

PERSONAL INCOME TAX PIGGYBACKING IN INDONESIA

A NOVEL WAY TO INCREASE SUBNATIONAL FISCAL INDEPENDENCE

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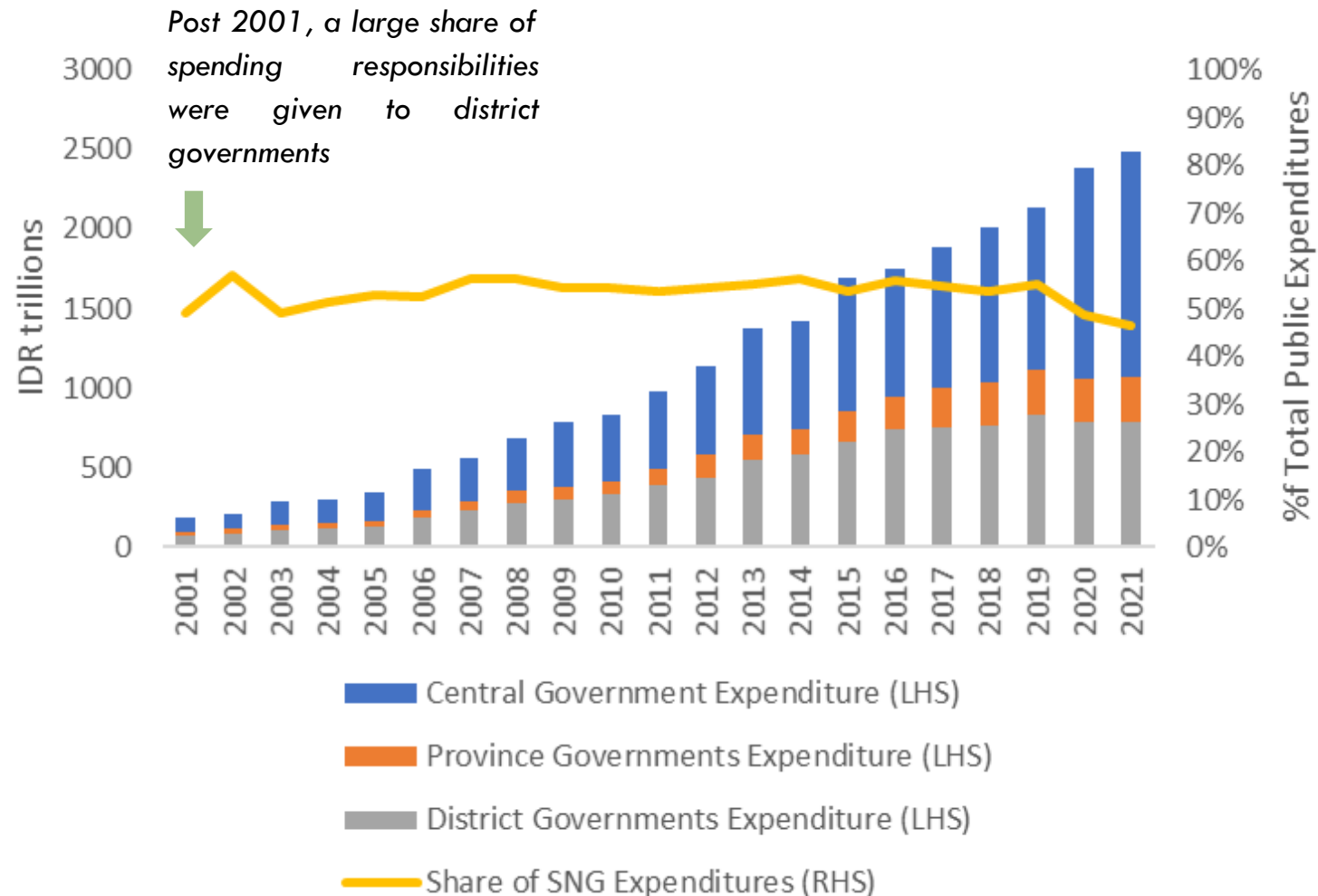
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TODAY'S SESSION WILL ANSWER THE FOLLOWING QUESTIONS

