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Encountering the Policy Dilemma of the Effective Rate of the Value Added Tax on Tobacco Products

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Abstract. The purpose of this study is to analyze the policy implementation of the increase in the effective rate of Value Added Tax (VAT) on tobacco from 8.7% to 9.1%. This study applies a qualitative with descriptive approach and data collection techniques of research in the literature and in-depth interviews. The findings show that the policy implementation on the increase in effective rate of VAT on tobacco from 8.7% to 9.1% with the enactment of the Regulation of the Minister of Finance No. 207/PMK.010/2016 has not been in accordance with the formulated objectives of the policy, namely, to minimize the negative externalities of cigarette consumption. This policy of the increase in the effective rate affects state revenues, however, the government's attention to minimize the negative externalities of high cigarette consumption through the policy is considered less accurate considering the cigarette control instruments commonly used in various countries is the excise tax. Cigarette consumption has constantly increased and its negative externalities cannot be minimized by the policies on state levies issued by the government, one of which is the policy on the increase in the effective rate of VAT on tobacco products. The increase in rate may not necessarily be a sustainable source of state revenue or a political instrument to reduce the negative impact of cigarette use in the society. In fact, the number of cigarette users still increases even following the rise of cigarettes prices due to insignificant increase in VAT and the excise rates.

Keywords: Tax Policy, VAT on Tobacco Products, Effective Rate of VAT, Indonesia

Abstrak. Tujuan penelitian ini adalah untuk menganalisis penerapan kebijakan kenaikan tarif efektif Pajak Pertambahan Nilai (PPN) atas penyerahan hasil tembakau dari 8,7% menjadi 9,1%. Penelitian ini menggunakan pendekatan kualitatif dengan teknik pengumpulan data studi literatur dan wawancara mendalam. Hasil penelitian menunjukkan bahwa penerapan kebijakan kenaikan tarif efektif PPN atas penyerahan hasil tembakau dari 8,7% menjadi 9,1% dengan dikeluarkannya PMK No.207/PMK.010/2016 belum berjalan sesuai dengan tujuan diformulasikannya kebijakan tersebut, yaitu untuk meminimalisasi eksternalitas negatif dari konsumsi rokok. Kebijakan kenaikan tarif efektif ini memang berpengaruh terhadap penerimaan negara, namun upaya pemerintah dalam rangka meminimalisasi eksternalitas negatif dari konsumsi rokok yang tinggi melalui kebijakan kenaikan tarif efektif PPN dirasa kurang tepat mengingat instrumen pengendalian rokok yang umumnya digunakan di berbagai negara adalah cukai. Konsumsi rokok yang terus meningkat dan eksternalitas negatif yang ditimbulkan dari konsumsi rokok belum dapat diminimalisasi dengan kebijakan pungutan negara yang dikeluarkan pemerintah, salah satunya adalah kebijakan kenaikan tarif efektif PPN atas penyerahan hasil tembakau. Kenaikan tarif belum tentu dapat menjadi sumber penerimaan negara yang aman dan berkelanjutan ataupun menjadi instrumen politik, dalam hal ini untuk mengurangi dampak negatif dari penggunaan rokok di masyarakat. Jumlah konsumen rokok pada akhirnya terus bertambah walaupun harga rokok sudah mengalami kenaikan akibat kenaikan tarif PPN maupun cukai.

Kata kunci: Kebijakan Pajak, PPN atas Produk Tembakau, Tarif Efektif PPN, Indonesia

INTRODUCTION

Functions of tax in the context of regulation and budgeting are apparently always crucial, especially when it comes to the tax policy on goods essentially limited or prohibited. The tax policy on tobacco as a focus in this article does not merely emphasize the function of state revenues but also how to reduce negative externalities of high cigarette consumption. Along with a continuous debate on several economic aspects related to tobacco consumption, there is also such debate on implications of taking this kind of tax into effects on its regulatory and revenue generating functions. This way, the VAT rate is an effective rate generally different from VAT rate on taxable goods in general.

As a consumption tax aiming to contribute income to the state, the tax policy on tobacco in a form of VAT is

levied on each stage of production and distribution having value added (Colbjørnsen, 2015, 326). Taxation on tobacco is practically a universal practice. A total of 152 out of 182 countries impose VAT on cigarettes, as quoted from one of the publications of World Health Organization (WHO, 2010). The majority of governments impose taxes on tobacco, one of which is VAT (Chaloupka, et al., 2012, 173). According to Yurekli and Beyer (2002), taxes on tobacco from cigarettes, namely the excise tax and VAT, contribute 70-80 percent to the price of a pack of cigarettes in almost all developed countries and 20-50 percent in other middle-income and low-income countries. However, it is not always effectively implemented (Samet and Yoon, 2010, 210). Tobacco tax tends to be a main source of revenue for several middle-income countries. Thus, an increase in tobacco tax rate shall result in a greater increase in tax revenue in the short term. Since 2008, WHO introduced

MPOWER (Monitor, Protect, Offer help, Warn, Enforce, Raise taxes) to reduce the prevalence and rate of global cigarette consumption (Kosen et al., 2017, 83). The most effective way in this policy to encourage tobacco users to stop smoking and prevent young people from starting smoking is raising tobacco prices through an increase in tax rate (Kosen et al., 2017, 27).

