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IMPACT OF TAX AND SUBSIDY ON REDUCING INCOME INEQUALITY IN INDONESIA

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ABSTRACT

Many countries have been successful in reducing income inequality by using fiscal policy, both tax and subsidy, as a key tool. In Indonesia, this policy tend to have a neutral effect on inequality today. This research aims to identify main causes of the ineffectiveness of Indonesia fiscal policy in reducing income inequality. Also, it intend to find what steps should be taken by the government to improve the role of fiscal policy in order to reduce income inequality. This paper finds that Indonesia should improve the quality of public spending. Indonesia government should Prioritize their spending on social expenditure and infrastructure to improve the fiscal policy role to reduce inequality. In addition, increasing direct tax such as personal income taxes should be done in order to make it more effective.

1. INTRODUCTION

1.1. Background

Inequality in Indonesia has raised sharply during 14 years period. After economic crisis period, Gini Coefficient, a measure of income inequality, has raised significantly from 0.3 points in 2000 to 0.4 points in 2014 (World Bank, 2015). According to the World Bank, Indonesia economic growth benefits only 20% of people in Indonesia during the last decade, while 80% – or about 205 million people – were left behind (World Bank, 2015). If this gap is kept in the future, the economic growth and poverty rate reduction will be hampered and the social conflict will potentially occur.

A few of research state that fiscal policy in Indonesia tends to have neutral affect towards income inequality today. Jellema, Wai-Poi, & Afkar (2015) finds that the net changes to household income from taxes and transfers leave the Gini coefficient almost unchanged; including in-kind health and education spending. Comparing with some other countries, such as Brazil, Chile, Colombia, Mexico, Peru and South Africa using comparable fiscal incidence analysis with data from around 2010, Indonesia has the smallest redistributive effect (Lustig, 2015). Therefore, this paper aims to identify the role of fiscal policy on income inequality in Indonesia and how to improve fiscal policy effectiveness in order to reduce inequality.

2. FISCAL FRAMEWORK

The government needs some revenue to cover its spending. Those earning is collected by the government through taxation. If the revenues exceed spending, then there is a budget surplus; if revenues fall short of spending, there is a budget deficit. In essence, Indonesia always implemented a deficit budget system. Based on Finance Note (Republik Indonesia, 2017), the deficit of budget in 2017 is 2.41% from Product Domestic Bruto (PDB). It means that the tax collection of the government could not suffice the spending.

However, the government always try to optimize the revenue at expanding the revenue base while at the same time balancing economic capacity, in order to maintain the level of investment. The refinement of spending is directed towards the utilization of budgets for priorities and productive spendings, such as infrastructure development, poverty reduction, job creation, and reduction of inequality.

The government budget has the functions of authorization, planning, supervision, allocation, distribution, and stabilization. All revenues collected from tax become the government rights to spend to runs the government tasks within a fiscal year that is included in the APBN. In 2017, the Government's Work Plan is "Spurring Infrastructure Development and Economics to Increase Employment Opportunities and Reduce Poverty and Intergovernmental Gap" (Republik Indonesia, 2017). It means that the government should prioritize the inequality reduction between regions in Indonesia.

Income inequality refers to the extent to which income is distributed in an uneven manner among a population (Lustig, 2015). It means that there is a gap of income between a group of high- income society and low-income society. The higher the gap, the more low-income society be burdened by the lack of sufficient economy. If the gap is quite high, the low-income economy society could not afford to meet its economic needs.

Gini coefficient or Gini ratio is intended to represent the income or wealth distribution of a nation's residents, and is the most commonly used measure of inequality. A Gini coefficient of zero expresses perfect equality, where all values are the same (for example, where everyone has the same income). A Gini coefficient of 1 (or 100%) expresses maximal inequality among values (e.g., for a large number of people, where only one person has all the income or consumption, and all others have none, the Gini coefficient will be very nearly one) (Wikipedia, 2017).

3. RESEARCH METHODS

This paper reviews the impact of tax and subsidy on reducing inequality based on some relevant literature. This research uses data and reports collected from government sources, previous research and other credible institutions such as World Bank and Oxfam.

4. DISCUSSION

In many countries, fiscal policy, both government expenditure and taxation, has played an important role in reducing inequality. It even becomes the primary tool for governments to reduce income distribution. In terms of government spending, its quality becomes an important key to reducing inequality. On the other hand, the tax revenue and progressive tax become important things to support the income inequality reduction.