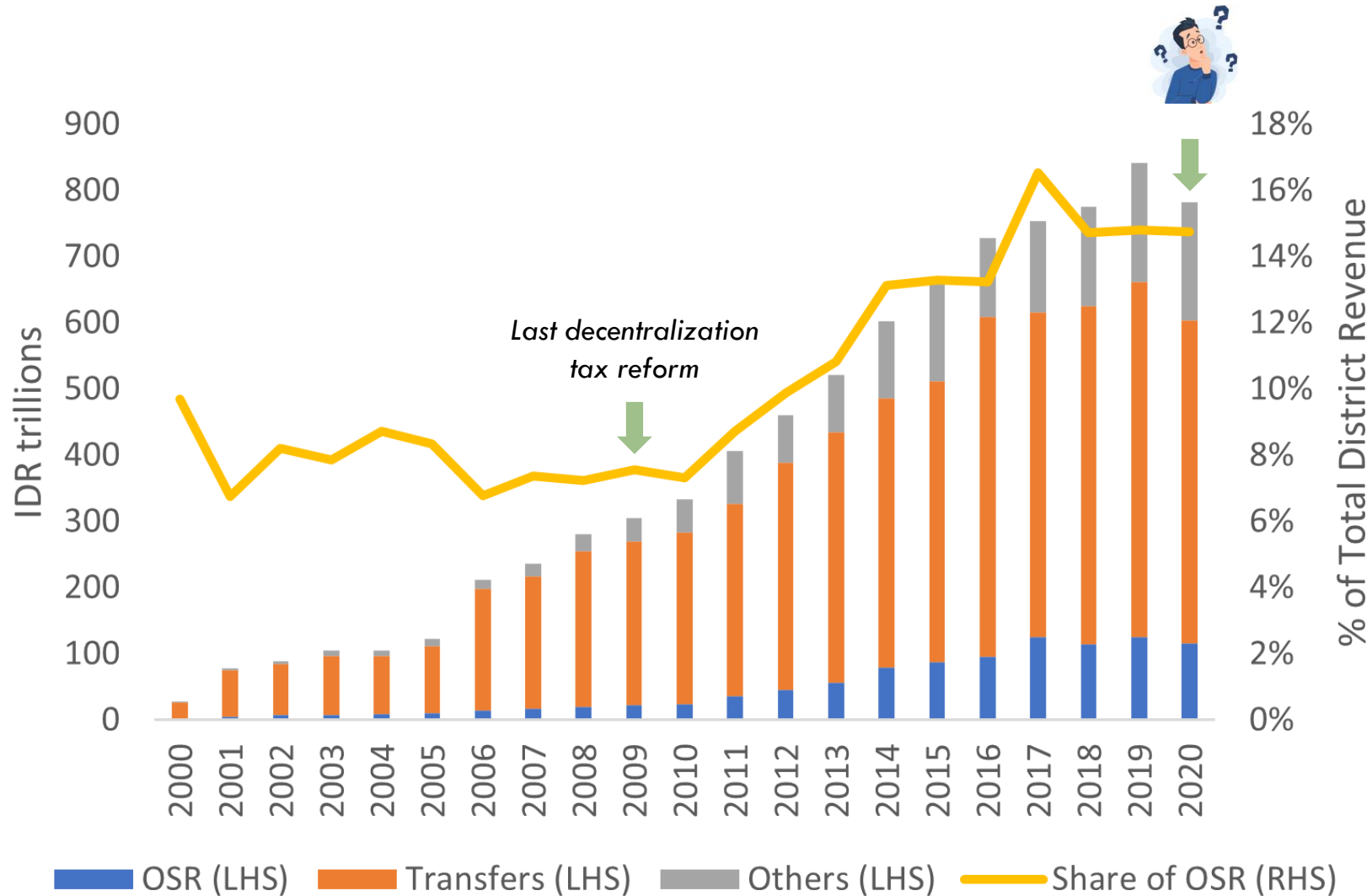
1. What is the fiscal decentralization context within Indonesia? What is the SNG revenue challenge within the country?