Tax revenue is an annual target that the government relies on, no exception to the case of Government of Indonesia. Approximately 80% of state revenues are sourced from the taxation sector, meaning that the source of state finances comes from taxation (Misbakhun in Akuntono, 2015). The tax revenue may source from various economic and industrial activities. Thus, it is undeniable that many sectors involved in economic activities in Indonesia play a role in state revenues, one of which is

the agricultural sector. This sector plays an important role in economic activities in Indonesia. It makes the second highest contribution to Gross Domestic Product (GDP) of Indonesia after the manufacturing sector with total contribution of 13.6% and 20.8% respectively (Hadad in Miftahudin, 2016). Among the most dominant agricultural subsectors are plantations, including tobacco. Tobacco plantation in Indonesia comprises of three types, namely public plantation, large state plantation, and large private plantation. A study by Ernst and Young (2015) of the economic impact of tobacco industry in Indonesia reveals that 57% of total tobacco production in ASEAN countries is produced by Indonesia in 2012 and the estimated value of cigarette sales reaches IDR 276 trillion in 2014. In addition, the value of cigarette sales also increases annually as shown in Figure 1.

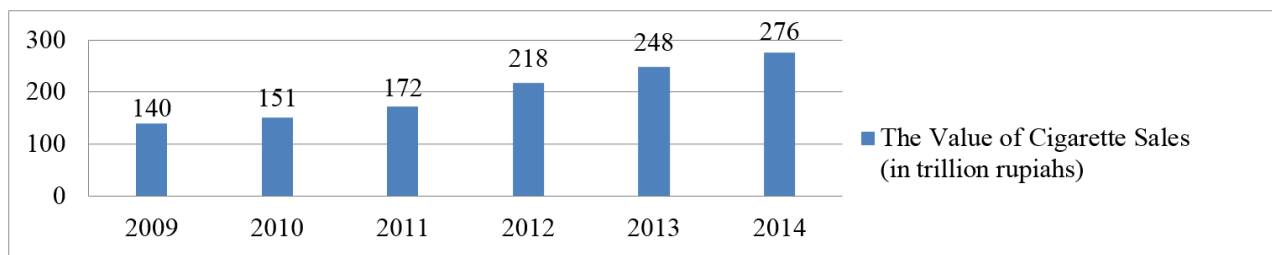


Figure 1. The Value of Cigarette Sales (in trillion IDR)

Source: A study by Ernst and Young, 2015 (reprocessed by the author)

In addition to its contribution to the economy of Indonesia, the Tobacco Products Industry (IHT) also makes a large contribution to the absorption of labor in Indonesia. IHT is capable to absorb manpower, equal to 6.1 million people. Furthermore, IHT is a historical part of the nation and culture of Indonesian society, particularly clove cigarettes (Central Bureau of Statistics, 2017). Based on the Regulation of the Minister of Industry No. 63/M-IND/PER/9/2015, the IHT is an industry entirely or partially processing raw materials from tobacco leaves with/ without cloves to produce value added in the form of tobacco products. The IHT consists of tobacco drying and its processing industry, clove cigarette industry, white cigarette industry, as well as cigarette and other cigars industry, while the products consist of cigarettes, cigars, leaf cigarettes, sliced tobacco, and other tobacco processing products, regardless of whether the substitute or auxiliary materials are used or not in their manufacture.

One of the focuses of government policy on IHT is the excise tax and tax policy. The IHT is considered a potential source of revenue and a driving force of economic sector of the country. The tax on tobacco is one of the government instruments to reduce the negative externalities caused by tobacco consumption. Other countries are using a tobacco tax (such as VAT, the excise tax, and cigarette tax) as "tobacco control strategy". In the context of tax policy on the IHT in Indonesia, the government imposes Value Added Tax (VAT). VAT and the excise tax are the components of tax levies on cigarette, one of tobacco products. Annually, there is a trend of increase in revenue from VAT and the excise tax. However, in particular, the VAT revenue on tobacco products decreases by IDR 2.6 trillion in 2016. It is in line with the decrease of the realization of total VAT revenue. In fact, the government

has issued an increase in effective rate by 8.7% based on the Regulation of the Minister of Finance No. 174/PMK.03/2015. The largest amount of VAT revenue is obtained in 2015, equal to IDR 23 trillion with effective rate of 8.4% based on the Decree of the Minister of Finance No.62/KMK.03/2002. In October 2017, the realization of VAT revenue reaches IDR 19.1 trillion with effective rate of 9.1% based on the Regulation of the Minister of Finance No.207/PMK.010/2016.

