance's discretion or the Director General of Taxation's authorisation to issue further guidelines in due course. But some guidelines were not issued until the early 1990s, leaving taxpayers in limbo for many years (Heij 1993).

The first major changes to the 1983 Income Tax Law were introduced in 1990.[101] The economy was booming and a growing self-confidence among government ministers[102] and senior tax officials resulted in the belief that foreign advice to improve the tax laws was no longer needed and that some of the recommendations from the past were not suitable any longer. This resulted in the re-introduction of income tax incentives to promote investment in Eastern Indonesia.[103] The government also included interest from time deposits in the income tax base. The reasoning behind this measure was to encourage investment in the stock exchange. The withholding tax on time deposit interest payments generated a nice windfall for the government during the financial crisis that commenced in 1997, when interest rates increased sharply, and was one of the major reasons why the government budget deficit in 1998–99 was not as high as originally forecast.

In 1994 the government gave the company Timor Putra significant tax incentives to develop the so-called 'national car'.[104] The incentives were abolished in 1998 after Suharto stepped down as president. In 1995, income tax incentives for certain corporate taxpayers were introduced in the form of accelerated depreciation, extended carry-forward of losses to ten years (under the 1984 Income Tax Law this was five years) and a reduction of withholding tax on dividends. The year 1995 saw also the lowering of the income tax rate from 35% to 30% and a widening of the withholding tax system. Currently the tax rate is 35% for individuals and 30% for companies.

In 1996 the government announced the reintroduction of corporate income tax holidays for large investors in specific industry sectors. The incentives included complete relief from corporate income tax and withholding tax on dividends for a maximum period of ten years, plus a possible two-year extension for certain new businesses established outside the islands of Java and Bali. A ministerial team was

101 The changes were formally approved as law in 1991 and subsequent implementing regulations introduced in 1992 and 1993.

102 Including J.B. Sumarlin as Minister of Finance and DG of Taxation Dr Mar'ie Muhammad.

103 This change can be interpreted as a symbolic gesture and a political move to include the outer regions rather than a real attempt to attract investment into that part of Indonesia. Aside from investment in resources, the outer regions did and do not attract major investment.

104 This tax incentive was clearly pushed by President Suharto to benefit his son Tommy Suharto. The incentive was not favoured by the then Minister of Finance (interview with Mar'ie Muhammad, June 1998).

appointed to recommend which industries should benefit from the holiday. It was not until 1998 that specific guidelines regarding these incentives were issued. In April 1999, six firms had been granted the facility, while another 30 applications were still under consideration. All firms granted were affiliated with Suharto. The Indonesian Parliament revoked tax holiday incentives in the year 2000.

Another interesting development was the introduction of a so-called poverty levy in Indonesia in 1996. Under a presidential decree that became effective on 4 December 1996, a 2% surcharge was levied on the after-tax profits and incomes exceeding Rp100 million of both companies and individuals.[105] The revenue from the surcharge was officially earmarked for helping the poor. The payments were channelled to charity foundations controlled by President Suharto and did not appear in the government revenue statements. The tax office was appointed collector of the payments. The levy was abolished in 1998.

Since 1998, Indonesia has undergone substantial political reform. This has made the arena in which tax policy-making takes place quite different. The present democratically elected government has to take the wishes of its electorate much more seriously than the Suharto regime ever did. It also has to deal with the legacy of the Suharto era, with Suharto cronies desperately trying to cling to privileges. They have a lot to lose, including their tax privileges, something they won't give up easily. The drastic political changes have seen much more public debate regarding tax problems and future tax policies. For example, in June 1999, a tax corruption seminar took place attended by 200 tax lawyers, government officials, accountants and students as well as representatives from several political parties, an event that would have been impossible in the 1980s and early 1990s. The question remains if this public debate will result in strong action. To date very little has been done.