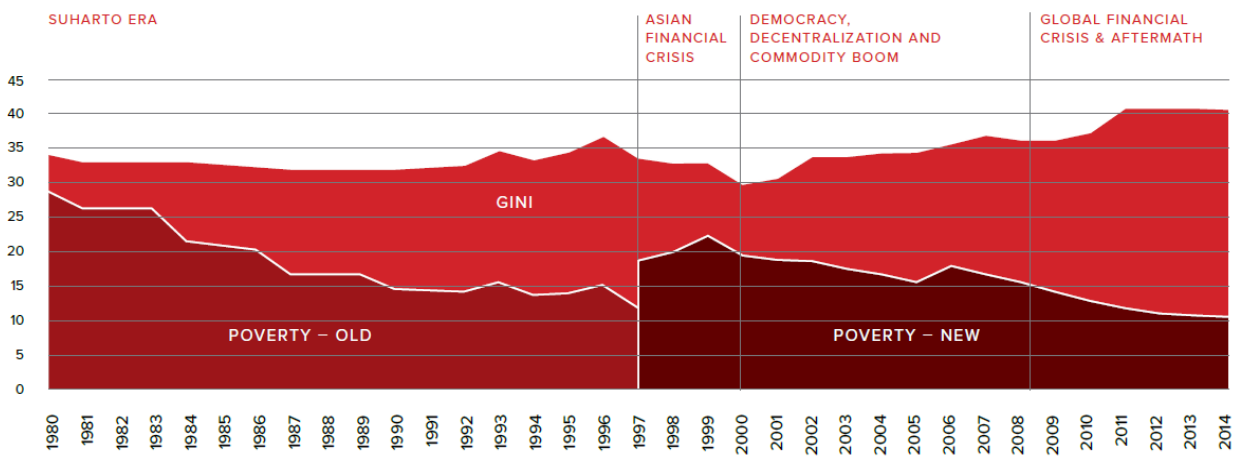
4.1. Trends in Inequality in Indonesia

The inequality of Indonesia has risen sharply between 1980 and 2014 (World Bank, 2015a). During 1980-1996, In the second period of President Soeharto era, the Gini coefficient relatively stable below 0.35 point until 1992 but then rose until 1996. After that, in Asian financial crisis period (1997-2000), it fell because during the crisis, it hit the rich people so that the income gap between them and the poor one was shorter. Then, in the next two periods of 2000-2008 and 2009-2014, the Gini increased significantly from 0.30 (2000) into 0.40 (2011) and remained stable at that point until 2014. Increases in commodity prices were the major factors of the Gini increasing in these periods. This most recent trend of the Gini shows that Indonesia has an unequal distribution of income, which means the gap between the rich people and the poorer one becomes larger.

In contrast, after financial crisis period, the economic growth had risen in 2000-2014 but had benefited only by small group of people. It is reflected by the consumption growth of 10% Indonesian reached 6% per year after adjusting for inflation while the 40% poorest only grew less than 2%. This contributed to a slowdown in the pace of poverty reduction, with the number of poor people falling by only 2 percent per year since 2002, and the numbers of those vulnerable to poverty falling barely at all (World Bank, 2015a).

Recent research (World Bank, 2015a) indicates that a higher Gini leads to make economic growth slower. When the share of total income held by the richest 20 percent of people increases by 5 percentage points, economic growth falls by 0.4 of a percentage point. At the same time, when the share of total income held by the poorest 20 percent of people increases by 5 percentage points, growth increases by 1.9 percentage points. Increased income shares for the second- and third-poorest quintiles have also been shown to increase economic growth. High inequality also has social costs, which may cause conflict. When people perceive that there are large differences in income and wealth, this can create social tensions and disharmony, which can in turn create conflict. Indeed, districts with higher levels of inequality than the average in Indonesia have 1.6 times the rates of conflict compared with districts with lower levels of inequality (World Bank, 2015b).

Picture 1. The Gini Coefficient of Indonesia in 1980-2014



Source: The World Bank (2016)

The World Bank (2015) has identified four main causes of Inequality in Indonesia that affect both current and future generations. First, inequality of opportunity, which is factors beyond an individual's control, occurs when not everyone has a fair start in life that can affect standards of living. Secondly, unequal jobs when high-skilled earn much more money than the low-skilled workers. Thirdly, high wealth concentration which a minority of Indonesian receive benefit from financial assets possession. Finally, low resiliency shocks which affect poor and vulnerable families. To overcome those problems there are at least four conditions need to be identified, which are: (1) Improving local service delivery which can improve health, education and family planning opportunities for people, (2) Promoting better jobs and skills training opportunities for the workforce, which can improve the competitiveness of workers who have missed out on a quality education, (3) Ensuring protection from shocks through government policies, and (4) Using taxes and government spending to reduce inequality now and in the future which is the pre-requisite for the first three policies.