The Government, in this regard the Ministry of Finance, issued a policy on December 28, 2016 through the Regulation of the Minister of Finance No. 207/PMK.010/2016 on the Amendment to the Regulation of the Minister of Finance No. 174/PMK.03/2015 on the Procedures for Calculating and Collecting VAT on Tobacco effectively since January 1, 2017. The amendment is related to the increase in effective rate of VAT from 8.7% to 9.1%. In this regard, the government intends to collect VAT on tobacco or cigarettes through two stages, at a rate of 10% when the cigarettes leave the factory and another 10% when large distributors or wholesalers sell them to the public. Based on the current regulation, the collection is only carried out in single stage, namely at a rate of 9.1% at the producer level. On the one hand, the increase in rate is certainly quite threatening for the tobacco industry, since such an increase does not merely apply to VAT, but also to cigarette excise tax, namely 10.54% on average in 2017. The policy in the Regulation of the Minister of Finance is considered a form of government inconsistency against the original agreement with industry actors, in which the effective rate of VAT is previously agreed to increase from 8.7% to 8.9% and the new rate of 9.1% will be applied in 2018 instead of 2017. The tobacco industry has a sensitive issue when

associated with an increase in tax rate. The increase in the rate of VAT has an impact on the increase in tobacco prices, including cigarettes, as well as the increase in the excise rate.

The increase in effective rate of VAT on tobacco through the Regulation of the Minister of Finance No. 207/PMK.010/2016 is expected to optimize state revenue supported by the revenue from tobacco excise. In addition, the main purpose of the increase in effective rate of VAT is to reduce the level of cigarette consumption using tax instruments. On the other hand, the government should take into consideration the sustainability of the tobacco industry due to the large number of workers involved and the role of tobacco industry as the source of state revenue. In addition, the government needs to understand that the legal character of VAT is a consumption tax, having a different character from excise taxes to control the consumption of particular goods causing negative externalities to the community or the environment. This study attempts to analyze the application of VAT instruments as one of the taxes on tobacco/ cigarettes to control cigarette consumption. Therefore, the application of VAT instruments to control the negative externalities of cigarettes needs to be studied further, including the increase in effective rate of VAT annually. Based on the aforementioned background, this study analyses the policy implementation on the increase in effective rate of VAT on tobacco from 8.7% to 9.1%.

This study focuses on the analysis of the policy implementation on the increase in effective rate of VAT on tobacco according to the Regulation of the Minister of Finance No. 207/PMK.010/2016 using several concepts, including tax policy, tax functions, and VAT as a consumption-based tax in terms of the effective rate setting and the legal characters. Bringing this focus to the fore, we analyze tax policy on tobacco by departing from a definition of tax policy related to the rate setting and compared to the legal character of VAT as consumption-based taxation. Overall, our argument in this study subsequently highlights the need to clarify VAT on tobacco based on its legal character. As mentioned earlier, the legal characters of VAT are different from those of excise or sales tax. As opposed to excise emphasizing the regulatory function, VAT is collected for the purpose of state revenue (the budgetary function). In general, the government of Indonesia determines VAT at a single rate of 10%. However, such rate is different from the effective rate in this study, namely a lower VAT rate specifically stipulated in the Regulation of the Minister of Finance No. 207/PMK.010/2016. This policy is important to study since theoretically VAT is not determined to perform the regulatory function such as reducing negative externalities of consumption/delivery of a product. Thus, the rate is determined to increase state revenue. Meanwhile, excise is commonly collected to perform the regulatory function on the consumption of a product/service. This section discusses the policy implementation on the increase in effective rate of VAT on tobacco observed from tax function and collection system as well as the effort to reduce the negative externalities of cigarette consumption. In this regard, the government has a discourse to collect VAT on tobacco with multi-stage levy system. In the final part of

the discussion, the study discusses the alternative tax collection of tobacco to minimize the negative externalities of cigarette consumption.

According to Mansury (1999), tax policy is a fiscal policy in a narrow definition, namely a policy related to the determination of what will be used as a tax base, who is taxed, who is excluded, what will be used as tax object, anything excluded, how to determine the amount of tax payable, and how to determine the procedure for the implementation of tax payable. Tax policy can be formulated as (1) an option or decision taken by the government in order to support state revenues and create conducive economic conditions; (2) an action taken by the government in imposing taxes to meet the needs for state funding; and (3) a decision taken by the government to increase state revenues from the tax sector to solve the needs for state funding (Marsuni, 2006, 37-38). Mikesell (2012, 133) states that the best standard for tax policy is the broad base-low statutory rate approach. When applied, it will guarantee smaller economic distortions, reduce inequality or injustice among taxpayers, and improve dynamic revenue performance. The classification generated by the tax expenditure budget provides a good tool for implementing the strategy and for reducing the complications of tax preferences in the tax system.

In formulating tax policies, policy makers shall consider policy objectives in compliance with the agenda setting, the extent to which policy impacts shall be achieved, and which policy tools to use. The purpose of tax collection can be classified based on the tax function, namely the budgetary and regulatory function. According to Nurmantu (2005, 30), the budgetary function means that taxation is used as a tool to optimally collect funds for the state treasury based on the applicable tax laws. This is also confirmed by Mansury (1999, 2) that the function of filling the state treasury (budgeting) is the function of collecting funds from the public for the state treasury for the sake of financing government activities, both routine financing and development financing. Rosdiana and Irianto (2012, 45) point out that the budgetary function should take into account a safe and sustainable source of state revenue. According to Rosdiana and Irianto (2012, 45), the most important tax function is as a source of state income.