2. How can Personal Income Tax (PIT) Piggybacking help address the SNG revenue challenge within Indonesia? What are potential benefits of introducing PIT piggybacking?

INDONESIA IS HEAVILY DECENTRALIZED WHEN IT COMES TO SPENDING RESPONSIBILITIES



...HOWEVER, DISTRICTS ONLY COLLECT A SMALL SHARE OF THEIR REVENUES AS OSR



WHERE DOES PIT PIGGYBACKING FIT INTO ALL OF THIS?



“Fiscal Decentralization is very important to create social and economic justice for society”

- Minister of Finance, Sri Mulyani

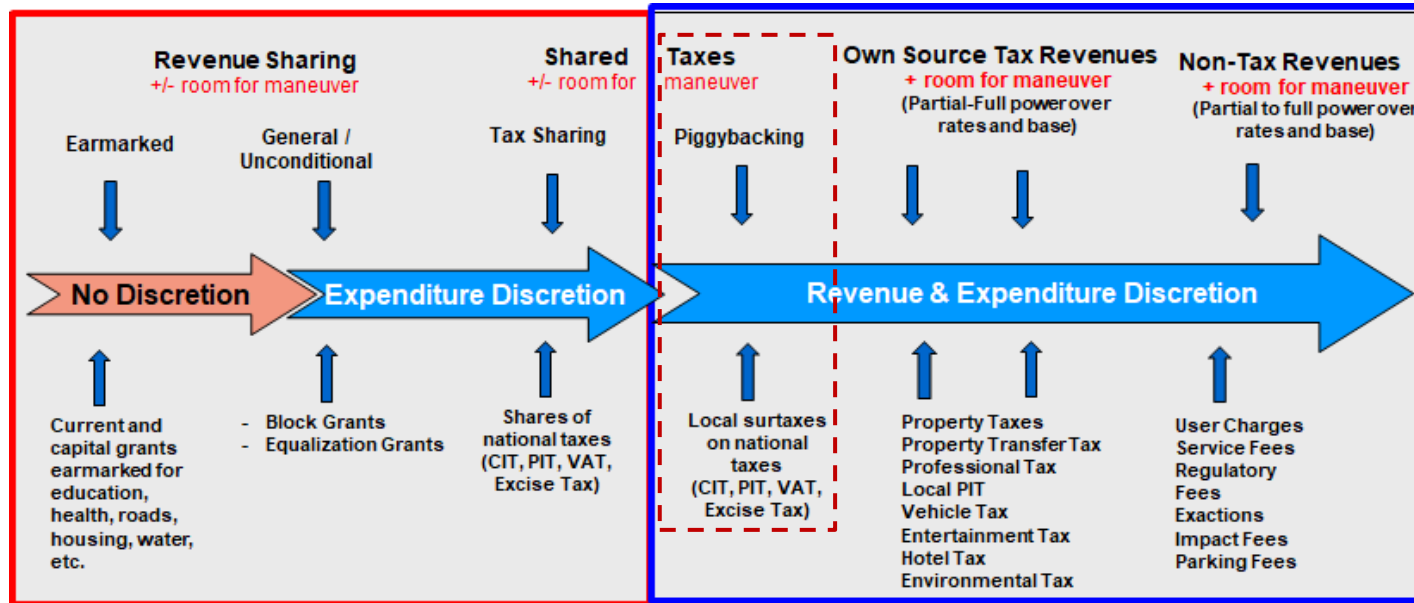
Reform Effort: Law 1/2022



Key Question: *Does the SNG policy framework set by MoF need any changes? i.e., should SNGs be given further taxation powers?*

WHAT IS PIT PIGGYBACKING? WHAT DIFFERENTIATES IT FROM OTHER FORMS OF SNG FINANCING?

Personal income tax (PIT) piggybacking is a subnational government (SNG) surcharge on taxable income or income tax liability.