After experiencing rapid rates of economic growth over a prolonged period, Indonesia, together with other Southeast Asian countries, has been undergoing a severe economic crisis since late 1997. Presently Indonesia's tax policy is under serious economic and political pressure. Due to political instability and the crisis, foreign investors have been avoiding Indonesia and the government is very keen to reverse this trend. Drastic changes to the 1983 Income Tax Law may be introduced attempting to lure in the desperately wanted foreign capital. This would mean more tax incentives, a doubtful instrument, though increasingly used by Indonesia's neighbours in Southeast Asia. On the other hand, as a result of the crisis, Indonesia formally requested help from the IMF. So the foreign advisers are back in the tax policy-making area, with the government locked into a stringent fiscal policy dictated by the IMF, and tax incentives are not high on the IMF agenda. But because of the major political changes in the last few years, an authoritarian top-down approach based on foreign advice only, as in the 1983 tax reform, is no longer a realistic possibility for the present government to use to shape its tax policy.[106]

[105] The legal status of the poverty levy was unclear: was it voluntary or compulsory? The presidential decree (4 December 1996) introducing this levy did not clarify this.

[106] Having said that, some of the strategies adopted by the Indonesian Government are the same as in the 1980s, illustrated by accusations surrounding the latest memorandum of economic and financial policies signed between Indonesia and the IMF on 20 January 2000. According to the IMF, a major concern of many foreign business people was the feeling that they were under

5.11 CONCLUSION

Indonesia's tax reforms were initiated in response to concern about the country's heavy dependence on oil resources. Revenue from oil companies formed the major source of income for the Indonesian Government and this dependency was a cause of concern for the economic policy-makers of Indonesia. The reform was pushed by far-sighted economic ministers rather than forced by an immediate economic or fiscal crisis.

The reforms were initiated and formulated by a relatively small group of people, particularly Minister Wardhana together with a select group of foreign consultants, mainly Americans hired by HIID. But Wardhana could only succeed with the reform because of the implicit support he enjoyed from President Suharto. The reform can be seen as a limited success for the technocrats in Indonesian policy-making. Wardhana's team achieved those outcome that were relatively easy to achieve, but in the sensitive areas of the civil service and the Suharto interests, they were unable to pursue their proposed reforms. Those tax proposals that might have created social unrest or economic or political instability never made it to the final version tabled in parliament. Moreover, reforms that would directly have affected the president or powerful supporters around him did not succeed or were watered down. For example, the taxation of foundations and co-operatives, and the taxation of benefits in-kind received by government officials, touched on very sensitive issues in the highest government circles. It was therefore left to later ministerial discretion to deal with these matters. In other words, senior policy-makers were free to develop their new tax laws, but only within the boundaries set by President Suharto.

The reform included some lessons from previous Indonesian experience as well as from other tax missions and country studies. However, the main framework of the new income tax law was based on the dominant views amongst economists in the US and Western Europe concerning what constitutes a good and efficient tax system. These views emphasised the goals of simplicity and appropriate tax technology, low tax rates, and the abolition of tax incentives. The aim of simplicity, though, resulted in too much discretion for the Ministry of Finance and much uncertainty regarding its practical application of the income tax law. Leaving the implementation of further guidelines created major problems. Guidelines were issued many years later or not issued at all. In effect, the law was designed by macro-economists with little appreciation of the administrative and practical implications of the polices adopted. Those left to work with the income tax law were given very little sense of ownership.

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increasing scrutiny by Indonesian tax officials. Dodsworth, the IMF representative in Indonesia, accused Indonesian tax authorities of justifying their stepped-up examinations and assessments by saying, "The IMF is making us do it". In other words, tax authorities are scape-goating the IMF for increased enforcement, a measure that is desperately needed to increase state revenue. Moreover, it seems likely that tax officials interpret this new enforcement policy quite differently from the way it was intended by IMF advisers.