While the budgetary tax tends to concern with state revenue, the regulatory function, also called an additional tax function, implicates that taxation is used by the government as a means of achieving particular objectives (Nurmantu, 1994, 32). Mardiasmo (2011, 2) explains that the regulatory function means that taxation is a tool for organizing or implementing government policies in the social and economic sphere. Rosdiana and Irianto (2012, 45) define the regulatory function with another term, namely the function of political instruments. It refers to the taxation that is used by the government to achieve particular objectives determined by the government. Taxation is used to encourage or protect domestic production, discourage or distort a trading activity, i.e. during scarcity, as well as reducing the production and consumption of goods and/or services.

VAT is a tax designed to be levied on all economic activities in the process of producing goods or services

(general tax) as well as on consumers (consumption tax) (Tait, 1988, 16-17). In general, there are two forms of indirect tax on consumption, namely a single-stage tax (i.e. retail sales tax) or a multi-stage tax (i.e. VAT). Sales tax can be imposed on the manufacturing level or the wholesale level, even on more than one but not all levels of production or distribution. Meanwhile, VAT is the modern multi-stage sales tax on the value added by each business entity imposed on all levels of production and distribution of goods and services (Tait, 1988, 30; Gunadi, 2011, 1; Pohan, 2016, 22). Different from Sales Tax, VAT has some legal characters (Sukardji, 2014, 1-12): (1) VAT is an Indirect Tax; (2) VAT is an objective tax; (3) VAT is a multi-stage levy tax so that VAT is levied on each production and distribution chain of the taxable goods or taxable services; (4) The calculation of VAT payable to the state treasury applies indirect subtraction method; (5) VAT is non-cumulative; (6) VAT in Indonesia adheres to a single rate; (7) VAT is levied on domestic consumption; and (8) VAT applied in Indonesia is consumption type VAT. Observed from the side of the treatment for capital goods, VAT in Indonesia is included in the consumption type VAT, meaning that all of the expenses incurred for the acquisition of capital goods can be deducted from the tax base. In this type of VAT, the possibility of double taxation on capital goods can be avoided to encourage every entrepreneur subject to VAT to rejuvenate their capital goods on a regular basis.

In term of tax collection, rate is defined as a certain number established as the basis for calculating the amount of tax payable. This character is highly important and crucial to test the principle of equity in the imposition and payment of tax by taxpayers (Pandiangan, 1993, 82). Waluyo and Ilyas (2002, 16) also assert that the rate should be determined based on equity. According to Tait (1988, 39), "the rate or rates at which VAT is levied is an important consideration in the operation of VAT." Regarding the effective rate of VAT, Tait (1988, 44) also points out that it is similar to the protection from customs rates, invisible to consumers or traders. This rate exists since traders cannot claim full income tax, yet VAT is levied on the total value of sales. Therefore, the value added on a particular trade is effectively taxed at higher rate. Mirrlees et al. (2010, 174) state that the effective rate of VAT will always be below the standard rate, but different in amount depending on the structure of the supply chain.

According to Purwito (2008, 402), an excise tax is different from VAT or an income tax. An excise tax is a tax on manufactured products or goods produced under special permit when the goods leave the factories. An excise tax is no longer viewed as a tax on luxury goods, but rather emphasized on social interests. Otherwise, for other excise goods, the focus is directed on supervision and restriction with consideration that those products have a negative impact and endanger human life and health. Essentially, the distinguishing features of excise are selectivity in coverage, discrimination in intent, and frequently several forms of quantitative measurements in determining the tax liability. It is different from general consumption tax, such as VAT and retail sales tax (RST) generally including all goods and services for sale

in the tax base other than those specifically exempted. Furthermore, VAT and RST are levied merely to increase revenue, while excise is levied for other particular purposes. Excise collection is generally related to physical control, while VAT or RST collection is generally verified through inspections of books of account and other documentary evidence (Cnossen, 2005, 2).

RESEARCH METHOD

This study applies a qualitative approach, defined as an approach to explore and understand meaning, and derived from social phenomena of individuals or groups of people (Creswell, 2007). Here, the main focus of this study is to obtain information from the informants and apply the theory, in a comparative fashion, to clarify the data and obtain a more comprehensive understanding of the issues. The qualitative approach applied in this study is intended to provide an in-depth understanding of the policy implementation on the increase in effective rate of VAT on the delivery of tobacco products.

Additionally, this study applies data collection techniques of research in the literature and a field study through in-depth interviews. In-depth interviews are conducted with the Directorate General of Taxes, the Fiscal Policy Office, the Indonesian Consumers Foundation, the Association of Indonesian White Cigarette Producers (Gaprindo), one of the tobacco companies, and academics.