Transfers: Received by LGs

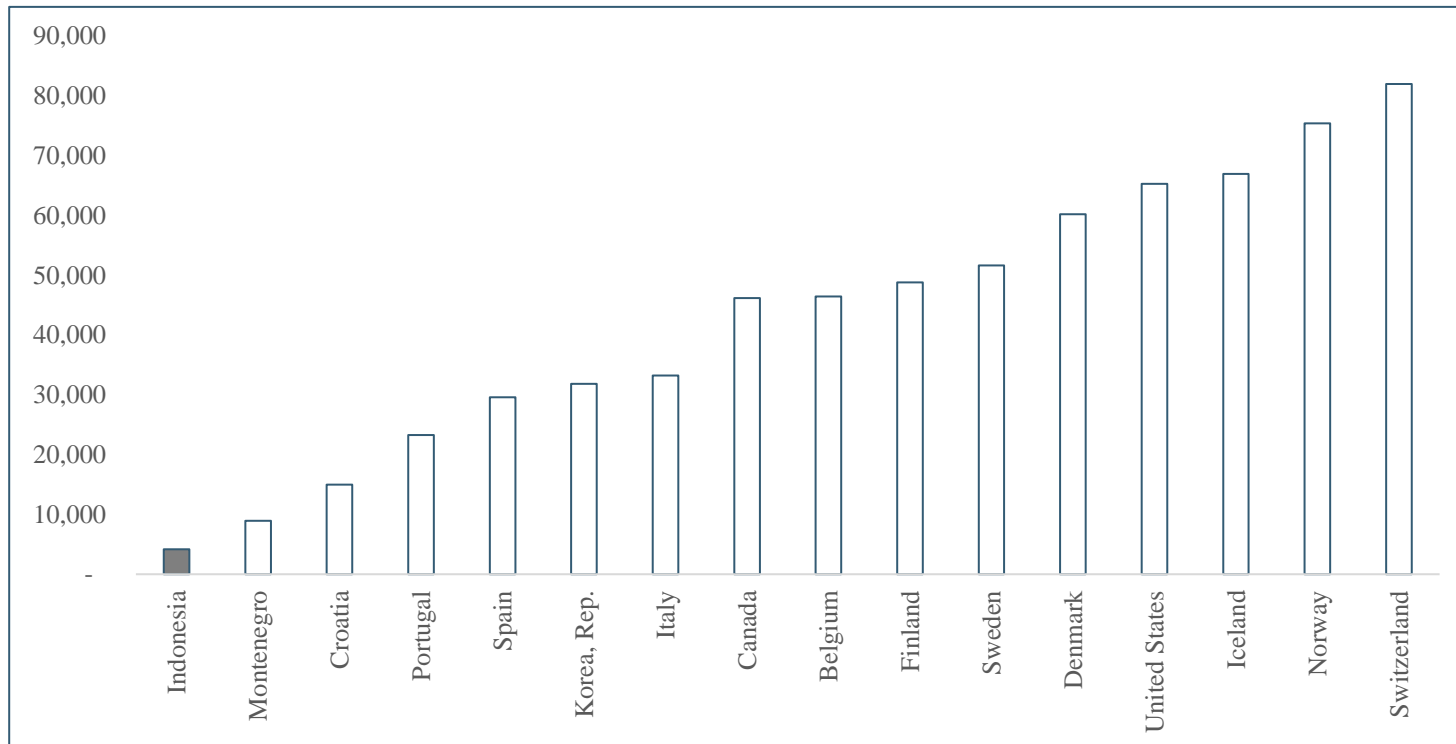
Own Source Revenues: Levied by LGs

Key differentiating feature of PIT piggybacking is that the SNG should have the rate setting authority

Otherwise it is just a shared tax and shouldn't classify as OSR

IN PRACTICE, PIT PIGGYBACKING IS MOSTLY IMPLEMENTED IN HIGH-INCOME COUNTRIES

GDP per capita of countries with PIT piggybacking compared with Indonesia



PIT also happens to be a lower as a share of GDP for low- and middle-income countries.

It is also harder to enforce in low- and middle-income countries due to structural challenges such as informality

WHAT ARE THE BENEFITS OF PIT PIGGYBACKING?

Benefits

1. Increase SNG OSR without requiring additional SNG tax administration capacity

2. Improve fiscal contract

How?