Wardhana led the tax reforms with support from other cabinet members.[107] Wardhana depended particularly on one key foreign consultant, Malcolm Gillis. HIID, and Gillis in particular, emphasised that the final choices were made by the Indonesian policy-makers and not by HIID. The facts (including the number of internal memos) do not support this. HIID advisers clearly had the upper hand and the steering and subcommittees were no match for them in the decision-making. Part of the reform was the narrowing down of proposed options and setting priorities, a process controlled by a selected group of foreign advisers with the support of Minister Wardhana.[108] Senior tax officials played a very minor role in the reform and had little influence.

Tax administrators felt left out and the letter of Suharsono Hadikusumo (Hadikusumo 1993) clearly aired their grievances. The shortage of tertiary-educated tax officials who might have influenced the debate did not help. Nor did the apparently rather limited efforts of the reform team members to include their Indonesian counterparts. The fact that the team comprised mainly academic economists, who most certainly would adhere to the instrumentalistic approach to law, also did not assist engagement with Indonesian tax administrators. And the reform team did not seriously address the issue that without local ownership any reform project is doomed to fail. The resistance within the tax department to implementation of the law partially relates to this.

The culture of Indonesian public institutions is well illustrated in this case study. As with many Indonesian government departments at the time, few Indonesian bureaucrats had the right skill sets and adequate education, resulting in those Indonesian officials involved being no match for foreign advisers when debating reform aspects. The sensitive issue of bribery and corruption, intrinsic in the culture throughout large parts of the bureaucracy, plays an important role in many decisions made regarding the reform. The top-down approach, so common in Indonesian governments (as previously introduced by the Dutch colonial rulers), was clearly applied in this process.

The role of interest groups in the reform clearly reflects the power structure of Suharto's Indonesia. Public criticism would have been dangerous. But the regime did have to take account of public reaction. Most people were not affected by the reform as only companies and high earners were included in the new tax net. But in areas where they could be affected, such as the taxation of civil servants, a key support group for the regime, the reform was extremely careful not to upset this group too much. Suharto's cronies benefited from their connections as the reform team was clearly steered away from the taxation of foundations and cooperatives. In addition, these close allies could rely on their connections to ensure that the practice of taxation by negotiation would continue. Other less well connected companies were very cautious as Suharto's influence was far reaching and could easily jeopardise their businesses.

The press was in no position to create public debate and political parties had only very limited room to exercise any influence once the law was tabled in parliament.

107 Such as Radius Prawiro, Widjojo Nitisastro, and J.B. Sumarlin

108 The same observations are made by Winters in regard to the overall economic policy and the role of HIID in Indonesia (Winters, J. A. (1998). "A review of 'Building a modern financial system: The Indonesian experience' by David Cole and Betty Slade." Journal of Asian Studies **57**(3): 908-09.).

International factors, as outlined in organisational theory, had some role in the reforms, as the views represented by the economists on the team were a reflection of the demands of international competitiveness and other international trends in fiscal policies. As discussed in Chapter 3, the worldwide neo-liberal model that emerged in the 1970s influenced many economists, including HIID consultants. And their advice to the Indonesian Government reflected that thinking. In addition, the advice also reflected an ideal tax system as seen by economists (Owens 2006).

The definition of tax is very important in analysing this case study. In Indonesia the payment of bribes, additional fees and levies and other informal payments is a fact for many individuals and companies. As mentioned above, it is an intrinsic part of the bureaucratic culture within Indonesia. Including these forms of taxes in the discussion of the tax reform is crucial in understanding the process and the reaction of certain groups. For example, certain business groups were clearly not much concerned about the formal changes in the laws as these would not influence the informal payments they would have to make. And the amounts of money paid to government officials to obtain government contracts were much more substantial than the possible increase in tax burden under the new tax laws.

The political response to a looming fiscal crisis was an overhaul of the tax system including a change in the level of taxation. It remains to be seen if the distribution of the tax burden changed. Overall the reform did result in a significant increase in non-oil-related tax revenue. The tax laws were broad and often did not deal with detailed implementation regulations, particularly in sensitive areas. They also did not change the burden of informal taxes so part of the reform can be seen as essentially symbolic.