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A simplified tax system could draw more small businesses to pay tax

Regulations need to be stronger, and their implementation needs to be simpler, to bring more small- and medium-sized enterprises (SMEs) into Indonesia's tax system.

SMEs are an important and growing segment of Indonesia's economy but they are under-represented when it comes to paying tax. In 2015, SMEs accounted for 60% of the country's gross domestic product.

The SME sector has been growing fast because the use of information technology and the promotion of creative industries have been adapted to local characteristics. Significant SME growth has taken place in fashion, food, advertising, interior design, and software development.

Like many other developing countries, Indonesia has trouble collecting taxes. In 2012, only 9.4 million of the 17.6 million registered taxpayers filed income tax returns. With SMEs, the issue is how to get more to pay tax without stifling growth in the sector.

The government took one step toward simplifying taxes for SMEs in 2013. Until then, small companies could choose to be taxed under a formula that involved a calculation of their net profits and yearly gross turnover. That formula was adjusted according to whether the government was trying to promote certain business activities in the region where the business is based.

Since 2013, to simplify things for the smallest companies, those that have no more than 4.8 billion rupiah in gross annual turnover are taxed at 1% of their turnover.

Businesses that make more than 4.8 billion rupiah but less than 50 billion, which is the cutoff for being considered an SME, can get a 50% discount on their tax rate from the normal 25% income tax for non-SME companies.

Despite those changes, SMEs face high administration and compliance costs in paying their taxes. They need to register, then prepare and submit tax returns. They can be subject to audits and inspections by tax authorities or face written questions about their operations. All of that takes time and effort which many small companies find difficult to manage.

The current system may also discourage SME growth and investment, since they might face a higher tax bill if they become too large to qualify for the lower rates.

Companies that are found to be avoiding their responsibilities to pay tax should be punished and the rules need to be strengthened to make sure that happens. But the rules should also acknowledge that those who take part in the tax system need to be rewarded. The first way to reward those who pay their taxes is to make the system simpler to use and less of a strain on their limited resources.

A simpler and more efficient tax system for SMEs cannot be the only way the government promotes the sector, however. Other methods should be included alongside special tax treatment. For example, SMEs might be offered access to micro-financing, but only if they could show a clean tax record.

An improved tax system can be both a carrot and a stick for Indonesia's important SME sector.

This podcast is based on a chapter of the Asian Development Bank Institute book, *Tax and Development, Challenges in Asia and the Pacific*. The chapter, Taxation of Small and Medium-Sized Enterprises: The Indonesian Perspective, was written by Wawan Juswanto, special advisor to the dean of ADBI and a senior economist in the Capacity Building and Training Department of ADBI at the time the book was written; and Milson Febriyadi, a fiscal analyst in the Fiscal Policy Agency of the Ministry of Finance in Indonesia.

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