VAT on service export ineffective

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Reducing tax rates seems to be an increasingly popular policy now. After slashing income tax rates for small and medium enterprises (SMEs) and income tax on repatriated export proceeds, which are put in domestic banks, the government is currently formulating a policy that will reduce the value added tax (VAT) rate to 0 percent for service exports.

Following Finance Ministerial Regulation (PMK) No. 70/PMK.03/2010, the government has to subject only three items of export services to 0 percent VAT, including repair and maintenance services and construction services. Six additional items of export services that will be subjected to 0 VAT rate include technology and information services, research and development services, transportation equipment rental, transportation management services, professional and trade services.

The strategy is one of the government's responses to the current account deficit, which has been generated mainly by the services sector deficit. Therefore, the elimination of the VAT rate is intended to encourage the value of service exports in order to reduce the service account deficit.

The abolishment of VAT on service exports is also targeted to accelerate growth. The growth of service exports is only around 9 percent a year and is relatively low among other ASEAN countries. Not surprisingly, Indonesia's services export ratio is only in the range of 2.6 percent of the gross domestic product.

In fact, Indonesia's services sector has great potential to be the backbone of economic growth. In 2017, for example, the services sector grew by 5.68 percent and slightly exceeded the national economic growth of only 5.07 percent. In the same year, 60 million people or nearly half of Indonesia's workforce worked in the services sector.

The services sector also plays an important role in poverty alleviation and enabling instruments for other economic sectors, such as information on technology, transportation and others. It implies that the services sector could be a new generator of economic multiplier effects in achieving broader social welfare.

However, the above efforts are not spared from the pros and cons. Cutting the VAT rate from 10 percent to 0 percent will potentially reduce government revenue. VAT contributes at least 45 percent to total tax revenue, which is only slightly below income tax revenue.

The VAT policy adopted by Indonesia actually refers to the destination principle, meaning that that once the service has already crossed Indonesian customs jurisdiction, the VAT is borne by the foreign consumers. As a result, the government's 10 percent VAT levied on service exports becomes double taxation. It makes Indonesia's services sector less competitive in the global market.

The double taxation also takes place in service imports. The government keeps levying 10 percent VAT on the imported services. In fact, the importing countries may have already imposed VAT. To omit double taxation, a consensus has been formed at the global level to implement the destination principles within the framework of the cross-jurisdictional VAT taxation system.

Under the problematic configuration above, the VAT exemption is quite a quirk. The Law No. 42/2009 concerning VAT on Goods and Services clearly explains that when the consumption of goods and services is outside the territory of Indonesia, there is no VAT.

Accordingly, the VAT exemption for service exports cannot be considered as an additional incentive. On the contrary, a 0 percent VAT on all service exports should be considered as a permanent policy, not a temporary measure only.

The misperception of temporary incentive vis-à-vis permanent policy will undoubtedly affect the credibility. In addition, many empirical studies in low-income countries call for the re-consideration of VAT incentive. For example, Michael Keen points out that the VAT also taxes the informal sector indirectly as the VAT is levied on some of the inputs and imports they use.

In a broader sense, the magnitude of the VAT rate is one (but not the only) factor influencing services export supply. The VAT rate is not the major determinant in investment decision making in the services sector.

Manipulating the VAT rate is not the right solution when a number of other factors do not support it. Eventually, 0 percent VAT is necessary but not sufficient condition yet. The government should dedicate its tax policies to improving the business climate.

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