Zhuang, Kanbur, & Rhee, 2014 suggests that inclusive growth is needed as a solution to reduce inequality. Inclusive growth can be defined as growth with equality of opportunity, supported by three policy pillars: sustained growth to create productive jobs; social inclusion to equalize access to opportunity; and social safety nets to mitigate vulnerability and risks and prevent extreme poverty. This strategy would ensure that all members of society can benefit equitably from the opportunities generated by economic growth.

4.2. The Indonesia Policies to Reduce Income Inequality

In order to overcome inequality issue, Indonesia government have improved the social protection to reduce income inequality and improve poverty alleviation. Many social protection programs have been implemented. Firstly, JKN program. The government has supported health incentive for the poor and vulnerable people. In 2016, health incentives were given for 91.10 million people or 88.03% of 40% people who are in the lowest income. It had included the new baby born to poor and vulnerable families, disabilities people, and the prisoners. Secondly, the rice subsidy program for people with low income, namely Raskin program. This program aims to protect society from the food price shock. In 2015 and 2016, Raskin is distributed to 15.50 million families for 15 kg/month/families during 12 months (Bappenas, 2017).

There are also some efforts to improve the equality of opportunity in terms of the access to the basic infrastructure such as electricity, clean water and sanitation access. Electricity is a basic need for the society which government should provide it. In 2016, the access of the poor and vulnerable people into electricity has increased from 95.58% in 2015 become 95.97% in 2016. In terms of clean water and sanitation, the access of the poor people into the facilities has also improved into 60.01% and 52.39% in 2016 from 59.22% and 46.63% in 2015 respectively.

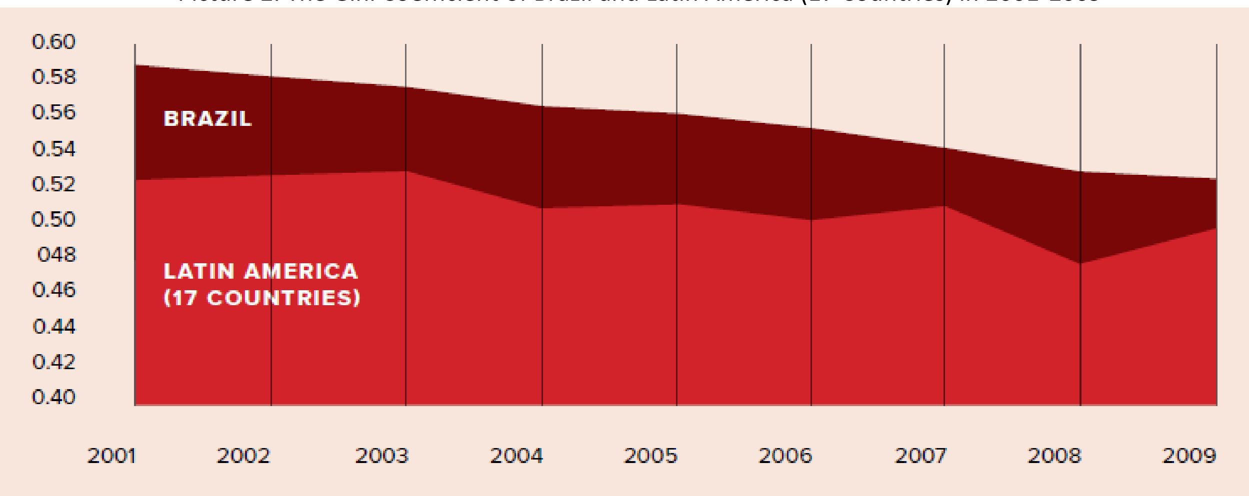
In terms of workforce, the government tries to improve the formal sector to increase its competitiveness. Compared with the number of formal workers in 2015, it has increased to be 42.40% in 2016 from 42.25% in 2015. This positive feature indicates that there is a better job certainty and work guarantee. There are also training programs to improve the capacity of the poor and vulnerable people in terms of working skill. In 2015, the number of people who attend the program reaches 875,129 million people and 570,839 million people in 2016. This program is also supported by the certification program for workers with any skills or experiences which aims to improve the bargaining position of workers in labor market.