SNG sets the tax rate, CG collects additional PIT allocated to SNG

Increase in SNG OSR means, in theory, that there could be a positive accountability loop

Application for Indonesia

We simulate that PIT piggybacking can increase district OSR by 8.3%

Under three conditions:

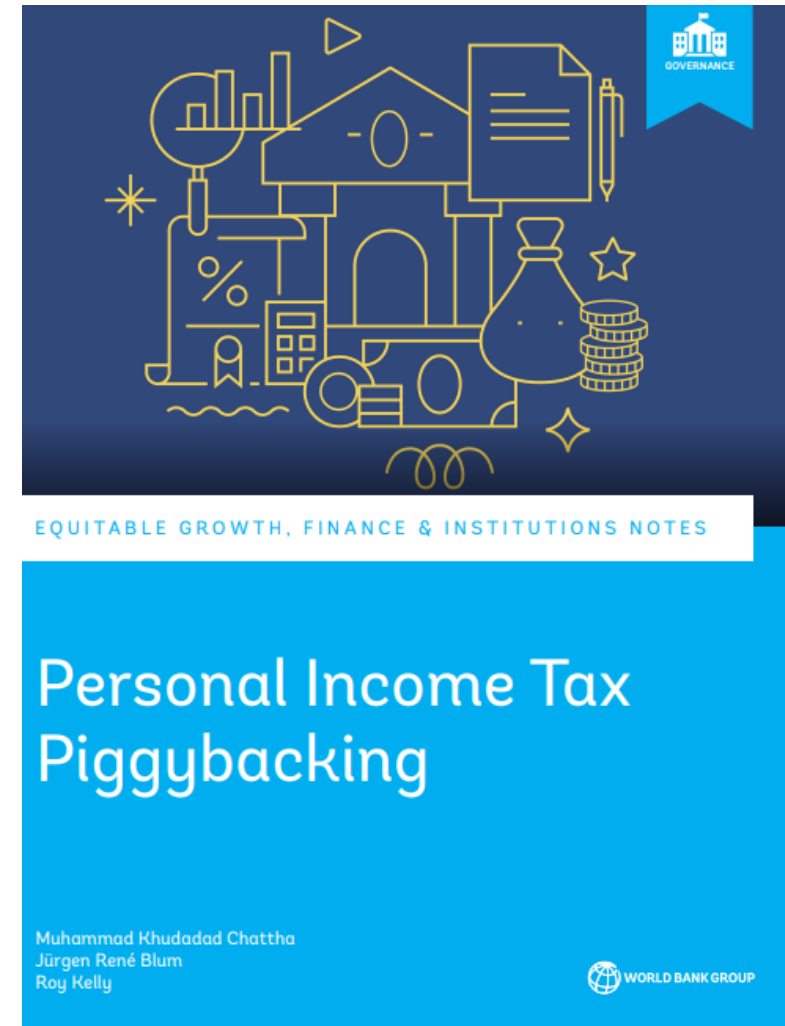
- A. SNG autonomy*
- B. Up-to-date taxpayer residence info*
- C. Taxpayer awareness*

WHAT ARE THE REFORM TRAJECTORY OPTIONS FOR INDONESIA?

- **Option 1: Additive approach from independent income taxes**
(Denmark and Canada)
- **Option 2: Additive Approach while maintaining PIT DBH and adding a SNG PIT Piggyback surtax (Croatia)**
- **Option 3: Substitution Approach: Replacing PIT DBH 20% with a mandated SNG surtax (with no local rate option)**

RECAP AND FURTHER DETAILS

- PIT piggybacking is an SNG surcharge on taxable income or income tax liability.
- It is an effective way to increase SNG fiscal independence without requiring additional SNG administrative capacity.
- It can strengthen the fiscal contract, conditional on (i) SNG autonomy in rate setting; (ii) ability to allocate revenues to residence; (iii) taxpayer awareness.
- Further details in published report.