RESULTS AND DISCUSSION

In the case of Indonesia we argue that an increase in rate may not necessarily be a solution to a safe and sustainable source of state revenue or a social-political instrument, in this regard to reduce the negative impact of cigarette consumption. In fact, cigarette consumption continues to exist and tends to increase although the price of cigarettes has increased due to the increase in VAT and excise rates. In general, it seems that the increase rate is not necessarily being a silver bullet to control tobacco consumption. Considering another factor such as price sensitivity of consumers, particularly young people, permanent increase in tobacco tax rate shall result in a more significant reduction in the prevalence of smoking (Samet and Yoon, 2010, 222). A study carried out by Bader et al. also states that tobacco tax and increase in tobacco tax rate do not merely reduce the level of cigarette consumption in general, since socio-economic factors and characteristics of smokers shall be taken into account considering this policy is related to the consumption of addictive goods (Bader, et al., 2011).

Increasing the Effective Rate of the VAT on Tobacco in Indonesia, in 2015, the Ministry of Finance issued a regulation to revise the effective rate of VAT on the tobacco products. Since 2002, the previous applicable effective rate of VAT of 8.4% has been amended to 8.7% in 2015 with the enactment of the Regulation of the Minister of Finance No. 174/PMK.03/2015 effective starting from January 1, 2016. The regulation is also issued to simplify the administration within the mechanism of VAT collection on tobacco and provide

legal certainty over the delivery of tobacco products. Then, in 2016, the Regulation of the Minister of Finance No. 207/PMK.010/2016 is reissued, effective starting from January 1, 2017, in which the effective rate of VAT changed from 8.7% to 9.1%. The government has already socialized and communicated with the association or company regarding the increase, but what is communicated during the socialization is different from its implementation, as stated by Gaprindo. During socialization, it was said that the effective rate shall increase by 0.2% to 8.9% starting from 2017. Then, the rate shall increase again by 0.2% to 9.1% in 2018. In reality, the effective rate increased by 0.4% in 2017 with the enactment of PMK-207/PMK.010/2016 (Interview with Gaprindo, 14 September 2017). This indicates an inconsistency in the communication process of policy.

Tax rate is an important component in calculating the amount of tax on a good or service. Tax rate has various kinds, one of which is the effective rate. Referring to the Regulation of the Minister of Finance No. 174/PMK.03/2015, the effective rate is the rate applied to calculate and collect VAT on the tobacco. The reason for applying the applicable effective rate concept to VAT on the tobacco is a long distribution and production chain in cigarette industry and a consideration of the calculation that 9.1% has already represented the value of 10% of the Retail Price because in this case the Retail Price already includes VAT (Interview with the Directorate General of Taxes, 16 November 2017).

In Article 7 paragraph (3) of Law No 8 of 1983, as amended by Law No 42 of 2009, it is mentioned that the provisions of rate of VAT of 10% can be changed into a minimum of 5% and a maximum of 15%. The changes are governed by a Government Regulation. Paragraph (3) explains that based on the consideration of economic development and/or increased funding requirement for development, the Government is authorized to change the rate of VAT into a minimum of 5% and a maximum of 15% by applying a single rate principle. The change of rate as referred to in this paragraph shall be submitted by the Government to the House of Representatives in the framework of discussion and drafting of the State Budget Revenue.

Currently, the provisions of the effective rate of VAT on the tobacco are regulated in accordance with the Regulation of the Minister of Finance instead of the mandate of the Law specifying that the change of rate should be regulated by a Government Regulation. According to the law, the Government is authorized to change the tax rate into a minimum of 5% and maximum of 15% by applying a single rate principle. So far, there is no Government Regulation regulating the change of rate and/or the concept of effective rate of VAT. No Government Regulation issued in the policy implementation on the increase in effective rate of VAT on the delivery of tobacco products.

Essentially, the implementation of such effective rate has advantages and disadvantages. The advantage is seen from simpler administration, while the disadvantage is more focused on the difficulty to obtain taxpayer data in the chain of cigarette consumption between producers and consumers, such as distributors, wholesalers, and

retailers. The taxpayer may be a Taxable Entrepreneur subject to VAT, yet it remains unclear due to the limited data. In addition, the use of the effective rate of VAT basically distorts the use of normal rate of VAT since the effective rate is calculated based on the tax base of 'other values'.

VAT on tobacco is different from VAT on other taxable goods, in which VAT is levied on the beginning of the tobacco distribution chain, namely at the manufacturer level, due to long chain ranging from manufacturers, distributors, agents, retailers, to consumers. In fact, not all parties involved in the chain are Taxable Entrepreneurs. Thus, VAT is levied on the manufacturer level. In this regard, the government uses the excise tape purchased by cigarette producers as a mechanism for collecting VAT on cigarettes.

Implementation of Multi-Stage Levy on the Collection of VAT on the Tobacco is one of the legal characters of VAT in Indonesia (Sukardji, 2014, 5). A multi-stage levy means that VAT is levied on every production and distribution chain of taxable goods or taxable services. This is included in the general and applicable characteristics of VAT in Indonesia. However, observing the imposition of VAT on tobacco, there is a slight difference between the theory and the implementation. In practice, VAT on tobacco does not adhere to this legal character and implements the principle of single-stage levy instead. According to Rosdiana and Tarigan (2005, 208), a single-stage levy means that the tax is merely levied on one level, namely the manufacturers. In this regard, the implementation of single-stage levy is shown when the manufacturers order the tobacco excise tape. This is stipulated in Article 5 of the Regulation of the Minister of Finance No. 174/PMK.03/2015, that on the delivery of Tobacco Products starting from the Producers and/or Importers, Distributors to End Consumers, a single-stage VAT is levied on the Producers and/or Importers.