Indonesia have made a good effort in reducing income inequality and achieved many progressions in terms of reducing the gap of opportunity inequality. However, the income inequality, reflected by the Gini, still shows a large gap between the rich and the poor.

4.3. The Role Of Indonesia Fiscal Policy on Income Inequality

Many countries, particularly in Latin America, have used fiscal policy to significantly reduce their inequality problem. A case in point is Brazil. Brazil's fiscal policy leads to reduce income inequality during 2001-2009. The Gini has decreased from 58.8 in 2001 to 53.7 in 2009. Brazil's social spending plays an important role in achieving the inequality reduction. The percentage of their social spending almost reaches 50% from the total expenditure, which includes health, education and transfer. It contributes to reducing the Gini around 30% in 2001-2009. Brazil's conditional cash transfer program, called Bolsa Familia, similar to Program Keluarga Harapan (PKH) in Indonesia, is the most cost-effective program in reducing inequality. It has covered 25% of Brazilian families higher than PKH which covers only 5% of Indonesian families (World Bank, 2015a).

Picture 2. The Gini Coefficient of Brazil and Latin America (17 Countries) in 2001-2009



Source: The World Bank (2015)

Argentina and Uruguay have also had benefits from their fiscal policy, which are direct tax and cash transfer. Both can reduce income inequality in these countries (Lustig, 2013).

While many countries have succeeded in reducing the inequality through their different fiscal policy, Indonesian fiscal policy tends to have a neutral effect on inequality today. Recent research (Jellema et al., 2015; World Bank, 2015a) explores the impact of different government taxes and spending on inequality. This research result shows that the government taxes and spending do not have an impact on inequality. The Gini is almost unchanged, that only drops a modest 1%, even the household income has changed from taxes and spending. In addition, in the paper that examines the redistributive impact of fiscal policy for Brazil, Chile, Colombia, Indonesia, Mexico, Peru and South Africa using comparable fiscal incidence analysis with data from around 2010, Indonesia has the smallest redistributive effect while South Africa has the largest redistributive effect (Lustig, 2015).

In terms of expenditure, historically Indonesia has spent more budget on many less impact policies on reducing inequality, such as energy subsidies than on greater impact policies, such as social assistance programs like PKH (a conditional cash transfer), BSM (now Kartu Indonesia Pintar, or KIP, a scholarship program for the poor), and health. In addition, the national health insurance system (Jaminan Kesehatan Nasional, or JKN) which get a big proportion of health spending is relatively less pro-poor. Most of this spending is used towards large hospitals in the big cities, which tend to give more advantage for the rich people rather than the poor one (World Bank, 2015a).

Compared to South Africa, based on the government expenditure in 2012, Indonesia has much lower social spending and in-kind transfers, which were 4,86% and 4,47% of GDP while South Africa reaches 17.6% and 12.6% of GDP respectively. The spending of education and health of Indonesia were also lower than South Africa which were only 3.4% and 0.88% of GDP while South Africa were 7.0% and 4.1% of GDP.

Recently, government spending has shown an improvement which is reflected by the lower energy subsidy in expenditure posture and ratio of capital expenditure is expected to rise. In 2015, the energy subsidy ratio has decreased from 1.03% of GDP into 0.86% of GDP in 2016. However, the capital expenditure ratio of GDP decreases from 1.87% in 2015 into 1.34% in 2016 (Bappenas 2017).

In terms of taxation, much of the Indonesia tax revenue is gained from indirect taxes, mainly Value Added Tax (VAT), which do not have much effect on inequality. This is because the percentage of the market income in VAT which should be paid by the richer, as well as the poorer families, is the same. On the other hand, the more progressive tax, which is personal income taxes, is only about 10% of the total tax revenue, or around 1.9% of GDP. This percentage is much lower compared with South Africa which reaches 8.5% of GDP in 2012.

On the other hand, during 2015-2016, tax-to-GDP ratio tends to decrease. On December 2016, tax amnesty policy has succeeded to collect Rp107.0 billion or 64.90% of the target. However, it is still far from the Indonesia target for tax-to-GDP ratio that is 13.1%-13.2% of GDP (Bappenas, 2017). This is influenced by the global economic weakness, the lower price of commodity and oil, and the lack of tax compliance and tax basis. These problems limit the fiscal role to finance the development.