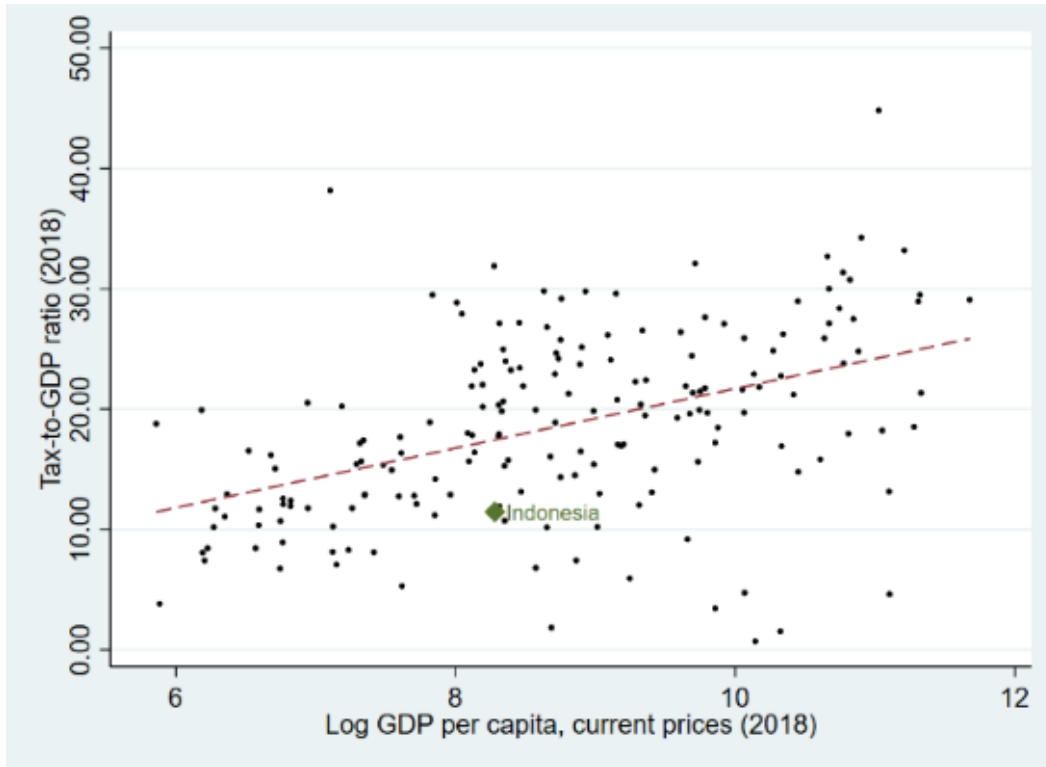


THANK YOU

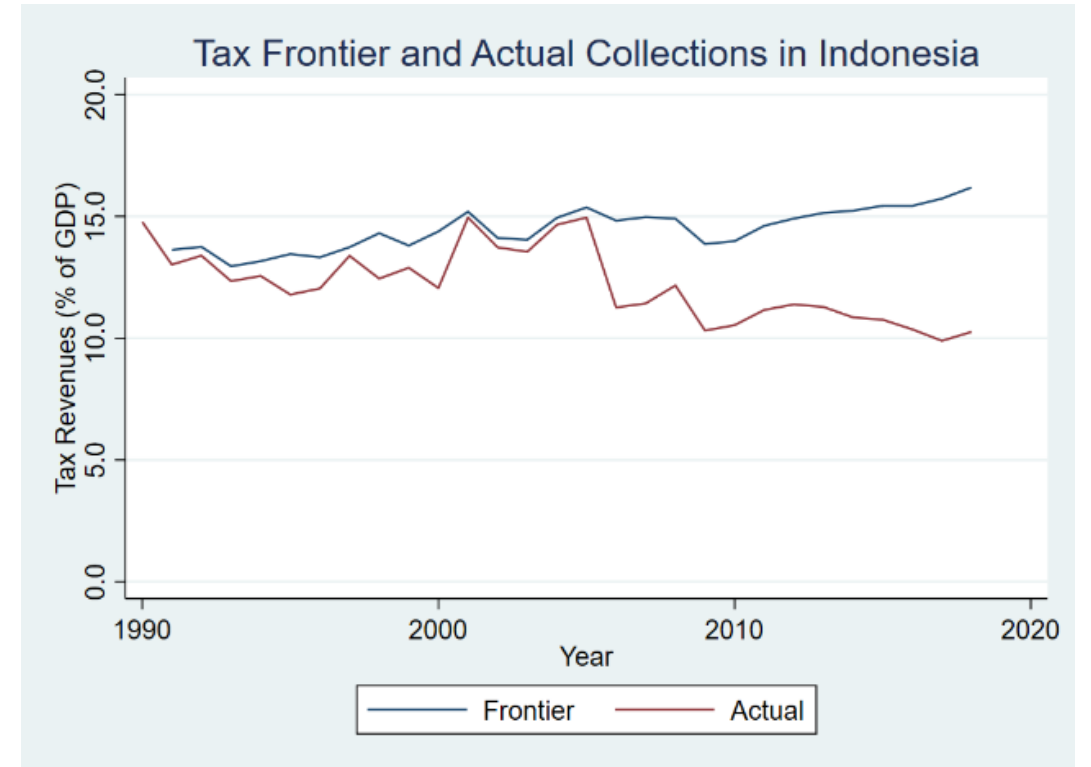
ANNEX

INDONESIA FACES A SIGNIFICANT REVENUE MOBILIZATION CHALLENGE

Indonesia's tax collections are significantly lower compared to structural peers



The tax gap has widened over time



KEY CHARACTERISTICS OF PIT PIGGYBACKING

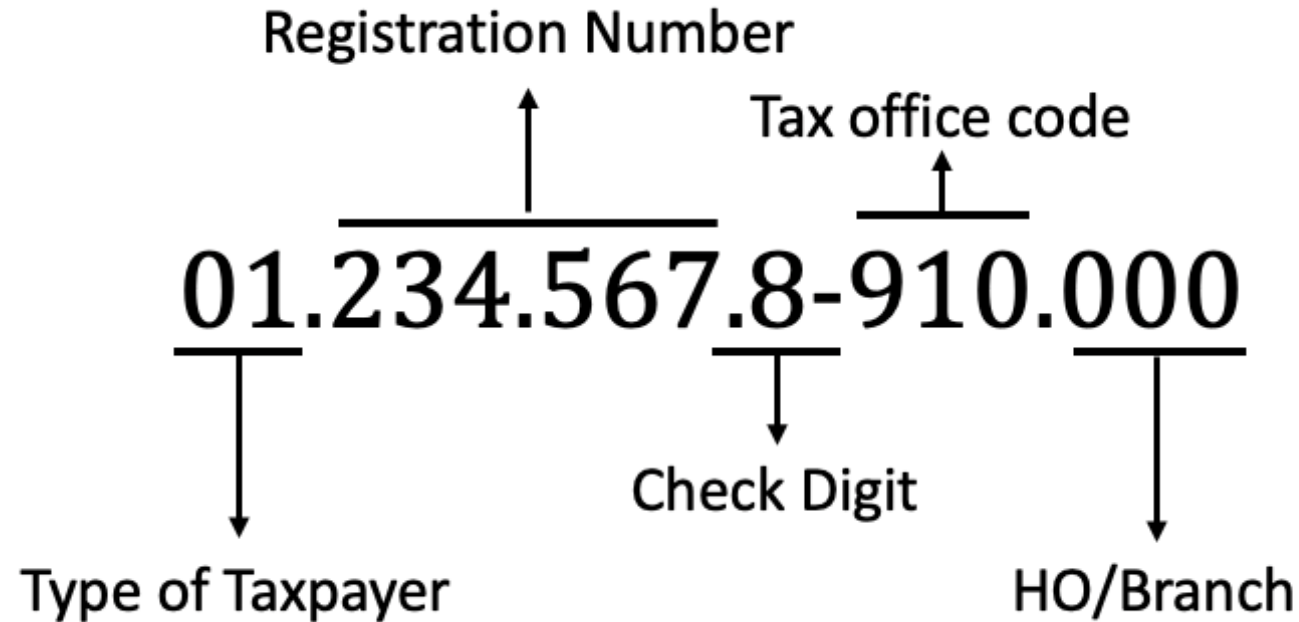
- **CG definition of tax base:** The PIT base is set by the central government.
- **CG administration:** All administration remains with the central government
- **Rate setting autonomy for SNGs:** The local government (LG) is given some autonomy to set a surcharge rate on top of the CG tax rate.
- **Accrual to SNG:** This additional revenue accrues to the subnational government and helps close the vertical fiscal gap.