Therefore, there is a discourse to change the VAT mechanism from single-stage levy to multi-stage levy according to the legal character of VAT. It is argued that multi-stage levy system will be better applied to control the reported sales value of the taxpayer. By using a multi-stage levy system, the collection of VAT on tobacco will be more uniform and fair since it is in accordance with the legal characteristics of VAT.

The government requires an extra effort in terms of supervision even though eventually able to discover the business circulation at every level of tobacco producer. The lack of the application of multi-stage levy is seen from tax administration of the taxpayer. It is quite difficult for small companies without a good tax administration and supportive resources, particularly in terms of issuing tax invoices. Even international companies have to adjust their internal taxation system to the retailer level. In addition, the Directorate General of Taxes, as the executor in this tax collection, is able to control the business circulation of the taxpayers involved. However, the transition of this collection system should be supported by the readiness of the Directorate General of Taxes as an institution that oversees the implementation of policies as well as the readiness of companies involved in tobacco sector.

On the other hand, the applicable VAT collection with single-stage levy mechanism is considered better than the multi-stage levy mechanism. The single-stage levy mechanism facilitates the cigarette industry players to collect VAT since it is merely carried out once (Interview with Gaprindo, 14 September 2017). In addition, it facilitates the government to monitor VAT collection since it is carried out simultaneously with the

excise tax collection through excise tape instruments (Interview with the the Directorate General of Taxes, 16 November 2017). In terms of price, the tax levied on one cigarette through multi-stage levy mechanism will be higher than the tax levied through single-stage levy mechanism. In fact, the market price, namely the price that consumers pay is greater than the retail price. The calculation is described in Table 1.

Table 1. Comparison of Calculation of Tax Levies on Cigarette Through Single-Stage Levy and Multi-Stage Levy System (in IDR)

| | Single-Stage Levy | Multi-Stage Levy |
|---|-------------------|------------------|
| Retail Price | 1,120 | 1,120 |
| Market Price | | 1,400 |
| Levy: | | |
| a. Excise on tobacco products | 590 | 590 |
| b. Cigarette tax = 10% x excise tax | 59 | 59 |
| c. VAT (9,1% for Single-Stage Levy; 10% for Multi-Stage Levy) | 101.9 | 140 |
| Total Levies (a+b+c) | 750.9 | 789 |

Source: author's elaboration

Based on the data in Table 1, it is assumed that there are three chains involved between the manufacturers and end consumers, namely distributors, wholesalers, and retailers. Thus, there are three stages of sales before the end consumers purchase cigarettes. Supposing that the selling price at each stage is IDR 1,400, or higher than the retail selling price in the excise band, then at least there is a payable VAT of IDR 420 (3 x IDR 140; outside the credit mechanism). The amount of VAT is much higher than the VAT payable through single-stage levy (IDR 101.9). Therefore, it can be said that the multi-stage levy system has a significant effect on VAT revenue. Such amount of VAT is almost similar to the amount of excise on one cigarette. Observed from the budgetary and regulatory functions, it is beneficial for the government. From the budgetary function, VAT revenue will certainly be greater in amount, while from the regulatory function, it is expected that VAT provides additional burden to cigarette buyers and reduces tobacco consumption due to the high amount of taxes to pay, namely excise, VAT, and cigarette taxes. However, theoretically, the tax that has to be raised significantly is the excise tax on tobacco instead of VAT. Eventually, the government needs to consider the advantages and disadvantages of each VAT collection mechanism. To successfully apply a policy, it is necessary to have a good and sufficient transition period where all actors involved can successfully adjust. The discourse on the transition in VAT collection mechanism on the tobacco by the government should be well prepared and communicated to the companies since it requires a long time to prepare it. On the one hand, justice should be applied to all industrial sectors to prevent any distinction between the cigarette industry and other industries in the application of this system. In addition, the legal character of VAT should also be applied to avoid distortion from the current VAT collection.

The policy on increasing the effective rate of the VAT on the Tobacco observed from tax function, the

imposition of tax on goods, including VAT on the tobacco, is inseparable from the tax function itself, namely the budgetary and regulatory function. In terms of the budgetary function, the imposition of tax is expected to increase the state revenue from the tax itself. Meanwhile, in terms of the regulatory function, the imposition of tax is expected to regulate to achieve particular objectives. The Regulation of the Minister of Finance No. 207/PMK.010/2016 seems to be sufficient to accomplish the budgetary function observed from the increase in revenue from VAT on tobacco at the end of December 2017 as illustrated in Table 1 and the realization of revenue amounting to IDR 19,147.85 billion as illustrated in Table 2.

Compared to the realization of revenue from VAT on tobacco products between January to October in 2016 and 2017, it shows an increase in revenue of IDR 4,590.85 billion as illustrated in Table 3.