4.4. IMPROVE FISCAL POLICY EFFECTIVENESS IN INDONESIA IN ORDER TO REDUCE INEQUALITY

The fiscal policy, both tax and expenditure policies have to be designed well to improve its effectiveness in reducing inequality. In developing economies, there are several options which can be done, which are: (i) consolidating social assistance programs and improving targeting; (ii) introducing and expanding conditional cash transfer programs as administrative capacity improves; (iii) expanding noncontributory means-tested social pensions; (iv) improving access of low-income families to education and health services; and (v) expanding coverage of the PIT (IMF, 2014).

Regarding the fiscal policy of Indonesia, an improvement is still needed particularly in terms of its role in reducing income inequality. The government should prioritize the expenditure on social spendings such as health, education, social assistance and infrastructure because it becomes one key role that fiscal policy can help reducing income inequality in long term, particularly due to factors beyond individual's control. These spending can improve the access of low-income families to education, health and transfer, which means will give the people wider opportunity to get a better job and achieve a higher wealth.

Indonesia should continue to expand coverage of JKN Program particularly 40% of people with the lowest income. This program can reduce the risk for the poor getting poorer when they have an illness. Previously, people from informal sector often lose their income due to illness because they spend most of their income for health cost. JKN program has important role in preventing such risk as it covers the health cost which needs to pay by these people. Meanwhile, other factors related to this which are needed to consider are the health workers distribution across Indonesia regions and health facilities availability.

In terms of education spending, it should also be increased so people can gain free education of 12 years compulsory education. Education is an important tool to reduce income inequality in the next future as it opens equal opportunity to all people to gain better jobs and then higher income and achieve better standards of living.

According to the Brown (2016), health expenditure should be increased to at least 2.2 percent of GDP in order to address supply-side constraints, especially health workers and primary health care. Meanwhile, education spending should be increased to 4 percent of GDP in the short term, and in the long term becomes 6 percent of GDP as UNESCO's recommendation.

The spending should also more focus on infrastructure particularly social infrastructure to ensure people can gain their basic needs. Improving access to health and education facilities and also infrastructure of housing including water and sanitation infrastructure are examples of this social infrastructure.

However, a good quality of public spending should be supported by a fairer taxation system designed to address some of the current tax regulations that encourage the concentration of wealth. The government should reform existing tax regulations, because it is not able to achieve the potential tax revenue and capture the reality of wealth owned by wealthy people in Indonesia over the last 15 years. According to International Monetary Fund (IMF), Indonesia has a potential tax take above 21.5 percent of Gross Domestic Product (GDP), while in 2016, the country only raised up to 10 percent GDP (Brown, 2016).

There are specific actions need to be implemented in order to improve the taxation role in reducing the income inequality. The tax-to-GDP ratio towards Indonesia's maximum tax capacity should be increased by 21.5 percent of GDP to raise revenues to fund vital public services. The personal income tax system should be reformed in order to make it more progressive for example by adding additional tax bands for those at the top, at higher rates. The wealth taxation should be reviewed to increase land and property taxation for the highest value land and properties, increase inheritance tax rates, and introduce a net wealth tax to address inequality. Finally, all taxpayers should pay their fair share.

5. CONCLUSION

The implementation fiscal policy has not given significant effect on reducing income inequality in Indonesia. This feature contrasts with many other countries, for example Brazil, that has succeeded to decrease their income inequality significantly by using the fiscal policy as a key tool. In terms of spending, government expenditure program such as Raskin and KIP give insignificant impact on reducing inequality. Moreover, the social spending such as JKN is still less pro-poor. On the other hand, in terms of taxation, much of the Indonesia tax revenue is gained from indirect taxes, mainly Value Added Tax (VAT), which do not have much effect on inequality.

Indonesia government should take actions to make its fiscal policy more effective in reducing inequality. Prioritizing the budget on the social spending and infrastructure is likely to be a key aspect to improve the fiscal policy role to reduce inequality. In terms of taxation, increasing direct tax such as personal income taxes should be done in order to make it more effective.

6. IMPLICATIONS AND LIMITATIONS

This research gives some implication to the role play of taxes and subsidy. Hopefully, it gives some input to The Ministry of Finance of Indonesia enriching the literature of preparation scheme of tax to be more efficient in reducing inequality.

Nevertheless, this study still has some limitations. Due to the complexity of the topic, while facing time constraint, this paper only use study literature in conducting some suggestions of tax and subsidy in affecting income inequality. By using primary data, further research may depict more actual conditions of income inequality.

7. APPRECIATION

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