WHAT ARE THE ADMINISTRATIVE CONDITIONS UNDER WHICH PIT PIGGYBACKING COULD IMPROVE FISCAL CONTRACT?

1. **SNG Autonomy:** LGs need to be given some autonomy in setting the tax rate, even if this is within bounds defined by the CG.
2. **Allocation to residence:** The piggyback revenue levied by the LGs should be allocated to the taxpayer place of residence.
3. **Taxpayer awareness:** Citizens need to be informed that the PIT piggyback is a LG surcharge (a *PAD**) rather than a CG tax (a *DBH*[^]).

* PAD = Penerimaan Asli Daerah (OSR) ^ DBH= Dana Bagian Hasil (Shared Revenue)

TAXPAYER ID NUMBER (NPWP)



PIT DBH consists of PPh21 and PPh25/29. PPh21 is collected as a withholding tax by the employer which is remitted to the DG Tax KPP tax department linked to the place of employment. PPh25/29 is the final tax filed by the taxpayer that is paid to the KPP tax department where the taxpayer is registered

CURRENT SITUATION WITH PIT SHARING IN INDONESIA

Indonesia shares 20% of the PIT with the provincial & district governments

The PIT is collected by the CG Tax Department and then allocated as follows:

- Province: 7.3%
 - District/City: 8.9%
 - Surrounding LGs in region: 3.6%
-
- TOTAL: 20.0%

CONDITION 1: SNG RATE SETTING AUTONOMY

WHAT CAN INDONESIA LEARN FROM DENMARK, CANADA AND US?

Denmark

- Denmark SNGs set the PIT surcharge rate on CG determined tax base, with CG responsible for entire tax administration.

Canada

- Canada provinces (except Quebec Province) choose and levy their tax rate on the common federal tax base, with the federal-level Canada Revenue Agency collecting both the federal and provincial level PIT.

United States

- US states set their own tax rates, determine their own income tax base (although many are adjusted from the federally-determined tax base) and administer/collect the state-level income tax themselves.
- US municipalities/cities/towns in 17 states levy a personal income tax. LGs in 12 levy their own rates, determine their own base, and administer/collect their own income taxes. However, LGs in 5 states choose their local PIT tax rate but piggyback this income tax on the state-level determined tax base and leave the administration/collection to the state-level Department of Revenues.

NOTE: The US state level income tax operates as a pure SNG tax (i.e., the state level administers/collects their PIT), although it is often referred to as a piggyback since the PIT tax base used by the states is closely linked to the federal income tax base.

CONDITION 2: ALLOCATION TO RESIDENCE

THE CHALLENGE IN INDONESIA – HOW TO IMPROVE LINKAGE TO RESIDENCE IN INDONESIA?

- a) **Integrate DG Tax's systems with national identity card database:** The residential addresses available with the national resident identity card (KTP/NIK) may have more updated actual taxpayer residence.
- b) **Strengthen and formalize existing head of village reporting mechanism:** Informally, citizens who move to a new location should report to the village head (RT/RW). Possible opportunity to formalize this reporting mechanism.

DG Tax is now developing the core tax administration system (*Sistim Inti Administrasi Perpajakan/SIAP*) which provides opportunity to put in regulations and related business processes to improve taxpayer residence.

CONDITION 3: TAXPAYER AWARENESS

HOW TO ENSURE PIT PIGGYBACKING IS SEEN AS AN SNG REVENUE INSTRUMENT?

1. **Prepare administrative systems, forms, and procedures** for filing the PIT to make it clear that there is an added LG-levied incremental PIT surcharge. This will help taxpayers understand that this is a LG PIT piggybacking amount and will also ensure that the Tax Dept will be able to allocate the PIT surtax to the right LG.
2. **Prepare a communication outreach strategy** to raise awareness among citizens on the PIT piggyback, to improve accountability between taxpayers and their LGs.

THE REVENUE IMPLICATIONS FOR PIT PIGGYBACKING IN INDONESIA ARE POSITIVE BUT VARY ACROSS REGIONS