The increase of effective rate of VAT on the tobacco by 0.4% is capable to increase revenue amounting to IDR 4,590.85 billion in the span of ten months after the rate increase. It shows that the budgetary function in the increase of effective rate runs optimally. This is related to the definition of the budgetary function according to Nurmantu (2005, 30) that tax is used as a tool to optimally collect funds for the state treasury based on the applicable tax laws.

Observed from the regulatory function, or the function of political instrument according to Rosdiana and Irianto (2012, 45), tax is used by the government as a means to achieve particular objectives determined by the government. However, this policy on rate increase has not been able to control cigarette consumption or its negative externalities since the level of public consumption tends to increase annually. The increase of cigarette consumption from 2005 to 2016 is approximately 220 billion cigarettes. Based on The Tobacco Atlas in Industry Update, a study conducted by Mandiri Sekuritas, of a

total of 5.8 trillion cigarettes consumed in the world in 2014, Indonesia ranks fourth largest in the world, amounting to 237.8 billion cigarettes. The illustration of cigarette consumption is presented in Table 4.

Table 2. The Realization of Revenue from VAT on Tobacco Products of 2013 - 2017 (in billion IDR)

| Year | VAT | | | Total |
|-------|--------------|------------|-----------|-----------|
| | Domestic VAT | Import VAT | Other VAT | |
| 2013 | 15,766.20 | 1,338.69 | 0.30 | 17,105.19 |
| 2014 | 16,965.63 | 1,929.41 | 0.00 | 18,895.04 |
| 2015 | 20,792.08 | 2,224.45 | 0.00 | 23,016.54 |
| 2016 | 18,513.69 | 1,888.15 | 0.73 | 20,402.58 |
| 2017* | 17,600.45 | 1,547.42 | (0.01) | 19,147.85 |

Source: Directorate of Potential, Compliance and Revenue of the Directorate General of Taxes, 2017

Table 3. Comparison of the Realization of Revenue from VAT on Tobacco Products Before and After Rate Increase (in billion IDR)

| Month | Total | Description |
|------------------------|-----------|-------------|
| January - October 2016 | 14.557,01 | Before |
| January - October 2017 | 19.147,85 | After |

Source: Directorate of Potential, Compliance and Revenue of the Directorate General of Taxes, 2017 (reprocessed)

Table 4. Top Five Countries with the Largest Cigarette Consumption in 2014

| Country | Percentage | The Number of Cigarettes |
|--------------------------------|------------|--------------------------|
| China | 44.3% | 2,569,400,000,000 |
| Russia | 5.5% | 319,000,000,000 |
| United States of America (USA) | 4.8% | 278,400,000,000 |
| Indonesia | 4.1% | 237,800,000,000 |
| Japan | 3.3% | 191,400,000,000 |

Source: The Tobacco Atlas in Industry Update, 2015

The high amount of consumption in Indonesia is very worrisome and proves that the tax instrument to control the consumption of cigarettes has not run properly. The regulatory function is also related to the background of the implementation of the policy on the increase in effective rate of VAT on the tobacco, namely the consideration that goods with negative externalities need to be controlled by using the instruments of the excise tax and later VAT. Conceptually, the imposition of VAT is certainly not intended to minimize negative externalities since VAT is a consumption tax, levied on each level of the delivery of taxable goods or taxable services (multi-stage level) Therefore, there is no visible regulatory function related to the control of negative externalities of cigarette consumption. The excise tax, on the other hand, shows the implementation of the regulatory function. It is revealed by Cnossen (2002) that the purpose of the excise tax collection is focused more on the regulatory function.

Alternative tax levies on Tobacco to minimize negative externalities of cigarette consumption, in terms of controlling cigarette consumption, the more appropriate instrument to apply is the excise tax rather than VAT on tobacco. This is because the excise tax has four philosophies about the characteristics of goods subject to the

excise tax, regulated in Law No. 39 of 2007. The characteristics are: (1) the consumption needs to be controlled; (2) the circulation needs to be supervised; (3) its utilize may have a negative impact on the community or the environment; or (4) its utilize requires the imposition of state levies for justice and balance.

Observed from the perspective of its effectiveness, the excise tax plays a role in minimizing negative externalities since excise taxes are imposed merely on particular items with the aforementioned characteristics, while the VAT is neutral for all goods. Through the excise tax policy, the government also internalizes the concept of pigovian tax. The pigovian tax is used as a tool to regulate and minimize the negative externalities caused by cigarette consumption (Interview with Fiscal Policy Agency, Division of Customs and Excise Policy, December 2017). Mankiw (2015, 203) explains that the tax imposed to overcome the effects of negative externalities is called corrective or pigovian tax. The tax is considered ideal supposing that the amount will be equal to the external costs of activities with negative externalities. The principle of pigovian tax is similar to the piggybacking concept proposed by Liberati and Sachhi (2013), yet this concept explains more about the mechanism of taxation. Liberati and Sachhi (2013) add that the concept of piggybacking

emphasizes that the tax imposed on goods with high negative externalities and the collection of this tax is attached to other taxes to facilitate the administration, where the transfer of different types of taxes will not be perceived by the public.

Associated with excise policy, however, the high level of cigarette consumption in the last ten years in Indonesia shows the failure of the application of excise law. The Excise Law has not been amended in the last ten years. The Law stipulates that the maximum excise rate on tobacco products is 57%. This figure has not been able to raise the price of cigarettes considered ideal to decrease

cigarette consumption. The excise tax should ideally cause an annual increase of 20% in cigarette prices. Based on the findings of the study, the increase of 20% in cigarette prices will decrease the prevalence of smoking by 1% each year (Interview with Prof. Hasbullah Thabrany, Public Health Expert, 18 November 2017). Meanwhile, the price of cigarettes in Indonesia is considered inexpensive compared to other countries. Indonesia ranks the 25th of 30 countries in Asia selling Marlboro cigarettes for IDR 20,000 per pack. The highest selling price is IDR 130,459.4 by Israel. The price of cigarettes in several countries in Asia is shown in Table 5.

Table 5. List of Price of Cigarettes in Several Countries in Asia (in IDR)

| Rank | Country | Price per Pack |
|------|-----------------------|----------------|
| 1. | Israel | 130,459.40 |
| 2. | Singapore | 130,343.32 |
| 3. | Hong Kong | 98,894.72 |
| 4. | Palestinian Territory | 95,926.03 |
| 5. | Sri Lanka | 88,364.45 |
| 6. | Saudi Arabia | 86,702.42 |
| 7. | Cyprus | 74,959.14 |
| 8. | Malaysia | 56,445.06 |
| 9. | South Korea | 55,895.00 |
| 10. | Japan | 54,924.50 |
| 11. | Thailand | 49,849.91 |
| 12. | Turkey | 45,897.10 |
| 13. | Taiwan | 42,861.47 |
| 14. | India | 42,008.24 |
| 15. | China | 40,911.17 |
| 16. | United Arab Emirates | 40,568.99 |
| 17. | Jordan | 40,124.20 |
| 18. | Qatar | 36,861.70 |
| 19. | Bangladesh | 35,268.22 |
| 20. | Iran | 32,733.81 |
| 21. | Azerbaijan | 31,874.62 |
| 22. | Lebanon | 30,480.10 |
| 23. | Iraq | 27,093.42 |
| 24. | Georgia | 20,184.07 |
| 25. | Indonesia | 20,000.00 |
| 26. | Pakistan | 17,627.47 |
| 27. | Armenia | 16,771.27 |
| 28. | Philippines | 16,115.85 |
| 29. | Vietnam | 14,308.67 |
| 30. | Kazakhstan | 14,113.05 |

Source: The Tobacco Atlas in Industry Update, 2015

The low price of cigarettes in Indonesia is caused by inexpensive the excise tax on tobacco products. The excise tax should be revised. Instead of setting a

maximum rate of 57%, Indonesia should set a minimum rate of 60%, following the WHO recommendation that the excise rate for cigarette should be at least 2/3 of retail

price for all types of cigarettes. The current excise rate for cigarette applied is not at the maximum limit of 57%, but close to that limit merely for tobacco class I, excluding tobacco class II and III. The government should take this matter into consideration in order to minimize the negative externalities caused by high consumption of cigarettes.

CONCLUSION

The results of this study indicate that the implementation of the policy of the increase in the effective rate of VAT on tobacco by the enactment of the Regulation of the Minister of Finance No. 207/PMK.010/2016 has not run in accordance with the objectives of the policy, namely to minimize the negative externalities of cigarette consumption. It seems that the government's attention to minimize the negative externalities of high cigarette consumption using the increasing effective rate of VAT seems less accurate as the instrument commonly used to control cigarette consumption in various countries is the excise tax. It is unfortunate that the study does not include discussion on the excise tax on tobacco in Indonesia in a more comprehensive way. It would be fruitful to compare both taxes from their legal characters and perspective of tax principle for further studies.

In implementing the policy of the increase in the effective rate of VAT on tobacco, it is expected that the government issues a government regulation as mandated in Law No 8 of 1983 as amended by Law No 42 of 2009, that the government is authorized to change the effective rate of VAT through a government regulation. Furthermore, the discourse by the government on collecting VAT on cigarettes in accordance with the legal character of VAT in general, namely multi-stage levy, needs to be reconsidered. It is expected that the existing policies can actually minimize cigarette consumption, not merely as revenue-generating policy. The tax instrument that can be optimized to minimize the negative externalities of cigarettes is the excise tax. Therefore, the government should consider the excise tax more than VAT since VAT is inappropriate to overcome the negative externalities caused by cigarette consumption. The government is expected to revise the Excise Tax No. 39 Year 2007 by amending the excise rate at maximum of 57% to a minimum of 60%. Further studies might explore other factors that shall be taken into account by the government in formulating tobacco tax policies from socio-political factors such as the impact of the increase in tax rate among various high-risk subpopulations (based on age, socio-economic status, etc.). The effectiveness of setting the appropriate tax rate of tobacco tax as well as the type of relevant tax to impose at the central or local government level is necessary to answer why the increase in effective rate of VAT on tobacco cannot reduce high cigarette consumption in Indonesia.

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